DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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Contact Person:

Identification Number:

Contact Number:

T:EO:B4

Employer Identification Number:

Legend:

M =
N =
O =
P =

Ladies and Gentlemen:

This is in response to a letter dated August 31, 2001, from your authorized representatives, who have requested certain rulings on your behalf. This letter addresses issues arising in connection with the merger of N into M, including the treatment under sections 501(c)(8), 511 through 514, and other provisions of the Internal Revenue Code (the Code).

Facts:

Our records indicate that M is exempt from federal income tax under section 501(a) of the Code as a fraternal beneficiary society described in section 501(c)(8). M's local and subordinate units are also described in section 501(c)(8). M provides its members with fraternal benefits and offers life, sick, accident, or other benefits to its members in accordance with section 501(c)(8). M has a number of wholly owned taxable subsidiaries. Our records also indicate that N is exempt from federal income tax under section 501(a) as a fraternal beneficiary society described in section 501(c)(8). N's local and subordinate units are also described in section 501(c)(8). N offers life, sick, accident, or other benefits to its members in accordance with section 501(c)(8), as well as fraternal benefits to its members. N also has a number of wholly owned taxable subsidiaries, including O.

M's Articles of Incorporation provide that its purposes are to bring together individuals who share a common bond and their families with similar individuals and their families, to offer membership in a fraternal beneficiary society, and to assist members and others. M's articles

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also refer to its involvement in a number of endeavors, including those of a charitable, religious, and educational nature.

N's Articles of Incorporation provide that its purposes revolve around service to its members and include those of a charitable, religious, and educational nature. N's articles refer to providing life, sick or accident benefits to its members.

As stated in the Agreement and Plan of Merger between M and N and in accordance with the applicable insurance laws, N will be merged with and into M, and the separate existence of N will cease. Upon effectiveness of the Merger, N's contracts and certificates will be converted into corresponding contracts and certificates of M as the surviving corporation. Each member of N will automatically become a member of M as the surviving corporation. M, as the survivor of the Merger and the successor to N, will assume all obligations of N, including the obligations under the insurance and annuity contracts that were issued by N (N's Policies). No formal exchange of insurance and annuity contracts and certificates will occur due to the Merger. As of the effectiveness of the Merger, M will issue endorsements to N's Policies, pursuant to which N's Policies will be converted into corresponding insurance and annuity contracts and certificates of M as the surviving corporation.

As represented, the Merger and the endorsements to N's Policies issued by M will not change the terms of any of N's Policies except, as the law requires, the Articles of Incorporation and Bylaws of M will become part of N's Policies. Similarly, the substitution of M's Articles of Incorporation and Bylaws for N's Articles of Incorporation and Bylaws will not change in any material respect the terms and conditions of N's Policies and the policyholders' rights and obligations under N's Policies. Except for the substitution of M's Articles and Bylaws, all of the terms of N's Policies, including the terms, conditions, rights and obligations concerning premiums, benefits, cash surrender values, charges, annuity options, surrender rights, interest and mortality assumptions and policy loan provisions will remain the same after the Merger and the issuance of the endorsements.

As represented, the Merger and the endorsements to N's Policies issued by M will not change the terms of any of N's Policies, except, as the law requires, M's Articles and Bylaws will become part of N's Policies. Similarly, the substitution of M's Articles and Bylaws for N's Articles and Bylaws will not change in any material respect the terms and conditions of N's Policies. Except for the substitution of M's Articles and Bylaws, all of the terms of N's Policies, including the terms, conditions, rights and obligations concerning premiums, benefits, cash surrender values, charges, annuity options, surrender rights, interest and mortality assumptions and policy loan provisions, will remain the same after the Merger and the issuance of the endorsements. The owners of N's Policies will continue to own their insurance and annuity contracts after the merger. The owners of N's Policies will not receive new policy forms.

Other representations relating to the Merger include the following:

1. Following the transaction, M will continue the historic fraternal and any other activities of N, or use a significant portion of N's historic assets in M's activities.

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2. M and N will pay their respective expenses incurred in connection with the transaction.

3. There is no intercorporate corporate indebtedness existing between M and N that was issued, acquired, or will be settled at a discount.

4. The fair market value of the assets of N transferred to M will equal or exceed the liabilities assumed by M plus the amount of liabilities to which the transferred assets are subject.

5. The total adjusted bases of the assets of N will equal or exceed the sum of the liabilities assumed by M, plus the amount of the liabilities to which the transferred assets are subject.

6. No fractional Membership Interests of M will be issued in the Merger.

7. The aggregate fair market value of all Membership Interests of M is greater than the aggregate fair market value of all Membership Interests of N and the members of N will not receive, as a result of being members of N, Membership Interests of M which represent more than 50 percent of the fair market value of the Membership Interests of M.

8. Any property previously used by M or N in a business that gives rise to unrelated business taxable income will continue to be so used after the merger.

The respective Boards of Directors of M and N have concluded that the Merger of N with and into M, as provided in the Agreement and Plan of Merger, will enable M and N to best fulfill their common objective of improved and expanded service to the P community. They will also increase their financial strength and resources for growth, and enhance their potential for expanded delivery of services to existing and new members and other constituencies. Moreover, the Merger is expected to achieve substantial cost savings.

The Agreement and Plan of Merger between M and N contains the following provisions:

1. One provision of the Agreement refers to employee benefit plans including plans described in section 401(a) of the Code.

2. A second provision of the Agreement refers to plans, contracts or arrangements described in sections 401(a), 403(a), 403(b) and 408 of the Code.

3. A third provision of the Agreement refers to employee benefit plans including plans described in section 401(a) of the Code, and

4. A fourth provision of the Agreement refers to plans, contracts or arrangements described in sections 401(a), 403(a), 403(b) and 408 of the Code.

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Contemporaneously with the Merger of M and N, wholly owned subsidiaries of the respective organizations will also merge. The taxpayer's authorized representatives assert that these other mergers will have no effect on any contract issued by N, or any qualified plan maintained by N.

Law and Discussion – Exempt Organizations Issues:

Section 501(c)(8) of the Code provides for the exemption from federal income tax of fraternal beneficiary societies, orders, or associations that operate under the lodge system or for the exclusive benefit of the members of a fraternity itself operating under the lodge system, and provide for the payment of life, sick, accident, or other benefits to the members of such society, order, or association or their dependents.

Section 1.501(c)(8)-1(a) of the Income Tax Regulations (the regulations) provides that a fraternal beneficiary society is exempt from tax only if operated under the 'lodge system." The regulations provide that "operating under the lodge system" means carrying on its activities under a form of organization that comprises local branches, chartered by a parent organization and largely self-governing, called lodges, chapters, or the like. In order to be exempt, it is also necessary that the society have an established system for the payment to its members or their dependents of life, sick, accident, or other benefits.

Section 1.501(a)-1(a)(2) of the regulations provides that, to establish exemption, an organization must file an appropriate application form. A determination that an organization is exempt can be relied upon so long as there are no substantial changes in the organization's character, purposes, or methods of operation.

Rev. Rul. 67-390, 1967-2 C.B. 179, provides that an organization must file a new application for exemption from federal income tax when a change in its structure results in the creation of a new entity.

Section 511 of the Code imposes a tax on the unrelated business taxable income of organizations exempt from federal income tax under section 501(c) of the Code.

Section 512(a)(1) of the Code defines the term "unrelated business taxable income" as gross income derived by any organization from any unrelated trade or business regularly carried on by it, less the allowable deductions that are directly connected with such trade or business.

Section 513(a) of the Code defines the term "unrelated trade or business" as any trade or business the conduct of which is not substantially related (aside from the need of the organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its exempt function.

Section 514 of the Code sets forth rules with respect to unrelated debt-financed income.

Section 1.513-1(a) of the regulations states that unless one of the specific exceptions of section 512 or 513 is applicable, gross income of an exempt organization subject to the tax

imposed by section 511 is includible in the computation of unrelated business taxable income if: (1) It is income from trade or business; (2) such trade or business is regularly carried on by the organization; and (3) the conduct of such trade or business is not substantially related (other than through the production of funds) to the organization's performance of its exempt functions.

Section 1.513-1(b) of the regulations provides that, when an activity does not possess the characteristics of a trade or business within the meaning of section 162, the unrelated business income tax does not apply. The term "trade or business" generally includes any activity carried on for the production of income from the sale of goods or performance of services.

Section 1.513-1(c) of the regulations provides that, in determining whether a trade or business is "regularly carried on" within the meaning of section 512, regard must be had to the frequency and continuity with which the activities are conducted and the manner in which they are pursued. For example, specific business activities of an exempt organization will ordinarily be deemed to be "regularly carried on" if they manifest a frequency and continuity, and are pursued in a manner, generally similar to comparable commercial activities of nonexempt organizations.

Neither the exempt purpose nor the operations of M as a fraternal beneficiary society described in section 501(c)(8) of the Code will materially change due to the Merger of N with and into M. As represented, M's Articles of Incorporation and Bylaws will be substituted for N's Articles of Incorporation and Bylaws. Although the "purpose" provisions in the organizations' articles are not identical, M's and N's respective purposes are to promote the general welfare of their membership through various programs as well as to support P institutions. Both M and N are organized for exempt purposes under section 501(c)(8) as fraternal beneficiary societies, and thus, M's exempt purpose will not materially change as a result of the Merger.

At the completion of the Merger, N's separate existence will cease, and M will assume all obligations of N. As represented, the Merger will not materially change the terms and conditions of N's Policies and the policyholders' rights and obligations under N's Policies. Also as represented, the Merger will not change the membership rights or the terms of any contracts or certificates of any member of M. Following the transaction M will continue the historic fraternal and any other activities of N or use a significant portion of N's historic assets in M's activities. The Merger will not materially change the nature of the operations underlying M's basis for exemption under section 501(c)(8) of the Code.

Therefore, immediately following the Merger, M will continue to be exempt from tax under section 501(c)(8) of the Code as a fraternal beneficiary society. Generally, when the exempt purposes and activities of an organization remain the same after reorganization and no new legal entity is created, its tax-exempt status is not adversely affected. The Merger will also not affect the status of N as an exempt organization under section 501(c)(8) prior to the Merger.

With regard to whether a new Application for Recognition of Exemption must be filed, it appears that M, the surviving organization, is not a new entity. The Merger of N with and into M, in the manner described does not substantially change M's exempt purpose or the nature of its operations, and most importantly, does not result in the creation of a new organization.

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Therefore, M will not need to file a new exemption application as a result of the Merger. Rev. Rul. 67-390, *supra,* is distinguishable, as the situations described therein involved the creation of new legal entities that were required to submit new exemption applications.

With regard to the unrelated business income tax, the Merger of N with and into M will not result in either organization realizing or recognizing any unrelated business taxable income under sections 511 through 514 of the Code. The Merger is not considered a "trade or business" under section 1.513-1(b) of the regulations because it does not constitute an activity carried on for the production of income from the sale of goods or performance of services. Also, the information submitted indicates that the Merger will be a one-time transaction, and, therefore, it will not be "regularly carried on" as required by section 1.513-1(c). Furthermore, for purposes of sections 511 through 514, N's basis and holding period in assets, including shares of O will carry over in the hands of M; no gain or loss need be recognized on exchanging N's Membership Interests for M's Membership Interests; and, as a result of the Merger, no depreciation need be recaptured with respect to any debt-financed asset or other asset that may give rise to unrelated business taxable income.

Law and Discussion – Employee Plans and Insurance Issues:

Section 401(a) of the Code provides requirements for qualification under that section for both defined benefit and defined contribution employee plans. Such requirements permit the purchase of annuity contracts both for investment purposes and for purposes of distributing benefits to participants.

Sections 402(a), (c), and (e) of the Code provide the rules applicable to distributions from retirement plans, which are qualified under section 401(a).

Section 72 of the Code provides, in summary, rules governing to what extent distributions under annuities, endowment or life insurance contracts constitute gross income.

Section 72(e)(5) of the Code provides, in relevant part, certain rules applicable to distributions made from a trust described in section 401(a) which is exempt from tax under section 501(a).

Section 401(k)(1) of the Code provides, in short, that a profit-sharing or stock bonus plan, a pre-ERISA money purchase plan, or a rural cooperative plan may include a cash or deferred arrangement (CODA) and retain its section 401(a) status.

Section 401(k)(2) of the Code, in relevant part, sets forth the distribution rules applicable to section 401(k) CODAs.

Section 403(a) of the Code provides rules for taxability of a beneficiary of amounts distributed under annuity contracts that satisfy the requirements of section 404(a)(2). Section 404(a) relates to the purchase of annuity contracts such as retirement annuities, or those that cover both retirement annuities and medical benefits. Similarly, section 403(b) provides rules for taxability of amounts distributed under certain annuity contracts described in that section

purchased by an employer for its employees.

Section 403(b)(7) of the Code provides, in short, that as long as the requirements in section 403(b)(7) are met, amounts paid by an employer described in paragraph (1)(A) to a custodial account which satisfies the requirements of section 401(f)(2) shall be treated as amounts contributed by him to a section 403(b) annuity contract.

Section 403(b)(11) of the Code sets forth certain distribution requirements applicable to annuities described in section 403(b).

Section 408(b) of the Code provides requirements that individual retirement annuities (IRAs), issued by insurance companies, must satisfy for the tax treatment of section 408 to apply to distributions from those contracts.

Section 408A sets forth the rules applicable to Roth IRAs.

Section 72(t)(1) of the Code imposes a 10% additional income tax on certain distributions made from qualified retirement plans prior to the date on which an employee, IRA holder, annuitant etc. attains age 59 ½.

Section 3405(e)(1)(A) of the Code provides that the term "designated distribution" is defined in part as "any distribution or payment" from an employer deferred compensation plan, an individual retirement plan, or a commercial annuity.

Section 4974(c) of the Code provides that the term "qualified retirement plan," as used in section 72(t), includes (1) a plan described in section 401(a), which includes a trust exempt from tax under section 501(a), (2) an annuity plan described in section 403(a), (3) an annuity described in section 403(b), (4) an individual retirement account described in section 408(a), and (5) an individual retirement annuity described in section 408(b).

Section 4973(a) of the Code provides, in relevant part, for the imposition of a 6-percent excise tax on the amount of an excess contribution to an individual retirement annuity within the meaning of section 408(b) or to a custodial account treated as an annuity contract under section 403(b)(7)(A).

Section 4979 of the Code provides, in relevant part, for the imposition of a 10-percent excise tax on the amount of an excess contribution for a year or excess aggregate contribution (as defined in section 401(k)(8)(B)), to (1) a plan described in section 401(a) which includes a trust exempt under section 501(a), (2) an annuity plan described in section 403(a), or (3) an annuity contract described in section 403(b).

Generally speaking, annuity contracts issued by an insurance company that satisfy the requirements set forth in section 404(a)(2) of the Code (and thus the taxability of whose distributions is subject to section 403(a)), or section 403(b), or that are permitted to be purchased under the qualification rules of section 401(a) or the IRA annuity rules of section 408(b), or the Roth IRA rules of section 408A, do not lose their tax status under section 403, or,

with respect to a section 401(a) plan or section 408 IRA or section 408A Roth IRA, have their qualified status adversely affected merely because the issuing company has changed ownership, if the change in ownership has not changed the terms of the annuity contracts.

Additionally, an annuity issuing company's changing ownership, in and of itself, without a change in the terms of the annuities issued does not result in a distribution, for purposes of sections 402, 403, 408(b), 4973, or 4979 of the Code from any of its issued annuity contracts.

In this case, the taxpayer's authorized representatives have asserted that neither the Merger of M and N nor the endorsements issued by M with respect to N's Policies will change the terms of any of N's Policies except as required by law and except with respect to the Articles and Bylaws of M. Furthermore, except for the substitution of M's Articles and Bylaws, all of the terms of N's Policies, including the terms, conditions, rights and obligations concerning premiums, benefits, cash surrender values, charges, annuity options, surrender rights, interest and mortality assumptions and policy loan provisions, will remain the same after the Merger and after the issuance of M's endorsements.

Additionally, the owners of N's Policies will continue to own their insurance and annuity contracts after the Merger. The owners of N's Policies will not receive new policy forms.

The authorized representatives have asserted that the differences between the Articles and Bylaws of M and N are incidental to the terms and conditions and the policyholders' rights and obligations under N's Policies.

The Merger will not change the membership rights or the terms of any benefit contracts or certificates of any member of M.

Furthermore, the authorized representatives in this case make the following representations: the fair market value of M's interests received by the members of N in the Merger will be approximately equal to the fair market value of N's interests exchanged therefor; and the fair market value of the assets of N's assets transferred to M will equal or exceed the liabilities assumed by M plus the amount of liabilities to which the transferred assets are subject.

Also, the proposed merger will not result in any designated distribution under section 3405(e)(1)(A) of the Code that is subject to withholding under section 3405(b) or (c) of the Code.

Conclusion:

Based on the above facts and representations, we rule as follows:

1. Immediately following the Merger, M will continue to be exempt from tax pursuant to section 501(c)(8) of the Code.

2. The Merger will not affect the status of N as an exempt organization pursuant to section 501(c)(8) of the Code immediately before the Merger.

3. M will not need to file a new application for exemption as a result of the Merger.

4. The Merger will not result in either M or N realizing or recognizing any unrelated business taxable income pursuant to sections 511-514 of the Code.

5. N's basis and holding period in its assets, including the shares of O, will carry over in the hands of M after the Merger.

6. N Membership Interest holders will recognize no gain or loss on exchanging N Membership Interests for M Membership Interests.

7. (A) The proposed transaction will have no effect on the date each annuity contract, purchased by a trust described in section 401(a) of the Code, purchased by a plan described in section 403(a), described in section 403(b), or from an individual retirement arrangement within the meaning of either section 408(a) or 408(b), of either M or N was issued, entered into, purchased, or came into existence for purposes of section 72(e)(5).

   (B) The Merger will have no effect on the date that any policy (including "any life insurance or annuity contract") issued by M or N was, or is deemed to have been, issued, purchased, or entered into for purposes of sections 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, 7702A or 7702B of the Code; will not require retesting or the start of a new test period for any Company policy under sections 264(d)(1), 7702(c)(3)(A), 7702(f)(7)(B)-(E) or 7702A; and for purposes of sections 72(b) and 72(c)(4) will not cause annuity contracts with annuity start dates before the Merger to be treated as having starting dates after the Merger.

8. As a result of the Merger, no depreciation will be recaptured with respect to any debt-financed asset or other asset that may give rise to unrelated business taxable income.

9. The proposed transaction will have no effect on any life insurance or annuity contract of either M or N for purposes of sections 72(e)(5), 401, 402, 403, 408, or 408A of the Code.

10. The proposed transaction will not result in distributions for purposes of section 403(b) of the Code with emphasis on section 403(b)(11). Additionally, the proposed transaction will not result in distributions for purposes of section 401(k) with emphasis on section 401(k)(2).

11. The proposed transaction will not constitute, with respect to policies issued by either M or N, in effect prior to the effective date of the proposed transaction and which are qualified within the meaning of section 401(a), 403(b), 408(b), or 408A of the Code, a distribution from or a contribution to any of these policies, plans or arrangements for

federal income tax purposes, and

12. The proposed transaction will not result in any distributions and thus will not result in

(A) Any gross income to the employee (or the beneficiary thereof) as a distribution from a Code section 401(a) qualified plan pursuant to section 72 unless accompanied by an actual distribution to either the employee (or beneficiary thereof);

(B) The imposition of the 10-percent additional income tax imposed under section 72(t) of the Code on premature distributions from qualified retirement plans;

(C) The imposition of any excise tax described in either section 4973 or 4979 of the Code; or

(D) Any designated distribution under section 3405(e)(1)(A) of the Code that is subject to withholding under section 3405(b) or (c).

This ruling is based on the understanding that there will be no material changes in the facts upon which it is based.

Except as specifically ruled upon above, no opinion is expressed concerning the federal income tax consequences of the transactions described above under any other provision of the Code.

We have not been asked and we express no opinion on whether any property previously used by M or N in a business that gives rise to unrelated business taxable income under sections 511 through 514 of the Code will continue to give rise to this tax as a result of the Merger. This ruling only addresses whether the Merger itself results in unrelated business taxable income.

The rulings that you have requested, other than those enumerated above, have been forwarded to the Office of the Associate Chief Counsel (Corporate). That office will respond directly to you.

Pursuant to a Power of Attorney on file in this office, a copy of this letter is being sent to M's and N's authorized representatives. A copy of this letter should also be kept in M's and N's permanent records.

This letter is directed only to the organizations that requested it. This letter modifies and supersedes the letter issued to the organizations on December 21, 2001. Section 6110(k)(3) of the Code provides that it may not be used or cited by others as precedent.

If there are any questions about this ruling, please contact the person whose name and telephone number are shown in the heading of this letter.

Sincerely,

Gerald V. Sack

Gerald V. Sack
Manager, Exempt Organizations
Technical Group 4

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