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Department of the Treasury

Washington, DC 20224

Person to Contact:

Identifying Number:

Telephone Number:

Refer Reply To:
CC:DOM:IT&A:2 –PLR 112541-99
Date: June, 29, 2000

Legend:
X=
State =

Dear :

This is in response to your request for certain rulings concerning the distributions X will make to eligible policyholders in connection with its conversion from a mutual life insurance company to a stock life insurance company.

FACTS:

X is a mutual life insurance company within the meaning of § 816(a) of the Internal Revenue Code and is organized under the laws of State. It is the common parent of an affiliated group that has, pursuant to § 1504(c)(2), elected to file a life-nonlife consolidated federal income tax return with its subsidiaries.

As a mutual life insurance company, X has no authorized, issued, or outstanding stock. You state that stock companies have many business and organizational advantages over mutual companies, including the ability to access equity and debt capital markets, the ability to use stock for acquisitions, and the ability to use stock for executive and employee compensation. In order to obtain these advantages, X plans to demutualize under State's demutualization statute to become a stock life insurance company.

In order to accomplish the demutualization, X's Board of Directors will adopt a plan of reorganization subject to the approval of its policyholders and the appropriate regulatory authorities. Under this plan, X will reorganize as a stock life insurance company subsidiary of a stock subsidiary of a parent holding company. Pursuant to the plan of reorganization, you state that in a fair and equitable manner, X will distribute to its eligible policyholders consideration in the form of shares in the parent holding company, policy credits, or cash for extinguishment of their membership interests in X. Eligible policyholders are those policyholders who own or are deemed to own a policy that is in force or deemed to be in force on the date the plan of reorganization is adopted by the Board of Directors.

It is represented that the proposed demutualization transaction will qualify as a recapitalization described in § 368(a)(1)(E) in which eligible policyholders will receive stock, policy credits, or cash upon extinguishment of their membership interests in X, followed by (1) transfers of the X stock received by the eligible policyholders to the parent holding company in exchange for stock in the parent holding company, in a transaction qualifying under § 351, followed by (2) a transfer by the parent holding company to its stock subsidiary of the X stock received from the eligible policyholders.

X also has “missing policyholders,” i.e., policyholders whose TINs are not known to X and with undeliverable addresses. Over the last 12-18 months X has attempted to locate these policyholders by mailings to last known addresses, searches by independent search organizations, and searches of Social Security Administration records. Most of these policyholders’ policies were issued before 1967, and no premiums have been paid on them since 1982. X will maintain records of the amounts owed to missing policyholders, and as any comes forward after demutualization and before escheat of the amount to State, X will distribute the amount to the policyholder.

RULINGS REQUESTED

The rulings you have requested are as follows:[1]

(1) The distribution of stock and cash to eligible policyholders upon the extinguishment of their membership interests in X does not constitute a ”designated distribution” within the meaning of § 3405(e)(1) because the distribution is not from, or under, a commercial annuity.

(2) The distribution of cash to eligible policyholders upon the extinguishment of their membership interests in X is not reportable by X under (i) § 6043(c)(2), relating to reporting for recapitalizations, under (ii) § 6041, relating to certain payments of income in amounts of $600 or more, or under (iii) § 6045 relating to returns of brokers.

(3) Because the distributions of cash to eligible policyholders upon the extinguishment of their membership interests in X are not reportable payments, the backup withholding rules of § 3406 do not apply.

LAW AND ANALYSIS

The rulings issued below are conditioned on the demutualization transaction qualifying under §§ 368(a)(1)(E) and 351.

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[1]X previously submitted a separate ruling request and received rulings on other issues related to the income tax treatment of the proposed demutualization transaction and on issues raised by the proposed demutualization on contracts issued to or under certain retirement plans, including policy credits.

(1) Section 3405 provides for withholding on payments from annuities and other deferred income. In general, § 3405 requires withholdings on ”designated distributions” unless the recipient of such distributions elects no withholding. Section 3405(e)(1)(A) defines a designated distribution as including any distribution or payment from or under a commercial annuity. Section 3405(e)(6) defines a commercial annuity as an annuity, endowment, or life insurance contract issued by an insurance company licensed to do business under the laws of any state. However, § 3405(e)(1)(B)(ii) provides that a designated distribution shall not include the portion of a distribution that it is reasonable to believe is not includible in gross income.

Rev. Rul. 71-233, 1971-1 C.B. 113, holds that, pursuant to a statutory merger under § 368(a)(1)(A), a policyholder’s transfer of his or her proprietary interest in a mutual company in exchange for non-voting preferred shares in a stock company is a nontaxable exchange under § 354. In determining that a mutual policyholder had a zero basis in such proprietary interest, the ruling distinguished between policyholder payments allocable to a policyholder’s contract and payments allocable to a policyholder’s proprietary rights in the mutual company. The ruling reasoned that none of the premium paid by a policyholder could be allocated to the basis of a policyholder’s proprietary interest in the mutual company since such premiums were paid pursuant to the terms of the contract of insurance and therefore represented an investment solely in the policyholder’s contract.

Here, if the exchange of membership interests solely for X stock qualifies as a nontaxable exchange, it will be reasonable to believe that, for purposes of § 3405, the distribution of stock will not be includible in the recipient’s gross income. Similarly, because the distribution of cash will not be made pursuant to the policyholder contracts but rather pursuant to a plan under which the proprietary interests of X will be reorganized, such cash distributions should be viewed as payments solely attributable to the policyholders’ proprietary interests in X and not from or under the policyholders’ contracts.

Accordingly, in connection with X’s proposed demutualization whereby X plans to pay stock and cash to its policyholders in exchange for the extinguishment of their membership interests, we conclude that:

(a) If an eligible policyholder receives solely stock in exchange for his or her membership interests, and if the exchange qualifies as a nontaxable exchange, the distribution of stock will not constitute a designated distribution within the meaning of § 3405(e)(1)(A) because it is reasonable to believe that no portion of the distribution will be includible in the policyholder’s gross income in the year of the distribution.

(b) If an eligible policyholder receives solely cash in exchange for his or her membership interests, the distribution of cash will not constitute a designated distribution within the meaning of § 3405(e)(1)(A) because the distribution will not be from or under a commercial annuity.

The foregoing conclusions are based on the further assumption that plans qualified under § 401(a), tax sheltered annuities described in § 403(b), and individual retirement arrangements described in § 408 will not be among the eligible policyholders receiving either stock or cash.

(2) Your next request asks that we issue a ruling concluding that the distribution of cash to eligible policyholders upon the extinguishment of their membership interests in X will not be reportable by X under several Code sections including § 6041. Section 6041 provides, in part, that all persons engaged in a trade or business and making payment in the course of the trade or business to another person of rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable gains, profits, and income of $600 or more in any taxable year, shall render a true and accurate return to the Secretary of the Treasury setting forth the amount of those gains, profits, and, income and the name and address of the recipient of the payment. Section 1.6041-1(c) defines "fixed or determinable income." Income is fixed when it is to be paid in amounts definitely predetermined, and is determinable whenever there is a basis of calculation by which the amount paid may be ascertained. Section 1.6041-1(a)(2) of the Income Tax Regulations provides that information returns required by § 1.6041-1(a)(1) must be made on Forms 1099 and 1096.

Thus, under § 6041 a person engaged in a trade or business generally is required to report payments of fixed or determinable gains, profits, and income of $600 or more made in that trade or business. Under the facts presented, X is engaged in a trade or business and at the time of the demutualization will make payments of fixed or determinable gains, profits, and income. The income is fixed because X will pay gains in an amount definitely predetermined in redemption of policyholders' membership interests. The income is determinable because there is a basis of calculation by which the amount of gain may be ascertained; that is, the cash amount distributed is known and the basis of each policyholder's interest in a mutual life insurance company is zero. See § 1.6041-1(c) and Rev. Rul. 71-233. Therefore, X is able to determine that the full amount of the cash payments distributed to policyholders in redemption of their membership interests are capital gains that must be included in the policyholders' gross income. X should report these cash payments of fixed or determinable gains, profits, and income of $600 or more in any taxable year on Form 1099-B. However, as to the missing policyholders, X should not report the amounts designated to them at the time of the demutualization because there is no actual or constructive receipt of payments. See §1.6041-1(f).

(3) Section 3406 imposes a requirement that a payor withhold 31 percent of a payment if one of four specified conditions for backup withholding exists. Section 3406(a)(1) provides that backup withholding applies only in the case of a reportable payment. The term "reportable payment" is defined in § 3406(b)(1) as a reportable interest or dividend payment, or any other reportable payment. "[R]eportable interest or dividend payment" is defined in § 3406(b)(2) as any payment required to be shown on a return required under §§ 6049(a), 6042(a), or 6044 (payments in money only). The term "other

reportable payment" is defined in § 3406(b)(3) as a payment that is required to be shown on a return required under §§ 6041, 6041A, 6045, 6050A, or 6050N.

Therefore, the backup withholding rules of § 3406 apply to the distributions in question if they are reportable under one of the above Code sections. Because the distributions of cash to eligible policyholders upon the extinguishment of the membership interests in X are reportable payments under § 6041 (but not as to the missing policyholders), the backup withholding rules of § 3406 apply.

Caveats:

A copy of this letter ruling should be attached to any income tax return to which it is relevant. Enclosed is a copy of the ruling showing the deletions proposed to be made when it is disclosed under § 6110. Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this ruling. This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Sincerely,
Lewis J. Fernandez
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(Income Tax & Accounting)
By: Robert A. Berkovsky
Chief, Branch 2