CHUCK VS. GOLIATH: BASIS OF STOCK RECEIVED IN DEMUTUALIZATION OF MUTUAL INSURANCE COMPANIES

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I. INTRODUCTION

For several years, Charles Ulrich ("Chuck"), a solo accountant from Baxter, Minnesota, pleaded with taxpayers to fight against the Internal Revenue Service's ("IRS") position that stock or cash received in the demutualization of a mutual insurance company had a cost basis of zero.[1] The issue became pertinent to Chuck when he sold some stock he had received from a demutualization and the entire amount was treated as capital gain.[2] This outcome seemed intuitively incorrect to Chuck, as he had paid for insurance knowing he was purchasing an ownership interest in the insurance company, which is how mutual insurance companies are structured.[3] Those interests were subsequently distributed as stock and the IRS then claimed he had no cost basis in the item.[4] Oversimplified, the IRS's position was that the ownership was an incident of the policy ownership and worthless until the demutualization; therefore, no basis should be allocated to it.[5]

Chuck devoted substantial time and effort into trying to change people's minds on the issue of basis in stock received in demutualizations of mutual insurance companies; unfortunately, few people cared about demutualization of mutual insurance companies. Chuck continued to write about this subject, educating clients about the IRS's position and other potential positions, and creating a website devoted to stock basis in demutualizations.[6] Some thought Chuck was crazy for caring so much about stock basis in demutualizations and for taking on an IRS position that had been entrenched for thirty years.

Eventually, Chuck convinced Burgess Raby and William Raby that his position had merit. The Rabys began writing about the topic, and started believing they could beat the IRS.[7] As the Rabys were well respected and recognizable tax practitioners, and because the arguments were valid, the position that stock received in a demutualization of a mutual insurance company should have basis above zero started to gain traction. Eventually, Chuck would get his chance to challenge the IRS.

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1. *See* Demutualization Income Tax Class Action Litigation, http://www.demutualization.org (last visited Dec. 16 2005); *see also* Burgess J.W. Raby & William L. Raby, *Life Insurance, Stock Basis, and Demutualization*, TAX NOTES, Aug. 4, 2003, at 681.

2. *See* Christopher S. Rugaber, *Tax Battle Could Help Investors*, DESERET NEWS, Mar. 5, 2007, http://findarticles.com/p/articles/mi_qn4188/is_20070305/ai_n18722262/.

3. *See The MetLife Demutualization Securities Fraud Masked a Breach of Contract*, BLOGGER, Aug. 10, 2008, http://www.demutualization.org.

4. *See* Rugaber, *supra* note 2; *see also* Joseph Beth, *Taxation of Policyholders in Demutualization*, SCHIFF'S INS. OBSERVER, Aug. 22, 2003, at 1.

5. *See* Beth, *supra* note 4, at 1.

6. *See* MetLife Policyholders' Class Action, http://www.demutualization.org (last visited Dec. 16, 2005).

7. *See* Raby, *supra* note 1.

The IRS position, which had been in place for nearly thirty years, was recently questioned in the Court of Federal Claims, and, as it turned out, the court agreed with Chuck.[8] The court determined, based on the infrequently used "open transaction doctrine," that the basis in the stock received in the demutualization could be up to the full value of the basis in the life insurance policy.[9] Although this case gives taxpayers a valid position for claiming a return of basis on returns, or for filing refunds for taxes paid on prior gains, the IRS is not likely to acquiesce to the holding. Moreover, the analysis has several flaws.

The remainder of this paper explains what a mutual life insurance company demutualization is, how it occurs, the applicable tax laws, and outlines the IRS's position and practitioners' arguments regarding the basis and distributions in demutualizations. Finally, *Fischer v. United States*, Chuck's tax case, is discussed and critiqued, and a better solution for basis allocation is advanced.

II. MUTUAL INSURANCE COMPANIES AND THE BASIS PROBLEM

Insurance companies, regardless of the products or coverage they offer, have traditionally been formed as either stock insurance companies or mutual insurance companies.[10] A stock insurance company is similar to other stock companies in that the company sells a product – the insurance – and the company is owned by shareholders.[11] In a mutual insurance company, the insurance policyholders are also the owners of the company and are often referred to as members of the company.[12]

A. *Mutual Insurance Company and Historical Advantages*

In mutual insurance companies, the members elect the board of directors.[13] The board of directors functions like the board of directors of a stock company in guiding the company and overseeing management.[14] Historically, insurance companies formed as mutual companies for various reasons. First, the lack of shareholders allowed the mutual stock companies to insure individuals and invest without having to worry about returns for shareholders.[15] This allowed the mutual insurance company to invest conservatively, which some insurance companies viewed as

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8. *See* Fischer v. United States, 82 Fed. Cl. 780, 799 (2008).

9. *See id.*

10. *See* James A. Smallenberger, *Restructuring Mutual Life Insurance Companies: A Practical Guide Through The Process*, 49 DRAKE L. REV. 513, 516 (2001).

11. *See* Joseph W. Meador & Lal C. Chugh, *Demutualization in the Life Insurance Industry: A Study of Effectiveness,* REV. BUS., Winter 2006, at 10, 10-11.

12. *See id.*

13. *Id.*

14. *See* STEVEN PLITT ET AL., COUCH ON INSURANCE § 39:22 (3d ed. 2009).

15. Meador, *supra* note 11, at 11.

stabilizing and protecting their ability to pay benefits to the insured when the policies required.[16]

Next, the members, who are the policy purchasers, would benefit from the mutual insurance company's investing.[17] This benefit either translated to lower premiums on insurance policies or dividends to the members.[18] In addition, the members would receive the proceeds of the liquidation of assets in a sale, or the remainder of the proceeds in bankruptcy.[19] These arguments have created a view that, without shareholders, the mutual insurance company focuses only on the needs of the policy owners, leaving only the board of directors with a potentially conflicting agenda.[20]

Finally, state law, which is usually fairly similar for both mutual insurance companies and stock insurance companies, governs insurance companies;[21] however, federal law may be applicable and can benefit mutual insurance companies.[22] As equity in mutual insurance companies cannot be traded, there is some decreased regulation and filings under both state and federal securities laws and other corporate governance laws.[23] In addition, historically, mutual insurance companies and stock insurance companies were treated similarly regarding dividends distributed to shareholders or members, but this was changed in 1984, and will be discussed in more detail below.[24]

B. *Stock Insurance Companies and the Advantages*

As stated above, stock insurance companies are formed under the traditional form of corporate governance. Shareholders own the company and elect the board of directors.[25] The board of directors is responsible for steering the company and creating desirable insurance products and services, but must also provide an adequate return on investment for the shareholders.[26]

Although this takes some of the focus off the policyholders, it can also provide better checks on corporate governance. Shareholders tend to be much more interested in how the board of directors is acting, as they have actively pursued the ownership interest as an investment and can easily review the value by looking to the price of the stock being traded.[27]

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16. *Id.*
17. *See id.*
18. *Id.*
19. *See id.*
20. *See id.*
21. Smallenberger, *supra* note 10, at 523.
22. *See id.*
23. *See, e.g.*, Meador, *supra* note 11, at 10.
24. *See* Smallenberger, *supra* note 10, at 523.
25. *See, e.g.*, Meador, *supra* note 11, at 11.
26. *Id.* at 12.
27. *See* Smallenberger, *supra* note 10, at 522-23.

Conversely, members of mutual insurance companies focus on the ability to pay coverage, not on the company as an investment. In addition, a stock insurance company is usually actively traded, and therefore subject to federal and state laws applicable to corporate governance and equities markets.[28]

Similarly, stock insurance companies, as discussed below, are more easily taken over by other corporations, particularly when large blocks are held by mutual funds or other investment groups. This concern can act as a strong check on corporate governance for the board of directors and management.[29]

Another large benefit for stock insurance companies is the ability to raise capital. Stock insurance companies can issue capital stock as a method to quickly generate large sums of working capital.[30] In addition, stock insurance companies can use stock options and bonus plans to compensate management, which is widely viewed as a significant tool in attracting competent management.[31] Stock insurance companies also allow for easier affiliation with non-insurance companies with the use of holding companies.[32]

The vast majority of states, if not all states, allow insurance companies to invest only in a certain percentage of non-insurance subsidiaries.[33] Stock insurance companies have the luxury of creating an overarching holding company to own a controlling interest in the stock insurance company, and in other non-insurance companies the stock insurance company may have wanted to own.[34]

Similarly, stock companies can issue stock to enter into tax-free restructurings, mergers, or to purchase other entities.[35] This allows the board of directors great flexibility in deciding the direction of the company, and makes it a good partner for transactions with other companies.[36]

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28. *See id.*

29. *See* Edward X. Clinton, *The Rights of Policyholders in an Insurance Demutualization*, 41 DRAKE L. REV. 657, 664-65 (1992).

30. *See* Smallenberger, *supra* note 10, at 521.

31. *See* Clinton, *supra* note 29, at 672-73.

32. *See* Smallenberger, *supra* note 10, at 521. Since 1995 many states have allowed for Mutual Insurance Holding Companies. These holding companies presented several logistical problems and may not be particularly beneficial for the members of mutual insurance companies. However this option has fueled demutualization. *Cf. id* at 552. *See also* Clinton, *supra* note 29, at 671-72 for a discussion of Mutual Insurance Holding Companies.

33. Smallenberger, *supra* note 10, at 522.

34. *Cf. id.* at 520 (noting that "a mutual company is not able to create a holding company structure - whereby the insurer is owned by a holding company that would allow it to more efficiently own other businesses, such as securities firms and banks").

35. *Id.* at 522.

36. *See id.*

C. *Reasons for Demutualizations*

Although both forms of insurance companies have advantages, there have been numerous factors over the last quarter century that have made demutualization more attractive to mutual insurance companies' boards of directors.[37] This has led to a drastic increase in the number of demutualizations over this time period.[38] The two large factors behind demutualization are (1) an increase in competition in the insurance industry and (2) a need for mutual insurance companies to generate more capital.[39]

Some of the factors that have created the competition and the need to raise capital are: (1) a decrease in the demand for traditional insurance products and an increase in demand for hybrid insurance structures, annuity-based products and other financial instruments; (2) a decrease in regulation in the financial services industry, including the passage of the Gramm-Leach-Bliley Act in 1999 that removed barriers between investment banking, commercial banking and the insurance industry; (3) an increase in foreign life insurance companies in the U.S. market; and, (4) changes to the Internal Revenue Code ("IRC") that made mutual insurance companies less advantageous.[40]

Regarding the first and second sub-factors, the demand for simple insurance products that do not have other investment potential has dropped as other hybrid policies have been created.[41] Some of these products have blurred the lines and are more similar to traditional investments, with only some insurance-like characteristics.[42] With the passage of the Gramm-Leach-Bliley Financial Services Modernization Act in 1999, financial service providers, commercial banks, and insurance companies were less restrained in the combination of products, and essentially allowed all of the above to provide investment products, insurance, and hybrid products.[43] The newly formed entities are better suited to create and market innovative products, and perhaps to provide better service to their clients. This has greatly increased the competition in the insurance market, and has led many insurance companies to believe that they must become larger in order to take advantage of economies of scale in order to survive.[44]

Similarly, foreign insurance companies have grown more interested in the United States' insurance products market. This, too, has increased competition in the insurance market, and has led insurance companies to

37. Meador, *supra* note 11, at 10.
38. *See id.*
39. *See id.*
40. Smallenberger, *supra* note 10, at 523.
41. *See id.* at 518, 523.
42. *See id.* at 518.
43. *Id.*
44. *Id.*

look for a competitive edge. As stated above, many companies have looked to growth in order to maximize economies of scale.

Finally, from 1984 until 2004, I.R.C. § 809 limited the amount of deductions that could be taken by a mutual insurance company for dividends to its policyholders.[45] This placed a competitive tax advantage on stock companies that were not subject to the same restriction.

As stated above, a driving force for demutualization has been competition, leading to a desire for growth of the insurance company. Since the insurance market in the United States is overly saturated, the options for growth are largely in acquisition, merger, and diversifying product lines, not in increasing the market share of the insurance market by selling more policies.[46] There are various reasons a mutual insurance company is at a disadvantage as far as this type of growth is concerned.

First, mutual insurance companies are constrained in their ability to raise capital. Mutual insurance companies cannot issue capital stock as a method of generating cash. That leaves retaining earnings or surplus notes as methods to grow, neither of which is particularly appealing.[47] Raising enough capital through retained earnings to make a substantial move in the insurance market would probably be time-prohibitive. Surplus notes, which are loans against the company's retained earnings, are generally regulated by states and ratings agencies to an amount between 15% and 20% of the company's surplus.[48] Again, there would probably be time constraints in attaining a level high enough to actively pursue an acquisition or merger.

Further, the majority, if not all, states restricted mutual insurance companies holding non-insurance companies as subsidiaries, which restricts the mutual stock companies' ability to grow in a similar direction as the insurance market.[49] These restrictions are in place because of the fiduciary relationship insurance companies have in their dealings with policyholders.[50]

Moreover, mutual insurance companies are difficult to merge, purchase, or take over because the ownership rights in the company are inseparable from the insurance policies issued. In addition, in the limited situations where a mutual insurance company might be able to acquire,

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45. I.R.C. § 809 (West 2004), *repealed by* Pension Funding Equity Act of 2004, Pub. L. No. 108-218, § 205(c), 118 Stat. 610.

46. *See* Smallenberger, *supra* note 10, at 522.

47. *Id.* at 521-22. One example is a limit in the investment to the lesser of 10% of the insurance company's assets or 50% of the surplus. *See id.* at 522 n.43 (citing, *inter alia*, ALA. CODE § 27-29-1(b)(1) (2007 & Supp. 2008)).

48. Smallenberger, *supra* note 10, at 519-21.

49. *Id.* at 522.

50. Robert E. Schultz & Raymond G. Schultz, *The Regulation of Life Insurance Company Investments*, 27 J. INS. 57 (1960).

merge, or be taken over by a company, many of the options for tax-free transactions are centered on stock acquisitions or distributions of stock.[51]

With regard to the increased competition, many insurance companies also view the ability to use stock options as a strong tool to acquire the most capable management, a tool unavailable to mutual insurance companies.[52] Similarly, the increased attention given to boards of directors and management in a publicly traded company is viewed as a necessary impetus for insurance companies to perform at the highest level, to offer the newest and most innovative products, and to provide the best service.[53]

For the reasons above, the pace of demutualization in the United States increased greatly during the 1980s and 1990s. In 1999, of the over 1400 life insurance companies, only 106 of them were mutual life insurance companies.[54] Since then, more than 15 of the largest mutual life insurance companies have demutualized,[55] and smaller mutual life insurance companies have done so as well.

D. *How Demutualizations Occur*

Demutualization of mutual life insurance companies occurs in one of three ways: (1) a reorganization, where the mutual insurance company becomes a stock insurance company; (2) a merger of a mutual insurance company with a stock insurance company, where the stock insurance company remains; and (3) the creation of a mutual insurance holding company.[56]

In a reorganization, where a mutual insurance company becomes a stock insurance company, there are two general frameworks of state laws regulating the demutualization.[57] First, there is the "New York" framework, which is available in a majority of states, and gives the members an insurance policy and the choice of shares of stock or cash for ownership interest in the company.[58] The less popular subscription method only gives members the option to purchase shares in the new company, which option lapses after a certain amount of time.[59] This option is not available in most states and is less likely to be approved by the members.[60]

The next option involves the merger of a mutual insurance company and a stock insurance company, leaving only the stock insurance

51. *See* I.R.C. § 368 (West 2009).
52. *See* Meador, *supra* note 11, at 11.
53. *Id.* at 11-12.
54. Smallenberger, *supra* note 10, at 517.
55. *See* Meador, *supra* note 11, at 10.
56. *See* Clinton, *supra* note 29, at 660-61.
57. Meador, *supra* note 11, at 12.
58. *Id.*
59. *Id.*
60. *See id.*

company.[61] This option can also utilize the two methods available in the reorganization, except that the stock remaining is that of the original stock insurance company.[62] This can be done in conjunction with a mass reinsurance of the mutual insurance companies' policies by the stock insurance company.[63] In some states the stock insurance company can simply purchase the assets of the mutual insurance company, which are the policies, and simply reissue new policies.[64] In most demutualizations, the member receives an insurance policy similar to the one owned before and ownership rights in the stock insurance company.[65]

The final method of demutualization is the use of a mutual insurance holding company, which originated in Iowa in the mid 1990s and has spread to other states.[66] This method is more complex and may be less advantageous for members; therefore, it has been credited somewhat with the increase in demutualizations over the last several years.[67] Under the state demutualization statutes, the mutual insurance company is allowed to create a holding company, which usually retains the mutual insurance contracts and creates a stock insurance subsidiary.[68] The mutual insurance holding company generally has to own a set percentage of the subsidiary and the members of the mutual insurance company are not required to receive ownership interests in the subsidiary.

The most prevalent method, and the focus of the remainder of this paper, is that of demutualization, which occurs when a mutual insurance company becomes a stock insurance company by distributing ownership interests to members because of a simple reorganization or because of a merger with a stock insurance company.

The steps to these demutualizations are similar to the steps in all demutualizations. In general, there must be approval by the board and approval by the members.[69]

First, the board of directors must create and approve a plan to demutualize that complies with the laws of the mutual insurance company's domicile state.[70] This is followed by approvals from the state's regulators.[71]

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61. Clinton, *supra* note 29, at 674.

62. *See id.* at 674-76.

63. *See id.* at 660-61.

64. *Id.* at 661.

65. *See What Demutualization Means for Policyholders*, INSURE.COM, Jan. 28, 2003, http://www.insure.com/articles/lifeinsurance/demutualization-2.html.

66. *See* Smallenberger, *supra* note 10, at 552-53; IOWA CODE ANN. § 521A.14(1)(a) (1995).

67. *See* Clinton, *supra* note 29, at 664-65, 674.

68. *See* Smallenberger, *supra* note 10, at 524-25.

69. *See id.* at 558-59.

70. *See* Clinton, *supra* note 29, at 677.

71. *Id.* at 677.

Included in the approvals by the board and the state regulators is the determination of what must be distributed and to whom. Usually, the surplus, *i.e.*, retained earnings, is distributed to the members who decide if they would like to receive cash or stock in return for their share of the surplus.[72] Those who choose to take cash are obviously not owners in the new, or existing, stock insurance company. There are many different methods of valuing the amount of the surplus that must go to each shareholder, most of which are beyond the purview of this paper.[73]

Some members, such as members who had policies governed by §§ 403(b) and 408(b), must receive policy credits and are not allowed to receive cash or to opt-in for ownership interests.[74] Section 403(b) deals with retirement annuities, with tax preferential treatment received from certain tax exempt entities,[75] and § 408(b) deals with certain tax preferred retirement annuities that are treated like individual retirement accounts.[76] A distribution of cash or stock would jeopardize the qualified status of the annuity. The policy credits are treated as returns on investment for the year of the demutualization, and do not have basis allocated to them. However, the overall basis is recouped in eventual annuity payouts under § 72(d)(1)(A).[77]

Once the appropriate amounts have been calculated and approved by the board of directors and the state regulators, the members eligible to vote must approve the plan.[78] Usually, states will limit members' eligibility to be an owner when the demutualization plan was approved by the board of directors, or to a set look-back period of ownership from the date of the members' vote.[79]

The final step is usually the distribution of the appropriate items to the appropriate members. When a mutual insurance company is becoming a stock insurance company, this often coincides with the initial public offering of the new stock insurance company.[80] This is done to ensure there is enough capital to pay the members who must or who have elected to take cash.[81]

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72. *See* Smallenberger, *supra* note 10, at 530-31.

73. *See* Clinton, *supra* note 29, at 682-84 for a discussion of various valuation methods to calculate payouts to policy holders.

74. *See* Rev. Rul. 2003-19, 2003-1 C.B. 468.

75. I.R.C. § 403(b) (West 2008).

76. I.R.C. § 408(b) (West 2008).

77. *See* I.R.C. § 72(d)(1)(A) (West 2008).

78. *See* Clinton, *supra* note 29, at 685.

79. *See* Smallenberger, *supra* note 10, at 532. For examples of the voting requirements, *see* IOWA CODE § 508B.4 (2007, 2008); N.Y. INS. LAW § 7312(e)(3) (McKinney 2000, 2009); MASS. GEN. LAWS ch. 175, § 19E(5) (1998 & Supp. 2009).

80. *See* Smallenberger, *supra* note 10, at 532.

81. *See id.* at 530-31.

E. *Basis and Demutualization*

Often, as will be discussed in the following section, demutualization of a mutual insurance company is done in such a way as to qualify as a tax-free reorganization. However, members who receive stock for their ownership rights in the distribution have been treated by the IRS as having no basis in the stock.[82] This is the position Chuck, the solo accountant, found fundamentally unfair.[83]

It should be noted that in the past, the treatment of cash distributions and the basis in stock that was distributed pursuant to demutualizations has not noticeably affected the vote by members of mutual insurance companies. The vast majority, if not all, votes on demutualization have been approved by members.

III. APPLICABLE TAX LAWS

A. *Demutualizations as Tax Free Reorganizations*

In general, gain can be recognized on dealings in property, and those gains are included in gross income.[84] The gain from a sale or disposition of property is "the excess of the amount realized . . . over the adjusted basis" as determined by the IRC.[85] However, there are many sections that state income is not recognized on particular transactions.

Section 351(a) states there will be no gain or loss recognized (1) if the property is transferred to a corporation by one or more persons solely in exchange for stock in that corporation, and (2) immediately after the exchange, the person is in "control" of the corporation.[86] In addition, § 354(a) provides that there shall be no gain or loss recognized on the transfer of stock to a party involved in the *reorganization* if it is in pursuance of the plan of reorganization. This rule applies as long as such stock exchanged is solely for stock in the distributing corporation or in another corporation that is a party to the reorganization.[87]

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82. *See* Demutualization Income Tax Class Action Litigation, *supra* note 1; *see also* Raby, *supra* note 1.

83. *See* Demutualization Income Tax Class Action Litigation, *supra* note 1; *see also* Raby, *supra* note 1.

84. *See* I.R.C. § 61(a)(3) (West 2009). All section references are to the IRC of 1986, as amended, and currently in force, unless otherwise indicated.

85. I.R.C. § 1001(a) (West 2009).

86. Treas. Reg. § 1.351-1(a) (2009). "Control" is defined under § 368(c), which applies here, and in other sections discussed herein when control is referenced, as "the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation." I.R.C § 368(c) (West 2009).

87. Treas. Reg. § 1.354(a) (2009).

Section 368 and the applicable Treasury Regulations provide various definitions for "reorganizations."[88] Under § 368(a)(1)(A) a reorganization can be a transfer done because of a statutory merger or consolidation.[89] A "statutory merger or consolidation" is further elaborated on under the Treasury Regulations, and can be only accomplished when the applicable merger statute requires that all the assets and liabilities of one company in the merger become all the assets and liabilities of another company in the merger, and in addition, one of the companies ceases to exist as a separate legal entity.[90]

Section 368(a)(1)(B) provides that "reorganization" can mean "the acquisition by one corporation, in exchange solely for all or a part of its voting stock (or in exchange solely for all or a part of the voting stock of a corporation which is in control of the acquiring corporation), of stock of another corporation if, immediately after the acquisition, the acquiring corporation has control of such other corporation (whether or not such acquiring corporation had control immediately before the acquisition)."[91] Section 368(a)(2)(C) further extrapolates that a qualified transaction under § 368(a)(1)(B), where part, or all, of the stock is transferred to a corporation controlled by the acquiring corporation, will still qualify for non-recognition of any gain.[92] Similarly, assets or stock acquired in reorganizations qualifying under § 368(a)(1)(B) may be successively transferred to one or more corporations controlled (as defined under § 368(c)) in each transfer without disqualifying the reorganization.[93]

Section 368(a)(1)(D) allows "reorganizations" that occur when a company transfers its assets to another company, if immediately after the transfer the transferor is in control of the company to which the assets are transferred; provided that stock of the company to which the assets were transferred is distributed in a transaction in pursuance of the reorganization, the distribution of the stock qualifying under §§ 354, 355, or 356.[94]

Section 368(a)(1)(E) provides further that a reorganization may be a recapitalization.[95] A recapitalization has been defined as a "reshuffling of a capital structure, within the framework of an existing corporation."[96]

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88. I.R.C § 368(a) (West 2009).

89. *Id.* § 368(a)(1)(A).

90. Treas. Reg. § 1.368-2(b)(1)(ii) (2008).

91. I.R.C § 368(a)(1)(B) (West 2009).

92. *Id.* § 368(a)(2)(C).

93. Treas. Reg. § 1.368-2(k)(1) (2008); *see supra* note 86 (defining "control").

94. I.R.C. § 368(a)(1)(D) (West 2009); *see supra* text accompanying note 86. Section 355 allows, generally, for a company to distribute to its shareholder, stock in a corporation it "controls" immediately before the distribution. I.R.C. § 355. Section 356 applies to transactions that would have qualified under §§ 354 or 355 but for the inclusion of additional assets in the distribution. I.R.C. § 356. Section 356 allows the distribution of stock to remain a nonrecognition event. *Id.*

95. I.R.C. § 368(a)(1)(E) (West 2009).

96. Comm'r v. Southwest Consol. Corp., 315 U.S. 194, 202, 62 S. Ct. 546, 552 (1942).

Section 368(a)(1)(F) states that a reorganization can also mean "a mere change in identity, form or place of organization of one corporation."[97]

Two requirements for qualifying as a reorganization under § 368 are (1) a continuity of the business enterprise and (2) a continuity of interest.[98] Continuity of business enterprise requires the corporation issuing the stock to continue the prior corporation's historic business, or use a significant portion of the prior corporation's historic business assets in the new corporation's business.[99]

However, this is not required for a recapitalization to qualify as a reorganization under § 368(a)(1)(E).[100] The continuity of interest requires that a substantial part of the proprietary interest in the prior corporation be preserved in the reorganization.[101] Again, continuity of interest is not required for recapitalizations qualifying as reorganizations under § 368(a)(1)(E).[102]

In a simple demutualization, where a mutual insurance company becomes a stock insurance company by distributing shares in the new stock insurance company to eligible members who elect to receive shares in exchange for their ownership interest in the mutual insurance, the company qualifies for nonrecognition for two reasons (assuming new company is viewed as the same as old company under state law).[103] The transaction qualifies as a recapitalization under § 368(a)(1)(E) because it is just a reshuffling of capital under the existing corporate structure, and it qualifies as a mere change in form under § 368(a)(1)(F), if the continuity of business and continuity of interests requirements are met.[104]

As the transaction gets more complex, so does the qualification for nonrecognition treatment for the demutualization. These mergers potentially could qualify under various provisions of § 368, but are often structured to qualify under § 368(a)(1)(A) or § 368(a)(1)(D).[105]

As stated above, § 368(a)(1)(A) will depend on the underlying requirements of the applicable state law statute allowing the merger or consolidation. It will qualify under § 368(a)(1)(D) if all the assets and liabilities, including the interest in all life insurance policies, are transferred to the acquiring company, and the distribution of stock qualifies under one of the applicable sections.[106] The distribution of the stock will qualify under § 354(a) because the distribution is part of a reorganization plan, and

97. I.R.C. § 368(a)(1)(F) (West 2009).
98. 26 C.F.R. § 1.368-1(b) (2007).
99. 26 C.F.R. § 1.368-1(d)(1) (2007).
100. Rev. Rul. 82-34, 1982-1 C.B. 59.
101. Treas. Reg. § 1.368-1(e)(1)(i) (2008).
102. Rev. Rul. 77-415, 1977-2 C.B. 311.
103. *See* Rev. Rul. 2003-19, 2003-1 C.B. 468.
104. *Id.*
105. I.R.C. § 368(a)(1) (West 2009).
106. *Id.* § 368(a)(1)(D).

the stock is in one of the companies that are a party to the reorganization.[107] The continuity of business and continuity of interest requirements will both be applicable. The continuity of business is usually covered, as most, if not all, of the acquiring company's assets are still used to provide life insurance.[108] Continuity of interest requires the mutual insurance company's owners, the policyholders, be given stock in the new company.[109]

As one would assume, when the mutual insurance company uses a mutual insurance holding company along with a stock holding company in its tax nonrecognition reorganization, the transaction becomes more complicated to qualify for nonrecognition treatment. One example of this is when, pursuant to state law, an integrated plan is created where a mutual insurance company creates a mutual insurance holding company.[110] The mutual insurance holding company then creates a stock insurance company.[111]

Contemporaneously, the mutual insurance company amends its articles to allow the issuance of stock, and changes its name to stock insurance company.[112] Mutual insurance company's members then receive membership interest in the mutual insurance holding company, while stock insurance company issues all of its stock to the mutual insurance holding company.[113] The mutual insurance holding company then transfers all of its stock in the stock insurance company to the stock holding company in exchange for voting stock of the stock holding company.[114]

As the members of the original mutual insurance company do not receive a distribution for their ownership interest in the mutual stock company, walking through each step of this transaction to see how it is tax-free is not terribly important for this paper; however, it is worth noting that the IRS's position is that the stock exchanged has a zero basis.[115] The companies holding the stock are greatly dissuaded from transferring it, as most dispositions would cause recognition of the full value.

B. *Treatment of Distributions to Members*

As shown above, in some demutualizations, members receive either cash or stock in the new stock insurance company in exchange for their

107. I.R.C. § 354(a)(1) (West 2009).
108. Treas. Reg. § 1.368-1(d)(1) (1991).
109. Rev. Rul. 74-277, 1974-1 C.B. 88.
110. Rev. Rul. 2003-19, 2003-1 C.B. 468.
111. *Id.*
112. *Id.*
113. *Id.*
114. *Id.*
115. *See* I.R.S. Priv. Ltr. Rul. 9835039 (Aug. 28, 1998) (discussing nonrecognition of demutualization using mutual insurance holding company as allowed under state laws).

ownership interest in the mutual insurance company. Again, in general, § 61 (gross income) includes gains derived from dealings in property.[116]

The gain from the sale or other disposition of property shall be the excess of the amount realized over the adjusted basis.[117] The adjusted basis is generally the cost of the property being transferred.[118] However, § 351(a) provides that no gain or loss will be recognized if property is transferred solely in exchange for stock in a corporation if there is control of the corporation afterwards.[119] When a mutual insurance policyholder transfers his or her policy to a stock insurance company, the receipt of stock and a new insurance policy is shielded from recognition with provision 368.[120] Section 358 provides, in general, that the basis of the property permitted to be received without the recognition of gain or loss shall be the same as that of the property exchanged.[121]

This is where the IRS and taxpayers like Chuck have come to very different conclusions. The IRS's historical position has been that taxpayers have not paid for the ownership rights as members of mutual insurance companies, and the basis in the proprietary interest in the mutual insurance company is zero; however, the IRS has not provided much in the form of reasoning for the position.[122]

The IRS's rationale is:

> [p]ayment by each policyholder of the premiums called for by the insurance contract issued by [the mutual insurance company] represents payment for the cost of insurance and an investment in [the] contract but not an investment in the assets of [the mutual insurance company]. [The] proprietary interest in the assets of [the mutual insurance company] arises solely by virtue of the fact that he [or she] is a policyholder of [the mutual insurance company]. Therefore, the basis of each policyholder's proprietary interest . . . is zero.[123]

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116. I.R.C. § 61(a)(3) (West 2009).

117. I.R.C. § 1001(a) (West 2009).

118. United States v. Hill, 506 U.S. 546, 554-55, 113 S. Ct. 941, 948 (1993). Adjusted basis is calculated under § 1012. I.R.C. § 1012 (West 2009).

119. I.R.C § 351(a) (2009).

120. Rev. Rul. 2003-19, 2003-1 C.B. 468. This provision does not apply to the distribution of cash, and these distributions do not qualify as dividends, and therefore do not receive dividend treatment. I.R.C. §§ 354, 355, 368.

121. I.R.C. § 358 (West 2009).

122. Rev. Rul. 74-277, 1874-1 C.B. 88.

123. Rev. Rul. 71-233, 1971-1 C.B. 113. This Revenue Ruling dealt with the conversion of a tax exempt fraternal beneficiary society to a taxable mutual insurance company. This rationale has been parroted in other IRS rulings regarding demutualization of mutual insurance companies.

The Revenue Ruling discussing this position, relying on § 358(a), then stated that the basis in the new proprietary interest would be zero, since the prior proprietary interest had a basis of zero.[124]

In its most recent pronouncement of its position on basis in the stock received in a demutualization, the IRS has stated:

> A life insurance company may change from a mutual company to a stock company. This is commonly called demutualization. If you were a policyholder or annuitant of the mutual company, you may have received either stock in the stock company or cash in exchange for your equity interest in the mutual company.
>
> If the demutualization transaction qualifies as a tax-free reorganization under section 368(a)(1) of the Internal Revenue Code, no gain or loss is recognized on the exchange. Your holding period for the new stock includes the period you held an equity interest in the mutual company as a policyholder or annuitant.[125]

This publication did not include any information regarding basis for taxpayers in calculating taxable income from the disposition of stock received; however, it did indicate the holding period would be the same as the period the equity interest in the mutual company was held.[126] This is in line with the IRS's position that the prior ownership interest is zero, as tacking of a holding period in tax-free exchanges is generally only allowed where the property exchanged, for the purposes of determining gain on the exchange, is the same basis in whole or in part as the property exchanged.[127] It should be noted that this seems to indicate cash distributions are not recognized as gain; however, this is not the IRS's position.

Since 2002, the IRS has given taxpayers some guidance on this issue in the instructions for Form 1040, Schedule D.[128] The instructions contain some of the same information, but go further, and state, "[b]ecause the basis of your equity interest in the mutual company is considered to be zero, your basis in the stock received is zero."[129]

As a side note, both sets of instructions provide that members receiving cash in the distribution must recognize capital gain, stating, "[i]f you received cash in exchange for your equity interest, you must recognize

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124. *Id.*

125. I.R.S. Pub. 550 (Dec. 24, 2007), 2007 WL 4510279.

126. *See id.*

127. I.R.C. § 1223(1) (West 2009).

128. *See* 2008 Instructions for Schedule D, *available at* http://www.irs.gov/pub/irs-prior/i1040—2004.pdf.

129. 2008 1040 Instructions, D-4, *available at* http://www.irs.gov/pub/irs-pdf/i1040.pdf.

a capital gain in an amount equal to the cash received."[130] This gain would be long term if the equity interest were held for more than a year.[131] It is assumed since the IRS's position is the equity interest had no basis, there is no basis to recover, and the cash distribution is completely taxable, as there is no applicable nonrecognition provision.

Here again, we come back to Chuck, whom the IRS had informed there was no basis in his ownership interest in the mutual insurance company from which he had purchased insurance, and Chuck's wonder that the payments to the company did not include payments towards his ownership interest.[132] He was allowed to participate in the selection of the board, received distributions on his ownership interests, he could have voted on the demutualization, and was entitled to distributions in liquidations.[133] Chuck and others started to come up with arguments against the IRS position.

C. *Practitioners' Arguments for Basis Allocation*

The IRS has taken a position that the proprietary interest in mutual insurance companies has been acquired for zero dollars, and is simply an incident of ownership of an insurance policy in a mutual insurance company.[134] This is a somewhat contrary position to the applicable law, and to the IRS's position on similar matters.[135] This resulted in the crafting of arguments against the IRS's current position.[136]

One preliminary argument focuses on the validity of the IRS's position regarding basis and its ability to withstand judicial scrutiny. As stated above, the origin of the zero basis comes from Revenue Rulings 71-233 and 74-277, the language of which is quoted above. The argument has been advanced that these rulings are not comprehensive enough to be granted judicial deference.

In general, an administrative agency's interpretation of a statute may be accorded judicial deference when "upon the thoroughness evident in its consideration, the validity of its reasoning, its consistency with earlier and later pronouncements, and all those factors which give it power to persuade, if lacking power to control."[137] Due to the brevity of the section discussing the zero basis, and the dearth of legal citation for its position, it

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130. *Id.*

131. *Id.*

132. Chris Rugaber, *Lone Accountant Takes on IRS and Wins,* Aug. 24, 2008, http://demutualization.biz/article.htm.

133. *See supra* Part II.A.

134. Rev. Rul. 71-233, 1971-1 C.B. 113.

135. *See* Raby, *supra* note 1.

136. *See generally id.*; *see supra* Part III.C.

137. United States v. Mead Corp., 533 U.S. 218, 228, 121 S. Ct. 2164, 2172 (2001) (quoting Skidmore v. Swift & Co., 323 U.S. 134, 140, 65 S. Ct. 161, 164 (1944)).

has been observed that the IRS's position would not receive much judicial deference based on these pronouncements.[138]

A beginning question for many of the arguments against the IRS's position is whether the premium payments made for the mutual life insurance policy can be separated to show the amounts paid for the insurance portion and what was paid for the equity portion, or if there is just one tax basis in the insurance portion and equity portion until the two interests are separated.[139] Some practitioners have come to the conclusion that there is one tax basis that cannot be separated until the interests are separated.[140]

The rationale is based on *Moseley v. Commissioner*, in which the IRS sought to separate a life insurance policy into an investment fund portion and the life insurance portion.[141] The policy contained a special provision that created a special reserve account from a portion of each premium payment.[142]

At certain times, the policyholder could take a distribution from the special reserve account.[143] The policyholder took a distribution, and took the position that the aggregate of the premiums paid was greater than the amount distributed, and, therefore, sheltered from gain by § 72(e)(1)(B).[144] The IRS took the position that the special reserve account should be treated separately from the insurance policy, and the difference between the amount received and the amount allocated to the special reserve account should be treated as ordinary income.[145] The IRS argued there were "two distinct and economically independent policies" and bifurcation was appropriate.[146] The Tax Court, in holding for the taxpayer, stated the two components were interrelated and neither could be separately purchased.[147] The court held the full amount paid towards the premium was the basis, and no gain could be realized until the distributions were greater than that amount.[148] The IRS acquiesced to this position shortly after.[149]

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138. Raby, *supra* note 1, at 683.

139. *See id.* at 681-82.

140. *Id.* at 681.

141. *See* Moseley v. Comm'r, 72 T.C. 183, 186 (1979), *acq. in result*, 1980-2 C.B. 1.

142. *Id.* at 184.

143. *See id.* at 185.

144. *Id.* at 186. Section 72(e)(1)(B), in 1954, provided that any amount received under a life insurance contract, not in the form of an annuity payment, is only included in gross income to the extent that it exceeds the aggregate premiums or other consideration paid. I.R.C. § 72(e)(1)(B) (1954). Although the language of § 72 has changed, the general principal remains the same.

145. *Moseley*, 72 T.C. at 186.

146. *Id.* at 187.

147. *Id.*

148. *See id.* at 188.

149. *See* United States v. Mead Corp., 533 U.S. 218, 228, 121 S. Ct. 2164, 2172 (2001). The Commissioner's acquiescence does not include *Moseley*.

Moseley is important for two reasons in the argument against zero basis: first is the obvious, although probably flawed, argument that the distribution of stock or cash in a demutualization should have basis allocated to it under § 72(e)(1)(B); and second, that life insurance contracts with other rights included are treated as one.[150]

The recovery of basis under § 72(e)(1)(B) argument, which was advanced by Chuck, follows from *Moseley*, in that the ownership rights in mutual insurance policies cannot be removed from the policy, and distributions for the ownership rights cannot be taxable until the distributions outpace the premium payments.[151] The argument regarding a transferred basis in the stock seems to be one of equity, not based on any particular IRC section.[152] Unfortunately, § 72(e)(1) is qualified with the phrase "if no provision of this subtitle (other than this subsection) applies."[153]

The IRS's position, which is probably accurate, is that other provisions of the subtitle do apply, namely the tax free reorganization sections under § 368, upon which all parties to demutualizations tend to rely.[154] This IRS position is predicated on the fact that absent the reorganization, state law would not have allowed the insurance contract to be separated from the ownership interest; therefore, it could not simply be a distribution and § 368 must apply.[155] Although this may be a correct position regarding § 368, it does not support the assignment of zero basis to the stock received in a demutualization.

In addition, the deductibility by the insurance company in a § 72 distribution is covered by § 805, and distributions in reorganizations have not been deductible.[156]

In *UNUM Corp. v. United States*, the First Circuit concluded that §§ 805 and 808 did not override the applicable reorganization provisions that disallowed deductions for the company making distributions to its shareholders.[157] Specifically, the court held that a policyholder dividend under § 805 was only a distribution to a policyholder in his or her capacity as a policyholder, not owner of the mutual life insurance company.[158] This again casts doubt on whether § 72 could effectively be used; however, it

150. *Moseley*, 72 T.C. at 187-88.

151. Brief of Petitioner at 7-8, Fisher v. United States, No. 04-1726T (Cl. Ct. 2007), 2008 TNT 173-17.

152. *Id.* at 13.

153. I.R.C. § 72(e)(1)(A)(ii) (2001).

154. Raby, *supra* note 1, at 682-83.

155. *Id.* at 682.

156. UNUM Corp. v. United States, 130 F.3d 501, 509 (1st Cir. 1997), *cert. denied,* 525 U.S. 810 (1998).

157. *Id.* at 507.

158. *Id.* at 512-13.

provides no grounds for apportioning zero dollars of basis to ownership interests in mutual insurance companies.

A second similar argument is based on an argument-by-analogy to the disposition of a position of a linked security. The case law surrounding linked securities indicates that when the two assets started as a single investment, and it was not possible to deal with the individual parts, then basis should be allocated as pieces are sold.[159] This argument has some traction in the courts, and will be covered below in the discussion of the *Fischer* case.

A third version of the full recovery of basis argument would be to analogize the ownership of a mutual insurance policy to the ownership of stock, and argue the distribution is recoupable under § 301. Section 301 states that a distribution by a corporation that is not a dividend, is applied to and reduces the basis in the stock before gain is realized.[160] Property distributed receiving nonrecognition treatment then receives fair market value as its basis under § 301(d).[161]

An actual alternative method, not based on the full recovery of basis, would be to allocate the basis between the ownership interest and the insurance contract. The regulations to § 61 indicate where a portion of property is distributed, the basis of the property shall be equitably apportioned among several parts.[162]

The amount of basis in these transactions is known, and the value of the life insurance policy is ascertainable. In addition, the fair market value of the stock is known the day of, or shortly after, the demutualization. From these figures, it is possible to allocate the basis proportionately based on the current fair market value of each asset.

There are some provisions of the IRC that allocate basis based on the fair market value of the assets at the time of the distribution. Most applicable is probably § 355(a)(1) in divisive reorganizations.[163] The applicable regulations under § 358 indicate that when stock is received in a divisive reorganization, the basis in the original stock should be allocated between the original stock and the new stock in proportion to their fair market value. [164] Similarly, this is seen under § 305(a) when stock in a corporation is distributed to its shareholders.[165] The applicable regulations state that the original basis is allocated between the old and new stock

159. *See, e.g.*, De Coppet v. Helvering, 108 F.2d 787 (2d Cir. 1940).

160. I.R.C. § 301(c) (West 2009).

161. *Id.* at § 301(d).

162. 26 C.F.R. § 1.61-6(a).

163. *See* Post-Trial Brief of Petitioner at 22-23, Fisher v. United States, 82 Fed. Cl. 780 (2008) (No. 04-1726 T), 2008 TNT 173-17.

164. *See* Treas. Reg. § 1.358-2(a)(iv) (2006).

165. *See* Treas. Reg. § 1.307-1(a) (as amended in 1960).

based on the relative fair market values of each on the date of distribution.[166]

D. *Current State of Stock Basis in Demutualization*

Prior to 2000, Sun Life Assurance Company ("Sun Life") was a mutual life insurance company from which the Seymour P. Nagan Irrevocable Trust (the "Nagan Trust") purchased a life insurance policy containing all the additional rights of a normal mutual life insurance policy.[167] In early 2000, Sun Life demutualized pursuant to a tax free reorganization.[168]

The Nagan Trust made the cash election in the demutualization, which in this case allowed the new stock company to sell the Nagan Trust's proportionate amount of stock in the company on the open market.[169] It turned out that the Nagan Trust's accountant was Chuck, and the trustees of the trust, along with Chuck and Burgess Raby, decided to file for a refund of the tax paid on the distribution of the cash.[170] When the request was declined, the Nagan Trust sued for a refund in the Federal Claims Court. During motions, the court determined that the sale of the stock was unrelated to the distribution of the stock, and the gain could not be sheltered under § 72(e)(1)(B) as a dividend; however, it also determined that the allocation of basis to the stock was a question of fact that had to be resolved by trial.[171]

Before the court, the Nagan Trust advanced the arguments discussed above. The Justice Department, on behalf of the IRS, stated the ownership rights in mutual insurance policies were zero, because they had no fair market value since they could not be bought or sold.[172] It further argued that the Nagan Trust not only had the burden to show that the IRS's position was erroneous, but that the Nagan Trust had to prove the correct amount of basis to be allocated.[173] The IRS argued that absent such a showing, it may appropriately assign a zero cost basis.[174]

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166. *Id.*

167. *See* Fisher v. United States, 82 Fed. Cl. 780, 781-82 (2008).

168. *See id.* at 782-83. The IRS ruled that the Sun Life demutualization was tax free, and no gain would be recognized on the distribution of stock in the new stock insurance company. I.R.S. Priv. Ltr. Rul. 200020048 (May 19, 2000).

169. *Fisher*, 82 Fed. Cl. at 782-83.

170. *Id.* at 783; Arthur D. Postal, *I.R.S. Told to Stop Taxing Mutual Deal Policyholders*, NAT'L UNDERWRITER, (Aug. 14, 2008) *available at* http://www.property-casualty.com/News/2008/8/Pages/IRS-Told-To-Stop-Taxing-Mutual-Deal-Policyholders.aspx.

171. *Id.*

172. Plaintiff's Post Trial Brief at 5-12, Fisher v. United States, 82 Fed. Cl. 780 (2008) (No. 04-1726 T), 2008 TNT 173-14.

173. Defendant's Post Trial Memorandum at 2, Fisher v. United States 82 Fed. Cl. 780 (2008) (No. 04-1726 T), 2008 TNT 173-14.

174. *Id.* at 2.

The IRS and the Nagan Trust both put forth experts to value the ownership interest attributable to mutual insurance policies.[175] The experts for the Nagan Trust came to the conclusion that because the value of the ownership interests were inextricably tied to the policy, they were not determinable until there was a market for them.[176] The IRS expert argued that the rights were worth zero because there was not a market for them, no premium payments were allocated to them, and when the policy was purchased a demutualization was very unlikely.[177]

To cut to the chase, the court held that the stock did have basis for determining the fair market value.[178] As discussed in Part III.C, Burgess Raby argued in favor of basis recovery similar to that of linked securities. The court agreed with this argument, placing these cases in a chain of case law referred to as the "open transaction" doctrine.[179] The open transaction doctrine is a method of reporting gain or loss from the sale of property when it is difficult to ascertain the cost or other tax basis of portions of the property sold separately, wherein the basis is used against the sales as they occur until the basis is all consumed.[180]

The court began its discussion of the applicable law with a review of § 61, and the applicable regulations requiring apportionment of basis, but noted that apportionment must be done by each component's fair market value.[181] The court then noted that Treasury Regulation § 1.1001-1(a) states that "only in rare and extraordinary cases will property be considered to have no fair market value."[182] The court then went on a historical journey through old tax regulations relating to the apportionment of basis in situations where apportionment is difficult, and emphasized that historically the regulations stated gain could not be realized until basis was recovered.[183] Next, the court covered the last of these regulations and the committee reports criticizing this approach as unworkable because of the uncertainties in timing and amount.[184] This was, the court commented, the transition point where the judicial exception to basis apportionment known as the open transaction doctrine was created.[185]

There is no exception in the regulations for situations where it is impractical or impossible to allocate basis on fair market value.[186]

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175. *Fisher*, 82 Fed. Cl. at 783.
176. *Id.* at 792.
177. *Id.* at 792-93.
178. *Id.* at 793.
179. *See id.* at 786-90.
180. *See id.* at 791.
181. *See Fisher*, 82 Fed. Cl. at 783-84.
182. *Id.* at 784 (quoting Treas. Reg. § 1.1001–1(a) (as amended in 2007)).
183. *Id.* at 785-87.
184. *Id.* at 791-92.
185. *Id.*
186. *Id.* at 791.

However, there were situations where it was inequitable not to apportion some basis to sales; the court then discussed cases where this doctrine has been applied over the last century, placing great emphasis on its continued validity today.[187] Finally, the court states that the open transaction doctrine and the treasury regulations have coexisted for decades.[188]

The court concludes by stating that the experts in this case came to very different conclusions on the basis and that the IRS's experts did very little to back up their assertion that the basis was zero.[189] The court agreed with the Nagan Trust's experts in that there was some value, but it could not be calculated. This led the court to apply the open transaction doctrine.[190]

In the end, Chuck's contention that there should be some basis allocated to the stock received in a demutualization was validated, but not for the reasons he originally advanced. From a sniff-test perspective, it also seems to pass, as the ownership rights that have been acquired by paying premiums appear as if they should have basis allocated to them, but there some substantial issues still remain.

IV. REMAINING ISSUES IN CURRENT LAWS AND POTENTIAL SOLUTIONS

As the *Fisher* case was decided in August of 2008, the United States is still considering an appeal to the Circuit Court for the District of Columbia.[191] In addition, the IRS would not have to acquiesce to the position in the Tax Court, and could hope for a different holding before other district courts. One of these two is likely to occur, as the basis issue could result in refunds for millions of Americans and substantial lost revenue for the IRS.

If the IRS does not acquiesce to the position, it is unclear if someone else will take this issue to court. For most tax payers, the resulting tax liability is not great, and probably not worth the cost of litigation. It has been commented that class certification may be too difficult for this issue, and consolidating individual cases may be more appropriate.[192] This would require a concerted effort, of probably multiple practitioners, to gather enough individuals to make such an action cost effective.

Another issue in the *Fisher* holding, which may or may not be raised on appeal, is that the assets usually involved in the open transaction doctrine will eventually be disposed of; conversely, life insurance policies

187. *Fisher*, 82 Fed. Cl. at 785-92.

188. *Id.* at 790-91.

189. *Id.* at 799.

190. *Id.* at 795.

191. Sam Young & Crystal Tandon, *Korb Says IRS Considering Appeal*, Doc 2008-18895, 2008 TNT 173-5 (Sept. 5, 2008) (discussing IRS Chief Counsel's assessment of recommendation on appeal of *Fisher*).

192. Raby, *supra* note 1, at 684-85.

are generally held until the death of the insured, at which time the basis is no longer needed.[193] The taxpayer is 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.

In addition, the increase of value of the ownership interests that occurred while the mutual policy was owned is now being allocated, which may not be appropriate.

This is further compounded when the stock received increases in value after it has been distributed, and then is sold. Is that increase in value of the ownership interest still covered by the basis from the premiums being paid? The language of *Fisher* would seem to indicate that the basis is allocated to the stock when it is sold, not when it is distributed.[194] This seems terribly inequitable to other taxpayers.

Further, what occurs to ownership rights that are transferred to holding companies, which was not in the purview of the *Fisher* case? If the holding company ever distributes those interests in some sort of tax-free reorganization, what amount of basis is allocated to them? Do holding companies that have not purchased the insurance receive this benefit?

The issue in both of the above fact situations occurs because the court did not work through the steps of the tax-free reorganization and show where and when the basis was being transferred. The court did a good job of explaining and making an argument for the use of the open transaction doctrine, but simply jumped to the end conclusion of two assets, and allowed the entire basis to be apportioned to both assets.[195]

The open transaction doctrine, historically, has been applied to an asset that was split and sold, but was not split because of a reorganization.[196] The court would have done well to address this issue.

In addition, the IRS procedural argument that the taxpayer bears the burden of proving the cost basis is a valid argument. It is very possible that on appeal, this issue could be decided differently. The treasury regulations and the applicable case law indicate that the open transaction doctrine should be used judiciously.[197] Since a majority of the experts in the *Fisher*

193. It should be noted that sales of life insurance have been somewhat deregulated, and there is a much larger market for life insurance policies being sold to investors. *See generally* Mitchell M. Gans & Jay A. Soled, *A New Model for Indentifying Basis in Life Insurance Policies: Implementations and Deference*, 7 FLA. TAX REV. 569 (2006).

194. *Fisher*, 82 Fed. Cl. at 799.

195. *Id.* at 789-90.

196. *See generally* STANLEY I. LANGBEIN, FEDERAL INCOME TAXATION OF BANKS & FINANCIAL INSTITUTIONS ¶ 402[2][a] (7th ed. 2009) (discussing the rejuvenation of the "open transaction" doctrine and its historical applications).

197. *See id.* ("Open transaction treatment is greatly disfavored under current law and should not be routinely counted on in structuring transactions.").

case agreed that the basis could not be determined, the doctrine obviously fails to show the actual cost basis.[198]

Similarly, the continued validity of the open transaction doctrine has been questioned by some courts since the enactment of Treasury Regulation 1.61-6(a).[199] It may also be possible to argue that if the open transaction doctrine still applies, it only applies to portions of property that cannot be separated, and therefore valued, as a distinct asset. This argument would also place the burden on the taxpayer to show and prove that the property was impossible to separate and value. This is essentially the unsuccessful argument the IRS made in *Fisher*. This argument, however, has the potential to be more artfully crafted, by emphasizing that the burden is on the taxpayer and indicating potential ways to value the asset. Compounding this argument could be the fact that the IRS allows assets to be valued based on the hypothesis that they will be separable in the future, and then discounted for contingencies prior to reaching the date where they are separated.[200] It may be more realistic to actually value the assets.

Based on the foregoing, it appears that a more workable, and more equitable, solution would be to apportion the basis on the fair market value of the insurance policy and the stock at the time of distribution. This would apportion basis to the part of the asset that likely will not be sold, and will take into account each asset's actual value, or at least the closest actual value. Unfortunately, this argument appears to be made only by analogy, and has no specific statute or regulation to apply. Without this framework, it seems unlikely that a court will apply this rationale. In order to enact this method of apportionment, it may require the IRS to promulgate regulations or Congress to amend the IRC.

Since the *Fisher* case has been fairly widely publicized, demutualized insurance companies may disclose to members that basis should be allocated. This, along with the money that may need to be refunded, could be the impetus for some sort of legislation or regulations. Similarly, now that members are made more aware of the issue of basis in demutualized stock, they may be more likely to vote against a demutualization, although this could be a stretch. This could also result in a lobbying effort by the insurance industry.

V. CONCLUSION

Although the holding in *Fisher* was good for taxpayers who acquired stock in the demutualization of mutual life insurance companies,[201] and

198. *Fisher*, 82 Fed Cl. at 792.

199. *See id.* at 784-85.

200. *See* Rev. Rul. 77-287, 1977-2 C.B. 319 (discussing restrictive transfer agreements on closely held stock).

201. *See Fisher*, 82 Fed Cl. 780.

Chuck was validated, the issue has not been finally determined, nor is it likely that the IRS will acquiesce to the court's holding. Compounding the uncertainty is the burden on the taxpayers, and the lack of an airtight position to argue for basis apportionment in this uncommon situation.

The decision gives taxpayers a valid reason to claim a refund or to apportion basis to stock received for future sales. While the IRS may disagree with the practice, it is not able to impose penalties and, therefore, practitioners should encourage their clients to request refunds or apportion the basis in the assets. In addition, there may be a push by practitioners to organize those individuals making these refund requests and taking this position on returns. These options may allow clients to cost-effectively challenge a disallowance of the position by the IRS.

Since, based on case law, statutes, and regulations, the fairest solution seems to be the least likely to be applied, hopefully there will be an intervention by the Treasury Department or Congress. Such intervention would allow the basis to be apportioned based on the fair market value of each asset at the time of the demutualization. The reader is encouraged to call or write his or her respective representative and petition him or her to act on this issue.