

Internal Revenue Service

Department of the Treasury
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7702B.00-00

Person To Contact: _____, ID No.

Telephone Number:

Refer Reply To:
CC:FIP:B04
PLR-107228-17

Date:
August 15, 2018

Insurer A =

Insurer B =

Parent =

State =

Court =

X =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Dear _____ :

This letter is in response to the letter and supplemental correspondence submitted by your authorized representative that requested rulings on the application of §§ 104, 803, 805, 807, 1001, 1011, and 7702B of the Internal Revenue Code (the “Code”) to the liquidation of Insurer A and Insurer B (each, an “Insurer”).

FACTS

Corporate Structure and Insurance Business of Insurers

Parent is a holding company that is the common parent of a life/non-life consolidated group that includes the Insurers. Parent owns all of the stock of Insurer A. Insurer A, in turn, owns all of the stock of Insurer B. Both Insurers are State-domiciled stock insurance companies and are life insurance companies under § 816.

The Insurers have issued primarily long-term care policies and certain other accident and health insurance policies (each, a “Policy”). None of the Policies has any cash value. Many of the long-term care policies are tax-qualified under § 7702B, but others are not. Neither Insurer has written any new business since Date 1, but both Insurers have been required to renew their existing business, pursuant to and subject to the terms of the Policies and applicable law.

Overview of Liquidation Proceedings and Liquidator’s Authority

On Date 2, under approval by the Court, the State Insurance Commissioner (the “Commissioner”) ordered the Insurers into rehabilitation. Due to the Insurers’ deteriorating financial conditions and other relevant considerations, the Commissioner requested that the Court convert the Insurers’ rehabilitation to a liquidation. On Date 3 (the “Effective Date”), the Court entered orders of liquidation for the Insurers (the “Liquidation Orders”). The Court appointed the Commissioner as the statutory liquidator (the “Liquidator”). As of, or soon after, the Effective Date, state insurance guaranty associations (“GAs”) were required to provide coverage to the Insurers’ policyholders for Covered Benefits. Covered Benefits are the amount of a Policy’s benefits that are within the limits, conditions, and scope of coverage of the responsible GA, taking into account the residence and other attributes of the policyholder as determined by the responsible GA in accordance with applicable law. Uncovered Benefits are the amount of a Policy’s benefits that exceed Covered Benefits.

Planned Restructuring

As part of the liquidation, the estimated liabilities under the Policies will be restructured as provided in a restructuring statement filed with and approved by the Court (the “Restructuring Statement”). Each Policy’s provisions shall be subject to certain modification provisions as described in the Restructuring Statement. To determine the extent of restructuring, a determination will be made as to what portion of each Insurer’s assets will be required for costs of administration and contingencies, and the rest of its assets (the “Allocated Assets”) will be notionally allocated to each Policy in proportion to the estimated liability associated with each Policy, as determined by each Policy’s gross premium reserve before any restructuring or modification of the Policy following the Liquidation Orders.

Each Insurer has estimated liabilities with respect to its Policies (“Policy Liabilities”) that vastly exceed its assets, and therefore, are not fully funded by that Insurer. The amount of a Policy’s liabilities before the restructuring is referred to as the

Unmodified Policy Value. The amount of the Unmodified Policy Value that an Insurer can reasonably expect to fund based on future premiums and Allocated Assets is the Initial Funded Restructured Policy Value. The amount of the Unmodified Policy Value that exceeds the Initial Funded Restructured Policy Value is the Unfunded Benefit Liability.

As of the Effective Date, each Policy's Unmodified Policy Value will be restructured into a Covered Benefits component (a "Covered Benefits Component") and an Uncovered Benefits component (an "Uncovered Benefits Component"). Each Policy's Covered Benefits Component and Uncovered Benefits Component will be further divided into an Initial Funded Restructured Policy Value subcomponent and an Unfunded Benefit Liability subcomponent. This will allow the Insurers to have separate Policy components timely assumed or guaranteed as appropriate by the GAs and by another insurance company ("Reinsurer"), which could provide coverage for Uncovered Benefits. This is intended to prevent any Policy coverages from being unnecessarily terminated.

Also as of the Effective Date, a Policy's Uncovered Benefits Component will be restructured by reducing the Uncovered Benefits Component to its Initial Funded Restructured Policy Value subcomponent in return for an amount of indebtedness from the Insurer to the Policy's owner (the "Owner") that is equal to the Unfunded Benefit Liability by which the Uncovered Benefits Component is reduced. Within X days after this restructuring, the Initial Funded Restructured Policy Value subcomponent of the Uncovered Benefits Component will be transferred to and reinsured by Reinsurer, which will have a liability only to the extent that Reinsurer will have obtained sufficient funding from the Policy's Insurer.

As of the Final Restructuring Date, which is Date 4 unless a different date is approved by the Court, a Policy's Covered Benefits Component will be restructured by reducing the Covered Benefits Component to its Initial Funded Restructured Policy Value subcomponent in return for an amount of indebtedness from the Insurer to the Owner that is equal to the Unfunded Benefit Liability by which the Covered Benefits Component is reduced.

The GAs and Reinsurer will separately continue, reinsure, assume, or guarantee the respective Covered Benefits and Uncovered Benefits and receive transfers of Allocated Assets to fund these benefits through their rights of subrogation, in accordance with their agreements with the Liquidator. The transfer of Policy Liabilities to a GA or Reinsurer will be effected by a Court-approved transaction described by the Restructuring Statement that will extinguish the Insurer's liability with respect to such Policy. Generally, such a termination of the Insurer's liability will occur when Allocated Assets are transferred to (or for the benefit of) the transferee to fund the payment of such a liability. The Liquidator will seek an order from the Court discharging the Insurers for any remaining Unfunded Benefit Liability debt to the Owners and the GAs

pursuant to and at the time of the final discharge order (as defined in the Restructuring Statement) following completion of all of the other steps in the liquidation.

LAW AND ANALYSIS

Section 104(a)(3) provides that except in the case of amounts attributable to (and not in excess of) deductions allowed under § 213 for any prior taxable year, gross income does not include amounts received through accident or health insurance (or through an arrangement having the effect of accident or health insurance) for personal injuries or sickness (other than amounts received by an employee, to the extent such amounts (A) are attributable to contributions by the employer which were not includible in the gross income of the employee, or (B) are paid by the employer).

Under § 213(d), premiums paid under a qualified long-term care insurance contract are generally treated as payments for insurance for purposes of the deduction allowed under § 213 for expenses paid for medical care.

Under § 7702B(a), a qualified long-term care insurance contract is treated as an accident and health insurance contract and amounts received as benefits under such a contract generally are treated as amounts received for personal injuries and sickness and as reimbursement for expenses actually incurred for medical care. Section 7702B(b) defines a qualified long-term care insurance contract as an insurance contract that (a) provides protection only for coverage of qualified long-term care services; (b) does not pay or reimburse expenses incurred for certain services or items reimbursable under Title XVIII of the Social Security Act; (c) is guaranteed renewable; (d) does not provide for a cash surrender value; (e) permits premium refunds or policyholder dividends to be applied only as a reduction in future premiums or an increase in future benefits; and (f) meets the consumer protection requirements of § 7702B(g).

In Rev. Proc. 92-57, 1992-2 C.B. 410, the Service recognized that “[i]nsurance companies that issue or assume (through reinsurance) annuity, life insurance, or endowment contracts can become financially troubled and subject to rehabilitation, conservatorship, insolvency, or similar state proceedings” and that the “[o]rderly rehabilitation of these insurance companies may require modification or restructuring of these annuity, life insurance, or endowment contracts.” Rev. Proc. 92-57 provides administrative relief with respect to these contracts by treating the modification or restructuring of certain contracts as not resulting in a loss of “grandfathered” status for purposes of §§ 72, 101(f), 264, 7702, and 7702A, and as not requiring retesting or the beginning of a new test period under §§ 264(d)(1), 7702(f)(7)(B)-(E), and 7702A(c).

To qualify for this administrative relief, the modification or restructuring of an affected contract must satisfy the following conditions:

- 1) The modification or restructuring (by endorsement or otherwise) of the affected contract must occur as an integral part of the rehabilitation, conservatorship, insolvency, or similar state proceeding. Modification or restructuring may include, but is not limited to, reductions in benefits, adjustments to mortality or other expense charges, reductions in the rate of interest credited to the contract, and restrictions on the policyholder's ability to receive benefits under the affected contract.
- 2) The modification or restructuring of an affected contract must be approved by the state court, the state insurance commissioner, or any other responsible state official with authority to act in a rehabilitation, conservatorship, insolvency, or similar state proceeding.

Rev. Proc. 92-57, Sec. 2.02.

The proposed modifications and restructuring of the Policies pursuant to the Restructuring Statement are within the scope of the relief provided by Rev. Proc. 92-57 because these modifications and restructuring are "an integral part of the rehabilitation, conservatorship, insolvency, or similar state proceeding" and will be approved by the appropriate state authorities as part of such proceedings.

Under § 1001(a), the gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in § 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

Section 1.1001-1(a) of the Income Tax Regulations provides that "the gain or loss realized from the conversion of property into cash, or from the exchange of property for other property differing materially either in kind or in extent, is treated as income or as loss sustained."

Section 1011(a) provides the general rule that the adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis (determined under § 1012 or other applicable sections of this subchapter and subchapters C (relating to corporate distributions and adjustments), K (relating to partners and partnerships), and P (relating to capital gains and losses)), adjusted as provided in § 1016.

Under § 803(a), gross income of a life insurance company includes (1) the gross amount of premiums and other consideration on insurance and annuity contracts, (2) the net decrease in reserves which is required by § 807(a), and (3) all other amounts not included under (1) or (2) which are includible in gross income.

Under § 805(a), a life insurance company is entitled to a deduction for (1) all claims and benefits accrued, and all losses incurred (whether or not ascertained), during the taxable year on insurance and annuity contracts, and (2) a net increase in reserves required by § 807(b) to be taken into account. Section 807(b) permits an increase in the amount of life insurance reserves, as calculated under § 807(d), for the taxable year to be deducted under § 805(a)(2).

HOLDINGS

1. Any Court-approved Policy restructuring or modification described in the Restructuring Statement will not affect the Policy's issue date for purposes of § 7702B.
2. Any Court-approved Policy restructuring or modification described in the Restructuring Statement will not be treated as a material change of the Policy or an exchange of property for other property differing materially either in kind or in extent, and thus will not result in a taxable disposition of any interest in such Policy by its Owner under § 1001.
3. Any Court-approved Policy restructuring or modification described in the Restructuring Statement will not result in any amount includible in gross income by its Owner under § 104(a)(3).
4. The Owner's adjusted basis under § 1011 in any Policy will remain the same immediately after any Court-approved restructuring, modification, guarantee, assumption, continuation, reinsurance, or enhancement of any of the Policy's provisions or benefit liabilities as such adjusted basis was immediately before such transaction.
5. When any Policy is initially restructured as of the Effective Date to reduce the Policy's unfunded liabilities, for purposes of Subchapter L of Chapter 1 of the Code, as of the Effective Date:
 - a. The restructuring Insurer will include in income under § 803(a)(2) the total amount of the existing tax reserves under § 807(d) attributable to the Policy's Unmodified Policy Value;
 - b. The restructuring Insurer will be able to deduct under § 805(a)(1) as accrued benefits an amount equal to the Policy's Unmodified Policy Value;
 - c. The restructuring Insurer will include in premium income under § 803(a) the sum of the restructured Policy's Covered Benefits Component and

Initial Funded Restructured Policy Value subcomponent of the Uncovered Benefits Component; and

- d. The restructuring Insurer will be able to deduct under § 805(a)(2) the increase in tax reserves under § 807(d) attributable to the sum of the restructured Policy's Covered Benefits Component and Initial Funded Restructured Policy Value subcomponent of the Uncovered Benefits Component.
6. When any Policy is finally restructured as of the Final Restructuring Date to reduce its unfunded liabilities, for purposes of Subchapter L of Chapter 1 of the Code, as of the Final Restructuring Date:
- a. The restructuring Insurer will include in income under § 803(a)(2) the total amount of the existing tax reserves under § 807(d) attributable to the then current Covered Benefits Component of the Policy;
 - b. The restructuring Insurer will be able to deduct under § 805(a)(1) as accrued benefits an amount equal to the then current Covered Benefits Component of the Policy;
 - c. The restructuring Insurer will include in premium income under § 803(a) the restructured Policy's then current Initial Funded Restructured Policy Value subcomponent of the Covered Benefits Component; and
 - d. The restructuring Insurer will be able to deduct under § 805(a)(2) the increase in tax reserves under § 807(d) attributable to the Policy's then current Initial Funded Restructured Policy Value subcomponent of the Covered Benefits Component.

Except as expressly provided herein, no opinion is expressed concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

We decline to rule on whether the restructuring Insurer excludes from gross income under § 108(a)(1)(B) any income from the discharge of indebtedness to policyholders or the GAs by court order resulting from the restructuring or modification of the Policies pursuant to the Restructuring Statement (the Unfunded Benefit Liability) to the extent that the restructuring Insurer is insolvent at the time of the discharge. See Rev. Proc. 2018-1, Sec. 6.11.

The rulings contained in this letter are based upon information and representations submitted by the Insurers 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. This ruling is directed only to the taxpayer who requested it. A copy of this ruling must be attached to any tax return to which it is relevant. Section 6110(k)(3) provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representatives.

Sincerely,

Rebecca L. Baxter
Senior Technician Reviewer, Branch 4
(Financial Institutions & Products)

cc: