

Internal Revenue Service  
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Ruling: **199908016**  
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NOVEMBER 23, 1998

Ancillary Receiver =

Company A =

Date B =

State C =

Reinsurer D =

Reinsurer E =

State F =

Number G =

Year H =

Amount J =

Dear

This is in response to the ruling request of Date B, as supplemented, submitted by Reinsurers D and E (Taxpayers) as to the federal tax consequences of a proposed assumption reinsurance of certain annuity and life insurance contracts issued by Company A.

Company A is a State F life insurance company which was licensed to do business in more than Number G states, including State C. Company A became insolvent in Year H. In that same year, the insurance commissioner of State F, the state of Company A's domicile, obtained a court order placing Company A in conservatorship, where it still resides.

When Company A first sought a certificate of authority to conduct business in State C, Company A was required to place in the custody of the insurance commissioner for State C certain government guaranteed securities having a value at that time of approximately Amount J (the Special Deposit). The Special Deposit was required to be increased from time to time based on the growth in Company A's business with State C policyholders. The purpose of the Special Deposit was to provide security for State C policyholders in the event of nonperformance of Company A's contractual obligations to the policyholders and their beneficiaries.

Accordingly, when Company A was placed in conservatorship in State F, the insurance commissioner of State C obtained an order from the State C court establishing an ancillary receivership. By that order, the insurance commissioner of State C was appointed as Ancillary Receiver and directed to liquidate the Special Deposit and State C liabilities of Company A. From that point forward (after some litigation to settle the rights to the Special Deposit), the original conservatorship in State F and the ancillary receivership in State C have operated separately although information has been exchanged as necessary.

Pursuant to the court's order, the Ancillary Receiver has developed an overall plan (the Plan) to liquidate Company A. Pursuant to the Plan, the Ancillary Receiver has arranged, where possible, for the reinsurance of certain blocks of Company A's business by creditworthy insurance companies, including Taxpayers. Taxpayers are both life insurance companies subject to federal income taxation as life insurance companies under part I of subchapter L of the Code, are accrual-basis, calendar-year taxpayers, and file a consolidated federal return with a joint parent.

In order to accomplish the reinsurance of Company A's contracts, the Plan requires that Company A's contracts be, in some cases, restructured to correspond to contract forms currently in use by a reinsurer. Because Company A's State C liabilities do not currently, and are not expected to, exceed the Special Deposit, the Plan does not require downward adjustments to the account values of Company A's contracts. Further, because there is no reduction in the value of the contracts, holders of Company A contracts were not given an opportunity to agree or disagree with the restructuring of their contracts or to the reinsurance of the restructured contracts under the rehabilitation plan as applicable to State C policyholders.

The Ancillary Receiver plans to dispose of blocks of business (the Contracts) to Taxpayers, through assumption reinsurance to be effective on a date to be determined and approved by the court. Certain life insurance Contracts and certain annuity

Contracts will be restructured to match Reinsurer D contract forms immediately before the reinsurance arrangement is consummated. The economic rights and benefits of the restructured Contracts immediately after the restructuring will be substantially similar to the economic rights and benefits of the Contracts immediately before the restructuring. The restructuring will be accomplished by endorsement. Certain other Company A, State C Contracts, including group annuity Contracts and single premium immediate annuity Contracts, will be assumed by Reinsurer E without restructuring.

The pending assumption reinsurance transactions were the result of a bidding process involving several potential reinsurers. Conversion of assumed contracts to existing policy forms of a bidder had a material effect on the bidder's anticipated costs of administering the assumed contracts and was a material consideration in bidding. The Ancillary Receiver represents that the restructuring of certain Contracts to conform with Reinsurer D policy forms will occur as an integral part of the State C ancillary receivership of Company A, and will occur pursuant to the order and approval of the State C court.

No terms of any of the Contracts to be assumed and reinsured by the Taxpayers, whether previously restructured or not, will be changed by the assumption reinsurance transaction except that the Reinsurers will become the insurer of the Contracts. Under the Agreements, Reinsurers will deliver to each policyholder of an assumed Contract a certificate confirming its assumption of all of Company A's liabilities under the restructured Contract. A policyholder has no further claims against Company A upon the assumption of the Contract by Reinsurer.

Taxpayers represent that the Contracts to be assumed that are issued as life insurance policies constitute "life insurance contracts" for federal income tax purposes. Further, Taxpayers represent that the Contracts to be assumed that are issued as annuity contracts constitute "annuity contracts" for federal income tax purposes.

## **Law and Analysis**

Section 1035(a) of the Internal Revenue Code 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.

The legislative history of § 1035 states that exchange treatment is appropriate for "individuals who have merely exchanged one insurance policy for another better suited to their needs and who have not actually realized gain." H.R. Rep. No. 1337, 83d Cong., 2d Sess. 81 (1954).

Section 1031(b) provides in part that, if an exchange would be within the provisions of § 1035(a), 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, for property acquired in an exchange described in § 1035(a), that 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 in the amount of loss to the taxpayer that was recognized on such exchange.

Although the primary purpose of reinsurance is to avoid too large a concentration of risk within one company, a 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 (reinsurer) 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* 684, n.10 (12th ed. rev. 1994). Assumption reinsurance is the assumption by one company of all of the functions and obligations of one or more contracts issued by another company. 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., 3d ed. 1973).

The intent of an assumption reinsurance transaction is that the reinsurer will replace the original insurer in all respects. 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 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. Section 1.809-5(a)(7)(ii) of the regulations.

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 policy. It merely allows the obligation of the original insurer under the existing contracts to be assumed by the reinsurer. See § 1.809-5(a)(7)(ii) of the regulations. After completion of the reinsurance, all terms of the reinsured underlying Contracts remain unchanged, including the amount and pattern of death benefit, the premium pattern, the rate guaranteed on issuance of the contract, and the mortality and expense charges. The substitution of the Taxpayers for the original insurer is the only modification to the underlying Contracts. The Contracts that the policyholders will have after the assumption reinsurance transaction are the same restructured or

unrestructured Contracts the policyholders would have maintained with Company A except for the fact that the original insurer will be replaced. No formal exchange of contracts will occur as a result of the assumption reinsurance transaction. Policyholders will receive an assumption certificate as notification of the change in insurers; they will not receive a new policy form.

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

(1) The assumption reinsurance transaction entered into by the Ancillary Receiver with Reinsurer D in accordance with the Plan, pursuant to which Reinsurer D will assume the Contracts after they are restructured in Taxpayer, if such transaction does not change the terms and conditions of the Contracts assumed (other than the insurer), will not have an effect on the date that each Contract was 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)(7)(B)-(E), and 7702A(c).

(2) The assumption reinsurance transaction entered into by the Ancillary Receiver with Reinsurer E in accordance with the Plan, pursuant to which Reinsurer E will assume the Contracts, if such transaction does not change the terms and conditions of the Contracts assumed (other than the insurer), will not have an effect on the date that each Contract was 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)(7)(B)-(E), and 7702A(c).

No opinion is expressed as to the tax treatment of the 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(k)(3) provides that it may not be used or cited as precedent.

A copy of this letter should be attached to the federal income tax returns to be filed by Taxpayers in the taxable year that includes the date upon which the assumption reinsurance agreement covering the Contracts is closed.

Sincerely yours,  
Assistant Chief Counsel  
(Financial Institutions & Products)

By: \_\_\_\_\_  
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Branch 4