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Open transaction doctrine does not apply where stock basis can be reasonably allocated

The US District Court for the District of Arizona recently held that the basis of shares received in a demutualization transaction could be reasonably determined, that the open transaction doctrine did not apply, and that the basis of the shares should be apportioned according to Treas. Reg. Section 1.61-6(a). *Bennett Dorrance et ux. v. United States,* No. 2:09-cv-01284.

In 1995, Taxpayers formed a trust which purchased five life insurance policies in 1996 from five different mutual insurance companies (MIC) in anticipation that the benefits to be received would provide cash to pay for estate taxes upon death of the plaintiffs. All five MICs demutualized beginning in 1998 through 2001. As part of the demutualization transactions, the plaintiffs retained their policies, but lost their mutual rights. As redress, plaintiffs received stock of the companies in an amount commensurate with the value of the mutual rights they had lost. The plaintiffs sold the stock in 2003, paid taxes on the gross receipts, and filed a claim for relief, which the IRS denied.

The government's argument focused on the fact that Taxpayers had only membership rights, that the payments made were to purchase only the policies and thus had no basis in the stock. On the other hand, the taxpayers argued that they had ownership rights, and that the payments they made were for both the policies and the mutual rights, that they had basis in the stock received and that the open transaction doctrine applied because the basis in the stock could not be reasonably allocated between the stock and the policies themselves.

The Court first discussed the Government's allegations that the stock received by the taxpayer had a zero basis. In so doing, the Court stated that where a taxpayer demonstrates he has invested in property but cannot establish its value, the basis should not be zero on the basis that the value cannot be readily determined. Denying it in its entirety would be an improper action. As a result, the Court denied the Government's motion for summary judgment.

The Court then discussed the plaintiffs' argument that although the stock had basis, the open transaction doctrine applied. The open transaction doctrine permits a delay in gain recognition and current taxation of property until the value is made certain. The Court stressed 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 Court noted that in demutualization transactions, the assets involved in the open transaction doctrine will generally be disposed of, whereas the life insurance policies generally are kept until the death of the insured. Further, the Court emphasized that in *Fisher v. United States*, 82 Fed. Cl. 780, 795 (Fed. Cl. 2008) (aff'd without opinion by *Fisher v. United States*, 333 Fed. App'x. 572 (2009)), neither the government nor the taxpayer addressed how the use of the open doctrine could be avoided completely by applying some reasonable apportionment method.

The Court emphasized that neither the government nor Taxpayer showed that allocating the basis between the rights and the stock was so difficult that it required application of the open transaction doctrine. The Court noted that at the time of the demutualization, the value of the stock and the market value of the policies without the rights could be reasonably calculated. As such, what the open transaction doctrine seeks to protect -- taxing a transaction that has no ascertainable fair market value in the year of sale -- was not an issue in this case, and that applying the doctrine to this case, would be inequitable.

Finally, the Court analyzed Treas. Reg. Section 1.61-6(a) with regard to basis allocations where only one part of a piece of property is sold. According to the court, there is no one single appropriate method for basis allocation. However, the Court concluded that neither the government nor the taxpayers had provided sufficient evidence for the Court to equitably do the allocation.

PwC Observation

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 this case by pointing out that Taxpayers held the stock instead of receiving cash, and that the basis of those shares could be reasonably determined.

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