

INTERNAL REVENUE SERVICE

Index Nos. 0072.00-00; 0101.00-00; 264.00-00
7702.00-00; 7702.20-00; 7702A.00-00

Number: **199912022**

Release Date: 3/26/1999

CC:DOM:FI&P:4/PLR-115770-98
December 22, 1998

Legend

Taxpayer =

Parent =

Purchaser =

Reinsurer A =

Reinsurer B =

State A =

State B =

Date a =

Date b =

Date c =

Date d =

Date e =

Date f =

Dear Sir:

This is in response to a letter dated August 5, 1998, which requests a ruling on behalf of Taxpayer regarding certain federal tax consequences resulting from a proposed modification and assumption reinsurance of certain of Taxpayer's life insurance and annuity contracts pursuant to a state supervised rehabilitation proceeding. The facts submitted with the ruling request are summarized below.

Facts

Taxpayer is a stock life insurance company subject to tax under § 801 of the Internal Revenue Code. Taxpayer is incorporated in State A and is licensed to transact business in all 50 states and the District of Columbia. Prior to the rehabilitation proceedings described below, Taxpayer was a wholly owned subsidiary of Parent, a mutual insurance company also domiciled in State A. Taxpayer is required to operate under the close supervision of the State A Commissioner of Insurance through year end 1999.

On Date a, Parent was placed in rehabilitation proceedings by order of the Superior Court of State A, under the supervision of the State A Commissioner of Insurance. The rehabilitation proceedings were necessary because Parent was experiencing an escalating liquidity crisis. The Commissioner of Insurance, as the Rehabilitator of Parent, concluded that Parent's assets were insufficient to meet its insurance liabilities. Under the Rehabilitation Plan developed and implemented in response to Parent's insolvency, Parent's policyholders were given the alternative of "opting-in" or "opting-out" of the Plan. Policyholders who "opted-out" of the Plan surrendered their policies in exchange for a cash payment equal to 55% of their account values as of Date a, with certain adjustments. Policyholders who chose to participate in the Plan received restructured policies with Taxpayer, which were guaranteed as to their account values and interest crediting rates by various State guaranty associations. The restructured policies were subject to "moratorium amounts," which restricted the amount of policyholders' account values which were available for withdrawal or surrender over the term of the Rehabilitation Period (which was to extend through year end 1999). Finally, the Rehabilitation Plan provided that Taxpayer stock would be transferred to a grantor trust. The State A Commissioner of Insurance, as trustee, was required to sell Taxpayer stock on or after January 1, 2000 (but not later than January 1, 2004), with the net proceeds of such stock sale being distributed to Parent's general unsecured creditors (Class IV creditors). No equity value in Taxpayer was allocated to Taxpayer's policyholders.

On Date b, a comprehensive Settlement Agreement was reached that resolved certain appeals to the Rehabilitation Plan relating to the award of Taxpayer stock to Class IV creditors and the level of guaranteed interest crediting rates during the term of the Rehabilitation Period. The Settlement Agreement provided that Class IV creditors and eligible policyholders holding restructured policies with Taxpayer would share in the future value of Taxpayer (including amounts realized from a sale of Taxpayer stock or substantially all of Taxpayer's assets prior to

year end 1999). This sharing would be based on a ratio of 70% for the Class IV creditors and 30% to eligible policyholders. Policyholders eligible to participate in the Policyholder Value Share include pre-Rehabilitation Parent policyholders holding restructured (or, in some cases, reaffirmed) policies with Taxpayer. As an incentive to maintain their policies with Taxpayer, the Settlement Agreement provided that the Policyholder Value Share would be credited as Policy Enhancements in accordance with the following vesting schedule: 25% of the Policy Enhancements, divided among all eligible policyholders who have policies in force on January 1, 2000; an additional 25% of the Policy Enhancements, divided among all eligible policyholders who have policies in force on June 30, 2001; an additional 25% of the Policy Enhancements, divided among all eligible policyholders who have policies in force on June 30, 2002; and an additional 25% of the Policy Enhancements, divided among all eligible policyholders who have policies in force on June 30, 2003. The Settlement Agreement, however, did not specify the methodology for allocating of the Policyholder Value Share or determining the specific form of the Policy Enhancements. Rather, the Settlement Agreement provided for the creation of a Joint Committee on Allocation which would undertake an analysis and resolve all issues relating to the allocation of the Policyholder Value Share prior to year end 1999.

On Date c, the Joint Committee on Allocation issued a report proposing a methodology for determining Policy Enhancements in the event of a sale of Taxpayer's stock or assets before January 1, 2000. The Joint Committee on Allocation recommended that Policy Enhancements be allocated among eligible policyholders using an "impairment approach." Under this approach, a policyholder's share of the Policy Enhancements would be calculated based on the interest credits, cost of insurance charges, and expense charges ("benchmarks") which would likely have been credited or charged in the absence of the Rehabilitation given the changes in the competitive environment during the Rehabilitation Period. For each policyholder, the impairment will reflect the difference between the account balance to which he or she would have been entitled at the end of the Rehabilitation based on these benchmarks versus the actual account balances as accumulated under the terms of the Plan of Rehabilitation. The report of the Joint Committee on Allocation, including the methodology for crediting Policy Enhancements, was approved by the Superior Court of State A on Date d.

On Date e, Taxpayer entered into a Purchase and Sale Agreement with Purchaser, which provides for a transfer of substantially all of Taxpayer's life insurance and annuity business to two of Purchaser's affiliates, Reinsurer A and Reinsurer B, by means of assumption reinsurance. The Agreement provides that, as of the projected closing date, Taxpayer will transfer substantially all of its assets, and cede 100% of the liability on its life insurance and annuity policies to Reinsurer A on an indemnity reinsurance basis. On the State B assumption date, the indemnity reinsurance will terminate with respect to Taxpayer's policies held by residents of State B and Taxpayer will transfer the State B policies to Reinsurer B on an assumption reinsurance basis. Thereafter, on the assumption date for each other jurisdiction, the indemnity reinsurance agreement will terminate with respect to Taxpayer's policies in that jurisdiction and Taxpayer will transfer those policies to Reinsurer A on an assumption reinsurance basis. The projected closing date for the transfer and assignment to Reinsurer A of substantially all of

Taxpayer's assets, together with the reinsurance of substantially all of Taxpayer's life insurance and annuity policies by Reinsurer A on an indemnity reinsurance basis, is Date f.

Proposed modification of Taxpayer's life insurance and annuity contracts

Prior to the projected closing date of the Purchase and Sale Agreement, Taxpayer will seek approval the Superior Court of State A to make further modifications to its life insurance and annuity policies, as follows:

- Taxpayer shall set the interest crediting rates at prescribed levels up to an accelerated date in 1999 on which the Rehabilitation Period will end (the "Rehabilitation Period Termination Date") or, if earlier, the date on which a policyholder holding a post-Rehabilitation contract accepts a replacement contract from Reinsurer A or Reinsurer B.
- The accelerated termination of the Rehabilitation Period also will accelerate the termination of moratorium charges and other restrictions imposed on policyholders' access to their account values under the Rehabilitation Plan.
- In accordance with the Settlement Agreement, the modified policies will be eligible for credits to their account values for Policy Enhancements based on the Policyholder Value Share of the net proceeds of the sale of Taxpayer's life insurance and annuity business in four installments, beginning on January 1, 2000.
- Provisions are added to ensure the continued compliance of the restructured policies, as modified, with certain tax provisions.

The determination of Policy Enhancements will be made in accordance with the vesting schedule and methodology recommended in the report of the Joint Committee on Allocation and approved by the Superior Court of State A. More specifically, the calculation and payment of Policy Enhancements with respect to Taxpayer's life insurance and annuity policies will be made as follows:

- The amount of a Policy enhancement as of a scheduled vesting date for a modified policy that is in effect or otherwise vested as of such date is equal to the greater of (i) the Defined Policy Enhancement, or (ii) the Individualized Policy Enhancement, both calculated as of such date.
- The "Defined Policy Enhancement" is the minimum guaranteed Policy Enhancement amount for a modified policy assuming that the policy remains in force as of each of the four scheduled vesting dates. The Defined Policy Enhancement will be incorporated as an endorsement to the policy prior to the

closing date for the reinsurance transaction called for by the Purchase and Sale Agreement. The Defined Policy Enhancement may be adjusted at each scheduled vesting date to take into account certain net withdrawals under the policy since the closing date.

- The “Individualized Policy Enhancement” for a modified policy which is in effect as of a scheduled vesting date is its proportionate share of the “Guaranteed Policy Enhancement Amount” as of such date for all modified policies. The Individualized Policy Enhancement for a modified policy will be computed by multiplying the Guaranteed Policy Enhancement Amount by the ratio of the modified policy’s Adjusted Impairment Amount as of the scheduled vesting date over the total Adjusted Impairment Amounts for all modified policies which are in force as of such date. As a result, the actual amount of the Individualized Policy Enhancement for a persisting modified policy may increase as of each successive scheduled vesting date, depending on the number of eligible policies that are no longer in effect on such date.
- For purposes of the preceding calculations, the Adjusted Impairment Amount for a modified policy represents its Impairment Amount adjusted for certain net withdrawals since the Rehabilitation Period Termination Date. The policy’s “Impairment Amount” (which could be zero) equals the excess of (i) a hypothetical account value for the policy as of the Rehabilitation Period Termination Date, based on interest crediting rates and mortality and expenses charges that likely would have been credited to, or charged against, the policy’s account value in a competitive environment assuming that the restrictions under the Rehabilitation Plan had not been imposed, over (ii) the policy’s actual account value as of the Rehabilitation Period Termination Date.
- If certain escrow amounts set aside pursuant to the Purchase and Sale Agreement are released and the released amount is eligible for inclusion in the total Policy Enhancement Amount, additional Policy Enhancements will be credited or paid as of the next scheduled vesting date in proportion to the respective Adjustment Impairment Amounts of the modified policies which are still in effect on such date.
- If the insured under a modified policy eligible for Policy Enhancements dies prior to the last scheduled vesting date, the policy will become fully vested in its Policy Enhancements when the death claim is processed, and the Policy Enhancements will be paid out as part of the death benefit under the policy.

The Policy Enhancements carried out in accordance with the Settlement Agreement and the report of the Joint Committee on Allocation are designed to compensate Parent’s pre-Rehabilitation policyholders holding restructured contracts with Taxpayer for a portion of the detrimental effect on account values resulting from the restrictions of the Rehabilitation Plan.

For purposes of this ruling, therefore, it has been assumed that eligible policyholders who receive such Policy Enhancements will not have higher account values as a result of the crediting of such Enhancements than would be the case if the rehabilitation proceedings had not occurred.

Proposed assumption reinsurance agreements

Pursuant to the Purchase and Sale Agreement, on the applicable assumption date for policies held by residents of a particular jurisdiction, the Reinsurer (A or B) will assume Taxpayer's life insurance and annuity policies for residents of that jurisdiction for which such assumption has not been validly rejected. For each such assumption reinsurance agreement, the Reinsurer will deliver to the policyholder of an assumed policy an assumption certificate confirming the Reinsurer's assumption of all of Taxpayer's liabilities under the policies. Thus, on the applicable assumption date, the Reinsurer will assume Taxpayer's liability for all benefits under the policy, including Taxpayer's liability relating to the calculation and payment of Policy Enhancements in accordance with the Settlement Agreement and the report of the Joint Committee on Allocation. No terms or conditions of the policies to be assumed by the Reinsurer will be changed by the assumption reinsurance agreement, except that the Reinsurer will become the insurer of the policies. The policyholder will have no further claims against Taxpayer upon the assumption of the policy by the Reinsurer, but will have rights against the Reinsurer under the assumed policy.

Applicable law and analysis

Except as otherwise provided in subtitle A of the Internal Revenue Code, the gain or loss realized from the conversion of property into cash, or from the exchange of property for other property different materially either in kind or extent, is treated as income or as loss sustained. See § 1001(a) of the Code.

Section 1035(a) provides that no gain or loss is recognized on the exchange of-- (1) a contract of life insurance for another contract of life insurance or for an endowment or annuity contract; (2) a contract of endowment insurance either for another contract of endowment insurance that provides for regular payments beginning at a date not later than the date payments would have begun under the contract exchanged, or for an annuity contract; or (3) an annuity contract for an annuity contract. See also § 1.1035-1 of the Income Tax Regulations.

Section 1031(b) provides, in part, that if an exchange would be within the provisions of § 1035, if it were not for the fact the property received in exchange consists not only of property permitted by these provisions to be received without the recognition of gain, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

Section 1031(d) provides that for property acquired in an exchange described in § 1035(a), the basis shall be the same as that of the property exchanged, decreased in the amount

of any money received by the taxpayer and increased in the amount of gain or decreased by the amount of loss to the taxpayer that was recognized on such exchange.

Rev. Proc. 92-57, 1992-2 C.B. 410, addresses the effect on policyholders of the modification or restructuring of an annuity, life insurance, or endowment contract issued or assumed (through reinsurance) by a financially troubled insurance company. If the modification or restructuring is an integral part of the rehabilitation plan and is approved by the state insurance commissioner, state court, or other responsible state official, the Service will treat the modification or restructuring as not having an effect on the date that the contract was issued, entered into, or purchased for purposes of §§ 72, 101(f), 264, 7702 and 7702A and also as not resulting in retesting or the start of a new test period under § 7702(f)(7)(B)-(E) and § 7702A.

The proposed modifications to Taxpayer's life insurance and annuity policies are within the scope of the relief provided by Rev. Proc. 92-57 because these modifications are an integral part of a state supervised rehabilitation proceeding and will be approved by the appropriate state authorities as part of such proceedings. Rev. Proc. 92-57, however, does not address whether this relief continues to apply if the modified policies are transferred to another insurer by means of assumption reinsurance.

Although the primary purpose of reinsurance is to avoid too large a concentration of risk within one company, an insurance company may wish to withdraw from business entirely or from a particular territory by transferring all or a specific portion of the company's existing liabilities to a reinsuring company, including the administration of the contracts directly with the policyholders. This transaction is known as assumption reinsurance. K. Black, Jr. and H. Skipper, Jr., Life Insurance, 431, n. 6 (11th ed. 1987). Generally, the insured will look to the assuming company in the future for all benefit payments under the policy, will pay all premiums to the assuming company, and will deal with the assuming company in the same manner as if it had originally written the policy. Steffen, "Reinsurance" in Life and Health Insurance Handbook, 1003 (D. Gregg and V. Lucas, eds., 3rd ed. 1973).

The intent of an assumption reinsurance transaction is that the reinsurer will replace the original insurer in all respects with respect to the assumed contracts. By accomplishing this replacement through a reinsurance technique, rather than the cancellation of old contracts and the issuance of new ones, a simplification and saving can be accomplished. The regulations under § 1.809-5(a)(7)(ii) state that the term "assumption reinsurance" means an arrangement whereby another person (the reinsurer) becomes solely liable to the policyholders on the contracts transferred by the taxpayer.

An assumption reinsurance agreement is not initiated by the policyholder and does not result in a change of the existing contractual obligations of the underlying life insurance or annuity policy. It merely allows the obligation of the original insurer on the existing policy to be assumed by the reinsurer. Similarly, under the present facts, the modified policies which Taxpayer's policyholders will have immediately after the assumption of their policies by the

Reinsurer, including eligible policyholders' rights to Policy Enhancements consistent with the Settlement Agreement and the methodology adopted by the Joint Committee on Allocation, are the same as before the applicable assumption reinsurance agreement except for the fact that Taxpayer has been replaced by the Reinsurer as the insurer on the policies. Taxpayer's policyholders will receive an assumption certificate as notification of the change in insurers; the terms and conditions of the policies being assumed by the Reinsurer, however, will be the same after the assumption reinsurance transaction as before.¹

Accordingly, based solely on the information submitted, it is held as follows:

1. Provided that the transaction does not change the terms and conditions of the modified policies being assumed (other than the insurer), the assumption reinsurance agreements entered into by Taxpayer with Reinsurer A or Reinsurer B, pursuant to which the respective Reinsurer will assume Taxpayer's life insurance and annuity policies for residents of a particular jurisdiction, will not have any effect on the date that such policies were issued, entered into, or purchased for purposes of §§ 72, 101(f), 264, 7702, and 7702A, and will not require retesting or the start of a new test period under §§ 264(d)(1), 7702(f)(B)-(E), and 7702 A(c).

2. Provided that a modified life insurance or annuity policy to be assumed by Reinsurer A or Reinsurer B qualifies to be treated under Rev. Proc. 92-57 and the preceding ruling as a continuation of the contract preceding such modification and assumption for purposes of § 72, the policyholder's investment in the contract under § 72(c)(1) for that policy immediately after its assumption by the Reinsurer will remain the same as immediately prior to such assumption.

No opinion is expressed as to the tax treatment of the proposed transaction or the subject life insurance and annuity contracts under the provisions of other sections of the Code and Income Tax Regulations which may also be applicable thereto.

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

A copy of this letter should be attached to the income tax returns to be filed by Taxpayer for the taxable year which includes the closing date of the Purchase and Sale Agreement, as well as for the taxable year for which an assumption reinsurance agreement covered by this ruling is completed.

¹ Under the Assumption Reinsurance Model Act adopted by the National Association of Insurance Commissioners in 1994, an assumption reinsurance transaction is considered to result in a transfer and novation of the insurance contract. The policyholder has the right to consent to or reject the transfer and notation. The notice and consent requirements of the Act, however, do not apply to the transfer of insurance contracts of any insurer subject to a judicial order of liquidation or rehabilitation.

Pursuant to a power on attorney on file in this office, a copy of this ruling has been provided to Taxpayer's authorized representative.

Sincerely yours,

Assistant Chief Counsel
(Financial Institutions and Products)

By: /S/ Mark Smith
Mark Smith
Chief, Branch 4