Uniform Issue List: 72.00-00, 401.00-00, 403.00-00, 408.00-00, 3405.00-00, 4979.00-00

Internal Revenue Service

Department of the Treasury
Washington, DC 20224

Person To Contact

Telephone Number:

Refer Reply To:
T:EP:RA:T3

Date:
APR 18 2001

Legend:

Company A =

Company B =

Company C =

Company D =

State M =

State N =

Dear

This is in response to your request for a ruling dated November 9, 2000, submitted by your authorized representative concerning federal income tax consequences of the proposed conversion of Company A, a State M mutual holding company into a stock corporation and the related restructuring of the affiliated group of which Company A is the common parent. Correspondence dated February 27, 2001, April 3, 2001, supplemented the request.

Company A was formed in ****** as a mutual insurance holding company for Company B and its affiliates. Company A is the common parent of an affiliated group of corporations that has elected to file a consolidated return. Company B issues and reinsures annuity contracts, accident and health insurance policies and life insurance policies (collectively, "Policies"). Company B's primary business segments are Pension Operation, Group Insurance Operations, and Individual Insurance Operations. For federal income tax purposes, Company B qualifies as an "insurance company" taxable under Subchapter L of the Internal Revenue Code ("Code").

As a "mutual insurance holding company", Company A cannot issue common or preferred stock. Instead, policyholders of Company B, by reason of their ownership of Company B policies, become members of Company A . As members, the policyholders have certain rights under State M law. These rights ("Membership Interests") include the

332

right to vote for directors of Company A and the right to receive any residual assets of Company A in the event of a liquidation. Company A is not authorized to engage in the business of insurance. Company A is not authorized to pay dividends or make any other distributions or payments of income or profit, except as directed or approved by the State M Commissioner of Insurance or as provided in Company A ' s Articles of Incorporation in the event of the liquidation or dissolution of Company A .

Company A currently owns 100 per cent of the stock of Company C, a State M stock corporation, which in turn owns, as its only significant asset, 100 per cent of the stock of Company D. Company D owns 100 per cent of the stock of Company B, as well as substantially all of the stock of seven foreign and domestic subsidiaries that are principally engaged (directly or through their subsidiaries) in overseas operations. Company A and its subsidiaries will be referred to collectively herein as the "Group W".

State M law does not provide for the direct merger of a mutual insurance holding company into a stock corporation. As a result, it is necessary for Company A to convert from a mutual insurance holding company to a stock corporation under State M law before it can merge with and into a newly formed stock company in State M ("New State M Corporation"). State M law further provides that any such conversion and merger must be fair and equitable to the mutual company and its policyholders. New State M Corporation will be a wholly-owned subsidiary of a newly formed State N Corporation ("State N Holding"), which will be a wholly-owned subsidiary of Company A prior to consummation of the Plan.

Prior to the effective date of the Demutualization (the "Effective Date"), Company A will organize State N Holding as its wholly-owned subsidiary, and State N Holding will in turn form New State M Corporation as its wholly-owned subsidiary. It is presently anticipated that, under the terms of the Plan, the following steps will occur on the Effective Date:

1. Company A will, by operation of section ********** and Chapter **** of the State M Code, become a stock corporation.

2. Company A will merge with and into New State M Corporation in a forward triangular merger pursuant to section ******** of the State M Code.

3. As consideration for the termination of their membership interests in Company A , Eligible Members will receive Common Stock, cash or Policy Credits.[1]

4. State N Holding will sell shares of its common stock to the public in an initial public offering (the "IPO"). State N Holding may also raise capital through one or more of the following: (a) a private placement or public offering of debt, (b) a private placement or public offering of preferred stock, (c) a private placement of Common Stock, (d) a private or public offering of convertible securities, (e) bank borrowing, or (f) other sources of capital, or a combination thereof, on the Effective Date.

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[1] For purposes of the Plan the term "Policy Credit" means consideration to be paid in the form of an increase in cash value or account value, as appropriate, depending on the Policy. If the Policy is owned by a Qualified Plan Customer (as defined below), the Policy Credit may take the form of an interest in a separate account holding (common Stock or an increase in the contract value, as appropriate).

5. State N Holding will contribute a portion of the cash raised in the IPO or other capital-raising transactions to Company B. The amount contributed will be at least equal to the amount Company B will use to pay expenses resulting from the transactions contemplated by the Plan that are properly allocated to State N Holding and to fund the payment and crediting by Company B of mandatory cash payments and Policy Credits required to be paid or credited under the terms of the Plan.

Under the Plan, consideration will be paid through the addition of Policy Credits with respect to policies that are (1) tax-sheltered annuities ("TSAs") within the meaning of section 403(b), (2) individual retirement annuities ("IRAs") within the meaning of section 408(b), (3) individual annuity contracts and individual life insurance policies issued directly to a plan participant pursuant to a plan qualified under section 401(a) or section 403(a), or (4) group annuity contracts issued to an employer, designed to fund benefits under retirement plans sponsored by an employer (including governmental plans described in section 414(d)) which are qualified under section 401(a) or section 403(a)). All policyholders described in the first sentence of this paragraph must receive Policy Credits and will not have the option of receiving stock or cash (with certain exceptions not pertinent to the rulings requested relating to Qualified Plan Customers who own contracts described in (4)).

All Policies issued by Company B and in force prior to the consummation of the Plan will remain outstanding in accordance with their terms. Policy premiums and guarantees will not be affected by the consummation of the plan, nor will benefits payable under policies or policy values (except in the case of Policies whose holders will receive compensation in the form of Policy Credits). Policy dividends on participating policies will continue to be paid as declared.

At the time Group W's mutual insurance holding company structure was created in ******, for policy dividend purposes only, Company B formed and began operating a closed block for the benefit of individual policies paying experience-based policy dividends (the "Closed Block"). For accounting purposes only, assets of Company B were allocated to the Closed Block in an amount that produces cash flows which, together with anticipated revenue from the Closed Block policies and contracts, were expected to be sufficient to support the Closed Block Policies including, but not limited to, provisions for payment of claims and certain charges and taxes, and to provide for continuation of policy and contract dividends in aggregate in accordance with the ****** dividend scales if the experience underlying such scales continues, and to allow for appropriate adjustments in such scales if such experience changes. Assets in the Closed Block remain general account assets of Company B and are fully subject to the claims of creditors of Company B, like any general account assets. The Closed Block continues in existence as established and will not be affected by the consummation of the Plan. No additional Policies will be added to the Closed Block as a result of this transaction.

Based on the foregoing, you request the following rulings:

1. The addition of Policy Credits to the TSAs and IRAs pursuant to the Plan will not (i) be treated as a distribution from such TSAs in violation of section 403(b)(11) of the Code that would cause such TSAs to fail to qualify as tax-sheltered annuities described in section 403(b) of the Code or (ii) be treated as a transaction described in section 408(e) of the Code that could cause the IRAs to become disqualified under section 408(b) of the Code.

2. The addition of Policy Credits to the TSAs, IRAs and contracts owned by Qualified Plan customers pursuant to the Plan will not be treated as a distribution under such retirement arrangements or a contribution to such retirement arrangements and, consequently, will not result in the imposition of (a) income tax on distributions from qualified retirement plans pursuant to section 72(e) of the Code, (b) the 10 per cent penalty tax on early distributions from qualified retirement plans pursuant to section 72(t) of the Code, (c) the 6 per cent tax on excess contributions to IRAs pursuant to section 4973 of the Code or (d) the 10 per cent tax on excess contributions or excess aggregate contributions to certain TSAs and qualified plans pursuant to section 4979 of the Code.

3. Policy Credits will not result in current taxable income to the TSA or IRA policyholders or the Qualified Plan Customers but will be includible in the taxable income of the distributee, in the taxable year of actual distribution, pursuant to section 72(a), 72(e) or 402 of the Code, as applicable.

4. Policy Credits will not be treated for purposes of section 72(c)(1) or 72(e)(6) of the Code as part of the investment in the TSA or IRA contract, but will be treated for purposes of sections 403(b)(10) and 408(b)(3) of the Code as investment earnings under the TSAs and IRAs, respectively, attributable to the year such Policy Credits are added to the TSAs and IRAs.

5. Policy Credits will not be treated as distributions to, or contributions by, Qualified Plan Customers, but will be treated as investment earnings under the applicable group annuity contract attributable to the year such Policy Credits are credited to such group annuity contracts.

6. For purposes of Section 403(b)(11) of the Code and the effective date provisions applicable thereto, a pro rata portion of the Policy Credits added to TSAs to which contributions have been made pursuant to a salary reduction agreement will be treated as earnings attributable to such contributions and will be treated as credited under the TSAs in the year such Policy Credits are added to the TSAs pursuant to the Plan.

7. The addition of Policy Credits to policyholder contracts, including TSAs, IRAs or Qualified Plan Customers, pursuant to the Plan will not constitute "designated distributions" within the meaning of section 3405(d)(1)(A) of the Code and will not be subject to any withholding requirement pursuant to section 3405(b) of the Code.

Section 72(a) of the Code generally provides that gross income includes any amount received as an annuity under an annuity, endowment, or life insurance contract. Section 72(e)(2) provides that any amount which is received under an annuity, endowment or life insurance contract and is not received as an annuity, (i) if received on or after the annuity starting date, shall be included in gross income, and (ii) if received before the annuity starting date, shall be included in gross income to the extent allocable to income on the contract and shall not be included in gross income to the extent allocable to the investment in the contract. Section 72(c)(1) defines the investment in a contract as the aggregate amount of premiums or other consideration paid for the contract, minus the aggregate amount received under the contract before such date, to the extent that such amount was excludable from gross income under this subtitle or prior income tax laws. Section 72(c)(4) defines the annuity starting date, in part, as the first day of the first period for which an amount is received as an annuity under the annuity contract. Section 72(e)(3) provides that an amount shall be treated as allocable to income on the contract to the extent that such amount does not exceed the

excess of the cash value of the contract immediately before the amount is received, over the investment in the contract at the time. Section 72(e)(5) provides, in part, that, with certain exceptions, an amount distributed from a trust described in section 401(a), which is exempt from tax under section 501(a), or is received from a contract purchased by a trust described in section 401(a), purchased as part of a plan described in section 403(a) or described in section 403(b), that the proceeds shall be included in gross income, but only to the extent it exceeds the investment in the contract. Section 72(e)(6) provides that the investment in the contract, as of any date, is the aggregate amount of premiums or other consideration paid for the contract as of such date, minus the aggregate amount received under the contract before such date to the extent such amount was excludable from income.

Section 72(t) of the Code provides, in part, that, if any taxpayer receives any amount from a qualified retirement plan (as defined in section 4974(c)) prior to certain dates or the occurrence of certain events specified in section 72(t)(2) the taxpayer's tax for the taxable year shall be increased by an amount equal to 10 percent of the portion of such amount which is includible in gross income.

Section 4979 of the Code imposes excise taxes on certain excess contributions made to plans described in sections 401(a) and 403(b). Excess aggregate contributions under section 4979 are defined, in part, as the sum of the employer matching contributions and employee contributions, actually made, on behalf of highly compensated employees, within the meaning of section 414(q), for a plan year in excess of the maximum amount of such contributions permitted under the actual contribution percentage test of section 401(m)(2) for such plan year

Section 4973 of the Code imposes excise taxes equal to 6 percent on certain excess contributions made to IRAs and to certain tax-sheltered annuity plans described in section 403(b). Section 408(i) and 408(l) require, in part, an IRA trustee, with respect to its IRA, and an employer, with respect to its simplified employee pension plan to make reports as specified therein with respect to contributions.

Distributions from plans qualified under section 401(a) must be made pursuant to section 401(a)(9). Sections 403(b)(10), 408(a)(6), and 408(b)(3) require distributions, under the respective plans, in compliance with rules similar to the minimum distribution requirements included in section 401(a)(9) and applicable to qualified plans under section 401(a) of the Code. Section 401(a)(9) and applicable regulations issued thereunder, contain the criteria for determining the minimum distribution amount for any year for which such minimum distribution is required. The minimum distribution amount is based in part on the total value of the retirement benefit. As the policy credits to be issued by Company A will be treated as increasing the value of the tax-qualified retirement funding contracts in the year such policy credits are added to the tax-qualified retirement contracts, for purposes of determining the minimum required distributions for any calendar year, the value of the benefits attributable to such policy credits will first be required to be taken into account in the year such policy credits are added to the tax qualified contracts.

Section 401(a)(9) of the Code requires, in part, that the entire interest of an employee under a qualified retirement plan be distributed, beginning no later than April 1 of the calendar year following the later of the calendar year in which the employee attains age 70 ½ or the calendar year in which the employee retires, over the life or life expectancy of the employee (or over the joint lives or joint life expectancy of the employee and a designated beneficiary), as enumerated in section 1.401(a)(9)-1 of the Proposed Income Tax

Regulations. The proposed regulations also provide that in the case of a benefit in the form of an individual account, the benefit used in determining the minimum distribution for a distribution calendar year is the account balance as of the last valuation date in the calendar year immediately preceding the distribution calendar year.

Section 403(b)(1) of the Code provides, generally, that amounts contributed by certain tax-exempt employers to an annuity contract purchased from an insurance company by such an employer for an employee shall be excluded from the gross income of the employee for the taxable year of contribution and that the amount actually distributed to any distributee under such a contract shall be taxable to such distributee in the year distributed under section 72. Section 403(b)(2) imposes a limit on the maximum amount which may be contributed to a tax-sheltered annuity described in section 403(b) on behalf of an employee in any taxable year. Section 403(b)(10) provides that the provisions of section 403(b)(1) will not apply to an annuity unless requirements similar to the minimum distribution requirements of section 401(a)(9) are met with respect to such annuity. Section 403(b)(11) provides that the provisions of section 403(b)(1) will not apply to an annuity unless, under the annuity, distributions attributable to contributions made pursuant to a salary reduction agreement may be paid only when the employee attains age 59 ½ , separates from service, dies, or becomes disabled; or in the event of hardship. Distributions in the event of hardship may not include income attributable to salary reduction contributions. The distribution limitations of section 403(b)(11) do not apply to distributions attributable to assets held in the tax-sheltered annuity arrangement described in section 403(b) as of the close of the last year beginning before January 1, 1989. P.L. 99-514 (the "Tax Reform Act of 1986") section 1123(e)(2), as amended by P.L. 100-647 ("TAMRA") section 101 1A(c)(11).

Section 408(b) of the Code defines an IRA annuity as an annuity or endowment contract which is issued by an insurance company and which meets the requirements of section 408(b). Section 408(b)(3) impose requirements similar to the distribution requirements of section 401(a)(9) on distributions of the entire interest of the contract owner. Section 219 permits an individual taxpayer to deduct from gross income amounts contributed to an IRA, subject to the maximum annual deduction limitations specified in section 219(b). Section 408(b)(2) establish the annual limit on contributions and premiums to an IRA. Sections 402(c) and 408(d)(3), relating to rollover contributions, permit an individual taxpayer to purchase an IRA using funds distributed from certain other plans, subject to certain requirements relating to the nature and amount of the distribution. Section 408(d)(1) provides that amounts paid or distributed from an IRA shall be included in gross income by the payee or distributee in the manner provided in section 72.

Section 3405 of the Code requires the payor of a "designated distribution," within the meaning of section 3405(e)(1), to withhold certain amounts from such distributions. In general, absent an election under section 3405(b)(2) made by a recipient, section 3405 requires the payor to withhold on distributions from employer deferred compensation plans, IRAs, and commercial annuities. Section 3405(c) provides that in the case of an "eligible rollover distribution", as defined in section 3405(c)(3), the payor of such distribution shall withhold from such distribution an amount equal to 20 percent of such distribution. Section 3405(e)(1)(B)(ii) provides that the term "designated distribution" does not include the portion of any distribution which it is reasonable to believe is not includible in gross income.

Central to our analysis of your submitted ruling requests is the question of whether or not membership interests in a mutual insurance company are within the stated plans.

In this regard, any membership interests in a mutual insurance company which arise from the purchase of an insurance contract are inextricably tied to the contract from the time of purchase. These membership interests are created by operation of state law solely as a result of the policyholder's acquisition of the underlying contract from a mutual insurance company and cannot be transferred separately from that contract. Prior to conversion, the membership interests have no determinable value apart from the insurance contract itself. Further, if the insurance contract is surrendered by the policyholder or, in the event an insurance contract is terminated by payment of benefits to the contract beneficiary, these membership interests cease to exist, having no continuing value. The membership rights associated with the tax qualified retirement contracts, are acquired as a direct result of tax-favored payments to a mutual insurance company. Indeed, these membership interests cannot be obtained by any purchase separate from an insurance contract issued by Company A. In view of the foregoing, such interests are part of the tax qualified retirement contracts, created pursuant to sections 401(a), 403(a), 403(b), and 408(b) of the Code respectively.

While it has been recognized that consideration received in a demutualization transaction is in exchange for a membership interest in a mutual insurance company, and not from or under an insurance contract, such a distinction does not require the detachment of such consideration from the tax qualified retirement contracts, which consists of both the contracts and all other interests which arise with the purchase of such a contract. See, Revenue Ruling 71-233, 1971-1 C.B. 113. Rather, contracts and the related membership interests must be viewed as part of a program of "interrelated contributions and benefits" which are retained within the plans. Cf., Income Tax Regulation section 1.72-2(a)(3)(i).

The planned issuance of policy credits does not constitute a distribution of such credits to the annuitants. The conversion of membership interests in Company A to policy credits, is a mere change in form of one element within the arrangement to another. Since the conversion increases the accumulation value of the annuity contracts, the policy credits are treated, for purposes of sections 401(a)(9), 403(b)(10), 403(b)(11), 408(b)(3), 408(a)(6) of the Code, in the same manner as any other return of, or return on, an investment within the arrangements described above, and are not regarded as having been received by the policyholder. Such amounts representing the policy credits will be considered as part of the respective balances to the credit of the employees in the plans.

Similarly, under sections 402(a), 403(a), 403(b)(1) and 408(d) of the Code, only amounts paid or distributed under the applicable plans, will be included in the gross income of the distributee under the rules of section 72. Section 72(e), dealing with the tax treatment of amounts not received as an annuity, provides for the inclusion of such amounts when received by the distributee. As policy credits will be issued in exchange for membership interests, such interests being held within the applicable plans, no amount is treated as received by, or includible in, the gross income of any policyholder, under such plans, of Company A. For purposes of section 72(e)(3), the value of policy credits which will be added to the tax-qualified retirement contracts will not be regarded as part of the investment in the contracts, an amount which under section 72(e)(6) consists of the aggregate amount of premiums or other consideration paid for the contract. In addition, as no amount is to be treated as having been distributed as a result of the issuance of policy credits, nor received by the tax-qualified retirement policyholders outside the plans, the additional 10 percent tax imposed by section 72(t) does not apply.

Similarly, for purposes of determining the applicability of section 403(b)(11) of the Code, the limitation on distributions of amounts attributable to salary reduction contributions, the policy credits added to the tax-sheltered annuity arrangements described in section 403(b) issued by Company B are treated as income received within the tax-sheltered annuity arrangement.

The planned issuance of policy credits likewise does not constitute a contribution of such credits by the annuitants. Thus, no excess contributions can be attributed to the addition of these policy credits to the pension annuities.

Section 3405(b) of the Code requires a payor to withhold income taxes on certain "designated distributions" (as described in section 3405(e)(1)), including distributions from or under an employer deferred compensation plan, an individual retirement plan or a commercial annuity. Similarly, section 6047(d) generally requires that the employer maintaining, or the plan administrator of, a plan from which designated distributions may be made, and any person issuing a contract pursuant to which designated distributions may be made, to report payments under the plan or contract. The addition of policy credits within the tax-sheltered annuity arrangement described in section 403(b), IRA arrangement, or other qualifying plan, pursuant to the conversion, does not result in the distribution of any amounts to individual policyholders, within the meaning of section 3405(e)(1)(a), and thus, will not be subject to any requirement to withhold or the reporting requirements under section 6047(d).

According with respect to rulings one through seven, we hold that :

1. The addition of Policy Credits to the TSAs and IRAs pursuant to the Plan will not (i) be treated as a distribution from such TSAs in violation of section 403(b)(11) of the Code that would cause such TSAs to fail to qualify as tax-sheltered annuities described in section 403(b) of the Code. Concerning part two of this ruling request, section 408(e) states, in part, that if, during any taxable year of the individual for whose benefit any IRA is established, that individual or his beneficiary engages in any transaction prohibited by section 4975 with respect to such account, such account ceases to be an IRA as of the first day of such taxable year. It seems unlikely that the described transaction results in a prohibited transaction, however, section 102(a) of the White House Reorganization Plan Number 4 of 1978 43, Federal Register 47713 (October 17, 1978), generally provides that authority to issue rulings under section 4975 of the Code is transferred from the Secretary of the Treasury to the Secretary of Labor. Accordingly, we are unable to issue a ruling on this issue. However, it is our opinion that the proposed transaction will not otherwise cause an individual retirement account or an individual retirement annuity to lose its status under section 408 of the Code.

2. The addition of Policy Credits to the TSAs, IRAs and contracts owned by Qualified Plan customers pursuant to the Plan will not be treated as a distribution under such retirement arrangements or a contribution to such retirement arrangements and, consequently, will not result in the imposition of (a) income tax on distributions from qualified retirement plans pursuant to section 72(e) of the Code, (b) the 10 per cent penalty tax on early distributions from qualified retirement plans pursuant to section 72(t) of the Code, (c) the 6 per cent tax on excess contributions to IRAs pursuant to section 4973 of the Code or (d) the 10 per cent tax on excess contributions or excess aggregate contributions to certain TSAs and qualified plans pursuant to section 4979 of the Code.

3. Policy Credits will not result in current taxable income to the TSA or IRA policyholders or the Qualified Plan Customers but will be includible in the taxable income of

the distributee, in the taxable year of actual distribution, pursuant to section 72(a), 72(e) or 402 of the Code, as applicable.

4. Policy Credits will not be treated for purposes of section 72(c)(1) or 72(e)(6) of the Code as part of the investment in the TSA or IRA contract, but will be treated for purposes of sections 403(b)(10) and 408(b)(3) of the Code as investment earnings under the TSAs and IRAs, respectively, attributable to the year such Policy Credits are added to the TSAs and IRAs.

5. Policy Credits will not be treated as distributions to, or contributions by, Qualified Plan Customers, but will be treated as investment earnings under the applicable group annuity contract attributable to the year such Policy Credits are credited to such group annuity contracts.

6. For purposes of Section 403(b)(11) of the Code and the effective date provisions applicable thereto, a pro rata portion of the Policy Credits added to TSAs to which contributions have been made pursuant to a salary reduction agreement will be treated as earnings attributable to such contributions and will be treated as credited under the TSAs in the year such Policy Credits are added to the TSAs pursuant to the Plan.

7. The addition of Policy Credits to policyholder contracts, including TSAs, IRAs or Qualified Plan Customers, pursuant to the Plan will not constitute "designated distributions" within the meaning of section 3405(d)(1)(A) of the Code and will not be subject to any withholding requirement pursuant to section 3405(b) of the Code.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited by others as precedent.

A copy of this letter is being sent to your authorized representative in accordance with a power of attorney on file in this office.

Sincerely Yours,

Frances V. Sloan

Frances V. Sloan, Manager
Employee Plans Technical Group 3
Tax Exempt and Government Entities Division

Enclosures:
Notice of Intention to Disclose
Deleted Copy of Ruling
Copy of Letter to Authorized Representative

CC: