INTERNAL REVENUE SERVICE
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Legend

X =

P =

Y =

Z =

State A =

State B =

Date a =

Date b =

Date c =

Date d =

Dear

This refers to the letter dated April 14, 1998, and the supplemental submission dated July 10, 1998, requesting 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 is available to X and Z, respectively.

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.

Y is a stock life insurance company. Y is incorporated in State B and is licensed to transact business in all 50 states and the District of Columbia. Y, as the common parent of several life insurance company subsidiaries, files a consolidated federal income tax return with these subsidiaries under § 1504(c)(1).

Z is a stock life insurance company and is a wholly owned subsidiary of Y. Z is incorporated in State B and is licensed to transact business in 27 states. Z is a member of Y's consolidated federal income tax return group.

Background of rehabilitation proceedings

On Date a, P was placed in rehabilitation proceedings under a court order issued by the Superior Court of State A, with State A's Commissioner of Insurance appointed as Rehabilitator. 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.

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 are subject to moratorium amounts which reduce their available account balances subject to withdrawals and surrenders. The moratorium amounts are progressively phased-out over the term of the Moratorium Period provided in the Plan, which begins on Date c and ends on 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, 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. X is currently considering such a sale of assets or stock to an unrelated party.[1]

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[1] If X enters into an agreement to sell substantially all of its assets to a third party, X will cease to operate as a going concern. In this connection, it is anticipated that such an asset sale will result in a revision of the Plan to substitute a date six months after the sale and purchase of assets for Date

Proposed reinsurance transfer

Prior to court approval of the Plan, the Insurance Commissioner of State A had reached an "Asset Agreement" with Y in which Y agreed to assume certain liabilities related to corporate-owned life insurance (COLI) contracts issued by P.[2] This transfer was effected by means of an assumption reinsurance transaction in which Y became directly liable to the business policyholders on the COLI contracts. Simultaneously, Y and P entered into a "Coinsurance Agreement" under which Y agreed to cede back to P approximately 80 percent of the assets and liabilities associated with the COLI contracts. This pair of reinsurance agreements was intended to ensure that the COLI policies would be assumed by a solvent life insurance company while allowing P to participate in the anticipated future expected earnings of the business.

Following court approval of the Plan, X succeeded to P's rights under the "Coinsurance Agreement." Thus, X was credited with approximately 80 percent of the assets and liabilities associated with the COLI contracts assumed by Y under the assumption reinsurance transaction. X and Y also entered into two additional coinsurance agreements in which Y ceded to X a pro rata share of the assets and liabilities on certain of P's group COLI policies that Y had assumed in a subsequent assumption reinsurance transaction.

As part of the Health Insurance Portability and Accountability Act of 1996 (HIPAA), P.L. 104-191, Congress amended § 264 to disallow any deduction for interest on borrowing with respect to life insurance, endowment, and annuity products in which a business taxpayer has an insurable interest, subject to an exception for key person insurance and a phase-out rule. See § 264 of the Code and §§ 501(c)(2) and (3) of HIPAA. The phase-in rule provides that with respect to debt incurred before January 1, 1996, otherwise deductible interest paid or accrued

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d as the closing date of the Rehabilitation Period. In addition, other contemplated amendments to the Plan include the elimination of the moratorium amounts for all policies, excluding a small number of reduced paid-up and reduced face amount policies, and the termination of support payments from the participating guaranty associations. It is represented that none of these contemplated amendments to the Plan will be effective for 1998.

[2] Taxpayers represent that each COLI contract subject to the Asset Agreement and the subsequent Coinsurance Agreement qualifies as a life insurance contract for federal income tax purposes.

after December 31, 1995 is deductible subject to the following percentage limitations: (1) for interest paid or accrued after December 31, 1995 and before January 1, 1997, the percentage is 100 percent; (2) for interest paid or accrued for 1997, the percentage is 90 percent; for interest paid or accrued in 1998, the percentage is 80 percent; and for 1999 and thereafter, the percentage is 0 percent.

As a result of the 1996 legislation, it is expected that surrender benefits and expenses to be paid on the COLI contracts in the future will greatly increase while few, if any, premiums are still being received on the policies.

Under the proposed transaction, X and Z will enter into a Retrocession Agreement which generally will result in the assignment of all of X's rights with respect to the coinsurance of P's former COLI business to Z. The Retrocession Agreement will effect a novation of the Coinsurance Agreements, so that Z will replace X as the reinsurer of the COLI business and Y will consent to the assignment and substitution of Z as the reinsurer with respect to all liabilities and obligations under the Coinsurance Agreements after the novation.

In exchange for the release of its obligations under the Coinsurance Agreements, X will be required to transfer to Z the large amount of assets that X held with respect to the reinsured COLI contracts. Consequently, the Retrocession Agreement will cause X to have net negative consideration, and will cause Z to have net positive consideration for purposes of applying § 1.848-2(f)(2)(i). It is also expected that the net negative consideration resulting from the Retrocession Agreement will cause X to have an excess negative capitalization carryover amount under § 1.848-2(i)(2).

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.[3]

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

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

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.

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 proceeding of P 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 transferred to 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 for the taxable year of the proposed transaction.

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, if as a result of the Retrocession Agreement, X has net negative consideration which results in an excess negative capitalization amount under § 1.848-2(i)(2), X and Z 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 Retrocession Agreement and allows Z 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 Retrocession Agreement is treated as "assumption reinsurance" under § 197(f)(5) for purposes of the capitalization and amortization of any § 197 intangible (such as insurance-in-force) 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 ruling letter should be attached to the federal income tax return of each of the taxpayers that requested the ruling for the taxable year that includes the proposed transaction.

Sincerely yours,

Assistant Chief Counsel
(Financial Institutions & Products)

By: Mark Smith
Mark Smith
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