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FINANCING ACQUISITIONS BY LIFE INSURANCE COMPANIES IN INSURANCE HOLDING COMPANY SYSTEMS¹

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This article compares the use of preferred stocks and surplus notes² by a life insurance company (the "Insurer"), which is a wholly-owned subsidiary of a business corporation (the "Parent"), to create additional surplus to compensate for the reduction of surplus that may result from the Insurer's cash purchase of all of the stock of another life insurance company (the "Subsidiary").³

The admissible carrying value of a Subsidiary is equal to the Subsidiary's net statutory capital and surplus.⁴ When the purchase price paid by the Insurer exceeds the Subsidiary's net statutory capital and surplus,⁵ the excess is nonadmitted. This results in the Insurer's surplus being reduced by the amount of the nonadmitted purchase price.⁶ To prevent a reduction in surplus, the Insurer typically uses its own assets to fund the admitted part of the purchase price and issues a surplus note or preferred stock to the Parent to fund the nonadmitted part of the purchase price.

If the Parent borrows the monies it pays to the Insurer, it may pledge the surplus note or the preferred stock as collateral on the loan, and it may use the interest and principal payments on the surplus note or the dividend and redemption payments on the preferred stock to repay the loan.

The following is a discussion of some of the factors that should be considered in determining whether the Insurer should issue a surplus note or preferred stock.

Surplus Notes. A surplus note is an unsecured promissory note on which the principal and interest is payable only out of the Insurer's surplus in excess of a stipulated amount. The form and content of a surplus note must be approved by the insurance regulatory authorities of the Insurer's domiciliary state (hereinafter referred to as the "Commissioner").⁷

A surplus note must provide that no payments of interest or principal can be made without the prior approval of the Commissioner and, in the event of the liquidation of the Insurer, all claims under the surplus note must be subordinated to policyholder, claimant and beneficiary claims as well as debts owed to all other classes of creditors, other than the surplus note holders. The surplus note may also provide that it is superior to the claims of the Insured's common and preferred stockholders.

A surplus note is treated as equity⁸ for statutory accounting purposes.⁹ However, if it has a fixed amortization schedule and is otherwise properly constructed and used to meet or maintain surplus requirements mandated by state statutes, it is treated as debt for federal income tax purposes.¹⁰

Interest and principal on a surplus note can be paid out of any available surplus to the extent approved by the Commissioner. After the Commissioner approves a payment of interest or principal, the amount approved constitutes a liability of the Insurer until paid. Under statutory accounting practices, interest payments on a surplus note reduce the Insurer's net gain from operations and principal payments on a surplus note reduce the Insurer's surplus.

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Preferred Stocks. The Insurer's articles of incorporation may initially authorize, or may be amended to authorize, the issuance of one or more classes of preferred stock with specific characteristics or may authorize a series of preferred stock with the classes and specific characteristics of each class determined by the Insurer's board of directors, subject to the approval of the Commissioner.¹¹

Preferred stock is limited and preferred over common stock, and any given class of preferred stock may be limited and preferred over other classes of preferred stock, as to the payment of dividends and liquidating distributions. Preferred stock may or may not be voting, redeemable or convertible. Dividends on preferred stock may be cumulative or non-cumulative.

If the Insurer sells preferred stock to its Parent for \$100 per share, the preferred stock typically would have a par value from \$1 to \$50 per share and be (i) nonvoting, (ii) entitled to discretionary non-cumulative dividends at an annual rate of \$6 to \$9 per share, payable quarterly, (iii) redeemable from time to time at the Insurer's option for \$100 per share¹², (iv) entitled to a liquidation preference of \$100 per share, and (v) nonconvertible.¹³

Under the insurance laws, dividends paid on preferred stock are subject to the same restrictions as dividends paid on common stock, both as to the source from which the dividends can be paid as well as the amount of dividends that can be paid without obtaining the Commissioner's consent. Approximately 27 states permit the payment of dividends only out of surplus funds derived from the insurer's profits and no distinction is made for dividends on common and preferred stocks. The remaining states permit the payment of dividends out of any available surplus.¹⁴

While payments made for the redemption of preferred stock are distributions within the meaning of the provisions in most, if not all, insurance codes relating to the payment of extraordinary dividends and other extraordinary distributions,¹⁵ such payments are not dividends.¹⁶ Therefore, in all states, preferred stock redemption payments should be able to be made out of any available surplus funds.

Under statutory accounting practices, dividends and redemption payments on preferred stock reduce the Insurer's surplus, but not its net gain from operations.

Federal Income Taxes. If the Parent and the Insurer file a consolidated federal income tax return, most intercompany distributions can be received tax-free and the gain or loss on most intercompany transactions is deferred for federal income tax purposes. The end tax effect of paying all of the interest and principal due on a surplus note and paying dividends on and redeeming all of the preferred stock would not be significantly different.¹⁷

If the Parent purchases a surplus note from the Insurer for cash, the Parent's original tax basis in the surplus note is equal to its cost. If the Parent and the Insurer file separate federal income tax returns, interest payments on the surplus note are deductible by the Insurer and taxable to the Parent as ordinary income.¹⁸ Principal payments on the surplus note are not deductible by the Insurer or taxable to the Parent.

If the Parent purchases preferred stock issued by the Insurer for cash, the Parent's original tax basis in the preferred stock is equal to its cost. However, if the Parent and the Insurer file separate federal income tax returns, the tax treatment of dividends paid on the preferred stock and monies paid for the redemption of preferred stock is different than the tax treatment of principal and interest paid on a surplus note.

Payments made as dividends or for the redemption of preferred stock are not deductible to the Insurer. Furthermore, under 302 of the Internal Revenue Code of 1986, as amended, ("IRC") payments made to the Parent to redeem the Insurer's preferred stock are taxable as dividends if paid out of the Insurer's accumulated and current earnings and profits ("Earnings and Profits").¹⁹

Dividend and redemption payments made out of a corporation's Earnings and Profits²⁰ are normally taxable as ordinary income to the recipient; but, dividend and redemption payments made by the Insurer out of its Earnings and Profits are not taxable to the Parent because of the 100% dividends received deduction provided by IRC 243.²¹ However, if the dividend and redemption payments made out of Earnings and Profits are deemed to be preferred extraordinary dividends within the meaning of IRC 1059,²² the Parent's tax basis in the shares of the Insurer with respect to which the dividend and redemption payments are made is reduced, but not below zero, by the amount which the extraordinary dividend and redemption payments are exempted from tax under IRC 243. Extraordinary dividend and redemption payments which exceed the Parent's tax basis are taxable as capital gains.

Dividend and redemption payments not made out of the Insurer's Earnings and Profits reduce the Parent's tax basis in the shares of the Insurer with respect to which the dividend and redemption payments are made, but not below zero. Dividend and redemption payments in excess of the Parent's tax basis are taxable as capital gains.²³

Advantages and Disadvantages

The non-tax advantages and disadvantages of using a surplus note are (i) principal and interest can be paid out of any available surplus if approved by the Commissioner, (ii) interest payments reduce the Insurer's net gain from operations, (iii) principal payments reduce the Insurer's surplus, and (iv) a surplus note with a fixed amortization schedule may have an adverse affect on the Insurer's ratings.

The non-tax advantages and disadvantages of using preferred stock are (i) in some states dividends can be paid only out of surplus funds derived from the insurer's profits, (ii) redemption payments can be made out of any available surplus, (iii) extraordinary dividend and redemption payments must be approved by the Commissioner, (iv) dividend and redemption payments do not reduce the Insurer's net gain from operations, (v) dividend and redemption payments reduce the Insurer's surplus, and (vi) preferred stock without fixed redemption dates should not adversely affect an Insurer's ratings.

The tax advantages and disadvantages of using a surplus note are (i) interest payments are deductible to the Insurer and taxable to the Parent as ordinary income, and (ii) principal payments are not deductible to the Insurer or taxable to the Parent.

The tax advantages and disadvantages of using preferred stock are (i) dividend/redemption payments, whether or not made out of the Insurer's Earnings and Profits, are not taxable as ordinary income,²⁴ (ii) dividend/redemption payments made out of the Insurer's Earnings and Profits are taxable as capital gains, but only to the extent that the dividend/redemption payments are deemed to be extraordinary preferred dividends and exceed the Parent's tax basis in the shares being redeemed,²⁵ and (iii) dividend/redemption payments not made out of the Insurer's Earnings and Profits are taxable as capital gains, but only to the extent that the dividend/redemption payments exceed the Parent's tax basis in the shares being redeemed.

Mergers

The foregoing discussion is based on the Parent's cash purchase of a surplus note or preferred stock from the Insurer followed by the Insurer's cash purchase of all of the stock of the Subsidiary. After the purchase of the Subsidiary is consummated, it may be desirable to merge the Subsidiary into the Insurer.²⁶ If the Subsidiary is merged upstream into the Insurer, the merger would be tax-free, whether or not the Parent and Subsidiary file a consolidated tax return.²⁷

If the Insurer's investment in the Subsidiary would exceed the applicable investment limitations²⁸ the Parent could purchase part of the Stock of the Subsidiary and subsequently exchange the Subsidiary's stock for a surplus note or preferred stock of the Insurer in connection with a merger of the Subsidiary into the Insurer. However, the merger would not be tax-free because the required continuity of interest would not be present.²⁹ Also, the issuance of a surplus note or nonqualified preferred stock³⁰ in the merger would be taxable as boot under IRC 356.³¹

A merger would be feasible from a tax point of view if the Parent and the Insurer filed a consolidated federal income tax return, because any adverse tax consequences would be eliminated in the consolidation. It would also be feasible if the Parent's tax basis in the shares of the Subsidiary is equal to or greater than the fair market value of the surplus note or preferred stock received by the Parent in the merger. Otherwise, a merger of the Subsidiary into the Insurer should not be

preferred stock received by the Parent in the merger. Otherwise, a merger of the Subsidiary into the Insurer should not be effected unless the Parent is willing to incur adverse tax consequences.

Conclusion

The structure of each acquisition and merger must be based on the facts and circumstances relating to that specific transaction. Structuring acquisitions and mergers involves complex legal, accounting and tax issues and should be undertaken only by a team of professionals experienced in insurance regulatory law, corporate law, insurance accounting and corporate taxation.

Endnotes

1. This article is intended to assist readers as a learning aid. It does not constitute legal advice. The author encourages all readers to verify all of the information contained herein by reviewing the original sources of such information.

2. Surplus notes are sometimes called surplus debentures, subordinated debentures, contribution certificates or capital notes.

3. Unless otherwise indicated, the Insurer's investment in the Subsidiary is deemed to be permitted under the applicable Insurance Holding Company Systems Regulatory Act. *See Note 27 infra.*

4. *See NAIC Accounting Practices and Procedures Manual for Life, Accident and Health Insurance Companies*, Chapter 6.

5. The purchase price of a life insurance company (the "Target") is generally an amount equal to the Target's formula adjusted capital and surplus plus the value of the Target's in-force insurance policies and contracts, agency operations and state licenses. The formula for determining adjusted capital and surplus is subject to negotiation, but generally consists of the Target's net statutory capital and surplus (x) plus (i) its asset valuation reserve and statement value interest maintenance reserve, (ii) a negotiated percentage of its net agents' debit balances, (iii) its non-deduction reserve reported on Page 14, Line 070002 of the annual statement blank, and (iv) certain of its nonadmitted assets, and (y) plus or minus the difference between the Target's statement value adjusted capital and surplus and the market value of the assets backing the adjusted capital and surplus. Thus, the amount of the Target's net statutory capital and surplus will usually be substantially less than the total purchase price.

6. The same surplus effect occurs whether the Subsidiary is carried as a separate entity or subsequently merged into the Insurer.

7. Life-health insurance companies had \$10.9 billion of surplus notes outstanding at December 31, 1996. *See The Insurance Forum*, Vol. 24, No. 12, December 1999.

8. The issuance of a surplus note with a fixed amortization schedule could adversely affect the rating assigned to the Insurer by various rating agencies because the Insurer's surplus may not be expected to increase significantly until the surplus note has been repaid.

9. *See NAIC Accounting Practices and Procedure Manual for Life, Accident and Health Insurance Companies*, Chapter 27.

10. *See Jones v. United States*, 659 F.2d 618 (5th Cir. 1981) and *Harlan v. United States*, 409 F.2d 904 (5th Cir. 1969).

11. At December 31, 1996, life-health insurance companies had preferred stock outstanding with an aggregate par/stated value of more than \$10 billion. *See Best's Insurance Reports, Life-Health*, 1997

aggregate par/stated value of more than \$10 billion. *See Best's Insurance Reports, Life-Health*, 1997 Edition.

12. If the insurance laws governing the Insurer do not prohibit the Insurer from acquiring its own stock without the prior approval of the Commissioner, the Commissioner may require that the Insurer's Articles of Incorporation provide that the preferred stock cannot be redeemed without the prior approval of the Commissioner.

13. If the Parent defaults on a loan secured by the preferred stock, the acquisition-of-control provisions under the applicable Insurance Holding Company System Regulatory Act (the "Act") could be triggered if the preferred stock is voting or is convertible into a voting common stock. For this reason, the preferred stock should be nonvoting and nonconvertible or, if convertible, the right to convert should be conditioned upon compliance with the Act.

14. *See "Funds Available to Life Insurance Companies for the Payment of Cash Dividends to Shareholders"*, *FORC Quarterly Journal of Insurance Law and Regulation*, Vol. VII, Edition 1, March 11, 1995.

15. *See NAIC Model Insurance Holding Company System Regulatory Act*, 5.B.

16. 1.4(6) of the 1991 Supplement to the American Bar Association's *Model Business Corporation Act*, as well as the general corporation laws of many states, provide, "'Distribution' means a direct or indirect transfer of money or property (except its own shares) or incurrence of indebtedness by a corporation to or for the benefit of its shareholders in respect of any of its shares. A distribution may be in the form of a declaration or payment of a dividend; a purchase, redemption, or other acquisition of shares; a distribution of indebtedness; or otherwise."

17. Under 1504 of the *Internal Revenue Code of 1986*, as amended, (*IRC*), the Parent and the Insurer would qualify to file a consolidated federal income tax return if, for a period of at least five years preceding the year for which the consolidated return is filed, the Parent owned stock representing at least 80% of the voting power and at least 80% of the total value of all of the stocks of the Insurer. Certain preferred stocks are not deemed to be stock for the purpose of *IRC* 1504.

18. No deduction is allowed for interest paid or accrued in equity of the issuer or a related party. *IRC* 163(1). However, such payments are taxable to the holder of the note.

19. *IRC* 302 and *Regs.* 1.302.2(b).

20. *IRC* 316(a). For a discussion on the calculation of earnings and profits, *see* Bittner and Eustice, *Federal Income Taxation of Corporations and Shareholders*, Sixth Edition, 8.03.

21. *IRC* 243(a)(3) permits a 100% deduction for certain intercorporate dividends received from a member of the same affiliated group.

22. Under *IRC* 1059, an extraordinary preferred dividend is any preferred dividend of more than 5% received during the first five years that the preferred stock is held. For the purpose of calculating the amount of the dividend, the aggregate preferred dividends received during any 85-day period are deemed to constitute a single dividend and the aggregate preferred dividends received during any 365-day period are deemed to constitute a single dividend if they total more than 20%.

23. *IRC* 302(a).

24. Dividend/redemption payments taxed as capital gains could be offset by any capital losses available to the Parent. Otherwise, the distinction between ordinary income and capital gains is academic because the

the Parent. Otherwise, the distinction between ordinary income and capital gains is academic because the corporate tax rates on ordinary income and capital gains are the same.

25. By proper timing, the Insurer could prevent the dividend/redemption payments from being deemed extraordinary preferred dividends under *IRC* 1059. If the Insurer paid preferred dividends of not more than 5% each fiscal quarter, the dividends would not constitute extraordinary preferred dividends unless the shares of preferred stock with respect to which the dividends are paid are redeemed within 85 days after the payment of the dividend.

26. The Subsidiary cannot be included in the consolidated tax return filed by the Parent and the Insurer until it is owned by the Insurer for five years. *See Note 17 infra.*

27. The merger of the Subsidiary into the Insurer would be deemed to be a liquidation for tax purposes and would be tax-free under *IRC* 332.

28. 2.B.(1) of the NAIC model *Insurance Holding Company System Regulatory Act* (the "Act") permits an insurer to invest in stock and debt obligations of one or more subsidiaries amounts which do not exceed the lesser of ten percent (10%) of the insurer's assets or fifty percent (50%) of the insurer's surplus as regards policyholders, provided that after the investment the insurer's surplus as regards policyholders is reasonable in relation to the insurer's liabilities and adequate to meet its financial needs. 2.B.(3) of the Act permits the insurer to invest a greater amount if approved by the Commissioner.

29. If the Insurer purchased 80% or more of the stock of the Subsidiary, a merger of the Subsidiary into the Insurer would qualify as a tax-free liquidation under *IRC* 332 with respect to the Insurer, but the merger would not be tax free with respect to the Parent. *See Bittner and Eustice, Federal Income Taxation of Corporations and Shareholders*, Sixth Edition, 12.21.

30. A "nonqualified preferred stock" is preferred stock that (i) is redeemable at the option of the holder, or (ii) the issuer is required to redeem, or (iii) the issuer has a right to redeem and it is more likely than not that the right will be exercised, or (iv) the dividend rate varies with reference to interest rates, commodity prices or similar indices. *See IRC* 351(g).

31. Under *IRC* 356, boot is taxable if the fair market value of the boot received by the taxpayer exceeds the taxpayer's basis in the stock or securities exchanged for the boot. It is taxed as a dividend to the extent of the taxpayer's ratable share of the issuer's accumulated, but not current, earnings and profits. Any excess is taxed as a capital gain. Corporation distributees are entitled to the dividend received deduction under *IRC* 243. *See Note 20 supra.*