

Court allocates basis to stock acquired from demutualization transactions upon sale of stock

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In brief

In July 2012, the US District Court for the District of Arizona concluded that a life insurance policyholder had basis in the shares of stock received in connection with the demutualization of five life insurance companies, but that a trial was required to determine the amount of that basis. A trial was held in December, and recently the court allocated basis consistently with the demutualizing company's allocation of shares to the policyholder in connection with the demutualization. *Bennett Dorrance et ux. v. United States*, No. CV-09-1284-PHX-GMS (March 19, 2013). This case is important for taxpayers who intend to sell stock received in a demutualization transaction, and demonstrates that courts continue to grapple with whether to apply the open transaction doctrine and how a taxpayer's basis, if any, should be allocated.

In detail

In 1995, the taxpayers formed a trust which purchased five life insurance policies in 1996 from five different mutual insurance companies in anticipation that the benefits to be received would provide cash to pay for estate taxes upon death of the plaintiffs. All five companies demutualized beginning in 1998 through 2001. As part of the demutualization transactions, the taxpayers received stock of the companies in exchange for mutual rights. The taxpayers sold the stock in 2003, paid taxes on the gross receipts (\$2,248,806), and filed a claim

for relief in the amount of \$337,321, which the IRS denied.

In its earlier order, the court analyzed Treas. Reg. Section 1.61-6(a), which addresses basis allocations where only a part of a piece of property is sold. According to the court, there is no single appropriate method for basis allocation. The court concluded that neither the government nor the taxpayers provided sufficient evidence for the court to resolve the case without a trial.

At trial, the parties provided the necessary information for the court to complete the allocation of basis. The court examined

how the companies allocated shares to the taxpayers upon the demutualization. Specifically, the companies allocated the shares based on (1) the value of the voting rights, (2) past contributions to surplus, and (3) projected future contributions to surplus. Applying Treas. Reg. Section 1.61-6(a), the court determined the basis of the shares using a similar methodology. The court concluded that projected future contributions to surplus could not be taken into consideration to determine the basis because they are a portion of premiums for which the taxpayers had not paid before receiving the shares.

As a result, the court held that the stock basis was equal to a combination of the IPO value of the shares allocated to the taxpayers for (1) the fixed component, which represented the compensation for relinquished voting rights, and (2) 60% of the variable component, which represented past contributions to surplus. Under this formula, the total basis in the shares amounted to \$1,078,128. Therefore, the court concluded that the taxpayers were entitled to a refund in the amount of \$161,719 instead of the \$337,321.

The takeaway

The court's approach in *Dorrance* is different from the approach that other courts have taken. For example, in *Fisher v. US*, 82 Fed. Cl. 780 (Fed. Cl. 2008), the Court of Federal Claims applied the open transaction doctrine. In *Reuben v. US*, No. CV 11-09448 SJO PJWX, the US District Court for the Central District of California held that the open transaction doctrine did not apply and that the individual had zero basis in the shares. In *Dorrance*, the Court took an approach different

from that of both *Fisher* and *Reuben* and allocated basis to the stock. The *Dorrance* case demonstrates that there is not a consistent approach to determining whether stock acquired in a demutualization transaction has basis and, if so, how that basis should be allocated. As a result, taxpayers should consult with their tax advisors if they intend to sell stock received in a demutualization transaction.

Let's talk

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

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