

TAX UPDATE

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Keeping Things Open—Life Insurance Demutalization Case
August 18, 2008



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Demutualization and the Insurance Policy

In a decision that has gotten a lot of attention, the U.S. Court of Federal Claims issued its decision in the case of *Fisher v. United States*, a case where the taxpayer disputed the IRS's consistent position that a policyholder who receives shares in a demutualization gets zero basis in those shares. Thus, in this case, where the shareholder takes cash in lieu of the shares, that taxpayer recognizes capital gain in the full amount of the cash.

In this case the taxpayer, who was an irrevocable trust, took cash and reported the entire amount as income, taking zero basis as consistent with the letter ruling the insurer had obtained from the IRS for the transaction. The taxpayer later filed a claim for refund, taking the position that there actually no gain on the transaction.

Basket of Assets

The key issue being dealt with is the fact that the taxpayers in these cases took a single

asset (their insurance policy with the mutual insurance company) and had that split into the policy standing alone (with none of the special rights mutual policyholders have) and stock in the new stock company. As the transaction was ruled to be a tax free splitting of the rights, the key question becomes what is the basis of each asset. Generally when we have a “basket” of assets and end up selling off some, we have to allocate that basis. Reg. §1.61-6(a) provides:

When a part of a larger property is sold, the cost or other basis of the entire property shall be equitably 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 or other basis allocated to such part. The sale of each part is treated as a separate transaction and gain or loss shall be computed separately on each part. Thus gain or loss shall be determined at the time of sale of each part and not deferred until the entire property has been disposed of.

We end up having to allocate the basis in order to determine what the gain or loss on the part sold would be. Judge Allegra, citing a number of cases, notes in this opinion, that “This 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.” However, the judge goes on to note:

Of course, for this formula to work, one must be able to derive the fair market values of the component parts of the larger property. The regulations presume these values are obtainable, stating that "only in rare and extraordinary cases will property be considered to have no fair market value." Treas. Reg. § 1.1001-1(a); see also *Likins-Foster Honolulu Corp. v. Comm'r of Internal Revenue*, 840 F.2d 642, 650 (9th Cir. 1988). But, what if, despite this regulatory bravado, it proves impractical or impossible to derive the values needed for the basis apportionment formula, at least without engaging in undue speculation? Does that mean that none of the basis of the originally-acquired property is allocable to the part disposed of or that all of it is allocable thereto until exhausted? These questions, of course, beg a deeper inquiry as to how, if at all, Treas. Reg. § 1.61-6 applies in such circumstances -- whether, for example, conditions not immediately apparent, perhaps those lying in the substructure of the income tax, serve to delimit the regulation?

As you might guess, our problem is this exact question of how to split up the basis in the case of a demutualization.

The IRS's position has been clear—all basis remains with the policy, and the resulting

shares have a zero basis. In this particular case the insurer, Sun Life, sought an IRS ruling on the tax status of their proposed demutualization transaction—and the ruling came to the same conclusion the IRS has always arrived at:

On May 19, 2000, in response to a request from the company, the Internal Revenue Service (IRS) issued Private Letter Ruling 200020048, which dealt with various tax aspects of the demutualization. In that ruling, the IRS noted that the aforementioned ownership rights "cannot be obtained by any purchase separate from an insurance contract issued by [Sun Life]." It ruled that, under section 354(a)(1) of the Internal Revenue Code of 1986 (26 U.S.C.) (the Code), "[n]o gain or loss will be recognized by the Eligible Policyholders on the deemed exchange of their Ownership Rights solely for Company stock." It further opined that the "basis of the Company stock deemed received by the Eligible Policyholders in the exchange will be the same as the basis of the Ownership rights surrendered in exchange for such Company Stock," that is, "zero."

It is important to note that the question of the basis of the Company Stock wasn't really the key issue Sun was looking to get resolved in this ruling. As well, as the court pointed out, the PLR wouldn't be binding on the shareholders and the IRS really didn't rule on this matter so much as parrot what Sun had said. In a footnote to the opinion, it was noted:

But that ruling merely parroted factual representations made by Sun Life and is of little moment in this case. While Sun Life could rely on that ruling in its dealings with the IRS, the ruling had utterly no binding or precedential impact on the tax treatment entitled by third parties, such as plaintiff here. *See, e.g., Wolpaw v. Comm'r of Internal Revenue*, 47 F.3d 787, 792 (6th Cir 1995); *see also* Rev. Proc. 2000-1, 2000-1 C.B. 4 (section 2); *Peerless Corp. v. United States*, 185 F.3d 922, 928 (8th Cir. 1999) (private letter ruling "by its terms is directed only to the taxpayer who requested it").

The question of how the IRS has tended to arrive at the zero basis conclusion, and whether their reasoning is valid, was the matter to be decided in this case. However, that was after an earlier decision in which the court rejected the view that this should be viewed as a policy dividend, excluded from income under §72. The court summarized its earlier decision in a footnote, noting:

Section 72 of the Code provides rules governing the reporting of income corresponding to annuities received under annuity, endowment or life insurance contracts. Section 72(e)(2) excludes from gross income certain amounts not received as annuities, among them "any amount received which is in the nature

of a dividend or similar distribution," as defined in section 72(e)(1)(B). In its November 15, 2006, opinion, the court held that the amounts received by plaintiff did not qualify for exclusion under these provisions, finding that plaintiff "received those proceeds upon an entirely unrelated sale of the stock it received in the demutualization." In its post-trial brief, plaintiff asks the court to reconsider this ruling. The court sees no basis for doing so.

So the taxpayer's case rested on the issue of whether basis could be allocated to the stock sold and, if so, how that would be done.

Open Transaction Doctrine

It is important to note that what was decided was not a matter of law—in fact, in many ways the parties didn't disagree on the law in general applicable, just how the facts fit into that law (and perhaps whether the facts in this case were or were not distinguishable from other cases). As the court noted in denying the taxpayer's motion for summary judgment on the issue that there was no gain to be reported:

The court then concluded that it could not resolve, as a matter of law, plaintiff's claim that no capital gain was realized on the sale of the Financial Services Stock because the proceeds were offset by plaintiff's basis in the stock, finding that the claim presented material questions of fact that required a trial.

So we have here the court ruling on the question of fact presented to it here. That is important because, as we will see, the Court simply found the taxpayer's expert more persuasive on the matter at hand.

While the opinion suggests it might be difficult to convince the court otherwise, either through a better analysis by the IRS expert or if the facts aren't exactly equivalent to the Sun Life facts, we do need to be aware that this case was a case decided on facts—and specifically, as is often referred to in the decision, facts that were one of the “rare and extraordinary cases” where fair market values could not be obtained. Conversely, if a court could be persuaded that values could be obtained at the time of demutualization, then the rationale of this decision would require a different result.

Which brings us to the open transaction doctrine, a doctrine the IRS argued did not apply to this case and which the taxpayer claimed did. The court examined this doctrine, beginning with the following discussion of the 1931 U.S. Supreme Court *Logan* case:

Into this evolving legal environment was born the so-called "open transaction" doctrine, an accouchement traced to *Burnet v. Logan*, 283 U.S. 404 (1931). In that case, Mrs. Logan sold stock of a closely-held corporation which assets

included stock in a second corporation that owned a mine lease. *Id.* at 409. She and the other shareholders, which included her mother, exchanged the stock for cash and a stream of annual payments corresponding to the amount of iron ore extracted from the mine. The IRS argued that, at the time of the sale, the right to receive the mining royalties could be estimated based upon the amount of reserves at the mine and that the transaction should be taxed based upon the value of that estimate. *Id.* at 412.¹¹ The Supreme Court demurred, holding that Mrs. Logan was entitled to recoup her capital investment in the stock before paying income tax based on the supposed market value of the mineral payments. It reasoned:

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 speculations. When the profit, if any, is actually realized, the taxpayer will be required to respond. The consideration for the sale was \$2,200,000 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. . . . She properly demanded the return of her capital investment before assessment of any taxable profit based on conjecture.

Id. Notably, Mrs. Logan's mother owned stock in the same company and sold it on the same terms. She, however, died and her payments under the same sales agreement were valued for estate tax purposes. *Id.* at 413-14.¹² The Supreme Court, however, summarily dismissed the notion that the valuation of the payment stream for estate tax purposes should be used for income tax purposes, stating "[s]ome valuation -- speculative or otherwise -- was necessary in order to close the estate. It may never yield as much, it may yield more." *Id.*; see also 1 Mertens Law of Fed. Income Tax'n § 5:15 (2008).

It is useful to note here that the problem for Mrs. Logan wasn't dividing up basis—rather, in her case the problem was that the amount to be received was unknown. The court noted, waxing a bit poetic in its writing that from this beginning “the "open transaction" doctrine developed like a pavane -- intertwined in theory, but rarely touching in the decisional law.” The opinion continues to reinforce the rarity of application of this doctrine, likely to attempt to limit the applicability of this decision outside of the fact

pattern we have here.

It turns out there is a precedential Court of Claims case involving the matter of having an uncertain split of basis—and, even better, it was the IRS that was arguing for the application of the open transaction doctrine (life is always nice as a tax professional where you have a case you are citing when the IRS is arguing the exact position you want to argue):

A dozen years after *Logan*, in *Pierce v. United States*, 49 F. Supp. 324 (Ct. Cl. 1943), it was not the taxpayer, but the United States, that claimed that a transaction was still open. In that case, the First National Bank of the City of New York, in order to give its stockholders the benefits of investments in securities that could not then be lawfully held by a bank, organized a separate company, First Security Company, to invest in such securities. Each of the certificates of stock in the bank was endorsed with a statement that the stockholder had an interest in the dividends or profits, and, in case of dissolution, in the distribution of capital of the Security Company, ratable with its interest in the bank. *Id.* at 329. Via this arrangement, the shareholders also had limited control over the Security Company, albeit control exercised through the votes of the holders of two-thirds of the bank stock. Neither the bank stock by itself, nor the interest represented by the endorsement, could be transferred separately from the other. Between 1928 and 1932, the plaintiffs' testator bought thirty-five shares of the bank stock with the endorsements. The Banking Act of 1933, however, banned the securities arrangement used by the bank, causing the Security Company to be dissolved; transferable interests in the proceeds of the dissolution were issued to the bank stockholders and the endorsements were removed from the stockholders' certificates of bank stock. The plaintiffs' testator received his interest in the proceeds of the dissolution on December 6, 1933, and promptly sold them on January 29, 1934, allegedly at a loss, on account of which they sought a refund of income taxes.

The United States contended that --

the sale by plaintiffs' testator of the declarations of interest in the dissolution of the Security Company may not be treated separately as showing a loss, since his interest in the Security Company was acquired in combination with his stock in the bank, and the answer to the question whether a loss or profit resulted from the transaction cannot be had until the bank stock is sold, so that it may be known how much the combined investment has sold for.

Id. at 330. While conceding that "in some instances apportionment of the amount of a single purchase price to several items purchased for that single total price may be had," defendant asseverated that the situation presented was "not a proper case for such an apportionment, since it would not be practicable here." *Id.* The court took the latter contention to mean that "no particular value could be assigned to the interest in the Security Company represented by the indorsement on the bank stock, as of the date of the purchase of the bank stock, with any degree of assurance that that assignment of value was correct, or even approximately so," requiring the "answer to the question of profit or loss" to wait "till the bank stock is sold." *Id.* Readily agreeing with this proposition, the court reasoned that "an attempt here to attribute a certain value to the interests in the Security Company acquired by plaintiffs' testator involves us largely in guess-work." *Id.* Rejecting plaintiffs' attempt to value the endorsement, the court found that "we do not think that the situation calls for such a rough estimate, when by patience the exact answer may be obtained." *Id.*¹³ The upshot, the court concluded, was that "the Commissioner acted within his powers in refusing to permit the deduction." *Id.*

The Court notes a matter the IRS would argue solved this matter—the issuance of Reg. §1.61-6 in 1957. The court notes that this regulation generalized the application of the doctrine of allocating basis to the parts should work similarly as it did in specific prior regulations that were limited to real property. However, the Court noted:

Nevertheless, even after this new and broader regulation was promulgated, both taxpayers and the Commissioner continued to invoke the "open transaction" doctrine -- and, at times, did so successfully. Sometimes, as in *Logan*, the doctrine was pressed by taxpayers claiming that no gain should be realized upon the sale of a portion of a given property until the basis of the entire original property acquired was recovered.¹⁷ In other instances, defendant invoked the doctrine in seeking either to: (i) postpone income to years in which the statute of limitations on assessments was still open; or (ii) argue that no loss should be deducted upon the sale or exchange of a portion of a property until all the interests comprising the property have been sold or exchanged.¹⁸

The Court also noted that the passage of IRC §453 also served to limit the open transaction—but not in a way that impacted this case's problem with basis:

Yet, the legislative history of this section confirms that Congress envisioned that the "open transaction" doctrine would still be available, albeit, to use the words in one report, in "rare and extraordinary" circumstances.¹⁹ And it bears noting

that none of these statutes directly addressed the impact of the doctrine on basis allocations -- the form of the doctrine pertinent here. Accordingly, while these statutes undoubtedly narrowed the scope of the doctrine,²⁰ they did not defenestrate it -- the doctrine survives, albeit in more limited form, but with its basic rationale unscathed, leaving the courts to apply it as appropriate. See *Gladden v. Comm'r of Internal Revenue*, 262 F.3d 851, 855 (9th Cir. 2001) (recognizing the continuing viability of the doctrine); *Davis*, 210 F.3d at 1348 (same).²¹

Thus finding the open transaction doctrine still to viable, though in more limited cases, the Court went on to look at the experts' opinions in this case.

Impossible to Value or Valueless?

A key question that would arise is whether this was the case of rights that were impossible to value or that were, in fact, valueless. The Court noted that experts for both sides agreed on a number of factors, including the fact that the rights prior to demutualization could not be sold separately. But they differed on what that meant.

The Court first noted the position of the taxpayer's expert:

Plaintiff's valuation expert, Mr. Cole opined that traditional methods could not be used to value the "ownership rights" associated with the policy because those rights were neither separable nor alienable. While convinced these rights added to the value of the policy, he concluded that, prior to the demutualization of Sun Life, their fair market value, separate from the policy itself, was "not determinable."

The key position noted there is Mr. Cole's conclusion that, in fact, the rights did add value to the policy, even though there might not be susceptible to valuation using traditional methods. The IRS's two experts viewed the lack of ability to value it somewhat differently than the taxpayer's expert. The Court first goes into Mr. Reiskytl's position

One of defendant's experts, Mr. Reiskytl, previously worked at a mutual insurance company. He confirmed many of the premises underlying Mr. Cole's opinion. Contrasting the ownership rights of mutual policyholders to those of traditional shareholders, Mr. Reiskytl observed that "[u]nlike shareholder ownership rights that are *separate* from the contractual rights of the insurance policy, the mutual policyholder's ownership rights are *inextricably tied* to the underlying insurance contract." (Emphasis in original). He further noted that the policyholder ownership rights could not be "separately purchased, transferred or

sold." and that "[t]here is no separately determinable or identifiable price for these ownership rights at the time of purchase of an insurance policy." Yet, in a somewhat self-contradictory fashion, Mr. Reiskytl proceeded to set a value for these rights, specifically concluding, based upon various factors, that they had "no" value.²³

The Court then noted the IRS's other expert, Mr. Penny:

Defendant's other expert, Mr. Penny, also recognized that "the subject ownership rights could not be purchased nor [sic] sold separate from the purchase of an insurance policy." But, he essentially turned a blind eye to this fact in concluding that the value of the ownership rights was "best stated at zero during the 1990 calendar year." To derive this value, Mr. Penny purportedly used cost-and market-based approaches to valuation, based on his view of the cost of replacing asset and its market value, respectively.²⁴ Yet, he did so, conspicuously, without considering any comparable properties, serving to highlight the fact that there were neither such comparables, nor, for that matter, any market in which the ownership rights or some derivative could be sold.

The Court noted these divergent opinions, explaining:

So what caused those differences? It would appear that the experts parted company in deciding whether the nature of the ownership rights made them "impossible or impractical" to value or simply valueless. And that disagreement, in turn, undoubtedly stemmed from unstated differences as to what is meant by the phrase "impossible or impractical" -- a phrase that, despite dozens of "open transaction" cases, has received little in the way of direct definition. That the phrase "impossible or impractical" has largely been left undefined almost undoubtedly derives from the fact that most "open transaction" cases are heavily fact-driven. Nonetheless, a synthesis of the decisional law yields several factors that have proven pivotal in deciding whether a rational basis exists for determining fair market value.

After noting various factors (marketability of the asset, lack of proxies to be used as comparables to value the asset, value contingent upon factors not possible to foretell with any degree of confidence), the Court concludes:

Logic and experience suggest that the presence *vel non* of the above factors ought to be reflected in the ability (or inability) of an expert to value an asset reliably using accepted valuation methods. *See McCormac*, 424 F.2d at 620. The

latter methods, of course, are not intended to produce results with talismanic precision, for it is well-accepted that fair market value is "incapable of mathematical precision and implicates methods of judgment." *United States v. 1,378 Acres of Land, More or Less, Situate in Vernon County, State of Miss.*, 794 F.2d 1313, 1318-19 (8th Cir. 1986).³¹ Yet, empirically-speaking, if an expert lacks any rational basis upon which to value an asset, that ought to be strong indication that the asset is insusceptible of valuation.

As noted, given the *Pierce* holding, the Court is willing to apply the open transaction doctrine if, in fact, the valuation is impossible. But the Court warns that the burden of showing this impossibility falls on the taxpayer.

The burden of demonstrating this, of course, lies squarely upon the one invoking the exception -- here the plaintiff -- which must show that there was not "enough hard information in place from which willing buyers and willing sellers could construct soundly based equations of value." *Campbell*, 661 F.2d at 215; *see also Bernice Patton Testament Trust*, 2001 WL 429809, at * 2; *Rosenberg v. United States*, 3 Cl. Ct. 432, 437 (1983) (P. Miller, J.). Ultimately, it falls to the court to consider the record evidence bearing on the factors listed above, with particular focus given the expert opinions provided, and to determine, as a factual matter, whether plaintiff has proven that a rational basis for establishing the value of the asset in question is lacking.³²

Burden Met

The Court concludes that, in fact, the evidence presented by the taxpayers' expert did show that a rational basis for establishing the value of the asset was lacking. The Court notes:

With this background, and after carefully weighing the evidence, the court finds that this case presents one of the "rare and extraordinary" situations in which the "open transaction" exception to Treas. Reg. § 1.61-6 should apply. Of the experts who testified, the court is persuaded that Mr. Cole most accurately considered the realities of the circumstances presented here and the limitations on valuation inherent therein. In particular, he focused on the fact that the ownership rights were, at the outset, inextricably tied to the underlying insurance policy and were not separately sellable. Both he and, to a certain extent, Mr. Reiskytl, viewed this fact as an important indication that the ownership rights lacked a determinable fair market value at the time the policy in question was first acquired.

The Court also noted that this was different from holding there was no value, the position the IRS needed to sustain for the entire amount to be taxable. While the IRS experts had testified the rights had no value, the Court noted:

Notably, Mr. Penny readily admitted that there was neither a market upon which to gauge the value of the ownership rights nor any assets that could be deemed comparable to those rights, so as to allow for accurate application of the market method of valuation. Rather, he, and to a lesser extent, Mr. Reiskytl, set the value of the ownership rights at zero because Sun Life had not incurred any costs in establishing those rights -- that is, because prior to the demutualization, Sun Life had neither associated any cost with the ownership rights on its books nor accounted for the rights in pricing its policies.

However, the Court found that factor to be utterly irrelevant, as it viewed it from the wrong perspective (that of Sun rather than the policyholder) and, as the Court noted, could just as well be deemed evidence that such rights were inherently intertwined with the policies and gave rise to no rational way to separate out the costs just as there was no rational way to separate the value, not that in fact they had been “no cost” items.

The Court also noted that this was not a “windfall,” a term the IRS used to describe what the policyholders received. It noted

Defendant's repeated and pejorative use of that term seemingly proceeds from the notion that, as in Orphic hymns, the value associated with the ownership rights here sprung from the aether, somehow sparked by the demutualization itself. As characterized by Mr. Scanlon, one of defendant's witnesses, these rights were "embedded values" that were not "monetized" until the demutualization occurred. But, if there is any meaningful distinction to be made between "embedded values" that were not previously "monetized" and ownership rights that were "impossible or impractical" to value at the time they were first acquired, it is almost certainly one without a difference.³⁹ Nor is there the slightest support for the suggestion, again made by one of defendant's witnesses, that the allocation of stock here was a "windfall" because it was mandated by Canadian and state regulatory agencies. A silent premise in this argument, of course, is that those agencies acted arbitrarily or at least with considerable largesse in requiring compensation to be paid for the loss of ownership rights that -- in defendant's view -- were valueless. But, the court is no more inclined to believe this charge, sans any shred of evidence to support it, than it would be to ascribe similar conduct to Congress and Federal agencies. Without any evidence to the contrary, the more logical conclusion is that such agencies, and the legislatures that empowered them, sincerely believed that the ownership rights had value and that the policyholders were entitled to be compensated for their

loss.⁴⁰ The "windfall" tag, therefore, lacks evidentiary adhesive and does not stick.

At all events, the assertion that the ownership rights here ever had a "zero" value is thoroughly rebuffed by the actuarial study provided by Sun Life to its policyholders with the plan for demutualization. That study focused on whether the stock to be provided in the demutualization adequately compensated those policyholders for the ownership rights that were being relinquished. It recognized, as a first principle, that the stock allocation "should fairly compensate for what policyholders lose in the demutualization; namely, voting control of the insurance company and the right to share in the insurance company's residual value if it is wound up." It noted that the demutualization plan "provided for a fixed allocation of 75 Financial Service Shares to each Eligible Policyholder, regardless of the number of policies held, and for a variable allocation to each Eligible Policy of a number of Financial Services Shares which depends on its Cash Value, the number of years it has been in force and its annual premium." The study stated that it --

regarded the fix allocation as compensation for loss of voting control and the variable allocation as compensation for loss of the right to share in residual value. It is appropriate that the fixed allocation be the same to each Eligible Policyholder, since each has one vote and all the votes should be treated as equal. It is appropriate that the variable allocation differ among Eligible Policyholders because they have different customer attachments to, different financial interest in, and different rights to receive surplus distributions from, Sun Life of Canada.

In concluding that the compensation for the lost ownership rights was "fair," "equitable," and "appropriate," the report cited several other facts that suggest that the ownership rights had value prior to the demutualization, including that: (i) value comparable to that being offered in the Sun Life demutualization had been allocated to voting rights in other prior demutualizations; (ii) the loss of voting control could indirectly impact policy dividends, the payment of which was "largely at the discretion of [Sun Life's] board of directors; and (iii) the "primary historical sources of surplus" for Sun Life had been its "individual participating policies." Finally, and importantly, the report recognized that the distribution of stock was a "zero-sum game," that is to say, that certain policyholders would be harmed if the plan struck the wrong balance between the value of the voting rights and the residual rights. Of course, there would be no such harm -- and, concomitantly, no need to strike such a careful balance -- if

either right properly were characterized as a "windfall."⁴¹

In what may be the most unkind slap to the IRS, the Court concludes “In sum, based on the record, the court simply cannot credit defendant's "zero" valuation of the ownership rights.” That is important because *only* a zero valuation would give the result the IRS demands, even if the open transaction doctrine did not apply. In fact, when I first read articles discussing this topic years ago (authored, as I recall it, by Burgess Raby and his father—Burgess being the plaintiff's attorney in this case) they emphasized that the IRS rulings seemed to grab this “zero basis” position as a given, not based on anything that appeared to be the absolute result under the law.

Where Do We Stand?

Well, we have some issues here. In this particular case, the taxpayers cashed out immediately, but given the time when most demutualizations took place for many insurers those years will be closed for claims for refund unless taxpayers have filed protective claims.

However, if taxpayers held onto the stock, they could have sold them in open years or still be holding the stock. In those cases, a real issue would be what would now be the basis of those shares. In an Leimberg Services article discussing this decision, Steve Leimberg quoted Burgess Raby as suggesting he believed a likely solution was that the shares took their fair value at the instant of the demutualization—but that wouldn't necessarily be the only solution, and any position would need to be researched to determine its standing and whether the position was one that would require disclosure.

Similarly, if a taxpayer cashes in the insurance policy, that “floating basis” issue also becomes a problem, since basis in the policy is one of the factors in determining gain or loss on disposition. The IRS position made this simple—all the basis was in the policy. But if, in fact, part of the basis “bled” into the new shares, then gain could be triggered on a surrender when the taxpayer believed there was no such gain—or, at the least, the gain would be larger.

It remains to be seen what the IRS's response to this case will be, including whether they will appeal. As well, right now we've only heard from the Court of Claims—we still will be watching for any cases that involve the Tax Court, District Courts, as well as any cases that make it to the Courts of Appeal.

But we should notify any potentially affected clients that there is an issue here they might want to look into, even if we right now all we know that is one venue has found the gain should not be taxable.