Court rules in favor of IRS in demutualization case

February 8, 2013

In brief

The US District Court for the Central District of California, recently ruled in *Timothy D. Reuben v. United States, ; No. 2:11-cv-09448,* that the open transaction doctrine did not apply, concluding that the taxpayer's insurance premium payments were not for membership rights and that the taxpayer had a zero basis in the shares it received as part of a demutualization.

In detail

In 1989, the Don H. and Jeannette H. Reuben Children's Irrevocable Trust (the Reuben Trust) purchased an insurance policy from a mutual life insurance company, Manulife. In 1999, Manulife converted from a mutual insurance company to a stock corporation and hence, demutualized. As part of the demutualization, the Reuben Trust received 40,307 shares of stock to compensate for the value of the mutual rights it had lost. Timothy D. Reuben (Plaintiff) received 5,001 Manulife shares as a distribution from the Reuben Trust. Plaintiff sold his shares in 2005 and reported a short term gain on his 2005 tax return. Plaintiff also reported zero basis on his 2005 tax return in connection with the Manulife shares.

In 2008, Plaintiff claimed a tax refund by filing a 2005 amended federal tax return. The Plaintiff claimed that he inaccurately characterized long term capital gain as short term gain and that the basis of his Manulife shares should have been $41.13 per share and not zero. The IRS allowed the Plaintiff's tax refund related to the inaccurate characterization of long term gain as short term gain, but denied the Plaintiff's claim for any basis in the Manulife shares.

The Plaintiff based his argument on a decision by the Court of Federal Claims, *Fisher v. United States, 82 Fed. Cl. 780 (2008)* (Fisher). In *Fisher*, the court decided that the plaintiff had cost basis in the stock received in connection with the demutualization and was entitled to a refund.

The government argued that the Reuben Trust paid nothing for the membership rights in Manulife and thus the Plaintiff's basis in the shares should be zero. In addition, the government argued that the Plaintiff had not satisfied his burden of establishing the basis for the Manulife shares and requested summary judgment.

The Court first discussed the application of *Fisher* to the Plaintiff's case. The Court distinguished the Plaintiff's case from the facts of the *Fisher* case. In addition to noting that the decision of the Court of Federal Claims in *Fisher* was not controlling, the Court pointed out that the decision in *Fisher* was affirmed in an unpublished opinion with no precedential effect.

The Court also stated that the Plaintiff failed to show that allocating basis between the mutual rights and the stock is so 'difficult' that the Open Transaction Doctrine would be appropriate. The open transaction doctrine permits a delay in gain recognition and taxation of property until the value is made certain. In general, courts have stated that the open transaction doctrine should be used only in "rare and exceptional" circumstances when it is not possible to discern the value of the property.

The Plaintiff argued that the premiums paid by the Reuben Trust were for the membership interests in Manulife as oppose to the underlying insurance policy. The Court disagreed, stating that the premiums paid for the Manulife insurance policies were identical before and after Manulife demutualized. As a result, the Court granted the government's motion for summary judgement and concluded that the stock had a zero basis.

The takeaway

Although in *Fisher* the court noted that the ownership rights were inextricably tied to the underlying insurance policy and were not separately sellable, and thus applied the open transaction doctrine, the Court distinguished the facts of the current case from that of *Fisher*. Moreover, the Court noted that the decision in *Fisher (*which the government has not acquiesced to) was not controlling, and was later affirmed in an unpublished opinion with no precedential effect.

In another recent demutualization case, *Bennett Dorrance et ux. v. United States*, No. 2:09-cv-01284, the US District Court for the District of Arizona concluded that the basis of shares received by the taxpayer could be reasonably determined, that the open transaction doctrine did not apply. The Court concluded in that case that the parties presented inadequate evidence to support to equitable basis allocation.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

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