Income Tax Consequences of Demutualization

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The shift from member-owned, mutual insurance companies, to policyholder-owned firms, often publicly-traded, has produced a dramatic reordering of the insurance landscape in recent years. The move, facilitated by changes in state insurance laws, has involved an exchange of shares (or money) for the members’ ownership rights in the company which included voting and distribution rights as well as contractual insurance rights. One reason often given for the move has been to position the company to conduct an initial public offering of securities.

A major concern has been the income tax consequences accompanying the move. A case decided in early August, Fisher, et al. v. United States, has cast some light on that question although further litigation appears likely. A final resolution of the issues involved could well be years away.

The income tax issues in a nutshell

The key question, which is still not answered, is the amount of income tax basis for the shares issued in the exchange. On May 19, 2000, the Internal Revenue Service released a private letter ruling which had been requested by the company, Sun Life Assurance Company. The ruling dealt with several aspects of the demutualization process as carried out by Sun Life. The ruling stated that the ownership rights at stake “cannot be obtained by any purchase separate from an insurance contract . . .” issued by the company. Accordingly, IRS ruled that, based on the Internal Revenue Code, “no gain or loss will be recognized by the Eligible Policyholders on the deemed exchange of their Ownership Rights solely for Company stock . . .” IRS further ruled 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 amount was zero. IRS did not rule on the cash received in the transactions.

The 2008 litigation

IRS has continued to maintain that the stock received had a zero basis and the expert witness for IRS in the litigation resulting in the opinion in Fisher, et al. v. United States testified that the fair market value of the ownership rights was zero. The taxpayer’s expert, by contrast, testified that he could not form an opinion as to the fair market value of the ownership rights because he found the ownership rights to be inextricably tied to the policy but he believed the ownership rights added value to the policy but never had a separate value. The taxpayers were insisting that the receipt of shares in...
the demutualization process was based on having paid premiums on an insurance policy so it followed that the shares should have some income tax basis.

The United States Court of Federal Claims, in deciding the case, stated that “... the opinion rendered by plaintiff’s valuation expert that the value of the ownership rights was not discernible” was supported by the record which led the court to conclude that this was an appropriate case for application of the “open transaction” doctrine by which taxpayers could treat amounts received as return of basis until the basis was exhausted, with the remaining amounts subject to income tax. The problem with that outcome is that the court provided no guidance as to how the income tax basis amount should be determined.

That virtually assures an appeal in the case and, in all likelihood, further litigation.

The “open transaction” doctrine

As is well known, the “open transaction” doctrine, which arose in the U.S. Supreme Court case of Burnet v. Logan in 1931, has been roundly criticized by the courts and limited repeatedly in its application. Although the court in Fisher declared that the case should not be read as a “... revivification of the “open transaction” doctrine” but “an unusual and unique result,” the application of the doctrine can only be termed an ill-fitting solution to a difficult, but not impossible, judicial problem. The inapplicability of Burnet v. Logan starts with the observation that there was never a question of the taxpayer’s income tax basis in that case (Burnet v. Logan). The key question was how much the taxpayer would realize in the future because the buyer’s promise to pay could not be ascertained. The court simply held that the taxpayer should not be taxed until there was certainty of gain. Yet in Fisher the focus was entirely on basis. That raises the question of whether the “open transaction” theory should have played any role in the case.

Taxpayer action needed

For those selling demutualization-based securities with the gain reported within the last three years, it is necessary to file a claim for refund or a protective claim in order to take advantage of the court’s order to grant a refund to the taxpayers in Fisher.

FOOTNOTES

2 2008-2 U.S. Tax Cas. (CCH) ¶ 50,481 (Fed. Cl. 2008).
4 I.R.C. § 354(a)(1).
6 2008-2 U.S. Tax Cas. (CCH) ¶ 50,481 (Fed. Cl. 2008).
7 Id.
9 283 U.S. 404 (1931).
10 See 1 Harl, Farm Income Tax Manual § 2.06[1] (2008 ed.).
12 283 U.S. 404 (1931).
13 Id.