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Diverse Approaches to Allocation of Basis in Demutualizations

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When a mutual life insurance company (owned by its policyholders) converts to a stock company, the policyholders may retain their policy rights and also receive stock in the reorganized company. Two recent U.S. District Court decisions have addressed how a policyholder should compute his tax basis in such stock.[1] The decisions take varying approaches and reach conflicting results, although both District Courts did decline to follow the approach taken by the Court of Federal Claims several years ago in a similar case.[2] This article contrasts the approaches taken in the three decisions, and explains how the resolution of this seemingly narrow issue may also be relevant in other circumstances in which a single "item" of property is divided into two or more parts before a disposition of one portion or the other.

Background

In all three cases, a life insurance policy had been obtained from a mutual insurance company. Because the issuer of the policy was a mutual insurance company, each policy holder also received, for no further consideration other than payment of the insurance premiums, certain other rights ("mutual rights"), including voting rights and rights to share in the surplus of the company under certain circumstances, such as liquidation.

The mutual insurance company decided to convert to a publicly traded stock company through a process known as "demutualization." In the demutualization, policyholders surrendered their mutual rights and receive shares of stock in a stock company. The demutualization transactions were effected for business reasons (for example, to facilitate raising additional capital through the issuance of stock to investors) and were structured to be nontaxable to policyholders.[3]

The policyholders then sold the stock received, in some cases at the time of the demutualization transaction and in others years later. What were the policyholders' bases in the stock received in the demutualization for purposes of determining gain or loss on the sales?

Analysis

The payment of premiums on a "permanent" life insurance with a substantial cash value may cause the policyholder to have substantial basis in the policy.[4] If the issuer of the policy is a mutual insurance company, however, the policyholder will not have paid any separate amount for the mutual rights associated with the policy, and it is unlikely that the policyholder and the insurance company will agree upon any allocation of a portion of the premiums paid to the mutual rights. Further, the mutual rights will not be separately transferable (and will lapse if the underlying policy lapses), and, absent a liquidation or demutualization transaction, such rights would appear to have little if any value. Thus, determining how much of the premiums should be allocated to mutual rights at the time of premium payments, or even a reasonable method for making such an allocation, is a difficult task.

A demutualization transaction can be viewed as itself assigning a value to the mutual rights, since the policyholder will have surrendered those rights for shares of stock, typically listed and publicly traded on a securities market, that may be sold at the time of the demutualization or thereafter. By analogy to the treatment of other nontaxable transactions under the Internal Revenue Code ("IRC"), the policyholder's basis might then be allocated between the insurance policy and the stock in proportion to relative fair market values.

However, even if the value of the stock, the value of the insurance policy retained, and the policyholder's overall basis in the insurance policy before the transaction are all readily ascertainable, there is no clear authority in the demutualization context for allocating that overall basis between the policy retained and the stock in proportion to relative fair market values.[5] In these circumstances, the IRS view for some time has been that the stock received in exchange for mutual rights in a nontaxable demutualization transaction has a zero basis, and that, if such stock is

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subsequently sold by the policyholder, the entire proceeds from the sale of stock (net of any selling expenses) will be taxable as gain.[6] Similarly, mutual insurance companies have, in describing the tax consequences of demutualization to their policyholders, advised that the stock has a zero basis.[7] However, a number of policyholders have taken different positions, giving rise to the case law discussed below.

One alternative analysis springs from the so-called "open transaction" doctrine, which has its roots in the Supreme Court's 1931 decision in *Burnet v. Logan*.[8] The taxpayer in *Logan* had sold stock of a corporation for cash plus a promise of future payments contingent on the amount of ore extracted from a mine in which the corporation had an indirect interest. The Court concluded that the right to receive the contingent payments could not be valued with fair certainty and that the sale was therefore not a closed transaction. Accordingly, the Court allowed the taxpayer to recoup her entire basis in the stock before reporting as income only amounts received after her entire basis in the shares had been recovered. The IRS has, by regulation, purported to limit application of the open transaction doctrine to rare and extraordinary circumstances where something is received the value of which is so speculative as to make any valuation impossible.[9]

In *Fisher v. United States*, the Court of Federal Claims was persuaded that the mutual rights had some value when acquired upon the original issuance of an insurance policy to the taxpayer, but that the mutual rights' value could not be determined as of the time they were acquired; and that it was therefore appropriate to apply the open transaction doctrine.[10] The policyholder before the court (a trust) had sold the shares received immediately after the demutualization transaction (pursuant to a "cash option" provided by the insurance company), and the court allowed the trust to reduce its aggregate pre-transaction basis in the policy by the cash received. Because the cash from that sale was less than the tax basis of the policyholder in the insurance policy as a whole, the taxpayer was not required to take any portion of the sale proceeds into income.

More recently, in *Reuben v. United States*, a District Court in California dealt with essentially the same issue, but in a context where stock received in a demutualization was held for six years before being sold. The taxpayer sought to apply "open transaction" treatment to the sales proceeds, based on the analysis in *Fisher*.

The district court declined to follow Fisher. Unlike the situation in *Logan*, the proceeds from the sale of the stock received in *Reuben* in exchange for the mutual rights were readily determinable in the year of sale. Also, the amount of taxable income resulting from the ultimate payment of a death benefit with respect to the insurance policy would in all likelihood be zero, under the general rule excluding life insurance proceeds from income, regardless of the exact amount of remaining basis.[11] Further, if the open transaction doctrine applied, the taxpayer might benefit unduly by avoiding the recognition of gain with respect to appreciation in the shares between the time of receipt and the time, approximately six years thereafter, when they were sold (and not merely with respect to the value of the shares at the time received).

The court in *Reuben* accordingly concluded that the open transaction doctrine did not apply and denied the taxpayer's motion for summary judgment. Moreover, in the view of that court, the record before it established that none of the insurance premiums were paid for the mutual rights, and, therefore, the policyholder has no basis in the shares of stock received in the demutualization. The court thus concluded that summary judgment in favor of the government was appropriate.

The most recent decision, *Dorrance v. United States*, by the District Court of Arizona, reflects yet a third approach to the computation of basis in the context of a fact pattern very similar to that of *Reuben*. In the court's first decision on the matter, denying the government's motion for summary judgment, the court found that the policyholder had by payment of premiums clearly acquired mutual rights as well as policy rights, and that some allocation of basis to the stock received for the mutual rights was accordingly required, notwithstanding that it could not be established what portion of the premiums were paid for the mutual rights.[12]

With respect to the open transaction approach applied by the Court of Federal Claims in *Fisher*, however, the court apparently agreed with the same arguments as were later made in *Reuben*, that the rights received by the taxpayer were susceptible of valuation at the time of the exchange, and, further, that the open transaction doctrine if applied here would provide an inappropriate tax benefit. The first *Dorrance* decision therefore concluded that the open transaction doctrine did not apply. The court further observed that by regulation (and under case law cited in the opinion), where a taxpayer sells a part of a larger property, the entire basis of the property must be equitably apportioned between the part sold and the part retained.[13] Given that authority and the court's prior analysis, the court ordered that the parties address at trial the equitable allocation of basis in the insurance policies to the mutual rights.

The more recent *Dorrance* decision addressed this allocation issue. The court noted that the methodology used by the insurance companies to determine the number of shares to be issued for the mutual rights had calculated two components: (i) a "fixed component" issued to compensate for the loss of voting rights; and (ii) a "variable component" issued to compensate for the loss of other rights, and based on past and projected future contributions by the policyholder to company surplus. With respect to the variable component, the court concluded that the part attributable to premiums that had not yet been paid should not be taken into account as a part of basis.

The court therefore concluded that the policyholder's basis in the shares was equal to the sum of the value, at the time of the demutualization and related

IPO, of (i) the shares issued in exchange for the surrender of voting rights and (ii) the shares issued on account of past contributions to surplus.[14]

The court's decision as to allocation of basis does not focus on the overall tax treatment of the demutualization transaction. It is noted, however, that a private letter ruling was issued to the companies involved—which ruling concluded the demutualization was a nontaxable recapitalization. Taking that into account, it is unclear, at least to the authors of this article, how the court reached the conclusion that the bases of the shares considered to have been received in exchange for mutual rights should be determined to be equal to the value of those shares when issued, without any reference to the fair market value of the policyholder's ongoing rights under the insurance contract or the policyholder's pre-demutualization basis in the policy. It seems likely that none of the decisions discussed above will be the final word on this puzzling issue.

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1 *Dorrance v. United States*, 111 AFTR 2d 2013-1280 (D. Ariz. 2013), and *Reuben v. United States*, 111 AFTR 2d 2013-620 (C.D. Calif. 2013)

2 *Fisher v. United States*, 102 AFTR 2d 2008-5608 (2008), aff'd without opinion, 105 AFTR 2d 2010-357 (Fed. Cir. 2009).

3 *See, e.g., Fisher v. United States*, supra note 2, and Rev. Rul. 71-233, 1971-1 C.B. 113.

4 The extent to which premiums are includible in the basis of an insurance policy, even in a non-mutual issuer context, is a potentially complex matter not dealt with in the cases discussed below, or herein.

5 *Compare* IRC §358 and Reg. § 1.358-2, regarding the allocation of basis to stock of a controlled corporation distributed in the context of a divisive reorganization under IRC §355.

6 *See, e.g.*, Rev. Rul. 71-233.

7 This conclusion is stated in tax discussions excerpted in the demutualization decisions discussed below.

8 283 U.S. 404.

9 *See generally* Treas. Reg. § 1.1001-1(a).

10 102 AFTR 2d 2008-5608. The decision was affirmed by the Court of Appeals for the Federal Circuit in an unpublished opinion (105 AFTR 2d 2010-357).

11 *See* IRC §101. Thus, the result achieved by the taxpayer in *Fisher* was in all likelihood a permanent exclusion of the demutualization proceeds from income rather than merely a deferral.

12 *Dorrance v. United States*, 110 AFTR 2d 2012-5176 (D. Ariz. 2012).

13 Treas. Reg. § 1.61-6(a).

14 It appears that the court was using the value of the stock issued in exchange for the mutual rights as a means of valuing the mutual rights, which would in turn indicate an appropriate measure for the allocation of basis. The opinion observes that the companies had represented to the IRS, in application for a tax ruling relating to the transaction, that the fair market value of the stock the policyholders would receive approximated the fair market value of the mutual rights being surrendered.