



# FINANCIAL SERVICES

## - Insurance Tax Bulletin

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### Trust's Demutualization Tax Refund Suit Continues

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The Court of Federal Claims denied summary judgment to a trust and the government in the trust's suit seeking refund of taxes paid on the sale of stock it received in a demutualization transaction.

Seymour P. Nagan Irrevocable Trust (the Trust) purchased a life insurance policy from Sun Life Assurance Company (Sun Life). The policy was a "participating policy," and on October 20, 1999, eligible policyholders of Sun Life voted to convert the company into a stock company (Financial Services). Sun Life distributed the full value of the company to its participating policy holders through the issuance of shares of Financial Services stock. Eligible policyholders transferred to Sun Life their voting rights and right to receive a distribution in the event of solvent liquidation, and the Trust received 3,892 shares of Financial Services stock in exchange for its voting and liquidation rights. The Trust sold those shares for \$31,579.00, reported this amount unreduced by any basis adjustment on its federal income tax return for 2000, and paid tax of \$5,725.00. Plaintiff then filed a timely claim for refund of the \$5,725.00, and upon being denied, filed this suit.

The Trust first asserts that proceeds from the sale of the Financial Services stock should be deemed a distribution by Sun Life of a policy dividend, or the equivalent thereof, and should be excluded from gross income as a return of capital under the annuity rules of section 72. Section 72(a) generally provides that gross income includes any amount received as an annuity. Section 72(e) provides special rules applicable to amounts "received under [a] . . . life insurance contract" that are "not received as an annuity." 26 U.S.C. § 72(e)(1)(A). Treas. Reg. § 1.72-1(d) provides that "amounts not received as an annuity" and before the annuity starting date "are generally includible in the gross income of the recipient only to the extent that such amounts, when added to all amounts previously received under the contract which were excludable from the gross income of the recipient under the income tax law applicable at the time of receipt, exceed the premiums or other consideration paid." But, plaintiff did not receive the \$31,579.00 as a distribution under its life insurance contract with Sun Life, but rather received those proceeds upon an entirely unrelated sale of the stock it received in the demutualization. Indeed, had plaintiff received cash in exchange for its voting and liquidation rights, the exchange would not have been tax-free under section 354 of the Code. Therefore, the court saw no basis for treating those proceeds as being received "under" a life insurance contract.

The Trust next argues that there was no capital gain realized on the sale of the Financial Services Stock because the proceeds were offset by the Trust's basis in the stock. Plaintiff argues that a portion of the premiums it paid were for the voting and liquidation rights that it exchanged for the stock, and contends that under section 358(a)(1), it acquired a basis in the Sun Life stock equal to the basis in the ownership rights surrendered. While defendant does not dispute the applicability of section 358(a)(1), it argues, as a matter of law and based upon the meager evidence in the record, that the voting and liquidation rights were worthless.

The Court found that amounts from the sale were not issued under the insurance plan and that there were questions regarding premium amounts. Accordingly, plaintiff's motion for partial summary judgment was DENIED and defendant's cross-motion for summary judgment was also DENIED.

**PwC Observes:** The court viewed the amount of the premiums that should be attributed to the liquidation and voting rights as a material question of fact that could not be resolved and thus requires a trial.

For additional information please call Anthony DiGilio at (202) 414-1702 or contact your local insurance tax professional. Please visit us at: <http://www.pwc.com/us/insurance/tax>

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