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- Insurance Tax Bulletin

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No Gain on Insurance Company Shares Acquired in Demutualization

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On August 6, 2008, The US Court of Federal Claims held that the open transaction doctrine applied to shares of an insurance company acquired as part of a demutualization. Cash received was considered a return of capital. *Fisher v. United States* 102 AFTR 2d 2008-XXXX, 8/6/08.

Taxpayer purchased life insurance policies from Sun Life Assurance Company ("Life"), a mutual life insurance company. The premiums paid by the Taxpayer purchased insurance and ownership and voting rights in the mutual insurance company. A mutual insurance company has no shareholders, and is owned by the participating policyholders, which have both ownership and contractual insurance rights.

Eight years later, Life undertook a plan to demutualize. Life would become a wholly owned subsidiary of a holding company, Sun Life of Canada Holding Corp. ("Holding"). Shares of Life were exchanged for shares of Holding, with approximately 20% allocable to compensate for the loss of voting rights and 80% allocable to the loss of other ownership rights. These figures were arrived at in an actuarial study commissioned by Life as part of the plan for demutualization. There was a cash election for policy holders preferring to sell their shares as part of the transaction rather than accepting stock in Holding. The Taxpayer chose the cash election and received cash for shares. The Taxpayer retained the life insurance policy. The gain was reported on its income tax return with no adjustment for any basis and the resulting tax liability was paid. The Taxpayer then filed a claim for refund, and when the claim was denied, filed suit.

The argument centered on the allocation of basis to the shares of Holding. The IRS contended that the shares had zero basis. The Taxpayer contended that the basis could not be determined because the purchase of ownership rights was tied to the purchase price of the life insurance policy and could not be segregated. Treas. Reg. Section 1.61-6 (a) discusses the application of this principle when a large asset is purchased and then a component is sold, that basis is allocated based on fair market value. The regulations presume that fair market values will be available except in "rare and extraordinary cases will property be considered to have no fair market value." In the instance that one of these "rare circumstances" arises, what is the proper course of action: that none of the basis from the original acquisition is allocable or that the entire basis of the original acquisition is allocable until exhausted?

The Court makes the observation that this formula will only work when it is possible to derive the fair market values of the component pieces. The Court then analyzes the regulatory history of the "open transaction doctrine". The Court traced the "open transaction doctrine" to the Logan case (*Burnet v. Logan*, 283 U.S. 404 [9 AFTR 1453] 1931). The doctrine was used by the taxpayer to claim that no gain should be realized on the sale of a portion of a property until the basis of the entire original purchase was recovered. Twelve years later, in *Pierce v. United States*, 49 F. Supp.324 [30 AFTR 1249] (Ct. Cl. 1943), the government claimed a transaction was open to deny a loss. "No particular value could be assigned to the interest...as of the date of purchase...with any degree of assurance that the assignment of value was correct...we do not think that the situation calls for such a rough estimate, when by patience the exact answer may be obtained." The Court then completed an exhaustive analysis of later cases and Regulations.

The Court also mentions Revenue Ruling 77-414, 1977-2 C.B. 299, where the IRS writes "when it is impractical or impossible to determine the cost or other basis of the portion of the property sold, the amount realized on such sales should be applied to reduce the basis of the entire property and only the excess over the basis of the entire property is recognized as gain."



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The Court found that the facts and circumstances in this case are similar to other "open transaction doctrine" cases and therefore this transaction was one of the "rare and extraordinary cases" where basis could not be determined and therefore the transaction remains open. The amounts received by the Taxpayer are less than its cost basis in the insurance policy as a whole, and therefore are a return of capital. The Court found that the Taxpayer did not receive any income on the sale of the stock and was entitled to the requested refund.

PwC Observes: The Court noted this is not an expansion of the open transaction doctrine, but rather the application of the open transaction doctrine to unique and unusual facts. The statute of limitations for filing refunds is generally three years after the filing of the tax return. This ruling will likely be too late for sales reported in the 2004 tax year or earlier, but may be available for later transactions or Taxpayers with open tax years.

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

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