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TOPIC: Sale of Stock Received on Demutualization Taxable with Zero Basis

CITATION: *Dorrance v. United States*; Nos. 13-16548, 13-16635 (9th Cir. Dec. 9, 2015).

SUMMARY: This case involved the calculation of the cost basis of stock received through a life insurance demutualization. Here, the taxpayers sold stock derived from the demutualization of five mutual insurance companies.

They initially stated that they had no cost basis in the stock and consequently paid tax on the gain. However, they later claimed a full refund.

The district court agreed the Dorrances had a calculable basis in the stock and were therefore entitled to a partial refund.

But now, the Ninth Circuit Court of Appeals has held that the IRS properly denied the refund claim and that the district court had erred in its cost basis calculation because taxpayers had not met their burden of showing that they had *paid* for the stock.

In an opinion that seems more logical than that of the majority, a dissenting judge disagreed that the Dorrances had "paid nothing" for their membership rights.

RELEVANCE: This appeal considers whether taxpayers had a cost basis in assets that they later sold, but for which they "paid nothing." The specific question is whether a life insurance policyholder has *any* basis in a mutual life insurance company's membership rights.

FACTS: In 2000 and 2001, each of the insurance companies from which the Dorrances bought policies demutualized. Bennett Dorrance, grandson of the founder of the Campbell Soup company, and his wife received and then sold stock derived from the

demutualization of five mutual life insurance companies from which they had purchased policies.

Post-demutualization, the Dorrances no longer held any mutual membership rights, but they retained their contractual interests under the insurance policies and continued to pay the same premiums. To produce a "fair and equitable" allocation of the company's surplus at the time of demutualization, the companies in question here opted to issue stock to their policyholders.

In 2003, the Dorrances sold all of the stock for $2,248,806. On their 2003 tax return, in compliance with IRS policy, the Dorrances listed their basis in the stock as zero, reported the $2,248,806 as capital gain, and paid the tax due on that gain.
But four years later, the Dorrances filed a tax refund claim in which they argued that they owed no taxes on the stock sale because it represented a return on previously-paid insurance policy premiums.

The district court calculated the Dorrances' basis in the stock using the following formula: (1) the initial public offering ("IPO") value of the fixed shares allocated to the Dorrances in 2003, plus (2) 60% of the IPO value of the variable shares. Applying this formula, the court found that the Dorrances were required to pay taxes on $1,170,678, rather than on the full $2,248,806 value of the stock. Because in 2003 the Dorrances paid taxes based on a zero basis calculation in the stock, the district court found that they were entitled to a refund.

Both parties appealed the adverse portions of the judgment.

The Dorrances had the burden of establishing basis. Because they failed to establish that they had any basis in the membership rights, the appeals court followed the basis utilized by the IRS under the “presumption of correctness” resulting in a zero basis.

According to the majority, the Dorrances acquired the membership rights at no cost, but rather as an incident of the structure of mutual insurance policies. When the Dorrances purchased their mutual insurance policies in 1996, the premiums they paid related to their rights under the insurance contracts, not to collateral membership benefits such as voting. Under the insurance contract, policyholders paid premiums for the following "contract rights": (1) a death benefit; (2) the right to surrender the policy for a "cash value"; and (3) annual policyholder dividends representing the policyholder's portion of the company's "divisible surplus."

According to the appeals court majority, the premiums paid covered the rights under the insurance contract but did *not* pay for any membership rights. The membership rights were assigned a monetary value at the time of the exchange only as a consequence of the demutualization process and their value was not linked with some premium value paid by the Dorrances.

To the contrary, the value received by the Dorrances and others in their position is a result of cash paid by new stockholders to receive their membership benefits, "a pot of money that no one expected or even envisioned… bargained for, or purchased." In a nutshell, the Dorrances received their share of a "windfall" resulting from the increase in the value of that policy arising from its unforeseen restructuring.'" Stated another way, the basis in the new stock was the same as the basis in what was being exchanged -- the membership rights – which was "zero."

This result follows the statements made by many insurers:

> If you receive common stock, you will not be taxed when you receive it. However, if you sell or otherwise dispose of your common stock, you will be taxed on the full amount of the proceeds you receive for the common stock. (Your tax basis in the common stock will be zero.)

Because the Dorrances could not show payment for their stake in the membership rights, the appeals court held they had no basis in it.

DISSENTING OPINION

The dissenting judge in this case stated, "If, as the majority contends, the Dorrances paid nothing for their membership rights, and did not contribute capital, then why did the several governmental regulators involved require, as a condition of demutualization of each of those insurance companies, that they issue stock to their policyholders to compensate them for the loss of those rights?"

Certainly, since those who acquired shares in the newly publicly traded insurance companies during the IPO process paid cash for their interests, neither the regulators nor the IPO investors would have tolerated the gratuity of a "free lunch" to older investors. So the stock distribution to the Dorrances, even if not specifically contemplated at the time they purchased the policies, was not a gift. That is why, when allocating shares during the demutualization process, the insurance companies relied on a calculation of a fixed component based on the loss of voting rights and a variable

component related to past and projected future contributions to surplus. Policyholders do contribute capital that they are eventually supposed to get back. The majority believes that it comes back with a basis of zero, which complements the majority's belief that the insurance companies created something out of nothing.

To the contrary, the district court determined the Dorrances' cost basis by deducting the expected future premium contribution from the IPO value of the stock, yielding a cost basis of $1,078,128. This was the sum of: (1) the IPO value of the fixed shares allocated to the Dorrances ($3,164) and (2) 60% of the IPO value of the variable shares ($1,074,964) (An estimate of past contributions by the Dorrances to the life insurance policies with the remaining 40% an estimate of the policyholders' future contributions to the policies. Applying this formula, the court found that the Dorrances were required to pay taxes on $1,170,678, which was their sale proceeds of $2,248,806 less their basis of $1,078,128.

Thus, the district court quite sensibly reduced the basis by an expert's estimate of the future contribution component of the IPO value, ensuring that the Dorrances would not underpay the taxes owed. By contrast, the majority's contrary conclusions do not follow from the facts. A portion of the assets of the insurance companies clearly came from the premiums paid by the Dorrances, and they had a substantial basis in the stock distributed to them. "By contending to the contrary, my colleagues in the majority have created nothing out of something. It's a miracle!"

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