Tax Impact of Demutualization – The Saga Continues

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Overview

In August 2008, the U.S. Court of Federal Claims ruled against the IRS position of assigning zero income tax basis to stock received in an insurance company demutualization.[1] Instead, the court ruled that basis is to be allocated to the stock of the policy up to the amount of the selling price of the stock. The court's opinion comes as no surprise – they ruled in November of 2006 against an IRS motion for summary judgment. That meant the case was to go to trial to determine the basis of the shares. If the court had agreed with the IRS, it would have granted summary judgment. So, we have known since that time that IRS would lose the case – the shares would have a positive basis and not all of the gain would be taxable. What was not known was how income tax basis would be computed.

In late 2009, the U.S. Court of Appeals for the Federal Circuit affirmed the U.S. Court of Federal Claims by issuing a decision without a published opinion.[2] However, IRS continued to litigate the issue in an Arizona federal district court.[3] On July 9, 2012, the court, on motion for summary judgment, disagreed with both the IRS position and the taxpayer's position setting the stage for a trial on the issue of how basis is to be allocated between the premium and the stock.[4]

On January 15, 2013, a California federal district court determined, on opposing motions for summary judgment, that the taxpayer failed to establish that the taxpayer had any income tax basis in the shares of stock received upon demutualization.[5]

In mid-March, 2013, a federal district court in Arizona (the court that set the stage for a trial on basis computation) delivered its opinion on the basis computation.

As the issue continues to unfold in the courts, the demutualization issue raises filing issues for practitioners.

What is Demutualization?

Demutualization is the process through which a member-owned company becomes shareholder-owned; frequently this is a step toward the initial public offering (IPO) of a company. Insurance companies often have the word "mutual" in their name, when they are mutually owned by their policy holders as a group. They've been around a long time. In fact, Benjamin Franklin established one of the first mutual insurance companies. Such a company doesn't have shareholders, but instead is owned by its participating policyholders who possess both ownership rights, such as voting and distribution rights, as well as the more typical contractual insurance rights.[6] In recent years, however, there has been a strong trend for these companies to *demutualize*, converting to a shareholder ownership base. Generally, policy holders are offered either shares or money in exchange for their ownership rights. Because shares can be traded or sold - in contrast to ownership rights, which cannot - demutualization increases the possibility of profit for those involved, and tends also to benefit the economy.

Demutualization was originally used to refer specifically to this conversion process by insurance companies, but the term has since become more broadly used to describe the process by which any member-owned organization becomes shareholder-owned. Worldwide, stock exchanges have offered another striking example of the trend towards demutualization, as the London, New York and Toronto Stock Exchanges and most other exchanges across the globe have either recently converted, are currently in the process, or are considering demutualization.

Insurance company demutualizations became popular in the late 1990s. Facilitated by revised state laws, mutual insurance companies were attracted to conversion to stock companies for the same reasons that companies have long sought to be publicly held - greater access to capital. The policyholders of mutual insurance companies were generally granted cash or stock in return for their interest in the mutual insurance company.

As of August 2008, the following life insurance companies have demutualized (with the approximate number of policyholders affected, when known):

1. Acacia Mutual (1997)
2. American Mutual (1996); 300,000 policyholders
3. American United (2000); 175,000 policyholders.
4. Ameritas (1997)
5. Canada Life (1999); 388,000 policyholders.
6. Central Life Assurance (2000); 300,000 policyholders.
7. Equitable Life Assurance Society (1992)
8. General American (2000); 330,000 policyholders.
9. Guarantee Mutual Life (1995)
10. Indianapolis Life (2001); 200,000 policyholders.
11. Industrial-Alliance (Canada) (1999); 700,000 policyholders.
12. John Hancock (2000); 3,000,000 policyholders.
13. Lafayette Life (2000)
14. Manulife (1999)
15. Metropolitan Life ((2000); 11,200,000 policyholders.
16. Midland Life (1994)
17. Minnesota Mutual Life (1998)
18. Mutual of New York (1998); 800,000 policyholders.
19. Mutual Life of Canada (2000)
20. Mutual Service Life (2005)
21. National Travelers (2000)
22. Nationwide Life (1997)
23. Northwestern National (1989)
24. Ohio National (1998)
25. Phoenix Home Life (2001); 500,000 policyholders.
26. Principal Mutual (2001); 925,000 policyholders
27. Provident Mutual (2002)
28. Prudential (2001); 11,000,000 policyholders.
29. Security Mutual Life of Nebraska (1999)
30. Standard Insurance Co. (1999); 125,000 policyholders.
31. State Mutual Life (1995); 100,000 policyholders.
32. Sun Life of Canada (2000)
33. Union Mutual (UNUM) (1986)
34. Western & Southern Life (2000)

But, the tax issue is tricky. Federal tax law specifies that gross income includes gain from the sale of property that are equal to the amount realized upon sale less the seller's cost basis in the property.[7] That's a simple enough principle, but sometimes its application can be difficult – such as in the situation where the property was purchased as component of a larger item. With a demutualization, insurance policy rights that were acquired as an indivisible package are separated and sold.

The IRS Position

The IRS position is that policyholders have a zero basis in the cash or stock received in demutualization, and a carryover basis from their time as a policyholder. This means that policyholders receiving cash are subject to tax on the cash received in the year of the demutualization. Policyholders receiving stock are not subject to tax until the stock is sold. But, the IRS position is highly questionable. Clearly, a portion of a shareholder's premium payments made over the years were not for insurance coverage, but for the voting and liquidation rights as a policyholder. That is evidenced by the fact that policyholders who have paid in the most premiums over the years were generally entitled to a larger cash or stock distribution as part of the demutualization transaction. But, it is difficult to determine what a shareholder has paid for those rights. In addition, a taxpayer bears the burden to support any basis claimed on the sale of an asset to offset gain. Otherwise, IRS says the basis is zero. In paying an insurance premium, policyholders pay only a premium amount - nothing is specified as being paid for any other purpose. So, that's what has given IRS an argument that the shareholder has zero basis.

The *Fisher*[8] Case

Before 2000 Sun Life Assurance Company (Sun Life) was a Canadian mutual life insurance and financial services company. In 1999, Sun Life's Board certified that eligible policyholders had approved a demutualization of the company. In early 2000, the company received the necessary regulatory approvals to proceed with the demutualization and filed a Private Letter Ruling request with the IRS as to the tax implications of the demutualization to the policyholders. The IRS, in the ruling, stated the following:[9]

- Policyholders' ownership rights could not be obtained by any purchase separate from any insurance contract that Sun Life issued.
- Under I.R.C. §354(a)(1), no gain or loss would be recognized by the eligible policyholders on the deemed exchange of their ownership rights solely for company stock
- The income tax basis of the company stock received by policyholders in the exchange will be the same as the basis of the ownership rights surrendered, namely zero.

Upon demutualization, the plaintiff received 3,982 shares of stock in exchange for its voting and liquidation rights. The plaintiff opted for the "cash election" which permitted Sun Life to sell those shares on the open market for $31,759. The plaintiff reported the entire amount on its tax return and paid $5,725 in tax. The plaintiff then filed a claim for refund, which the IRS denied. The plaintiff then sued, seeking summary judgment. IRS also moved for summary judgment. Alternate dispute resolution did not resolve the matter and the U.S. Court of Federal Claims, in late 2006, denied both of the summary judgment motions. The court determined that the proceeds from stock were not a distribution by Sun Life of a policy dividend, its equivalent, so as to be excluded from gross income as a return of capital under the annuity rules.[10] The court then concluded that it could not resolve the plaintiff's claim that no capital gain was realized on the sale of the stock because, as the plaintiff claimed, the proceeds were offset by the plaintiff's income tax basis in the stock. The court found that the plaintiff's claim presented fact questions that required a trial on the matter. At trial, the plaintiff's expert testified that he couldn't form an opinion as to the fair market value of the ownership rights because they were tied to the policy. The rights added value, the expert testified, but did not have a separate value. The IRS' expert determined that the ownership rights had no value, emphasizing that none of the premiums were specifically dedicated to acquiring the ownership rights, that there was no market for the ownership rights, and that it was highly unlikely, at the time of policy acquisition, that a demutualization would occur.

The court focused on Treas. Reg. §1.61-6(a) which specifies that when part of a larger property is sold, the cost basis of the entire property is to be equally apportioned among the several parts, and the gain realized or loss sustained on the part of the entire property sold is the difference between the selling price and the cost basis allocated to the part that is sold.[11] But, for the formula to work, the court noted that the market value of the part sold must be determinable. On that point, the court noted that the Supreme Court, in *Burnet v. Logan*,[12] dealt with a similar problem. *Burnet* involved a sale of stock under which the seller received cash and the buyer's promise to make future payments conditioned on contingencies.[13] The cash received did not equal the seller's cost basis for the stock, and the contingencies affecting future payments precluded ascribing a fair market value to the buyer's promise. In later years, payments were made which the seller did not include as income. The Court held that the seller was not required to do so. With respect to such payments, the court said:

> "As annual payments on account of extracted ore come in they can be readily apportioned first as return of capital and later as profit. The liability for income tax ultimately can be fairly determined without resort to mere estimates, assumptions and speculation. When the profit, if any, is actually realized, the taxpayer will be required to respond. The consideration for the sale was $2,200,000.00 in cash and the promise of future money payments wholly contingent upon facts and circumstances not possible to foretell with anything like fair certainty. The promise was in no proper sense equivalent to cash. It had no ascertainable fair market value. The transaction was not a closed one. Respondent might never recoup her capital investment from payments only conditionally promised. Prior to 1921 all receipts from the sale of her shares amounted to less than their value on March 1, 1913. She properly demanded the return of her capital investment before assessment of any taxable profit based on conjecture."

The Court's opinion gave rise to what has become known as the "open transaction" doctrine. IRS reconfirmed the validity of the doctrine in Rev. Rul. 74-414[14] where they described the general requirements of Treas. Reg. §1.61-6, but also stated that "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 on such sales should be applied to reduce the basis of the entire property is recognized as gain. In addition, the Court noted that IRS has repeatedly argued for the continued viability of the doctrine when seeking to disallow deductions.[15]

As to the value of the ownership rights sold, the U.S. Court of Federal Claims referenced Sun Life's actuarial study that suggested that the ownership rights had value before the demutualization. That study, which was provided to the company's policyholders with the plan for demutualization, specified that the stock allocation fairly compensated the policyholders for the loss of voting control of the company and the right to share in the company's residual value (if it were "wound-up"). The plan provided for a fixed allocation of 75 Financial Services Shares to each eligible policyholder, regardless of the number of policies held, and for a variable allocation to each eligible policyholder of a number of Financial Services Shares tied to its cash value, the number of years it has been in force and its annual premium. The study stated that it regarded the fixed allocation as compensation for loss of voting control and the variable allocation as compensation for loss of the right to share in residual value. The court viewed the actuarial study, coupled with the plaintiff's expert opinions, to be persuasive. As such, the taxpayer's cost basis in the insurance policy (determined by the amount of premiums that had been paid) as a whole exceeded the amount received in the demutualization and the taxpayer did not realize any income on the sale of the stock and was entitled to a full refund of taxes paid on the sale. The court also noted that numerous state statutes (enacted before the plaintiff acquired its policy) that authorize demutualization require that compensation be paid for the loss of ownership rights.[16] In addition, while the IRS' position was consistent with the private letter ruling issued to Sun Life, the court noted that the ruling had no binding or precedential effect on the tax treatment to be accorded the plaintiff.

Computing Basis

The plaintiff in *Fisher* had a cost basis in the insurance policy (as determined by the amount of premiums that had been paid) that exceeded the value of stock received in the demutualization resulting in zero tax liability. So, while the court's analysis of the procedure (or procedures) available for computing basis was truncated, it does appear that cost basis in an insurance policy can be established by looking to the amount of premiums that have been paid. But, some taxpayers may not have complete information concerning premiums payments. Thus, are there other ways in which basis can be computed? Perhaps a taxpayer could claim as basis for stock received in a demutualization the value of the stock at the time of the demutualization. Or, perhaps, the price at which the stock was initially issued (the "IPO" price). If either of these basis determination techniques is used, however, the *Fisher* case would seem to indicate that basis would be limited to the amount of premiums paid. Unfortunately, the Federal Circuit did not provide any further guidance on the matter.

The *Dorrance* Case[17]

The plaintiffs formed a trust in 1995 that purchased five life insurance policies in 1996. The policies provided a combined $87,775,000 in coverage and the benefits were to be used to provide the necessary funds to pay the plaintiffs' federal estate tax upon their deaths so that the family stock portfolio would not have to be liquidated to pay the tax. All of the policies were purchased from mutual insurance companies that demutualized from 1998-2001.

The trust received Form 1099-B denoting the stock basis as zero which was consistent with the IRS position that policyholders do not get a basis in stock received upon demutualization. The plaintiffs paid the necessary tax and filed suit for a refund. The IRS moved for summary judgment arguing that the plaintiffs never paid any amounts to acquire mutual rights under the policy. Instead, IRS argued that the entire premium attributable to a particular policy was paid to buy that policy. So, according to the IRS, the plaintiffs did not have any basis in the stock received upon demutualization of the companies. The plaintiffs also filed for summary judgment arguing the "open transaction" doctrine that the *Fisher*[18] court approved. If the doctrine applied, the plaintiffs argued, all of the proceeds from their sale of the stock would be a return of capital from the premiums and no tax would be triggered.

The court noted that the *Fisher* court had only been presented with a choice between the IRS position of zero basis and the opposite position of full basis. Neither party in *Fisher*, the court noted, addressed "how use of the [open transaction] doctrine could be avoided altogether by applying reasonable alternative basis apportionment methods." So, the court determined that *Fisher* was not precedential and that the court was not similarly limited at this procedural stage of the case – opposing motions for summary judgment.

The court denied the plaintiffs' motion for summary judgment on the basis that they had not shown that it was too difficult to allocate basis in accordance with the Treasury Regulations such that the open transaction doctrine should automatically apply. The court noted that it was possible to determine the mutual rights and the policy itself at the time of demutualization. Thus, there wasn't a problem that the plaintiffs would be taxed on a transaction that would later show a loss. The court also noted that while the taxpayers in *Fisher* received an immediate payment of cash in exchange for their mutual rights, the plaintiffs in *Dorrance* received stock, held it for several years and then sold it for more than its market value at the time of demutualization. So, the court reasoned the open transaction doctrine would have to actually be applied to determined basis in the stock.

The court also denied the summary judgment motion of the IRS, noting that IRS had only provided evidence that compared the cost of plaintiffs' policies before and after demutualization, but did not provide evidence that compared policy cost at time of purchase to similar policies that did not have mutual rights.

So, the court determined that there was no way the court could equitably apportion premiums paid before demutualization as income tax basis between the mutual rights and the policies themselves. Neither party presented any evidence for the court to make such a determination.

The court noted that the plaintiffs had established that they did actually pay something for the mutual rights, and that there was a way to compute the apportionment. That was to be taken up at a subsequent trial.[19]

At that subsequent trial, the court determined the plaintiffs' income tax basis in the shares of stock received upon demutualization, and also laid out the process the court used for determining that basis.[20] The court reiterated that the plaintiffs were compensated for the loss of their mutual rights in the various mutual insurance companies that they purchased life insurance policies from in the form of stock worth a total of $1,794,771. Later, the plaintiffs sold the stock for $2,248,806 and the IRS claimed that the amount received on sale was fully taxable because the plaintiffs lacked any income tax basis in the shares of stock.

The core of the IRS position was that the plaintiffs didn't pay any additional amount for the mutual rights and had no realistic expectation that the companies they purchased the policies from would demutualize. But, the court rejected that argument by noting that the plaintiffs acquired vested rights when they bought the insurance policies. Those rights included voting rights and the right to participate in the distribution of each company's surplus irrespective of whether the distribution was caused by a demutualization. Thus, the mutual rights could not be sold and were not separate from the respective policies, and the cost of obtaining those mutual rights could not be established through the payment of premiums. Thus, the court started its determination of the plaintiffs' basis in the mutual rights with the IPO price of the shares received upon demutualization. On that point, the court noted that the insurance companies determined that the fair market value of the shares equaled the value of the mutual rights and that they were allocated to policy holders in a fair and equitable manner. In addition, the court noted that the insurance companies allocated stock shares to the plaintiffs based on the value of the voting rights, past contributions to surplus and projected contributions to surplus. But, the projected contributions to surplus could not be included in the basis computation because the taxpayers had not actually paid those amounts before receiving the shares of stock. That portion, the court determined was 40 percent of the taxpayer's contributions to surplus. As a result, the could computed the plaintiffs' basis as equating to the compensation they received for established voting rights (fixed shares) and 60 percent of the amount representing past contributions to surplus (variable shares).

The court used the data of the insurance companies to determine that the IPO value of the fixed shares when added to 60 percent of the IPO value of the variable shares was $1,078,128. The result was a refund for the taxpayers of $161,719.20.[21]

The *Reuben* Case[22]

Before the basis decision in *Dorrance*, this case was decided. Here a married couple created an irrevocable trust for the benefit of their children. The trust later purchased a mutual life insurance policy from Manulife, and paid premiums exceeding $1.7 million over a ten-year period until Manulife demutualized. Shortly thereafter, the trust received 40,307 shares of stock as a result of the demutualization. In turn, the trust distributed over 5,000 shares to one of the beneficiaries, the plaintiff in the case, who sold a portion of the shares in 2005 for slightly over $200,000. On his tax return, the plaintiff initially claimed a zero basis in the shares, but later filed an amended return seeking a refund of $64,259 on the grounds that the stock had a basis of $41.13 per share in accordance with the decision of the Court of Federal Claims in *Fisher*. The IRS allowed a partial refund because the plaintiff had mischaracterized the gain on the sale of the stock as short-term gain, but took the position that the stock basis was zero. In late 2009, the plaintiff appealed, and in late 2011, IRS suspended further action on the matter pending the outcome of *Dorrance*. Plaintiff continued to seek a refund of $25,428 plus interest, and after the *Dorrance* opinion was issued, IRS moved for summary judgment in opposition to the plaintiff's summary judgment motion.

The IRS took the position that the premiums that the trust paid were not for membership rights in Manulife and, as a result, there was no income tax basis in the stock shares received upon demutualization. The plaintiff argued that the trust's ownership rights had some value before demutualization that was other than deminimis, and that the Open Transaction Doctrine should be applied to determine the basis in accordance with *Fisher*. Under that approach, the basis in the shares would be $42.38 per share determined by dividing the total amount of premiums that the trust paid by the number of shares of stock that the trust received when Manulife demutualized. However, the court determined that the facts of the case were materially different from the *Fisher* facts. The court noted that the Fisher plaintiff elected to receive cash in lieu of shares of stock, but that in this case the plaintiff sold shares of stock six years after distribution from the trust. Also, the Open Transaction Doctrine was applied in Fisher after a trial on the merits, whereas in this case the plaintiff was seeking to apply the Doctrine on a motion for summary judgment where the motion was opposed by the IRS offering evidence from an expert actuary whose opinion it was that the monetary value of membership rights "is best stated as negligible or zero predemutualization." The court also held that the plaintiff failed to show that allocating basis between the mutual rights and the stock was so difficult that the Open Transaction Doctrine was appropriate." As a result, the plaintiff's motion for summary judgment was denied and the court held that the application of the Open Transaction Doctrine was not appropriate to determine income tax basis in the shares of stock.

As for the government's motion for summary judgment, the court noted that the IRS was relying on *Gladden v. Comr.*[23] for its position that the plaintiff had to prove that the trust paid a premium for the membership interests, and that there was a realistic expectation (at the time the policy was purchased) that the company would demutualize. The court, however, said that this misconstrued the *Gladden* because *Gladden* only requires that the plaintiff show that some portion of the premiums paid to Manulife were in compensation for the ownership interests. On this point, however, the court noted that the plaintiff failed to provide evidence to support their argument that it was not possible to value the policy rights and the membership rights separately. All that the plaintiff did was cite the *Fisher* case. On the contrary, the government provided substantial evidence to support its argument that none of the premiums that the trust paid were for membership interests in Manulife, and that Manulife, at the time of demutualization, told its policyholders that shares received in exchange for ownership rights would not have any basis. But, plaintiff pointed out that Manulife's position was based on the IRS position and was staked out before the *Fisher* opinion was released. While the plaintiff had an expert, the court noted that the expert did not perform an independent valuation of the membership rights, and did not provide an opinion on whether any part of the premiums paid were in compensation for the membership rights. As such, the court determined that the plaintiff did not satisfy his burden to establish that the stock basis was anything other than zero." Thus, the government's motion to dismiss was granted.

Applicable Holding Period

If a taxpayer received stock in a demutualization and sold the stock within one year, a question arises concerning the applicable holding period of the stock. Unfortunately, the Fisher court did not address the holding period issue. However, in Rev. Rul. 2003-19,[24] IRS addressed three variations on the demutualization theme, one of which involved the classic demutualization picture where the former mutual company simply issued capital stock and dropped the word "mutual" from its name. IRS said that the demutualization involved a corporate reorganization. Indeed, IRS ruled that what was involved was both an I.R.C. §368(a)(1)(E) recapitalization as well as an "F" reorganization because of the change in name and corporate form from mutual to stock. The policyholders of the mutual company had both membership interests in the mutual company and contractual rights under their policies. Absent the reorganization, those membership rights could not be separated from the contract rights as a matter of state law. Those rights would terminate, with no continuing value, if the contract terminated. The membership interests were to be treated as voting stock, said the ruling, and thus the transaction was not taxable to the shareholders.

However, IRS did not follow through and deal with the tax basis and holding period of the stock received by former mutual policyholders. Earlier, in ILM 200131028,[25] IRS pointed out that if a demutualization qualified as a tax-free reorganization, "then Taxpayer's holding period for the stock runs from the date the Taxpayer first held an equity interest in the mutual life insurance company as a policyholder or annuitant. Section 1223(1) of the Code." I.R.C. §1223(1) allows the tacking on of holding periods "if, under this chapter, the property has, for the purpose of determining gain or loss from a sale or exchange, the same basis in whole or in part in his hands as the property exchanged. . . . " I.R.C. §358 provides that the basis of property received in a tax- free exchange without recognition of gain or loss is the same as the basis of the property exchanged. So, if the demutualization transaction qualifies as a tax-free reorganization under I.R.C. §368(a)(1) (and IRS has concluded that a demutualization does so qualify) the taxpayer's holding period for the new stock includes the period the taxpayer held an equity interest in the mutual company as a policyholder or annuitant. That means that any transaction that was properly reported as a long-term capital gain on the original return will also be treated as a long-term capital gain on an amended return.

Tax Planning for Clients

Without a doubt, practitioners with clients having demutualization distributions over the past few years while the *Fisher* and *Dorrance* litigation was pending should have been filing protective claims for refunds. Protective claims are commonly filed when a taxpayer's right to a refund is contingent on future events (such as pending litigation) that will not be resolved until after the statute of limitations expires.[26] A timely and proper protective claim will preserve the taxpayer's right to obtain a refund.[27] That was the suggested strategy after the court's denial of summary judgment for IRS in late 2006.[28] If a protective claim is not in place, the client will be subject to the three-year statute of limitations applicable to open tax years when seeking a refund. If tax on a demutualization was paid on an extended 2005 return, a refund claim must be filed by August 15, 2009 (or October 15 if a second extension was utilized), using Form 1040 X.

Given the affirmance by the U.S. Court of Appeals for the Federal Circuit, amended returns claiming refunds should be filed for those taxpayers outside of Arizona. It is not likely however that refunds will be processed until the matter is finally concluded in the federal courts, perhaps all the way to the U.S. Supreme Court.

Guidance won't be forthcoming until the law becomes more settled and IRS won't take any action on refund claims until that time. If a taxpayer can't wait as long as the IRS wants to drag the matter out, a refund suit can be filed after a claim has been filed with the IRS and they have not taken any action on it for six months. In any event, if a refund is determined to be due, interest will be added on.

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[1] Fisher, *et al*. v. United States, 82 Fed. Cl. 780 (2008).

[2] Fisher, *et al.* v. United States, *333Fed. Appx. 572*(Fed. Cir. 2009).

[3] Dorrance v. United States, No. CV09-1284-PHX-ROS (D. Ariz. filed Jun. 15, 2009).

[4] Dorrance v. United States, No. CV-09-1284-PHX-GMS, 2012 U.S. Dist. LEXIS 94107 (D. Ariz. Jul. 9, 2012).

[5] Reuben v. United States, No. CV 11-09448 SJO (PJWx) (C.D. Ill. Jan. 15, 2013).
[6]The voting rights of policyholders differ from those of traditional shareholders. Each policyholder has only one vote, regardless of the number of policies owned. Once the company pays its claims and operating expenses, the profits belong to the policyholders. Usually, some of the profits are returned to the policyholders as dividends, which reduce premium payments with the balance retained as surplus.
[7] I.R.C. §§61(a)(3); 1001(a); 1011.
[8] Fisher, *et al*. v. United States, 82 Fed. Cl. 780 (2008).
[9] Priv. Ltr. Rul. 200020048 (Feb. 22, 2000).
[10] See I.R.C. §72.
[11] See also Gladden v. Comm'r., 262 F.3d 851 (9th Cir. 2001)(the apportionment is done by dividing the cost basis of the larger property among its components in proportion to their fair market values at the time they were acquired).
[12] 283 U.S. 404 (1931).
[13] In *Burnet*, the defendant sold stock in a closely-held corporation which assets included stock in a second corporation that owned a mine lease. The defendant exchanged the stock for cash and a stream of annual payments corresponding to the amount or iron ore extracted from the mine. IRS took the position that, at the time of sale, the right to receive the mining royalties could be estimated based on the amount of reserves at the mine and that the transaction should be taxed based on that estimate. The Supreme Court, however, determined that the defendant was entitled to recover her capital investment in the stock before paying income tax based on the supposed market value of the mineral payments. This became known as the "open transaction" doctrine.
[14] 1977-2 C.B. 299.
[15] *See, e.g.,* Smith v. Comm'r., 78 T.C. 350 (1982); Hutton v. Comm'r., 35 T.C.M. 16 (1976); Grudman v. Comm'r., 34 T.C.M. 669 (1975)
[16] *See, e.g.*, Or. Rev. Stat. Ann. §732.612; N.Y. Ins. Law §7312(d)(4); Wash. Rev. Code Ann. §48.09.350(3); Wis. Stat. Ann. §611.76(4)(bm).
[17] Dorrance v. United States, No. CV-09-1284-PHX-GMS, 2012 U.S. Dist. LEXIS 94107 (D. Ariz. Jul. 9, 2012).
[18] 333 Fed. Appx. 572 (Fed. Cir. 2009).
[19] The court noted that the trial would be a non-jury trial.
[20] Dorrance v. United States, No. CV-09-1284-PHX-GMS, 2013 U.S. Dist. LEXIS 37745 (D. Ariz. Mar. 19, 2013).
[21] The taxpayers, in their posttrial briefing, offered an additional method to account for additional contributions made to surplus between the calculation date for share allocations and the IPO date. But, because of the lateness of the proffer of the method, the court deemed it waived.
[22] Reuben v. United States, No. CV 11-09448 SJO (PJWx)(C.D. Ill. Jan. 15, 2013).
[23] 262 F.3d 851 (9th Cir. 2001).
[24] 2003-1 C.B. 468.
[25] Jun. 29, 2001.
[26] GCM 38786 contains the IRS' most comprehensive discussion of protective refund claims and describes the various circumstances in which filing a protective claim is appropriate when the expiration of the refund statute of limitations is imminent
[27] Once a protective claim is filed, the process for triggering the request to process the claim involves filing an amended return with the tax computation and attaching a copy of the protective claim that was filed.
[28] A protective claim is filed as if the taxpayer were filing for a refund. The only exception is that "Protective Claim – Do Not Process" should be written at the top of Form 1040X. An explanation should be attached noting that the claim is filed to protect the taxpayer's right to a refund in the event of the court ruling that demutualization payments are not fully taxable.