

INTERNAL REVENUE SERVICE
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DECEMBER 8, 1998

Legend

X =

P =

Holdings =

Y =

Z =

State A =

State B =

State C =

State D =

Date a =

Date b =

Date c =

Date d =

Date e =

Date f =

Dear

This refers to the letter dated August 4, 1998, which requests a ruling that X qualifies as an insolvent insurance company within the meaning of § 1.848-2(i)(4)(v) of the Income Tax Regulations and, therefore, that the joint election under that provision to reduce the insolvent insurance company's excess negative capitalization carryover amount and the other party's specified policy acquisition expenses under § 848 of the Internal Revenue Code is available to X and Y, respectively.

The facts submitted with the ruling request are summarized below.

Corporate description

X is a stock life insurance company. X 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, X was a wholly owned subsidiary of P, a mutual life insurance company also domiciled in State A. X currently files a separate federal income tax return as a life insurance company taxable under § 801 of the Internal Revenue Code.

Holdings is a financial services holding company which is incorporated in State B. Holdings is the common parent of a consolidated group that includes several life insurance company affiliates. Holdings joins with eligible life members of the group in filing a life-nonlife consolidated return pursuant to an election under § 1504(c)(2).

Y is a stock life insurance company taxable under § 801 and is an eligible life member of Holdings' consolidated federal income tax return group. Y is incorporated in State C and is licensed to transact business in 49 states and the District of Columbia.

Z is a stock life insurance company. Z is incorporated in State D and is licensed to transact business in 3 states. At the time of the filing of this ruling request, Z was an eligible member of Holdings' consolidated federal income tax return group. However, after September 30, 1998, Z will file as separate return as a life insurance company taxable under § 801 as the result of

a "disproportionate asset acquisition" within the meaning of § 1.1502-47(d)(12)(viii).

Background of rehabilitation proceeding

On Date a, P was placed in rehabilitation proceedings under a court order issued by the Superior Court of State A. The rehabilitation proceedings were necessary because P was experiencing a level of policyholder withdrawals and surrenders that threatened to drain assets and render P unable to meet its contractual obligations to remaining policyholders.

The court order placing P in rehabilitation proceedings imposed a moratorium on most policyholder withdrawals and surrenders pending the development of an overall plan of rehabilitation for P (the "Plan"). On Date b, the Plan, together with supporting agreements with the National Association of Life and Health Guaranty Associations, participating state guaranty associations, and a consortium of reinsurers, was confirmed by the Superior Court of State A.

The Plan provides a definite period for the completion of rehabilitation proceedings of P's life insurance and annuity business, which is to run from Date c through Date d (the "Rehabilitation Period"). The Plan is also structured to protect the benefits and enhance the returns of P's policyholders through the participation of various State guaranty associations and reinsurers in the rehabilitation proceedings. Under the Plan, the following actions have occurred:

- The terms of certain of P's insurance and annuity contracts were restructured and transferred along with substantially all of P's liquid assets to X, then a wholly owned subsidiary of P. Policyholders were given the opportunity to opt-out of participation in the Plan by surrendering their contracts in exchange for a cash payment equal to 55 percent of their available account value on Date a, with certain adjustments.
- Policyholders who chose to participate in the Plan became subject to moratorium amounts which reduce their available account balances subject to withdrawals and surrenders. The moratorium amounts imposed on policyholder withdrawals and surrenders are progressively phased-out over the term of the Rehabilitation Period and will be eliminated entirely as of Date d. The moratorium amounts differ depending on the type of contract in question and the year of the contract's surrender.
- All of the stock of X was transferred to a stock trust,

where it continues to be held for the benefit of general creditors of P. The stock trust agreement provides that X stock will be sold for the benefit of the general creditors or distributed in kind to general creditors no later than Date d.

- The benefit payments of the restructured contracts transferred to X are guaranteed by various state guaranty associations for the duration of the Rehabilitation Period, subject to certain restrictions on interest crediting rates provided by State law.
- During the Rehabilitation Period, X will administer its existing business and the business acquired from P, but is generally prohibited from writing new business. Any sale of X stock or assets (other than in the ordinary course of business) requires the approval of the Superior Court of State A.
- Subsequent to the Court's approval of the Plan, litigation was pursued by policyholders over the possible distribution of X stock to general creditors of P. In settlement of the disputed issues, an agreement was reached that contains provisions to ensure appropriate distributions to the general creditors and credits to the contracts of policyholders in the event that 95% of the stock of X or 95% of the assets of X are sold.

Proposed reinsurance transfers

As of Date e, X and Holdings have entered into a Purchase and Sale Agreement (the "Purchase Agreement"), pursuant to which Holdings agreed to cause its life insurance affiliates, Y and Z, to acquire substantially all of X's life insurance and annuity business, including the restructured contracts assumed by X as part of the Court supervised rehabilitation proceedings for P. The Purchase Agreement provides a tentative Closing Date of Date f for the transfer of X's life insurance and annuity business to Holdings' life insurance subsidiaries.

Under the Purchase Agreement, on the Closing Date, X will reinsure 100 percent of its life insurance and annuity policies with Y on an indemnity reinsurance basis. The Purchase Agreement further provides that, on the State D assumption date, the indemnity reinsurance agreement will terminate with respect to X's life insurance and annuity policies held by State D residents, and these policies will be assumed by Z pursuant to an assumption reinsurance agreement between X and Z. No additional reinsurance premium will be paid by X as a result of this assumption reinsurance transaction. Rather, Y will transfer an

appropriate amount of consideration to Z for the assumption of liability on the State D policies. Finally, the Purchase Agreement provides that, on an appropriate date for each jurisdiction, the indemnity reinsurance of X's life insurance and annuity policies held by residents of that particular jurisdiction will terminate, and will be replaced by an assumption reinsurance agreement between X and Y in which Y will become directly liable to the policyholders on policies held by residents in that jurisdiction. Once X has been formally relieved of liability with respect to all of its life insurance and annuity policies on completion of these assumption reinsurance agreements, X will cease to operate as a going concern other than for the purpose of disposing of its remaining liabilities.

Proposed amendments to the Plan affecting the reinsured policies

The Purchase Agreement entered into by X and Holdings must be approved by the Superior Court of State A before it can be implemented. In addition to placing the Purchase Agreement with the Court, X is also filing certain proposed amendments to the Plan and related documents. The Plan is expected to be revised to substitute a date which is six months after the Closing Date of the Purchase Agreement for Date d for termination of the Rehabilitation Period. The Plan also will be revised to eliminate the obligation of participating State guaranty associations to make support payments under the Plan as of the Closing Date. The accelerated termination of the Rehabilitation Period also will accelerate the termination of moratorium charges and other restrictions imposed on the restructured life insurance and annuity policies by the Plan. Other documents also will be revised to provide that certain contracts will be modified as of the Closing Date to authorize the crediting of Policy Enhancements. The tax consequences of these modifications for X's policyholders will be the subject of a separate ruling request.

Proposed joint election

As a result the Purchase Agreement, it is anticipated that X will have net negative consideration as that term is defined in § 1.848-2(f) based on the amount of consideration required to be transferred to Y pursuant to the indemnity reinsurance agreement. Because X has been precluded from writing new business since the approval of the Plan by the Superior Court of State A, it is also anticipated that X will also have an excess negative carryover amount under § 1.848-2(i)(2) attributable to the indemnity reinsurance agreement. Based on these assumptions, the Purchase Agreement provides that X and Y will jointly make an insolvent insurance company election in accordance § 1.848-2(i)(4) with respect to the reinsurance of X's life insurance and annuity

policies. The availability of this election is dependent on X qualifying as an insolvent insurance company under one or more of the presumptions set forth in § 1.848-2(i)(4)(iv).

Applicable law and analysis

Section 848 of the Code provides that insurance companies must capitalize "specified policy acquisition expenses" and amortize these amounts on a straight-line basis, generally over ten taxable years. Instead of identifying the categories of acquisition expenses that must be capitalized and amortized, § 848(c) requires an insurance company to capitalize an amount of otherwise deductible expenses for the taxable year equal to specified percentages of net premiums with respect to certain types of insurance contracts. The maximum amount of expenses required to be capitalized for any taxable year is generally limited to the insurance company's general deductions for that year.

Section 848(d)(1) provides that, with respect to each category of specified insurance contracts, net premiums equal the excess, if any, of (A) the gross amount of premiums and other consideration for the contracts, over (B) the sum of return premiums and premiums incurred for the reinsurance of the contracts.

Section 848(d)(4)(B) authorizes the Treasury Department to prescribe regulations to ensure that premiums and other consideration for reinsurance are treated consistently by the parties of a reinsurance agreement in applying the provisions of § 848. Pursuant to this authority, § 1.848-2(f) provides special rules for determining the amount of premiums and other consideration for reinsurance for purposes of computing an insurance company's net premiums under § 848(d)(1).

Under § 1.848-2(f), all items of consideration transferred between a ceding company and a reinsurer pursuant to a reinsurance agreement are netted for purposes of determining each party's net premiums under § 848(d)(1). The net negative consideration determined by one party to the reinsurance agreement reduces its net premiums under section 848(d)(1)(B). The net positive consideration determined by the other party increases its net premiums under section 848(d)(1)(A). The "net consideration" rules in § 1.848-2(f) ensure that "premiums and other consideration with respect to reinsurance" are treated consistently by the parties in applying the capitalization requirements of § 848.¹

¹ The net consideration rules in § 1.848-2(f) apply only for purposes of determining the amount required to be capitalized

Section 848(f) provides that if for any taxable year there is a negative capitalization amount with respect to a category of specified insurance contracts, the negative capitalization amount reduces the amount of specified policy acquisition expenses that would otherwise be capitalized with respect to other categories of specified insurance contracts for that year (but not below zero). Any remaining negative capitalization amount is then applied as a reduction of the company's previously capitalized expenses under § 848 (with a corresponding ordinary deduction). For this purpose, the negative capitalization amount is determined by multiplying the negative net premiums for a category of specified insurance contracts by the applicable percentage for that category. As a practical matter, a negative capitalization amount for a category of specified insurance contracts will generally only arise as a result of reinsurance agreements.

Section 1.848-2(i) provides that if an insurance company's negative capitalization amount for a category of specified insurance contracts for a taxable year cannot be utilized for that year because it exceeds the company's specified policy expenses for other categories of specified contracts for the year plus the unamortized balance of specified policy acquisition expenses from prior taxable years, the excess is carried over to future taxable years (as an excess negative capitalization amount).

Section 1.848-2(i)(4) provides that an insolvent insurance company with an excess negative capitalization amount and net negative consideration under a reinsurance agreement and the other party to the reinsurance agreement may make a joint election. If the election is made, the insolvent company may not claim a carryover with respect to the portion of the excess negative capitalization amount attributable to the reinsurance agreement. Correspondingly, the party with net positive consideration may reduce its specified policy acquisition expenses for the taxable year by an amount equal to the reduction in the insolvent company's excess negative capitalization carryover amount.

under § 848 in connection with the reinsurance transaction. Compare § 1.817-4(d)(2)(ii), which provides that if the reinsurer receives an amount of consideration from the ceding company that is less than the increase in the reinsurer's reserves resulting from the transaction, the reinsurer is treated as having (1) received tangible and intangible consideration equal to the increase in such reserves, and (2) paid an allowance for the assumed contracts equal to the difference between the increase in such reserves and the consideration actually received.

Section 1.848-2(i)(4)(v) provides presumptions relating to the insolvency of an insurance company undergoing a court supervised rehabilitation or similar state proceeding for purposes of determining the availability of the joint election under § 1.848-2(i)(4) to reduce the insolvent company's excess negative capitalization carryover amount attributable to the reinsurance agreement and the other party's specified policy acquisition expenses. Under § 1.848-2(i)(4)(v), an insurance company undergoing a rehabilitation, conservatorship, or similar state proceeding will be presumed to be insolvent if the state proceeding results in-

(A) An order by the court finding that the fair market of the company's assets is less than its liabilities,

(B) The use of funds, guarantees, or reinsurance from a guaranty association,

(C) A reduction of the policyholders' account balances, or

(D) A substantial limitation on access to funds (for example, a partial or total moratorium on policyholder withdrawals or surrenders that applies for a period of 5 years).

As described above, X (as the successor to P) is subject to the jurisdiction of the Superior Court of State A, pursuant to the rehabilitation proceedings of P's life insurance and annuity business instituted on Date a and the Plan confirmed by the Court on Date b. Under the Plan, X is subject to substantial restrictions on its activities during the Rehabilitation Period. In addition, the policyholders on the restructured contracts assumed by X are subject to limitations on surrenders and withdrawals as a result of the Plan's imposition of moratorium amounts. Finally, the Plan provides for support payments and guarantees by various state guaranty associations. Therefore, one or more of the presumptions for insolvency in § 1.848-2(i)(4)(v) are met by X in connection with the rehabilitation proceedings of P's life insurance and annuity business.

Accordingly, based on the foregoing statement of facts and representations, it is held as follows:

X qualifies as an insolvent insurance company within the meaning of § 1.848-2(i)(4)(v). Therefore, assuming that X has net negative consideration which results in an excess negative capitalization amount under § 1.848-2(i) as a result of the indemnity reinsurance agreement, X and Y will be eligible to make the joint election under § 1.848-2(i)(4). That election allows X to forego the carryover of the portion of the excess negative capitalization amount attributable to the indemnity reinsurance agreement and allows Y to reduce its specified policy acquisition

expenses for that taxable year by an amount equal to X's excess negative capitalization amount that is not carried over.

No opinion is expressed as to the tax treatment of the proposed transaction under the provisions of other sections of the Code or regulations which might also be applicable thereto. Specifically, we express no opinion whether the Purchase Agreement is treated as "assumption reinsurance" under § 197(f)(5) for purposes of the capitalization and amortization of any § 197 intangible transferred in the transaction.

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

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 as precedent.

A copy of this letter should be attached to the federal income tax returns of each of the taxpayers who requested this ruling for the taxable year which includes the proposed transaction.

Sincerely yours,

Assistant Chief Counsel
(Financial Institutions & Products)

By: MARK S. SMITH
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