The world's most dangerous insurance publication℠

SCHIFF'S

August 22, 2003
Volume 15 • Number 14

INSURANCE OBSERVER

Taxation of Policyholders in Demutualization

$10 Billion at Stake

In the last few years, many of North America's largest mutual life insurance companies have demutualized, distributing about $75 billion in stock and cash to their policyholders. The demutualized companies include Prudential, MetLife, Principal, John Hancock, Sun Life, MONY, Manulife, Clarica, Canada Life, AmerUs, Provident Mutual, and Phoenix Home Life.

When these companies distributed stock and cash to their policyholders, they generally advised them that the tax basis of their distributions was zero. Thus, the entire amount of the distribution would be subject to taxes. Although the IRS, the demutualized insurance companies, and major law firms agreed that this was the correct tax treatment, a CPA in Minnesota, Charles D. Ulrich, did not. After a considerable amount of work, he contacted Joseph Belth, editor of The Insurance Forum *and author of the following article.*

Before we get to that article, however, we'd like to say a few words about Joseph Belth.

Joseph M. Belth, Ph.D., is the editor of The Insurance Forum, *the author of* Life Insurance: A Consumer's Handbook *and other books, and professor emeritus of insurance in the Kelley School of Business at Indiana University (Bloomington). He has received numerous awards for his work including a George Polk Award in 1990 and the Huebner Gold Medal from The American College in 1999. Awards, of course, don't really tell you much. Reading 30 years worth of* The Insurance Forum *will.*

The Insurance Forum*—an independent monthly written by Joe—is a testament to the power of thoughts, ideas, well-chosen words, and dedication. It would take many pages just to gloss over all the important articles Joe has written. Some of his notable topics include the following: deceptive sales practices, First Executive's reinsurance arrangements, A. L. Williams, policy transfers, fractional premiums, viaticals and life settlements, the sale of insurance on military bases, Unum Provident's disability claims practices, mutual holding companies, demutualizations, and the compensation of insurance-company executives.*

Joe isn't a household name, but deserves to be, and The Insurance Forum *should be read by everyone in any of the following categories: (1) people interested in life insurance, (2) people interested in insurance, (3) people who have purchased insurance, (4) people who will purchase insurance, (5) people who are interested in good journalism, and (6) people who read* Schiff's Insurance Observer.

Joe, who was a life insurance agent in Syracuse for five years in the 1950s, is one of our heroes—and we don't have a long list of heroes. He's a great insurance journalist, analyst, and historian, and we're fortunate to have gotten to know him well during the past decade.

The following article, "Income Taxation of Distributions to Policyholders in Demutualizations," was written by Joe and is adapted from an article that originally appeared in the June 2003 issue of The Insurance Forum. *You can contact* The Insurance Forum *at P. O. Box 245, Ellettsville, Indiana 47429, (812) 876-6502 (www.theinsuranceforum.com).*

The Internal Revenue Service (IRS) and the mutual insurance companies that demutualized in recent years have told policyholders about the income tax treatment of the distributions the policyholders received in exchange for their ownership interests in the companies. Early this year, Charles D. Ulrich, a certified public accountant who has studied the subject carefully, brought to my attention his belief that the treatment used by the IRS and the insurance companies is incorrect and is extracting billions of dollars of unwarranted taxes from policyholders. He recommends that policyholders who have already paid taxes on distributions should file amended tax returns and seek refunds.

When Mr. Ulrich contacted me, I found it difficult at first to believe there might be no statutory authority for the tax treatment used by the IRS and the insurance companies. After studying the matter, however, I think the treatment used by the IRS and the companies is open to serious question. This article has four purposes: (1) to describe the tax treatment used by the IRS and the insurance companies, (2) to discuss the absence of statutory support for that treatment, (3) to describe the tax treatment Mr. Ulrich suggests, and (4) to indicate what a policyholder might do.

A Note on Terminology

A mutual insurance company is a corporation that is engaged in the business of insurance, has no shareholders, has policyholders who are customers with ownership interests, and is operated exclusively for the benefit of the policyholders. I say individual policyholders have "ownership interests"—rather than saying they are owners—because they have some but not all the characteristics of owners. A policyholder has the right to vote on certain matters and the right to share in certain distributions, but those rights terminate when his or her policy terminates. In short, a mutual insurance company's policyholders—as a group—own the company, and individual policyholders of the company have ownership interests.

Some mutual insurance companies, especially those who downplay the rights of the policyholders, call the policyholders "members" and say they have "membership interests." The IRS uses the phrases "equity interests" or "proprietary interests." In this article, except when quoting others, I use the expression "ownership interests."

The IRS/Company Approach

Here, in brief, is how the IRS and the demutualizing insurance companies explain the income tax treatment of demutualization distributions. For the policyholder who receives shares of stock, there is no immediate taxable income; however, when the shares are sold, the policyholder's basis in the shares is zero and the full amount received in the sale is a capital gain. For the policyholder who receives cash, the full amount received is taxed immediately as a capital gain.

Whether a policyholder's capital gain is long term or short term depends on when the policyholder first acquired his ownership interest. Because the typical policyholder purchased his or her first policy in the company more than one year before the distribution, the amount received in most instances is a long-term capital gain. In this article, I refer to the tax treatment used by the IRS and the insurance companies as the *zero-basis* approach.

One Company's Explanation

Provident Mutual Life Insurance Company ("Provident") demutualized in 2002 and immediately became a subsidiary of Nationwide Financial Services, Inc. ("Nationwide"). In exchange for their ownership interests, eligible Provident policyholders received shares of stock in Nationwide.

In an information brochure accompanying the stock distribution sent to each policyholder, Nationwide said the value of a policyholder's ownership interest in Provident was $28.0146 per share—the volume-weighted average price per share during the 15 trading days ended September 24, 2002—multiplied by the number of shares allocated to the policyholder. The Nationwide/Provident proxy statement/prospectus ("proxy") sent to policyholders in August 2002, in a section entitled "Material Federal Income Tax Consequences" on page 58, said that "your tax cost or 'basis' for any shares you receive will be zero." The law firm of Debevoise & Plimpton provided a tax opinion dated August 2, 2002 to Provident's board of directors. The opinion was in the proxy and included this sentence:

> The summary of federal tax consequences to Eligible Members, the Company and its Affiliates resulting from the consummation of the Plan and the Merger Agreement, set forth under the heading "Material Federal Income Tax Consequences" in the Joint Proxy Statement/Prospectus is correct and complete in all material respects under the Federal Income Tax Law in effect as of the date hereof.

My Inquiry

As a Provident policyholder, Nationwide shareholder, and journalist, I wrote to Patricia R. Hatler, senior vice president, general counsel and secretary of Nationwide. I said that I received shares of Nationwide in exchange for my ownership interest in Provident, that I have not sold the shares, and that I may sell the shares soon. I quoted the above statement from the proxy and the above statement from the Debevoise tax opinion. I asked this question: "What is the specific *statutory* authority for the statement that my basis is zero?" I emphasized the word "statutory" because the phrase "Federal Income Tax Law" was used in the tax opinion. Kevin S. Crossett, vice president and associate general counsel of Nationwide, responded:

> Debevoise & Plimpton has advised us that the statement in the Joint Proxy Statement/Prospectus was based upon Revenue Rulings 71-233 and 74-277. These Rulings are administrative interpretations of the Internal Revenue Code and Treasury Regulations, which are within the defined term "Federal Income Tax Law" that you quote in your letter. As noted in the Joint Proxy Statement/Prospectus, we urge you, as we do everyone else who received consideration, to consult your own tax advisor regarding the tax consequences of the transaction.

As Mr. Crossett indicated, revenue rulings are administrative interpretations. They are not laws, which are subject to the legislative process, and they are not regulations, which are issued after allowing a period for public comment. Rather, revenue rulings are mere expressions of opinion by the IRS staff. By answering the question as he did, Mr. Crossett avoided acknowledging the lack of statutory authority for the zero-basis approach.

The Old Revenue Rulings

The revenue rulings cited by Mr. Crossett were issued in 1971 and 1974, respectively. They did not involve demutualizations; indeed, they were issued years before the first demutualization occurred, and years before the word "demutualization" came into use. Also, the rulings do not provide a satisfactory explanation for the zero-basis approach.

Revenue Ruling 71-233 involved the merger of a mutual life insurance company [X] into a newly organized stock life insurance company [Y]. Upon consummation of the merger, Y was to issue stock to policyholders of X in exchange for their ownership interests in X. The zero basis is mentioned in this paragraph of the ruling:

> Payment by each policyholder of the premiums called for by the insurance contracts issued by X represents payment for the cost of insurance and an investment in his contract but not an investment in the assets of X. His proprietary interest in the assets of X arises solely by virtue of the fact that he is a policyholder of X. Therefore, the basis of each policyholder's proprietary interest in X is zero.

Revenue Ruling 74-277 involved the transfer of the assets of a fraternal benefit society to a newly organized mutual life insurance company. There was no distribution to policyholders in exchange for their ownership interests, but Revenue Ruling 71-233 was cited and similar zero-basis language was used.

A Recent Revenue Ruling

Early in 2003, the IRS issued Revenue Ruling 2003-19. It discusses the tax consequences of a mutual insurance company's conversion to stock form, but the focus is on the consequences for the company rather than the consequences for the policyholder. Also, the ruling does not mention the zero-basis approach.

The Schedule D Instructions

Schedule D is that portion of the income tax return on which capital gains and losses are shown. The IRS instructions for Schedule D include a discussion entitled "Demutualization of Life Insurance Companies." The discussion was included for the first time in 2002, despite the fact that the first demutualization occurred in 1986.

The discussion says "the basis of your equity interest in the mutual company is considered to be zero," and because of that "your basis in the stock received is zero." The discussion does not explain why the basis of the policyholder's ownership interest "is considered to be zero."

The discussion in the Schedule D instructions also says the tax treatment described in the previous paragraph applies where the demutualization qualifies as a tax-free reorganization, suggests that the taxpayer can find out from the insurance company whether the demutualization qualifies as a tax-free reorganization, and describes the tax treatment where the demutualization fails to qualify as a tax-free reorganization. The distinction mentioned in the discussion is not relevant because all demutualizations are tax-free reorganizations. For the insurance company, the tax implications of a demutualization that does not qualify as a tax-free reorganization are draconian. For that reason, a demutualization would not occur if it fails to qualify as a tax-free reorganization.

Correspondence with the IRS

An individual wrote the IRS inquiring about the tax treatment of the distribution he received. The response was similar to the discussion in the Schedule D instructions. The individual then asked why the basis of his ownership interest is considered to be zero. The response does not provide an adequate explanation for the zero-basis approach. The IRS said:

> Your cost or other basis in a demutualization is zero because your policy is unaffected by this. The amount you paid in premiums remains with the policy. In essence, the payment you receive under a demutualization is paid to you so that you give up your voting rights in the company now that it has gone to the public market. As a shareholder you would have had some voting power on decision making for the company.

An Alternative Approach

Mr. Ulrich's suggested alternative to the zero-basis approach is to treat the distribution in the same manner as a policy dividend is treated for tax purposes. In this article, the alternative is referred to as the *dividend* approach.

For tax purposes, a policy dividend is not treated in the same manner as a dividend on a share of stock; instead, a policy dividend is treated as a reduction in the cost of insurance. Thus a policy dividend is not treated as income at the time it is received; instead, it reduces the policyholder's cost and increases the policyholder's "profit" in the event he or she surrenders the policy. The "profit" is taxed as ordinary income. (It is my belief that the reason for ordinary income rather than capital gain treatment is that the "profit" arises from the "inside interest," which would have been taxed as ordinary income if its taxation had not been deferred.)

For example, suppose the total of the premiums paid for a policy is $100,000, the total of the dividends is $60,000, and the cash received on surrender is $75,000. The cost of the insurance for tax purposes is $40,000 ($100,000 minus $60,000), and the "profit" on surrender is $35,000 ($75,000 minus $40,000).

Now suppose the distribution to the policyholder in connection with a demutualization is $10,000 in cash or stock. Under the dividend approach, the cost of insurance for tax purposes would be $30,000 ($100,000 minus $70,000), and the "profit" on surrender would be $45,000 ($75,000 minus $30,000). In other words, the cost would be reduced and the "profit" on surrender would be increased by the amount of the distribution.

Under the dividend approach, if the distribution is in shares of stock, the policyholder's basis in the shares—if the policyholder sells the shares later—would be the value of the shares at the time of the distribution ($10,000 in the illustration). Also, whether the sale results in a long-term or short-term capital gain or loss would depend on the length of the period between the distribution and the sale.

Multiple Policies

If a policyholder owns more than one policy, the dividend approach would involve a technical problem. Because a demutualization distribution consists of fixed shares (to compensate the policyholder for giving up his or her voting rights in the mutual company) and variable shares (representing the policyholder's proportionate contribution to the value of the mutual company), the fixed shares would have to be allocated among a policyholder's policies in each instance where a policyholder owns more than one policy. The problem would not present serious difficulties; the number of variable shares for each policy is known to the insurance company, and it would be a simple matter to allocate the fixed shares among the policies in the same proportion.

For example, suppose a person owns two policies. He or she receives a total of 240 shares, consisting of 40 fixed shares and 200 variable shares. If 120 variable shares are for Policy A and 80 variable shares are for Policy B, then 24 of the fixed shares should be allocated to Policy A and the other 16 fixed shares should be allocated to Policy B.

The Implications

For the policyholder who receives his or her distribution in cash, the zero-basis approach means a substantial capital gains tax is imposed immediately. For the policyholder who receives his or her distribution in shares of stock, the zero-basis approach means a substantial capital gains tax is imposed when the shares are sold.

There are two methods by which the policyholder who receives shares of stock can escape the tax effect of the zero-basis

The world's most dangerous insurance publication℠

SCHIFF'S
INSURANCE OBSERVER

Editor and Writer . . . . David Schiff
Production Editor . . . . Bill Lauck
Foreign Correspondent . . Isaac Schwartz
Copy Editor . . . . John Cauman
Publisher . . . . Alan Zimmerman
Subscription Manager . . . . . . Pat LaBua

Editorial Office
Schiff's Insurance Observer
300 Central Park West, Suite 4H
New York, NY 10024
Phone: (212) 724-2000
Fax: (212) 712-1999
E-mail: David@InsuranceObserver.com

Publishing Headquarters
Schiff's Insurance Observer
SNL c/o Insurance Communications Co.
One SNL Plaza
P.O. Box 2056
Charlottesville, VA 22902
Phone: (434) 977-5877
Fax: (434) 984-8020
E-mail: Subscriptions@InsuranceObserver.com

Annual subscriptions are $149.
For questions regarding subscriptions please call (434) 977-5877.

Insurance Communications Co. (ICC) is controlled by Schiff Publishing. SNL Financial LC is a research and publishing company that focuses on banks, thrifts, real estate investment companies, insurance companies, energy and specialized financial-services companies. SNL is a nonvoting stockholder in ICC and provides publishing services to it.

approach. One method is to hold the shares until death, in which case the policyholder's heirs would take as their basis the value of the shares on the date of the policyholder's death. Another method is to give the shares to a 501(c)(3) charitable organization, in which case the value of the shares on the date of the gift would be deductible as a charitable contribution (provided the policyholder itemizes his or her deductions).

The policyholder cannot escape the tax effect of the zero-basis approach by giving the shares to an individual. The recipient's basis in the shares would be the same as the policyholder's basis.

Under the dividend approach, neither the policyholder who receives cash nor the policyholder who receives shares of stock would have any immediate tax consequences. If the policyholder keeps the policy in force until death, the distribution would escape income taxation. If the policyholder surrenders the policy, the result would be ordinary income taxation of all, part, or none of the distribution; the result in any particular case would depend upon the relationship between the cost of the policy and the amount received on surrender of the policy.

Conclusion

On balance, I think the dividend approach is superior to the zero-basis approach for at least two reasons. First, the dividend approach probably would be preferred by most policyholders from an income tax standpoint. That is, most policyholders receiving cash would prefer to avoid immediate capital gains taxation of the distribution, and most policyholders receiving shares of stock would prefer to have a substantial basis in their shares, even though some or all of the distribution they receive might be subject to ordinary income taxation at a later date.

Second, the dividend approach makes economic sense. One of the policyholder's ownership rights is the right to share in certain distributions, and that right has an economic value even though no part of the premiums was earmarked as payment for that right. Moreover, it would be logical to treat demutualization distributions as a reduction in the policyholder's cost, just as dividend distributions are treated.

I am not aware of any effort by the insurance companies or their tax attorneys to persuade the IRS to use the dividend approach rather than the zero-basis approach. I think the effort should have been made.

What a Policyholder Might Do

Mr. Ulrich's opinion—that the dividend approach is correct and that the zero-basis approach is incorrect—is based on what he describes as two years of uncompensated research into the issue. He cites statutes, regulations, and case law to buttress his opinion. He thinks policyholders who have paid capital gains taxes—because they received cash in lieu of shares or because they sold their shares—should file amended tax returns and seek refunds. He has offered, for a small fee, to assist any interested policyholder in preparing an amended return. Alternatively, he will work with the policyholder's tax adviser in preparing an amended return. ■

See www.demutualization.org for further details, or contact Charles D. Ulrich, CPA, at P. O. Box 2568, Baxter, MN 56425. Phone: (218) 828-4289. E-mail: cdu@charter.net.