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THE OPEN TRANSACTION DOCTRINE APPLIES TO THE SALE OF STOCK OF A DEMUTUALIZED LIFE INSURER IN *FISHER*, BUT SHOULD IT?

By Emanuel Burstein

In *Fisher v. United States*,[1] the Federal Circuit affirmed the decision of the Court of Federal Claims, which concluded that the "open transaction" doctrine applied to prevent the current inclusion of taxable gain resulting from the sale of stock acquired in a demutualization. The appellate court included no analysis in its *per curiam* decision, although *Fisher* involves important issues that are not fully resolved as well as tax issues that apply to millions of policyholders that have sold or will sell stock in demutualized insurance companies.

FACTS

On June 28, 1990, the Seymour P. Nagan Irrevocable Trust acquired a life insurance policy from the Sun Life Assurance Company (Sun Life), a Canadian Mutual Life Insurer. Fisher was a trustee of the Trust. For an annual premium of $19,763.76 the Trust acquired $500,000 of life insurance coverage. It also acquired certain ownership interests in Sun Life including the right to vote on certain matters, to participate in the distribution of profits and demutualization benefits, and to surplus remaining after the satisfaction of Sun Life's obligations if Sun Life became insolvent. Before the demutualization, these rights could not be sold separately from the insurance coverage and they terminated when the policy ended.

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Sun Life converted from a mutual to the stock form in a demutualization in 2000. The Trust received 3,892 shares of Sun Financial stock, which it subsequently sold for $31,759 on the open market. The Trust could maintain its coverage by continuing to pay annual premiums, which remained unchanged in amount from before the demutualization.

The Internal Revenue Service (IRS) issued Letter Ruling 200020048[2] and ruled, *inter alia*, that no gain was recognized by eligible policyholders when they exchanged their ownership rights for the company stock. The basis of the ownership rights carried over to the stock issued in the demutualization, which the IRS held to be zero.[3]

SALE OF A PORTION OF PROPERTY

A taxpayer generally is taxable on the amount recognized from the sale or exchange of a capital asset, such as the sale of corporate stock for cash. The amount recognized equals the excess, if any, of the amount realized over the adjusted basis of the asset sold, under sections 1001(a) and 1001(c). The amount realized equals the fair market value of the property received.

Special rules apply if the property sold is a component of a larger property. Treasury Regulation section 1.61-6 provides, in part,

> When a part of a larger property is sold, the cost or other basis of the entire property shall be equitably 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 or other basis allocated to such part. The sale of each part is treated as a separate transaction and gain or loss shall be computed separately on each part. Thus, gain or loss shall be determined at the time of sale of each part and not deferred until the entire property has been disposed of.

THE OPEN TRANSACTION DOCTRINE

Instead of using a cost basis that is very speculative to compute the gain from the disposition of a portion of a larger property, the tax law treats certain dispositions as part of a transaction that remains open until the disposition of the remaining property. By integrating the transactions, any gain that would have been recognized in the initial disposition—if the open transaction doctrine had not applied—is offset by reducing the cost basis of the remaining property. This adjustment has the effect of deferring some, or all of the gain, if any, until the gain is recognized on the disposition of the second property.

In the landmark case of *Burnet v. Logan*[4] proceeds from the sale of Logan's stock included cash as well as a stream of amounts based on the total weight of ore extracted from a mine. The Supreme Court concluded that the sale of stock was not closed in 1916 when the stock was sold because the future proceeds depended on "facts and circumstances [that] were not possible to foretell with anything like fair certainty."[5] The proceeds from the stock sale were initially treated as a return of capital and taxed as recognized gain after the entire cost basis was exhausted.

The government treated the disposition of the Sun Life Financial stock in *Fisher* as a closed transaction so that the Trust recognized gain equal to cash received less the cost basis allocated to its Sun Life Financial stock. The recognized gain equaled the cash received because the cost basis, according to the government, equaled zero.

The Court of Federal Claims, however, concluded that the sale of the Sun Financial stock was an open transaction. It reasoned that the ownership rights had a value and the open transaction exception applied because one could not readily determine such value. The Trust could decrease the cost basis of the original integrated property by the amount received and recognized no gain because the cost basis exceeded the total amount received.

WAS THE SALE OF THE SUN FINANCIAL STOCK AN OPEN TRANSACTION?

One can argue that the government's position that the sale of the Sun Financial stock was a closed transaction has considerable merit, in part, because it was reasonable to treat the cost basis of the Sun Life Financial stock as zero. Treasury Regulations provide that the fair market value of property "is a question of fact, but only in rare and extraordinary cases will property be considered to have no fair market value."[6] Allocating a zero cost basis to the newly issued stock does not necessarily indicate that the ownership rights lacked a value to the mutual policyholders. Rather, expert testimony indicated that the value was very small and difficult to determine and thus zero was used as a reasonable estimate.

Along the same lines, insurance company tax rules and Sun Life Financial treat the equity component of a premium paid to mutual insurers as merely incidental to the underlying insurance coverage. They, in effect, allocate the entire cost basis to the insurance coverage and nothing to the equity component. Under section 803(a)(1), a mutual life insurer includes the entire premium received in its gross income. The nonrecognition of capital contributed to a corporation in return for an equity interest in the corporation does not apply to any of the premium received.[7] Furthermore, in *Fisher,* the size of the premiums Sun Life charged for the coverage (that was integrated with the ownership rights before the demutualization) remained the same after the demutualization, when the premiums paid only for the coverage. Again, nothing was allocated to the equity component.

Treating the disposition of the stock and the subsequent termination of the insurance coverage as components of an open transaction would be flawed because the disposition of the stock and termination of insurance coverage are subject to different tax treatment. The stock disposition is taxed as the sale of a capital asset, so that any gain is taxed as capital gain. Proceeds on the disposition of a life insurance policy upon the death of the insured are completely excluded from tax under section 101 so that deferred gain would be deferred indefinitely. If a policyholder allows the coverage to lapse, the policyholder's gain, if any, would be taxed at ordinary tax rates, not as capital gain.[8]

Policyholders and insurance companies would be subject to additional recordkeeping and compliance burdens if the open transaction doctrine applied to the sale of the stock of a demutualized life insurer. They would have to know the amount of gain deferred when the stock is sold, which would adjust the policyholder's investment in the contract. Obtaining the information needed to determine the gain would be especially burdensome for insurance companies because they are not a party to the underlying stock sale and a very large number of policyholders of any given demutualized insurer would sell stock acquired in the demutualization.

AN IMPORTANT ISSUE

Fisher involves a small amount of tax liability. The tax treatment addressed in *Fisher*, however, is very significant because it involves the tax treatment of the sale of stock acquired in a demutualization. There have been numerous demutualizations, including those involving some of the giants in the insurance industry, such as Metropolitan Life and Prudential, so that millions of policyholders have sold, or will sell, stock of insurance companies acquired in demutualizations.

The Federal Circuit indicated that its decision in *Fisher* is not precedent, but a taxpayer nonetheless can rely on the decision of the Court of Federal Claims—a court of national jurisdiction—to support its view that the open transaction

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doctrine applies to defer much, if not all, of the gain on the sale of stock acquired in a demutualization. Insurance tax practitioners stated in a summary of important policyholder tax developments in 2008[9] that numerous people who sold their stock in demutualized insurance companies have made refund requests in response to the Court of Federal Claims's decision.[10]

The IRS continues to apply the position that the basis of stock issued in a demutualization is zero. It addresses this and related tax treatment on page D-4 of its instructions for the 2009 Form 1040. In 2008, the IRS's Chief Counsel indicated in response to the Federal Claims Court's decision that "published guidance is needed very quickly."[11]

Few, if any, taxpayers will have an incentive to litigate a disagreement with the IRS on this issue because the amount of money would be relatively small. The total tax amount involved for all holders of stock acquired in a demutualization is very substantial, however.

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END NOTES

1 04 CV 1726 (Fed Cir 2009) *aff'g.* 82 FedCls 780 (Fed Cls 2008).
2 Feb. 22, 2000.
3 *Id. See also* LTR 200240051 (April 16, 2002) and LTR 200011035 (Dec. 20, 1999). The basis of stock acquired in mutual holding companies also equaled zero in LTR 200111013 (Dec. 8, 2000), for example.
4 283 U.S. 404 (1931).
5 *Id.* at 413.
6 Treas. Reg. section 1.1001-1(a).
7 Section 1032(a) provides that consideration received by a corporation for its "stock" is not recognized as gain. Congress could have provided separate tax treatment for the equity component of premiums received, but did not. In fact, before it was repealed, prior-law section 809 attempted to allocate policyholder dividends distributed by mutual life insurers between equity distribution (dividend) and traditional policyholder distribution components and, in effect, prevent the deduction of the payment of the equity component of the distribution. There are times, however, when it is appropriate to bifurcate property or a transaction to reflect the underlying economics or capture the purpose of a statute. *See*, for example, E. Burstein, *Federal Income Taxation of Insurance Companies* (2nd ed.) at 179 (2007).
8 Rev. Rul 2009-13, 2009-21 I.R.B. 1029, 1030.
9 F. Gelfond and Y. Fujimoto, 2008 Insurance Tax Year in Review: Part II – Product Tax Matters, *Insurance Tax Review* p. 229 (Feb. 2009).
10 *Id.* at 237.
11 S. Young and C. Tandon, Korb Says IRS Considering Appeal, Guidance in Response to *Fisher*, *Tax Notes* p. 921 (Sept. 8, 2008).