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Court Says IRS Position Wrong on Tax Impact of Insurance Company Demutualization

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Overview

As we have been predicting at the ISU Farm Income Tax Schools since 2006, the U.S. Court of Federal Claims has ruled against the IRS position of assigning zero income tax basis to insurance company demutualizations.[1] Instead, the court ruled that basis is to be allocated to the stock of the policy up to the amount of the selling price of the stock. The court's opinion comes as no surprise – they ruled in November of 2006 against an IRS motion for summary judgment. That meant the case was to go to trial to determine the basis of the shares. If the court had agreed with the IRS, it would have granted summary judgment. So, we have known since that time that IRS would lose the case – the shares would have a positive basis and not all of the gain would be taxable.[2] What was not known until now was how basis would be computed.

The demutualization issue raises filing issues for practitioners, as does the court's most recent opinion.

What is Demutualization?

Demutualization is the process through which a member-owned company becomes shareholder-owned; frequently this is a step toward the initial public offering (IPO) of a company. Insurance companies often have the word "mutual" in their name, when they are mutually owned by their policy holders as a group. They've been around a long time. In fact, Benjamin Franklin established one of the first mutual insurance companies. Such a company doesn't have shareholders, but instead is owned by its participating policyholders who possess both ownership rights, such as voting and distribution rights, as well as the more typical contractual insurance rights.[3] In recent years, however, there has been a strong trend for these companies to *demutualize*, converting to a shareholder ownership base. Generally, policy holders are offered either shares or money in exchange for their ownership rights. Because shares can be traded or sold - in contrast to ownership rights, which cannot - demutualization increases the possibility of profit for those involved, and tends also to benefit the economy.

Demutualization was originally used to refer specifically to this conversion process by insurance companies, but the term has since become more broadly used to describe the process by which any member-owned organization becomes shareholder-owned. Worldwide, stock exchanges have offered another striking example of the trend towards demutualization, as the London, New York and Toronto Stock Exchanges and most other exchanges across the globe have either recently converted, are currently in the process, or are considering demutualization.

Insurance company demutualizations became popular in the late 1990s. Facilitated by revised state laws, mutual insurance companies were attracted to conversion to stock companies for the same reasons that companies have long sought to be publicly held - greater access to capital. The policyholders of mutual insurance companies were generally granted cash or stock in return for their interest in the mutual insurance company.

As of August 2008, the following life insurance companies have demutualized (with the approximate number of policyholders affected, when known):

1. Acacia Mutual (1997)
2. American Mutual (1996); 300,000 policyholders
3. American United (2000); 175,000 policyholders.
4. Ameritas (1997)
5. Canada Life (1999); 388,000 policyholders.
6. Central Life Assurance (2000); 300,000 policyholders.
7. Equitable Life Assurance Society (1992)
8. General American (2000); 330,000 policyholders.
9. Guarantee Mutual Life (1995)
10. Indianapolis Life (2001); 200,000 policyholders.
11. Industrial-Alliance (Canada) (1999); 700,000 policyholders.
12. John Hancock (2000); 3,000,000 policyholders.
13. Lafayette Life (2000)
14. Manulife (1999)
15. Metropolitan Life ((2000); 11,200,000 policyholders.
16. Midland Life (1994)
17. Minnesota Mutual Life (1998)
18. Mutual of New York (1998); 800,000 policyholders.
19. Mutual Life of Canada (2000)
20. Mutual Service Life (2005)
21. National Travelers (2000)
22. Nationwide Life (1997)
23. Northwestern National (1989)
24. Ohio National (1998)
25. Phoenix Home Life (2001); 500,000 policyholders.
26. Principal Mutual (2001); 925,000 policyholders
27. Provident Mutual (2002)
28. Prudential (2001); 11,000,000 policyholders.
29. Security Mutual Life of Nebraska (1999)
30. Standard Insurance Co. (1999); 125,000 policyholders.
31. State Mutual Life (1995); 100,000 policyholders.
32. Sun Life of Canada (2000)
33. Union Mutual (UNUM) (1986)
34. Western & Southern Life (2000)

But, the tax issue is tricky. Federal tax law specifies that gross income includes gain from the sale of property that are equal to the amount realized upon sale less the seller's cost basis in the property.[4] That's a simple enough principle, but sometimes its application can be difficult – such as in the situation where the property was purchased as component of a larger item. With a demutualization, insurance policy rights that were acquired as an indivisible package are separated and sold.

The IRS Position

The IRS position is that policyholders have a zero basis in the cash or stock received in demutualization, and a carryover basis from their time as a policyholder. This means that policyholders receiving cash are subject to tax on the cash received in the year of the demutualization. Policyholders receiving stock are not subject to tax until the stock is sold. But, the IRS position is highly questionable. Clearly, a portion of a shareholder's premium payments made over the years were not for insurance coverage, but for the voting and liquidation rights as a policyholder. That is evidenced by the fact that policyholders who have paid in the most premiums over the years were generally entitled to a larger cash or stock distribution as part of the demutualization transaction. But, it is difficult to determine what a shareholder has paid for those rights. In addition, a taxpayer bears the burden to support any basis claimed on the sale of an asset to offset gain. Otherwise, IRS says the basis is zero. In paying an insurance premium, policyholders pay only a premium amount - nothing is specified as being paid for any other purpose. So, that's what has given IRS an argument that the shareholder has zero basis.

The *Fisher*[5] Case

Before 2000 Sun Life Assurance Company (Sun Life) was a Canadian mutual life insurance and financial services company. In 1999, Sun Life's Board certified that eligible policyholders had approved a demutualization of the company. In early 2000, the company received the necessary regulatory approvals to proceed with the demutualization and filed a Private Letter Ruling request with the IRS as to the tax implications of the demutualization to the policyholders. The IRS, in the ruling, stated the following:[6]

- Policyholders' ownership rights could not be obtained by any purchase separate from any insurance contract that Sun Life issued.
- Under I.R.C. §354(a)(1), no gain or loss would be recognized by the eligible policyholders on the deemed exchange of their ownership rights solely for company stock
- The income tax basis of the company stock received by policyholders in the exchange will be the same as the basis of the ownership rights surrendered, namely zero.

Upon demutualization, the plaintiff received 3,982 shares of stock in exchange for its voting and liquidation rights. The plaintiff opted for the "cash election" which permitted Sun Life to sell those shares on the open market for $31,759. The plaintiff reported the entire amount on its tax return and paid $5,725 in tax. The plaintiff then filed a claim for refund, which the IRS denied. The plaintiff then sued, seeking summary judgment. IRS also moved for summary judgment Alternate dispute resolution did not resolve the matter and the court, in late 2006, denied both of the summary judgment motions. The court determined that the proceeds from stock were not a distribution by Sun Life of a policy dividend, its equivalent, so as to be excluded from gross income as a return of capital under the annuity rules.[7] The court then concluded that it could not resolve the plaintiff's claim that no capital gain was realized on the sale of the stock because, as the plaintiff claimed, the proceeds were offset by the plaintiff's income tax basis in the stock. The court found that the plaintiff's claim presented fact questions that required a trial on the matter. At trial, the plaintiff's expert testified that he couldn't form an opinion as to the fair market value of the ownership rights because they were tied to the policy. The rights added value, the expert testified, but did not have a separate value. The IRS' expert determined that the ownership rights had no value, emphasizing that none of the premiums were specifically dedicated to acquiring the ownership rights, that there was no market for the ownership rights, and that it was highly unlikely, at the time of policy acquisition, that a demutualization would occur.

The court focused on Treas. Reg. §1.61-6(a) which specifies that when part of a larger property is sold, the cost basis of the entire property is to be equally apportioned among the several parts, and the gain realized or loss sustained on the part of the entire property sold is the difference between the selling price and the cost basis allocated to the part that is sold.[8] But, for the formula to work, the court noted that the market value of the part sold must be determinable. On that point, the court noted that the Supreme Court, in *Burnet v. Logan*,[9] dealt with a similar problem. *Burnet* involved a sale of stock under which the seller received cash and the buyer's promise to make future payments conditioned on contingencies.[10] The cash received did not equal the seller's cost basis for the stock, and the contingencies affecting future payments precluded ascribing a fair market value to the buyer's promise. In later years, payments were made which the seller did not include as income. The Court held that the seller was not required to do so. With respect to such payments, the court said:

> As annual payments on account of extracted ore come in they can be readily apportioned first as return of capital and later as profit. The liability for income tax ultimately can be fairly

> determined without resort to mere estimates, assumptions and speculation. When the profit, if any, is actually realized, the taxpayer will be required to respond. The consideration for the sale was $2,200,000.00 in cash and the promise of future money payments wholly contingent upon facts and circumstances not possible to foretell with anything like fair certainty. The promise was in no proper sense equivalent to cash. It had no ascertainable fair market value. The transaction was not a closed one. Respondent might never recoup her capital investment from payments only conditionally promised. Prior to 1921 all receipts from the sale of her shares amounted to less than their value on March 1, 1913. She properly demanded the return of her capital investment before assessment of any taxable profit based on conjecture.

The court's opinion gave rise to what has become known as the "open transaction" doctrine. IRS reconfirmed the validity of the doctrine in Rev. Rul. 74-414[11] where they described the general requirements of Treas. Reg. §1.61-6, but also stated that "when it is impractical or impossible to determine the cost or other basis of the portion of the property sold, the amount realized on such sales should be applied to reduce the basis of the entire property and only the excess over the basis on such sales should be applied to reduce the basis of the entire property is recognized as gain. In addition, the court noted that IRS has repeatedly argued for the continued viability of the doctrine when seeking to disallow deductions.[12]

As to the value of the ownership rights sold, the court referenced Sun Life's actuarial study that suggested that the ownership rights had value before the demutualization. That study, which was provided to the company's policyholders with the plan for demutualization, specified that the stock allocation fairly compensated the policyholders for the loss of voting control of the company and the right to share in the company's residual value (if it were "wound-up"). The plan provided for a fixed allocation of 75 Financial Services Shares to each eligible policyholder, regardless of the number of policies held, and for a variable allocation to each eligible policyholder of a number of Financial Services Shares tied to its cash value, the number of years it has been in force and its annual premium. The study stated that it regarded the fixed allocation as compensation for loss of voting control and the variable allocation as compensation for loss of the right to share in residual value. The court viewed the actuarial study, coupled with the plaintiff's expert opinions, to be persuasive. As such, the taxpayer's cost basis in the insurance policy (determined by the amount of premiums that had been paid) as a whole exceeded the amount received in the demutualization and the taxpayer did not realize any income on the sale of the stock and was entitled to a full refund of taxes paid on the sale. The court also noted that numerous state statutes (enacted before the plaintiff acquired its policy) that authorize demutualization require that compensation be paid for the loss of ownership rights.[13] In addition, while the IRS' position was consistent with the private letter ruling issued to Sun Life, the court noted that the ruling had no binding or precedential effect on the tax treatment to be accorded the plaintiff.

Applicable Holding Period

If a taxpayer received stock in a demutualization and sold the stock within one year, a question arises concerning the applicable holding period of the stock. Unfortunately, the Fisher court did not address the holding period issue. However, in Rev. Rul. 2003-19,[14] IRS addressed three variations on the demutualization theme, one of which involved the classic demutualization picture where the former mutual company simply issued capital stock and dropped the word "mutual" from its name. IRS said that the demutualization involved a corporate reorganization. Indeed, IRS ruled that what was involved was both an I.R.C. §368(a)(1)(E) recapitalization as well as an "F" reorganization because of the change in name and corporate form from mutual to stock. The policyholders of the mutual company had both membership interests in the mutual company and contractual rights under their policies. Absent the reorganization, those membership rights could not be separated from the contract rights as a matter of state law. Those rights would terminate, with no continuing value, if the contract terminated. The membership interests were to be treated as voting stock, said the ruling, and thus the transaction was not taxable to the shareholders.

However, IRS did not follow through and deal with the tax basis and holding period of the stock received by former mutual policyholders. Earlier, in ILM 200131028,[15] IRS pointed out that if a demutualization qualified as a tax-free reorganization, "then Taxpayer's holding period for the stock runs from the date the Taxpayer first held an equity interest in the mutual life insurance company as a policyholder or annuitant. Section 1223(1) of the Code." I.R.C. §1223(1) allows the tacking on of holding periods "if, under this chapter, the property has, for the purpose of determining gain or loss from a sale or exchange, the same basis in whole or in part in his hands as the property exchanged. . . . " I.R.C. §358 provides that the basis of property received in a tax- free exchange without recognition of gain or loss is the same as the basis of the property exchanged. So, if the demutualization transaction qualifies as a tax-free reorganization under I.R.C. §368(a)(1) (and IRS has concluded that a demutualization does so qualify) the taxpayer's holding period for the new stock includes the period the taxpayer held an equity interest in the mutual company as a policyholder or annuitant. That means that any transaction that was properly reported as a long-term capital gain on the original return will also be treated as a long-term capital gain on an amended return.

Tax Planning for Clients

Without a doubt, practitioners with clients having demutualization distributions over the past few years while the Fisher litigation was pending should have been filing protective claims for refunds. Protective claims are commonly filed when a taxpayer's right to a refund is contingent on future events (such as pending litigation) that will not be resolved until after the statute of limitations expires.[16] A timely and proper protective claim will preserve the taxpayer's right to obtain a refund. That was the suggested strategy after the court's denial of summary judgment for IRS in late 2006.[17] If a protective claim is not in place, the client will be subject to the three-year statute of limitations applicable to open tax years when seeking a refund. If tax on a demutualization was paid on an extended 2004 return, a refund claim must be filed by August 15, 2008 (or October 15 if a second extension was utilized), using Form 1040 X. Consideration should be made as to whether refund claims for 2005, 2006 and 2007 should be made.

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[1] Fisher, *et al*. v. United States, No. 1:04-cv-01726 (Fed. Cl. Aug. 6, 2008).

[2] It is, of course, possible that the court's opinion could be overturned by the Federal Circuit if the court's opinion is appealed.

[3]The voting rights of policyholders differ from those of traditional shareholders. Each policyholder has only one vote, regardless of the number of policies owned. Once the company pays its claims and operating expenses, the profits belong to the policyholders. Usually, some of the profits are returned to the policyholders as dividends, which reduce premium payments with the balance retained as surplus.

[4] I.R.C. §§61(a)(3); 1001(a); 1011.

[5] Fisher, *et al*. v. United States, No. 1:04-cv-01726 (Fed. Cl. Aug. 6, 2008).

[6] Priv. Ltr. Rul. 200002048 (Oct. 6, 1999).

[7] See I.R.C. §72.

[8] See also Gladden v. Comm'r., 262 F.3d 851 (9th Cir. 2001)(the apportionment is done by dividing the cost basis of the larger property among its components in proportion to their fair market values at the time they were acquired).

[9] 283 U.S. 404 (1931).

[10] In *Burnet*, the defendant sold stock in a closely-held corporation which assets included stock in a second corporation that owned a mine lease. The defendant exchanged the stock for cash and a stream of annual payments corresponding to the amount or

iron ore extracted from the mine. IRS took the position that, at the time of sale, the right to receive the mining royalties could be estimated based on the amount of reserves at the mine and that the transaction should be taxed based on that estimate. The Supreme Court, however, determined that the defendant was entitled to recover her capital investment in the stock before paying income tax based on the supposed market value of the mineral payments. This became known as the "open transaction" doctrine.

[11] 1977-2 C.B. 299.

[12] *See, e.g.*, Smith v. Comm'r., 78 T.C. 350 (1982); Hutton v. Comm'r., 35 T.C.M. 16 (1976); Grudman v. Comm'r., 34 T.C.M. 669 (1975)

[13] *See, e.g.*, Or. Rev. Stat. Ann. §732.612; N.Y. Ins. Law §7312(d)(4); Wash. Rev. Code Ann. §48.09.350(3); Wis. Stat. Ann. §611.76(4)(bm).

[14] 2003-1 C.B. 468.

[15] Jun. 29, 2001.

[16] GCM 38786 contains the IRS' most comprehensive discussion of protective refund claims and describes the various circumstances in which filing a protective claim is appropriate when the expiration of the refund statute of limitations is imminent

[17] A protective claim is filed as if the taxpayer were filing for a refund. The only exception is that "Protective Claim – Do Not Process" should be written at the top of Form 1040X. An explanation should be attached noting that the claim is filed to protect the taxpayer's right to a refund in the event of the court ruling that demutualization payments are not fully taxable.

PROTECTIVE CLAIM - DO NOT PROCESS

Form **1040X** (Rev. November 2007)

Department of the Treasury—Internal Revenue Service

Amended U.S. Individual Income Tax Return

▶ See separate instructions.

OMB No. 1545-0074

This return is for calendar year ▶ , or fiscal year ended ▶ , .

Please print or type

Your first name and initial	Last name	**Your social security number**
If a joint return, spouse's first name and initial	Last name	**Spouse's social security number**
Home address (no. and street) or P.O. box if mail is not delivered to your home	Apt. no.	Phone number ( )
City, town or post office, state, and ZIP code. If you have a foreign address, see page 3 of the instructions.		

A If the address shown above is different from that shown on your last return filed with the IRS, would you like us to change it in our records? ▶ ☐ **Yes** ☐ **No**

B Filing status. Be sure to complete this line. **Note.** You cannot change from joint to separate returns after the due date.

On original return ▶ ☐ Single ☐ Married filing jointly ☐ Married filing separately ☐ Head of household ☐ Qualifying widow(er)

On this return ▶ ☐ Single ☐ Married filing jointly ☐ Married filing separately ☐ Head of household* ☐ Qualifying widow(er)

* If the qualifying person is a child but not your dependent, see page 3 of the instructions.

Use Part II on the back to explain any changes		**A. Original amount** or as previously adjusted (see page 3)	**B. Net change—** amount of increase or (decrease)— explain in Part II	**C. Correct amount**
Income and Deductions (see instructions)				
1 Adjusted gross income (see page 3)	1			
2 Itemized deductions or standard deduction (see page 4)	2			
3 Subtract line 2 from line 1	3			
4 Exemptions. If changing, fill in Parts I and II on the back (see page 4)	4			
5 Taxable income. Subtract line 4 from line 3	5			
Tax Liability				
6 Tax (see page 5). Method used in col. C	6			
7 Credits (see page 5)	7			
8 Subtract line 7 from line 6. Enter the result but not less than zero	8			
9 Other taxes (see page 5)	9			
10 Total tax. Add lines 8 and 9	10			
Payments				
11 Federal income tax withheld and excess social security and tier 1 RRTA tax withheld. If changing, see page 5	11			
12 Estimated tax payments, including amount applied from prior year's return	12			
13 Earned income credit (EIC)	13			
14 Additional child tax credit from Form 8812	14			
15 Credits: Federal telephone excise tax or from Forms 2439, 4136, 8885, or 8801 (if refundable)	15			
16 Amount paid with request for extension of time to file (see page 5)	16			
17 Amount of tax paid with original return plus additional tax paid after it was filed	17			
18 Total payments. Add lines 11 through 17 in column C	18			

Refund or Amount You Owe

19 Overpayment, if any, as shown on original return or as previously adjusted by the IRS	19	
20 Subtract line 19 from line 18 (see page 6)	20	
21 **Amount you owe.** If line 10, column C, is more than line 20, enter the difference and see page 6	21	
22 If line 10, column C, is less than line 20, enter the difference	22	
23 Amount of line 22 you want **refunded to you**	23	
24 Amount of line 22 you want **applied to your** **estimated tax**	24	

Sign Here
Joint return? See page 2.
Keep a copy for your records.

Under penalties of perjury, I declare that I have filed an original return and that I have examined this amended return, including accompanying schedules and statements, and to the best of my knowledge and belief, this amended return is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which the preparer has any knowledge.

▶ Your signature Date ▶ Spouse's signature. If a joint return, **both** must sign. Date

Paid Preparer's Use Only

Preparer's signature ▶	Date	Check if self-employed ☐	Preparer's SSN or PTIN
Firm's name (or yours if self-employed), address, and ZIP code ▶		EIN	
		Phone no. ( )	

Part I Exemptions. See Form 1040 or 1040A instructions.

Complete this part **only** if you are:

- Increasing or decreasing the number of exemptions claimed on line 6d of the return you are amending, or
- Increasing or decreasing the exemption amount for housing individuals displaced by Hurricane Katrina.

			A. Original number of exemptions reported or as previously adjusted	B. Net change	C. Correct number of exemptions
25	Yourself and spouse . . . . **Caution.** If someone can claim you as a dependent, you cannot claim an exemption for yourself.	25			
26	Your dependent children who lived with you	26			
27	Your dependent children who did not live with you due to divorce or separation	27			
28	Other dependents	28			
29	Total number of exemptions. Add lines 25 through 28	29			
30	Multiply the number of exemptions claimed on line 29 by the amount listed below for the tax year you are amending. Enter the result here.	30			
31	If you are claiming an exemption amount for housing individuals displaced by Hurricane Katrina, enter the amount from Form 8914, line 2 for 2005 or line 6 for 2006 (see instructions for line 4). Otherwise enter -0-	31			
32	Add lines 30 and 31. Enter the result here and on line 4	32			

Tax year	Exemption amount	But see the instructions for line 4 on page 4 if the amount on line 1 is over:
2007	$3,400	$117,300
2006	3,300	112,875
2005	3,200	109,475
2004	3,100	107,025

33 Dependents (children and other) not claimed on original (or adjusted) return:

(a) First name	Last name	(b) Dependent's social security number	(c) Dependent's relationship to you	(d) ✓ if qualifying child for child tax credit (see page 6)
				☐
				☐
				☐
				☐
				☐
				☐

No. of children on 33 who:
- lived with you . . ▶ ☐
- **did not** live with you due to divorce or separation (see page 6) . ▶ ☐

Dependents on 33 not entered above ▶ ☐

Part II Explanation of Changes

Enter the line number from the front of the form for each item you are changing and give the reason for each change. Attach only the supporting forms and schedules for the items changed. If you do not attach the required information, your Form 1040X may be returned. Be sure to include your name and social security number on any attachments.

If the change relates to a net operating loss carryback or a general business credit carryback, attach the schedule or form that shows the year in which the loss or credit occurred. See page 2 of the instructions. Also, check here . . . . . ▶ ☐

SEE ATTACHED

Part III Presidential Election Campaign Fund. Checking below will not increase your tax or reduce your refund.

If you did not previously want $3 to go to the fund but now want to, check here . . . . ▶ ☐

If a joint return and your spouse did not previously want $3 to go to the fund but now wants to, check here . . . . ▶ ☐

[Taxpayer(s) name]
[Taxpayer SSN]

Attachment to
Form 1040X

Explanation of Changes

Taxpayer(s) is/are filing this Protective Claim to assert a tax basis other than $-0- for stock received in the demutualization of ________________________ (name of former mutual life insurance company). The taxpayer(s) originally reported proceeds received from this transaction in the amount of $____________ (amount of cash received in the demutualization/sale proceeds from stock that was received in the demutualization) on Schedule D as having a $-0- basis. However, based on a recent decision in the U.S. Court of Federal Claims, the taxpayer is filing a Protective Claim to claim tax basis against these proceeds. ((See: *Fisher, et al .v. United States.,* U.S. Court of Federal Claims No. 1:04-cv-01726 (Fed. Cl. Aug. 6, 2008).

The taxpayer's basis in premium payments associated with the former mutual life insurance policy surrendered in this demutualization exceeded the cash proceeds received **or** fair market value of the stock issued in the demutualization. Pursuant to the decision in *Fisher, et al .v. United States* referenced above, the taxpayer's basis in the proceeds received is equivalent to the cash proceeds received immediately following the demutualization **or** the fair market value of the stock received in the demutualization as of the date of the demutualization. Accordingly, the taxpayer has a diminished gain upon the stock recognition event originally reported in this tax year.