



Wednesday, 3 February 2016

WRN# 16.02.03

The WRNewswire is created exclusively for AALU Members by insurance experts led by **Steve Leimberg, Lawrence Brody and Linas Sudzius**. **WRNewswire #16.02.03** was written by **Steve Leimberg**, co-author with **Howard Zaritsky**, of **Tax Planning With Life Insurance**, Publisher of **Leimberg Information Services, Inc. (LISI)** and Creator of **NumberCruncher Software**.

The AALU WRNewswire and WRMarketplace are published by the Association for Advanced Life Underwriting® as part of the Essential Wisdom Series, the trusted source of actionable technical and marketplace knowledge for AALU members—the nation’s most advanced life insurance professionals.

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

CITES: [Timothy D. Reuben v. U.S.](#), No. 2:11-cv-09448-SJO-PJW (U.S.D.C. CD CA, Jan. 15 2013); [Timothy D. Reuben v. U.S.](#) 117 AFTR 2d 2016-313 (9th Cir. Jan. 5, 2016); [Dorrance v. United States](#); Nos. 13-16548, 13-16635 (9th Cir. Dec. 9, 2015); [Fisher v. United States](#), 82 Fed. Cl. 780 (2008).

SUMMARY: Timothy Reuben unsuccessfully appealed the district court’s decision to uphold the IRS denial of a tax refund based on his sale of stock received as part of a mutual life insurance company's demutualization. Based on the same logic as in the *Dorrance* case reported on at *WRNewswire #15.12.14* (i.e. the taxpayer’s failure to prove he had paid for the stock and that his basis was therefore something other than zero), this appeals court agreed with the IRS and district court’s holding that Reuben had no basis in the stock.

RELEVANCE: This appeal considered whether taxpayers had a basis in assets they later sold, but for which they “paid nothing.” Specifically, “Does a policy owner have any basis in a mutual life insurance company's membership rights?” Together with *Dorrance*, Reuben sends a clear message that – at least in the Ninth Circuit –

premiums paid will not be treated in part as payments for membership rights – leaving the taxpayer with a zero basis in shares received in a demutualization.

This case also provides a review of how gain or loss is calculated on sales of shares of stock under the “open transaction doctrine,” which is discussed below. It is also a reminder that it can be hard for a taxpayer—who has the burden to establish basis in property—to convince the IRS regarding his or her basis where the asset is hard to value.

FACTS: In 1989, the Don H. and Jeannette H. Reuben Children's Irrevocable Trust bought an insurance policy from Manulife, a mutual life insurance company. In a mutual life insurance company, the policyholders are members of the company and have membership interests in the company, in addition to holding the insurance policy. These interests include the right to participate in the distribution of benefits in the event of demutualization. Unless and until the company demutualizes, these membership interests are inseparable from the underlying insurance policies.

The Reuben Trust made premium payments on its policy in excess of \$1.7 million from 1989 until 1999. That year, Manulife demutualized and converted from a mutual to a stock company. Shares of Manulife were publicly traded on September 24, 1999, and eligible members of Manulife were entitled to receive common shares, cash, a combination of shares and cash, or policy credits in exchange for their membership interests.

On December 9, 1999, the Reuben Trust received 40,307 shares of stock in connection with the Manulife demutualization. On December 9, 2004, 5,001 of these shares were distributed to Reuben by the Reuben Trust. He sold 1,000 shares on January 3, 2005, for \$45,928.97. He then sold another 3,000 Manulife shares on September 27, 2005, for a total sale price of \$158,950. On his 2005 tax return, he listed his basis for those shares as zero. However, on September 18, 2008, he filed a Form 1040X to claim a tax refund in the amount of \$64,259 and filed an amended 2005 tax return.

Reuben based his claim for a tax refund on two alleged errors in his 2005 tax return: First, he claimed he inaccurately characterized long term gain as short term gain. This claim was allowed by the IRS. Second, he changed the basis value of his Manulife shares from zero to \$41.132 per share – based on a decision in the Fisher case where the court found that Fisher had basis in stock received in connection with the demutualization of an insurer and was thus entitled to a refund. Reuben stated that,

because the court in Fisher ruled the IRS was incorrect in its position that taxpayers have zero basis in stock received in connection with demutualization, he, Reuben, was similarly entitled to a refund.

The IRS rejected Reuben's contention that he was entitled to basis but suspended action on Reuben's appeal until the *Dorrance* case – cited above - concluded. Reuben had to establish (1) the IRS assessment was either illegal or erroneous; and (2) the correct amount of the refund.

The amount of a seller's taxable gross income on a sale of shares from a demutualization is determined by the excess of the "amount realized" from the sale "over the stock's adjusted basis." In general, basis is the cost of property. The IRS argued the Reuben Trust paid nothing for the Manulife membership rights and thus Reuben's basis in the Manulife shares was zero.

Reuben countered that he had a basis in the Manulife share under the following logic:

(1) The Reuben Trust's ownership rights in Manulife had some value prior to the demutualization of Manulife, and this value was not *de minimis*.

(2) Because it is impossible or impracticable to determine the value of these ownership rights, the open transaction doctrine applied to the calculation of the basis value. This would allow him to apply gains to the basis for all of the Manulife shares received by him without apportioning basis between the sold Manulife shares and the retained Manulife shares.

(3) Applying the open transaction doctrine results in a basis value of \$42.38 per share, derived by dividing the total premiums paid by the Reuben Trust by the amount of shares of Manulife stock received by the Reuben Trust upon demutualization. He based this argument on the *Fisher* court's open transaction decision.

The district court fully analyzed the issues. Generally, "when property is acquired in a lump-sum purchase but then divided and sold off in parts, the cost basis of the property is generally allocated over the several parts." But sometimes it is "'impossible or impractical' to apportion basis among several portions of a property. The open transaction doctrine allows taxpayers in such cases to avoid recognizing any capital gain until the *entire* cost basis of the property has been recovered. But this open transaction doctrine is applied very infrequently. It is applied mainly when the

taxpayer's shares of the company were sold in a transaction that was "not a closed one," and so it was not appropriate to impose tax until the profits or losses from the sale were fully realized. The doctrine will be allowed "only in the 'rare and extraordinary' case . . . that presents elements of value so speculative in character as to prohibit any reasonably based projection of worth."

Fisher, the district court recognized, was one of those limited situations. Fisher purchased a life insurance policy from a mutual life insurance company. He paid premiums, for which he received both the insurance policy and ownership rights in the company. The company later demutualized. Instead of receiving shares in the company, Fisher took cash. He reported this amount on his tax return, reported a zero basis, but later sought a tax refund, claiming that he was entitled to some basis in the shares because the ownership rights had value. As it did in the *Dorrance* and *Reuben* cases, the IRS maintained Fisher had no basis in the shares because "none of the premiums were specifically dedicated to acquiring the ownership rights, . . . there was no available market for the ownership rights, and . . . it was highly unlikely, at the time the policy was acquired, that a demutualization would occur." Fisher successfully countered that the value could not be ascertained, and thus the open transaction doctrine should apply. The court agreed that the ownership rights had some value but that value could not be ascertained, and thus the open transaction doctrine applied.

Reuben argued that the facts in *his* case mirrored the facts in *Fisher* and therefore the outcome should be the same. Here are the reasons this court declined to follow *Fisher*.

First, as in *Dorrance*, Reuben "failed to show that allocating basis between the mutual rights and the stock is so difficult that this case requires applying the open transactions doctrine." "The arguments advanced by the parties in *Fisher* may have made it appear more difficult to allocate basis under the regulations than it actually was . . . because neither party addressed how use of the open transaction doctrine could be avoided altogether by applying reasonable alternative basis apportionment methods."

Second, there are factual distinctions between situations where the open transaction doctrine has historically applied and the situation before the court in *Fisher*. The doctrine has traditionally been applied *only* to "situations where the IRS and the taxpayer can determine more accurately the taxpayer's tax liability if they 'wait and see.'" In other words, the open transaction doctrine has been used when the

"transaction" in question will "close," and the taxpayer's tax liability can be determined at that time. Here, by contrast, "the parties will not be able to more accurately determine the taxpayer's liability in the future because "life insurance policies are generally held until the death of the insured, at which time the basis is no longer needed." If the policy is never sold, therefore, application of the open transaction doctrine will result in "the taxpayer . . . getting a windfall, because all of the basis may be allocated to the assets that will be sold, while the asset that does not require basis has its basis reduced." Such a result would, in effect, create a new tax loophole without any foundation in the Code or regulations.

The district court, while agreeing that the facts in this case were similar to those in *Fisher*, claimed they were "materially distinguishable." Most significantly, *Fisher* took cash in lieu of shares in the insurer but Reuben sold the Manulife shares in question some six years following their distribution. So, as in *Dorrance*, "[t]he open transaction doctrine would . . . allow Reuben to apply this gain to basis accrued through policy payments made *before* demutualization, even though the increase in value took place entirely *after* the rights were split." At the same time, since the open transaction doctrine would not recognize any separate bases in the policy and the stock, policy payments made after the demutualization would increase the total basis towards which the stock sale would be applied, even those these payments were not made to obtain the membership rights or the stock.

Furthermore, according to the district court--and affirmed by the Ninth Circuit--Reuben "failed to show that allocating basis between the mutual rights and the stock is so difficult" that application of the open transaction doctrine is appropriate. The Ninth Circuit has provided that the "taxation of an 'open' transaction is deferred only to the extent that consideration received by the seller consists of property having no ascertainable fair market value in the year of sale." "Here, as in *Dorrance*, the Reuben Trust 'received stock, and retained a marketable life insurance policy; it is practical and possible in such circumstances to ascertain the value of these assets in the year of sale. '"

DISCLAIMER

This information is intended solely for information and education and is not intended for use as legal or tax advice. Reference herein to any specific tax or other planning strategy, process, product or service does not constitute promotion, endorsement or recommendation by AALU. Persons should consult with their own legal or tax advisors for specific legal or tax advice.