

## Internal Revenue Service

## Department of the Treasury

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Date:

**November 13, 2002**

### Legend

Company =

Intermediate =

Life Insurance Company =

Purchaser =

State X =

Court =

Year 1 =

Year 2 =

Year 3 =

Date 1 =

Date 2 =

Date 3 =

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Date 4 =

Date 5 =

Date 6 =

a =b =

Dear

This is in response to a letter dated June 20, 2002, submitted on behalf of Company, requesting rulings under § 331 of the Internal Revenue Code (the “Code”) with respect to a proposed transaction. Additional information was received in letters dated July 31, 2002, August 15, 2002, and August 21, 2002.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination. The material information submitted is summarized below.

Life Insurance Company was a mutual life insurance company prior to Year 1. In Year 1 it converted to a stock life insurance company in connection with the formation of Intermediate (a stock company) and Company (a mutual holding company). As a result of the Year 1 transaction, Company owned all the stock of Intermediate, which owned all the stock of Life Insurance Company. Certain holders of Life Insurance Company policies meeting certain eligibility requirements possess proprietary rights (“Membership Interests”) with respect to Company. Those proprietary rights in Company include the right to liquidation proceeds. Owners of record on all Company policies with such proprietary rights in effect as of Date 5 (the day preceding Date 3) are sometimes hereinafter referred to as “Eligible Members.”

In Year 2, Life Insurance Company experienced a liquidity crisis and was placed under rehabilitation by the Department of Insurance of State X pursuant to a court rehabilitation order (the “Rehabilitation”). Pursuant to the Rehabilitation, the Director of the Department of Insurance was named the statutory rehabilitator (“Rehabilitator”) of Company and the court assumed exclusive jurisdiction over all assets of, and claims against, Company. The court approved a Plan of Reorganization dated as of Date 2.

While under administrative supervision, Company entered into an agreement (“Sales Agreement”) on Date 1 to sell all the stock of Intermediate (together with Intermediate’s subsidiaries including Life Insurance Company) to Purchaser. The sale

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("Sale") was consummated under the Rehabilitator's supervision and pursuant to approval of the court on Date 3. The Rehabilitation allowed the Sale to occur before it was possible to determine Company's liabilities. Under the terms of the Sales Agreement, Purchaser can assert claims against Company during a claim period which is scheduled to expire on Date 6.

On Date 4, the Rehabilitator obtained a court order revising the status of Company from rehabilitation to liquidation and appointing the Rehabilitator as liquidator ("Liquidator"). The Date 4 liquidation order is sometimes hereinafter referred to as the "Plan." The Liquidator plans to liquidate Company by making cash distributions to the Eligible Members, including a final distribution to be made after the settlement of claims and expenses. The liquidation process and the manner and timing of distributions are and will remain subject to the control of Court.

As a result of the rehabilitation and the liquidation order, Company has ceased to be part of a mutual insurance holding company structure and its activities since the date of the Sale to the present time have been limited to investing the sale proceeds and winding up affairs. This winding up status will exist at the time of the first liquidating distribution and continue until the final liquidating distribution is made. The Liquidator intends to liquidate Company through cash payment of Company's net assets after deduction of all claims and expenses provided for in their reorganization plan ("Company Surplus") to the Eligible Members. The Liquidator will seek an order from the Court approving the ownership percentage interests of each of the Eligible Members and authorizing distributions of funds to them based on their respective interests. An initial distribution is expected to be made in the first quarter of Year 3. The initial distribution is expected to be approximately a% to b% of the Company Surplus. Once all outstanding claims have been settled or extinguished by the court, Company will distribute the remainder of the Company Surplus to the Eligible Members in a final distribution, and Company will dissolve and terminate its corporate existence.

Most of the Eligible Members are U.S. citizens or resident aliens. If Company is unable to locate certain Eligible Members, and they do not come forward, Company will pay over such amounts due them to the proper authorities of State X.

Although most of the Eligible Members will be U.S. citizens and resident aliens, Company anticipates that there will be a number of Eligible Members that Company will be unable to locate even after expending considerable efforts to do so. Thus, Company will be unable to obtain the necessary return information, including Taxpayer Identification Numbers, for some or all of the missing Eligible Members. Company will, however, maintain records of the amounts owed to missing Eligible Members in case any such Eligible Member contacts the company and request the Eligible Member's share of the distributions. If any or all of the missing Eligible Members fail to claim their share of the distributions prior to completion of the liquidation process, the funds will escheat to State X as unclaimed property.

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Although Company anticipates that all of its assets will be distributed and its liquidation complete within three years of the Liquidation Order (dated as of Date 3), there is a possibility that the liquidation will not be completed within such time. Taxpayer represents that, because of the period between Date 5, the record date, and the earliest possible distribution, all distributions that are made to Eligible Members will be with respect to Membership Interests held for more than one year.

Company has made the following representations with respect to the proposed transaction:

- (a) No formal or informal plan of complete liquidation has ever been adopted by Company except for the Plan.
- (b) The liquidation of Company will not be preceded or followed by the reincorporation in, or transfer or sale to, a recipient corporation of any of the business or assets of Company, if persons holding more than 20% in value of the Membership Interests in Company also hold more than 20% in value of the stock of such recipient corporation. For purposes of this representation, ownership has been determined by application of the constructive ownership rules of § 318 of the Code, as modified by § 304(c)(3) of the Code.
- (c) No part of the consideration to be received by any Eligible Member of Company will be received as a creditor, employee, or in some capacity other than that of a Eligible Member of Company.
- (d) Pursuant to the Plan, Company will cease to be a going concern and its activities will be limited to the winding up of its affairs, paying its debts, and distributing any balance of its assets to the Eligible Members. The status of liquidation will exist at the time of the first distribution under the Plan, and such status will continue until the final liquidating distribution is made.
- (e) The fair market value of Company's assets exceeded its liabilities on the date of adoption of the Plan and the fair market value of Company's assets will exceed its liabilities at the time the first liquidating distribution is made.
- (f) Company does not maintain a reserve for bad debts.
- (g) The liquidating distributions described in the request for this ruling are isolated transactions and are not related to any other past or future transaction.

## LAW AND ANALYSIS

Reportable Distributions under 6043(a)(2)

Section 6043(a)(2) of the Code provides that, when required by the Secretary, every corporation shall make a return regarding its distributions in liquidation stating the name and address of, the number and class of shares owned by, and the amount paid to, each shareholder, or, if the distribution is in property other than money, the fair market value of the property distributed to each shareholder.

Section 1.6041-1(f) of the Income Tax Regulations provides that, for purposes of a return of information, an amount is deemed to have been paid when it is credited or set apart to a person without any substantial limitation or restriction as to the time or manner of payment or condition upon which payment is to be made, and is made available to him so that it may be drawn at any time, and its receipt is brought within his control and disposition.

Although Company will maintain records of amounts owed to missing Eligible Members and set those funds aside for payment, Company will not make any additional distributions after completion of the liquidation process. Amounts that have not been claimed prior to complete liquidation will escheat to the State X and will no longer be available for payment by Company. Thus, amounts that would otherwise be distributable to missing Eligible Members will be paid over to State, and Company will not make liquidating distributions with respect to those amounts. Since there will be no actual or constructive receipt of distributions by the missing Eligible Members, Company will not have any reporting requirements under § 6043(a)(2) with respect to those amounts.

Backup Withholding under Section 3406

Section 3406(a) of the Code provides that, in the case of any reportable payment and where certain circumstances exist, the payor shall deduct and withhold from such payment a tax equal to the product of the fourth lowest rate of tax applicable under § 1(c) and such payment.

Section 3406(b)(1) states that the term “reportable payment” means any reportable interest or dividend payment, and any other reportable payment. Reportable interest or dividend payments are defined in § 3406(b)(2) as any payment of a kind, and to a payee, required to be shown on a return required under § 6049(a), § 6042(a), or § 6044. Section 3406(b)(3) defines other reportable payments as any payment of a kind, and to a payee, required to be shown on a return required under § 6041, § 6041A, § 6045, § 6050A, or § 6050N.

The backup withholding rules of § 3406 apply to the distributions to the

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Eligible Members if they are reportable under any one of the Code sections listed in § 3406(b). Although the distributions to the Eligible Members will be reportable under § 6043 of the Code, they will not be reportable under any of the sections listed in § 3406(b). Since none of the distributions will be reportable payments as defined in § 3406, Company is not required to engage in backup withholding with respect to those payments.

Withholding under § 1441

Section 871(a)(1)(A) imposes a tax of 30 percent of the amount received from sources within the United States by a nonresident alien individual as certain income, including interest (other than original issue discount as defined in section 1273), dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits, and income.

Section 1441(a) provides the general rule that all payors must withhold on payments to nonresident aliens to the extent that such payments constitute gross income from sources within the United States. Section 1441(b) provides that these items of income include interest, dividends, rent, salaries, wages, premiums, annuities, compensations, remunerations and emoluments.

Treas. Reg. § 1.1441-3(c)(1) provides the general rule that a corporation making a distribution with respect to its stock to nonresident aliens is required to withhold on the entire amount of the distribution, unless it elects to reduce the amount of withholding based on one of the circumstances enumerated in Treas. Reg. § 1.1441-3(c)(2)(i). Treas. Reg. 1.1441-3(c)(2)(i)(B) states that a distributing corporation may elect to not withhold on a distribution to the extent it represents a distribution in part or full payment in exchange for stock. Treas. Reg. § 1.1441-3(c)(2)(i) provides that an election is made under Treas. Reg. § 1.1441-3(c)(1) by actually reducing the amount of withholding at the time that the payment is made.

Capital Asset:

Section 1221 of the Code controls whether memberships interests of Eligible Members are capital assets. Section 1221(a) defines a "capital asset" as property held by a taxpayer, but does not include property described in section 1221(a)(1) through (8). The Membership Interests come within the general definition of capital asset and, based on the facts and representations in the request, do not fall within any of the exceptions in section 1221(a)(1) through (8).

Long-Term Capital Gain:

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Section 1222(3) provides, in part, that the term "long-term capital gain" means gain from the sale or exchange of a capital asset held for more than 1 year, if, and to the extent, such gain is taken into account in computing gross income.

Section 1222(11) provides that "net capital gain" means the excess of net long-term capital gain over net short-term capital loss.

Section 1(h)(4) provides that the term "adjusted net capital gain" means net capital gain reduced by unrecaptured section 1250 gain, as defined in section 1(h)(8), and 28 percent gain, as defined in section 1(h)(5).

Under section 1(h)(1), adjusted net capital gain is taxed at rates of 20%, 10% (generally for gain that would otherwise be taxed at 15%), or at ordinary rates (if lower), depending on the taxpayer's circumstances.

The Membership Interest of an Eligible Member qualifies as a capital asset under section 1221. Taxpayer represents that all final distributions that are made to Eligible Members will be with respect to Membership Interests held for more than one year. Thus, any gain from the sale or exchange of such Membership Interest, will constitute long-term capital gain. The gain will not be unrecaptured section 1250 gain or 28 percent gain.

Qualified 5-year Gain:

Section 1(h)(9) provides generally that "qualified 5-year gain" means the aggregate long-term capital gain from property held for more than 5 years, not counting collectibles gain or section 1202 gain as defined in section 1(h)(6) and (8).

With the above requirements satisfied, the qualified 5-year-gain rule replaces the rate in the 10% tax-band with an 8% one under section 1(h)(2)(A). This rate automatically applies to qualifying gains. Thus, distributions received by Eligible Members with respect to a Membership Interest held for more than 5 years at the time of distribution will automatically qualify for the 8% rate.

Under section 1(h)(2)(B), qualified 5-year gain that would otherwise be taxed at 20% will generally be taxed at 18%, but only for property whose holding period began *after* December 31, 2000. (A one-time election was provided for taxpayers who wished to be treated as having sold and reacquired property they held as of January 2001, in order to qualify for the 18% rate.) Thus, the 18% rate will not apply until 2006, at the earliest. The 18% rate will not apply to distributions received by Eligible Members because the 5-year holding period requirement, beginning or deemed to begin after December 31, 2000, will not have been met at the time of distribution.

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Based solely on the information submitted and the representations made, we have concluded that:

- (1) Membership Interests in Company will be treated as stock within the meaning of §§ 331 and 346. See Rev. Rul. 69-3, 1969-1 C.B. 103.
- (2) Each distribution by Company to the Eligible Members in accordance with the Plan will be treated as one in a series of distributions in complete liquidation within the meaning of section 346(a) of the Code.
- (3) The distributions received by the Eligible Members pursuant to the Plan will be treated as payments in exchange for their Membership Interests. Section 331(a) of the Code.
- (4) Each Eligible Member's basis in his or her Membership Interests is zero. See Rev. Rul. 71-233, 1971-1 C.B. 113.
- (5) A Membership Interest is a capital asset under § 1221.
- (6) Distributions received by Eligible Members who held a Membership Interest on the record date will be long-term capital gain under § 1222(3) that (depending on the taxpayer's other gains and losses) will be taxable as adjusted net capital gain under § 1(h)(4) of the Code.
- (7) Distributions received by Eligible Members with respect to Membership Interests that have been held for more than five years at the time of distribution (regardless of when their interest was acquired) will be qualified five-year gain under § 1(h)(9), eligible (depending on the taxpayer's other income, gains, and losses) for the 8%, but not the 18%, rate provided for in section 1(h)(2).
- (8) The cash held for distribution or distributable to missing Eligible Members is not reportable under § 6043(a)(2) relating to reporting for corporate liquidating transactions.
- (8) Backup withholding is not required for distributions to Eligible Members.
- (9) Company may elect not to withhold under § 1441 on the distributions to nonresident alien individual policyholders. This election is made, under Treas. Reg. § 1.1441-3(c)(2)(i), by actually reducing the amount of withholding at the time the payment is made.

No opinion is expressed as to the tax treatment of the transactions under other provisions of the Code or regulations or about the tax treatment of any conditions



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existing at the time of, or effects resulting from, the transactions that are not specifically covered by the above ruling.

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

Sincerely yours,

*Marlene P. Oppenheim*

Marlene P. Oppenheim

Senior Counsel, Branch 2

Office of Associate Chief Counsel (Corporate)

cc: