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INSURANCE COMPANY DEMUTUALIZATIONS AND THEIR TAX CONSEQUENCES

An increasing number of mutual insurance companies are converting to stock companies. As a result, there are more and more questions from those holding policies issued by mutual insurance companies about the demutualizations, as the conversions are called, and about the tax consequences that may flow from them. Hopefully, this explains the basics of demutualizations and their tax consequences to policyholders.

MUTUAL AND STOCK COMPANIES COMPARED

- Mutual insurance companies are owned by their policyholders, whose “membership interests” give them the right to vote on corporate governance issues. Mutual insurance companies can only raise capital by retaining earnings or charging excess premiums. They generally are subject to comprehensive regulation by state authorities. Stock insurance companies, on the other hand, are owned by their shareholders. They can raise capital more easily by selling stock on the open market. In addition, they can diversify more easily by creating upstream holding companies which can own subsidiaries engaged in other businesses.

DRIVE BEHIND DEMUTUALIZATION

- Demutualization has become increasingly common over the past several years. The process has been facilitated by state legislatures, which have passed statutes to permit the conversions. The drive behind demutualization has been to gain the capital raising and diversification opportunities enjoyed by stock companies. The process also was aided by the passage of the Gramm-Leach-Biley Act of 1999, which removed restrictions on affiliations between insurance and banking institutions. It also allows a mutual insurance company barred from demutualizing under state law to redomesticate to a state that permits demutualization.

FORMS OF DEMUTUALIZATION

- Demutualization can take different forms. Two common types are (1) full demutualization and (2) mutual holding company conversion. In general, either type must be approved by at least two-thirds of eligible policyholders who vote and by the applicable state insurance authority.

  With a full demutualization, the company is transformed into a stock company and its surplus is distributed to policyholders as stock, cash or policy credits. Each policyholder's share of the distribution is determined under an allocation formula devised by the company and reviewed by state insurance regulators. Contract rights under policies are unaffected.

  In a mutual holding company conversion, the original mutual insurance company becomes a stock insurance company that is wholly owned by a mutual holding company. Policyholders' membership rights are transferred to the mutual holding company in exchange for membership interests in it. Policyholders don't get stock, cash or policy credits but may get them at a later date if the mutual holding company decides to go ahead with a full demutualization. As with a full demutualization, contract rights aren't affected.

Either type of demutualization can ultimately be accompanied by a public offering of stock.

TAX CONSEQUENCES FOR POLICYHOLDERS RECEIVING STOCK OR CASH

IRS has issued a number of private letter rulings in which a conversion from a mutual life insurance company to a stock life insurance company in which policyholders exchange their membership interests in the company for stock is treated as a tax-free recapitalization with these results for policyholders:

... They don't recognize gain or loss on their exchange of membership interests for company stock under Code Sec. 354(a)(1) .
... Under Code Sec. 1223(1), their holding period for the stock includes the period they held the membership interest if it was held as a capital asset on the date of the exchange.
... The basis of a policyholder's membership interest is zero. Thus, under Code Sec. 358(a)(1), the basis of stock received in exchange for the membership interest also is zero.
... Policyholders receiving cash for their membership interests generally recognize capital gain under Code Sec. 302 and Code Sec. 1001. As noted above, the period the policy was held is taken into account in determining whether the gain is long-term or short term.
... A policyholder who receives stock and later sells it will have capital gain. It will be long-term if the combined holding period of the policy and the stock is more than 1 year.

TAX CONSEQUENCES OF POLICY CREDITS

In some demutualizations, policy credits are issued with respect to annuity contracts held by retirement plans, IRAs, Code Sec. 403(a) annuity plans, and Code Sec. 403(b) tax-sheltered annuity plans. The credits don't affect the qualified status of any these tax-favored retirement vehicles and they are not treated as distributions or contributions that could trigger income or excise taxes such as the early withdrawal penalty. Furthermore, the IRA owner, plan participant, etc., is not treated as realizing current income on account of the credits and gets no basis for them. The credits are treated as investment earnings of the plan, etc. in the year issued.