Section 368.—Definitions Relating to Corporate Reorganizations

26 CFR 1.368–1: Purpose and scope of exception of reorganization exchanges.

Insurance demutualization. This ruling provides guidance as to the tax consequences that occur when, as described in the facts set forth in this ruling, a mutual insurance company converts to a stock insurance company.

Rev. Rul. 2003–19

ISSUE

What are the tax consequences when, as described in the facts below, a mutual insurance company converts to a stock insurance company?

FACTS

In each of the situations described below, Mutual Company is a State Y mutual insurance company that offers life insurance and annuity products. Members of Mutual Company have both membership interests in Mutual Company and contractual rights under either insurance policies or annuity contracts.

A membership interest in Mutual Company arises from the purchase of a life insurance or an annuity contract and is inextricably tied to the contract from the time of purchase. A membership interest in Mutual Company entitles the member to vote for the board of directors and to receive assets or other consideration in the event of the demutualization, dissolution, or liquidation of Mutual Company. The rights inherent in each membership interest are created by operation of State Y law solely as a result of the policyholder's acquisition of the underlying contract from Mutual Company and cannot be transferred separately from that contract. Further, if the contract is surrendered by the policyholder or, in the event the contract is terminated by payment of benefits to the contract beneficiary, these membership interests cease to exist, having no continuing value.

Mutual Holding Company is a mutual insurance holding company. A membership interest in Mutual Holding Company arises from the purchase of a life insurance or an annuity contract from a wholly owned subsidiary of Mutual Holding Company and is inextricably tied to the contract from the time of purchase. A membership interest in Mutual Holding Company entitles the member to vote for the board of directors of Mutual Holding Company and to receive assets or other consideration in the event of the demutualization, dissolution, or liquidation of Mutual Holding Company. The rights inherent in each membership interest are created by operation of State Y law solely as a result of the policyholder's acquisition of the underlying contract from a wholly owned subsidiary of Mutual Holding Company and cannot be transferred separately from that contract. Further, if the contract is surrendered by the policyholder or, in the event the contract is terminated by payment of benefits to the contract beneficiary, these membership interests cease to exist, having no continuing value.

Stock Holding Company is a stock company the articles of incorporation and bylaws of which authorize the issuance of capital stock.

Each transaction described below is undertaken for a valid business purpose.

Situation 1. Pursuant to a plan to convert Mutual Company from a mutual insurance company to a stock insurance company, Mutual Company amends and restates its articles of incorporation and bylaws to authorize the issuance of capital stock and changes its name to Stock Company. Pursuant to State Y law, members of Mutual Company surrender their membership interests in Mutual Company to Stock Company in exchange for all of Stock Company's voting common stock. However, those persons holding Mutual Company membership interests under contracts covered by § 403(b) or § 408(b) of the Income Tax Code receive policy credits in exchange for those interests.

Situation 2. Pursuant to State Y law and pursuant to an integrated plan to convert Mutual Company from a mutual insurance company to a stock insurance company and create a holding company structure, the following events occur. Mutual Company incorporates Mutual Holding Company as a mutual insurance holding company, which, in turn, incorporates Stock Holding Company. Thereafter, the following events occur substantially contemporaneously: Mutual Company amends and restates its articles of incorporation and bylaws to authorize the issuance of capital stock and changes its name to Stock Company; Mutual Company's members receive Mutual Holding Company membership interests in place of their former Mutual Company membership interests; Stock Company issues all of its stock directly to Mutual Holding Company; and Mutual Holding Company transfers all of its Stock Company stock to Stock Holding Company in exchange for voting stock of Stock Holding Company.

After these transactions, the former members of Mutual Company are in control (within the meaning of § 368(c)) of Mutual Holding Company. Mutual Holding Company plans to maintain control (within the meaning of § 368(c)) of Stock Holding Company after these transactions, and Stock Holding Company plans to maintain control (within the meaning of § 368(c)) of Stock Company after these transactions.

Situation 3. Mutual Holding Company owns all of the stock of Stock Holding Company, which owns all of the stock of Stock Company 1, a stock insurance company that offers life insurance and annuity products. Pursuant to State Y law and pursuant to an integrated plan to acquire Mutual Company, the following events occur substantially contemporaneously: Mutual Company amends and restates its articles of incorporation and by-laws to authorize the issuance of capital stock and changes its name to Stock Company 2; Mutual Company's members receive Mutual Holding Company membership interests in place of their former Mutual Company membership interests; Stock Company 2 issues all of its stock directly to Mutual Holding Company; and Mutual Holding Company transfers all of its Stock Company 2 stock to Stock Holding Company in exchange for voting stock of Stock Holding Company.

After these transactions, the former members of Mutual Company are not in control (within the meaning of § 368(c)) of Mutual Holding Company. Mutual Holding Company plans to maintain control (within the meaning of § 368(c)) of Stock

Holding Company after these transactions, and Stock Holding Company plans to maintain control (within the meaning of § 368(c)) of Stock Company 2 after these transactions.

In Situations 1 and 2, under State Y law, Stock Company's corporate existence as a stock insurance company is a continuation of Mutual Company's corporate existence as a mutual insurance company. In Situation 3, under State Y law, Stock Company 2's corporate existence as a stock insurance company is a continuation of Mutual Company's corporate existence as a mutual insurance company. In Situations 1, 2, and 3, the conversion of Mutual Company from a mutual insurance company to a stock insurance company does not affect any of its policies in force as of the time of the conversion nor the policyholders' rights to receive any policy dividends thereunder. Moreover, after the transactions, Stock Company has no plan or intention to terminate or dispose of the policies in force as of the time of the conversion other than pursuant to their own terms. After the conversions, Stock Company and Stock Company 2 continue to offer life insurance and annuity products.

LAW

Section 351(a) provides that no gain or loss will be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation and immediately after the exchange such person or persons are in control (as defined in § 368(c)) of the corporation.

Section 368(a)(1)(B) provides that the term reorganization means the acquisition by one corporation, in exchange solely for all or a part of its voting stock (or in exchange solely for all or a part of the voting stock of a corporation which is in control of the acquiring corporation), of stock of another corporation if, immediately after the acquisition, the acquiring corporation has control of such other corporation (whether or not such acquiring corporation had control immediately before the acquisition).

Section 368(a)(1)(E) provides that the term reorganization includes a recapitalization. In *Helvering v. Southwest Consol. Corp.*, 315 U.S. 194, 202 (1942), the Supreme Court defined a recapitalization as a "reshuffling of a capital structure within the framework of an existing corporation."

Section 368(a)(1)(F) provides that the term reorganization means a mere change in identity, form, or place of organization of one corporation, however effected.

Section 354(a) provides that, in general, no gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

Section 368(a)(2)(C) states, in relevant part, that a transaction otherwise qualifying under § 368(a)(1)(B) will not be disqualified by reason of the fact that part or all of the stock that was acquired in the transaction is transferred to a corporation controlled by the corporation acquiring such stock.

Section 1.368–2(k)(1) of the Income Tax Regulations restates the general rule of § 368(a)(2)(C) but permits the assets or stock acquired in certain types of reorganizations, including reorganizations under section 368(a)(1)(B), to be successively transferred to one or more corporations controlled (as defined in § 368(c)) in each transfer by the transferor corporation without disqualifying the reorganization.

Generally, to qualify as a reorganization under § 368(a)(1), a transaction must satisfy the continuity of business enterprise (COBE) requirement. Section 1.368–1(d)(1) provides that COBE requires the issuing corporation (generally the acquiring corporation) in a potential reorganization to either continue the target corporation's historic business or use a significant portion of the target's historic business assets in a business. Pursuant to § 1.368–1(d)(4)(i), the issuing corporation is treated as holding all of the businesses and assets of all members of its qualified group. Section 1.368–1(d)(4)(ii) defines a qualified group as one or more chains of corporations connected through stock ownership with the issuing corporation, but only if the issuing corporation owns directly stock meeting the requirements of § 368(c) in at least one other corporation, and stock meeting the requirements of § 368(c) in each of the corporations (except the issuing corporation) is owned directly by one of the other corporations. Continuity of business enterprise is not required for a recapitalization to qualify as a reorganization under § 368(a)(1)(E). *See* Rev. Rul. 82–34, 1982–1 C.B. 59.

Generally, to qualify as a reorganization under § 368(a)(1), a transaction must satisfy the continuity of interest requirement. Section 1.368–1(e)(1)(i) provides that continuity of interest requires that in substance a substantial part of the value of the proprietary interests in the target corporation be preserved in the reorganization. All facts and circumstances must be considered in determining whether, in substance, a proprietary interest in the target corporation is preserved. Continuity of interest is not a requirement for reorganizations under § 368(a)(1)(E). *See* Rev. Rul. 77–415, 1977–2 C.B. 311.

In *Paulsen v. Commissioner*, 469 U.S. 131 (1985), a state-chartered stock savings and loan association merged into a federally-chartered non-stock mutual savings and loan association. The stockholders exchanged all of their stock in the state-chartered stock savings and loan association for passbook savings accounts and certificates of deposit in the federally-chartered non-stock mutual savings and loan association. The Supreme Court determined that the passbooks and certificates of deposit in the federally-chartered non-stock mutual savings and loan association had a predominantly cash-equivalent component and an insubstantial equity component. Because the passbooks and certificates of deposit essentially represented cash with an insubstantial equity component, the Court held that the transaction did not satisfy the continuity of interest requirement and, therefore, did not qualify as a tax-free reorganization.

In Rev. Rul. 69–3, 1969–1 C.B. 103, X, a mutual savings and loan association, merged into Y, another mutual savings and loan association. In the merger, Y issued to each share account holder of X a share account equal to the dollar amount evidenced by such holder's passbook. Because the share account holders of X received proprietary interests in Y that were equivalent to their equity interests in X before the exchange, the exchange was solely an equity-for-equity exchange that satisfied the continuity of interest requirement. Accordingly, the Service ruled that the transaction qualified as a tax-free reorganization under § 368(a)(1)(A).

Section 403(b)(1) provides, in general, that certain amounts contributed to an annuity contract that satisfies the requirements of § 403(b) are taxable to the distributee under § 72 in the year actually distributed. Similarly, § 408(d) provides, in general, that any amount paid or distributed out of an individual retirement plan is included in gross income by the payee or distributee, as the case may be, in the manner provided under § 72.

ANALYSIS

Situation 1. Because Stock Company is the same corporation as Mutual Company under State Y law, the conversion from a mutual insurance company to a stock insurance company is a reorganization under § 368(a)(1)(E) as well as a reorganization under § 368(a)(1)(F), and the exchange by members of their Mutual Company membership interests for stock in Stock Company is pursuant to that reorganization.

Those persons holding Mutual Company interests under contracts covered by § 403(b) or § 408(b) who receive only policy credits in the conversion are treated as receiving those policy credits in redemption of their Mutual Company interests. However, pursuant to §§ 403(b)(1) and 408(d), no amount credited to the account of a policyholder under a § 403(b) contract or under a § 408(b) contract is taxable until actually distributed to the policyholder or to a beneficiary under the contract in accordance with § 72.

Situation 2. As in Situation 1, because Stock Company is the same corporation as Mutual Company under State Y law, the conversion from a mutual insurance company to a stock insurance company is a reorganization under § 368(a)(1)(E) as well as a reorganization under § 368(a)(1)(F). This conclusion is not altered by the fact that there is a subsequent change in the direct ownership of the converted company. *See* § 1.368–1(e)(1); Rev. Rul. 96–29, 1996–1 C.B. 50; Rev. Rul. 77–415, 1977–2 C.B. 311.

Each of the membership interests in Mutual Company and Mutual Holding Company constitutes a proprietary interest in the entities that is treated as voting stock. *See* Rev. Rul. 69–3, 1969–1 C.B. 103. Because Mutual Holding Company acquires, in exchange solely for membership interests in Mutual Holding Company, either an interest equivalent to the stock of Stock Company or the actual stock of Stock Company, and, immediately after that acquisition, Mutual Holding Company controls Stock Company, that acquisition qualifies as a reorganization under § 368(a)(1)(B), provided that the continuity of business enterprise and continuity of interest requirements are satisfied. Because Stock Company continues to offer life insurance and annuity products after the transactions described herein, the continuity of business enterprise requirement is satisfied. *See* § 1.368–1(d)(1). In addition, the acquisition satisfies the continuity of interest requirement because, in the overall transaction, the Mutual Company members receive Mutual Holding Company membership interests in place of their former Mutual Company membership interests. *See* Rev. Rul. 69–3, 1969–1 C.B. 103; *cf. Paulsen v. Commissioner*, 469 U.S. 131 (1985). Thus, the acquisition qualifies as a reorganization within the meaning of § 368(a)(1)(B). Moreover, Mutual Holding Company's subsequent transfer of the Stock Company stock to Stock Holding Company does not prevent the acquisition from qualifying as a reorganization under § 368(a)(1)(B). *See* § 368(a)(2)(C); § 1.368–1(d)(4)(i); § 1.368–2(k).

For purposes of § 354, the former Mutual Company's members' exchange of their ownership interests for Mutual Holding Company membership interests is pursuant to that reorganization. That exchange also qualifies as a transfer described in § 351, even though Mutual Holding Company transfers all of its Stock Company stock to Stock Holding Company. *See* Rev. Rul. 77–449, 1977–2 C.B. 110.

Finally, because Stock Holding Company acquires in exchange solely for voting stock the stock of Stock Company and, immediately after that acquisition, Stock Holding Company controls Stock Company, that acquisition qualifies as a reorganization under § 368(a)(1)(B). For purposes of § 354, Mutual Holding Company's exchange of stock of Stock Company for stock of Stock Holding Company is pursuant to that reorganization. In addition, that exchange qualifies as a transfer described in § 351.

Situation 3. For the reasons described in the analysis of Situation 2, the conversion from Mutual Company to Stock Company 2 qualifies as a reorganization under § 368(a)(1)(E) as well as a reorganization under § 368(a)(1)(F). In addition, Mutual Holding Company's acquisition, in exchange solely for membership interests in Mutual Holding Company, of either an interest equivalent to the stock of Stock Company 2 or the actual stock of Stock Company 2 qualifies as a reorganization under § 368(a)(1)(B). For purposes of § 354, the former Mutual Company's members' exchange of their ownership interests for Mutual Holding Company membership interests is pursuant to that reorganization. Finally, Mutual Holding Company's transfer of its Stock Company 2 stock to Stock Holding Company qualifies as a reorganization within the meaning of § 368(a)(1)(B) and as a transfer described in § 351.

HOLDING

This revenue ruling describes the tax consequences that occur when, as described in the facts set forth in this ruling, a mutual insurance company converts to a stock insurance company. The same analysis with respect to subchapter C also would apply if Mutual Company had offered only property and casualty insurance products and not life insurance and annuity products.

The transactions described in Situations 1, 2, and 3 have no effect on the date each life insurance and annuity contract of Mutual Company was issued, entered into, purchased or came into existence for purposes of §§ 72(e)(4), 72(e)(5), 72(e)(10), 72(e)(11), 72(q), 72(s), 72(u), 72(v), 101(f), 264(a)(3), 264(a)(4), 264(f), 7702 and 7702A. Furthermore, the transactions do not require retesting or the starting of new test periods for contracts under §§ 264(d)(1), 7702(f)(7)(B) through (E) and 7702A (c)(3)(A).

The transactions described in Situations 1, 2, and 3 have no effect on each life insurance or annuity contract that is part of a qualified plan within the meaning of § 401(a) or that meets the requirements of § 403(b) or § 408(b) for purposes of §§ 72(e)(5), 401, 402, 403, 408 and 408A. These transactions do not result in a distribution in violation of § 403(b)(11) or otherwise disqualify a § 403(b) contract under § 403(b). Similarly, these transactions do not result in an actual or deemed distribution in violation of § 401(k)(2)(B) or otherwise disqualify a qualified cash or deferred arrangement within the meaning of § 401(k). These transactions do not con-

stitute, with respect to policies issued by Mutual Company and in force prior to the effective date of the reorganizations and that are tax-qualified under § 401(a) or meet the requirements of § 403(b) or § 408(b), a distribution from or a contribution to any of these policies, plans or arrangements for federal income tax purposes. Finally, the transactions described in Situations 1, 2, and 3 do not result in a distribution and, thus, do not result in: (a) any gross income to the employee or the beneficiary of a contract as a distribution from a qualified retirement plan under § 72, prior to an actual receipt of some amount therefrom by such employee or beneficiary; (b) any 10 percent additional tax under § 72(t) for premature distributions from a qualified retirement plan; (c) any 6 percent or 10 percent excise tax under §§ 4973 or 4979, respectively, for excess contributions to certain qualified retirement plans; or (d) a designated distribution under § 3405(e)(1)(A) that is subject to withholding under § 3405(b) or (c).

DRAFTING INFORMATION

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