pennsylvania
DEPARTMENT OF REVENUE

PERSONAL INCOME TAX BULLETIN 2009-01

Issued: April 27, 2009

Treatment of Demutualization for Pennsylvania Personal Income Tax (PA PIT) Purposes.

I. Introduction

This bulletin sets forth the Department of Revenue position regarding the appropriate method for calculating gain upon receipt of shares or cash in a demutualization transaction for Pennsylvania personal income tax (PA PIT) purposes.

This bulletin further explains that taxpayers may not rely on the recent Federal tax decision, *Fisher v. U.S.*, as authority for using the open transaction doctrine to establish the cost basis for calculating gain arising from a demutualization transaction. *Fisher v. U.S.*, 82 Fed. Cl. 780 (2008).

For Pennsylvania personal income tax purposes, the rights relinquished in a demutualization transaction must be assigned a $0 basis. As such, taxpayers will recognize gain upon demutualization equal to the fair market value of the stock or cash received in the transaction. Taxpayers who disagree bear the burden of establishing that the basis in the rights relinquished is greater than $0.

II. Definitions

For purposes of this bulletin, important terms are defined as follows:

A. Demutualization

The conversion of a mutual insurance company owned by participating policyholders into a publicly-traded stock company owned by shareholders. This bulletin applies to all demutualization transactions, including the following examples:

Example 1:

Demutualization may result in the issuance of shares by a mutual insurance company to a policyholder in exchange for the policyholder’s giving up of his or her ownership rights.

After demutualization, the policyholder owns shares in a new publicly-traded company over which the policyholder now has little or no control. The policyholder continues to own contractual insurance rights through an insurance policy.

Example 2:

Demutualization may result in an election pursuant to which eligible policyholders receive a cash payment in lieu of shares in the new publicly-traded company.

After demutualization, the policyholder has received a cash payment and has no ownership interest in the new publicly-traded company. The policyholder continues to own contractual insurance rights through an insurance policy.

B. Mutual Insurance Company

A company which is owned by its participating policyholders who possess ownership rights, such as voting and distribution rights, as well as rights under the insurance policy.

III. General tax implications of demutualization

A. Calculating the amount of gain

A taxpayer who receives shares or other property in a demutualization transaction will recognize gain to the extent that the value of the property received exceeds the basis of the property rights relinquished.

Therefore, the gain recognized when a taxpayer receives stock or cash in a demutualization transaction is calculated by subtracting the adjusted basis of the property relinquished from the value of the stock or cash received in the transaction.

Assuming a $0 basis is applied, upon demutualization in Example I the taxpayer will recognize gain equal to the fair market value of the stock received.

Assuming again that a $0 basis is applied, upon demutualization in Example II the taxpayer will recognize gain equal to the amount of cash received.

Section 4(a) of this bulletin discusses in greater detail the method for establishing cost basis for Pennsylvania personal income tax purposes.

B. Timing of gain recognition

Taxpayers must recognize gain at the time the cash or stock is received in a demutualization transaction.

C. Use of the "open transaction" doctrine to defer gain

In the recent case of *Fisher v. U.S.*, the U.S. Court of Federal Claims allowed the taxpayer to use the "open transaction" doctrine, permitting the taxpayer to use the basis in the entire insurance contract as his or her basis in the relinquished rights. 82

Fed. Cl. 780 (2008). The open transaction doctrine applied in the *Fisher* case because the taxpayer proved to the satisfaction of the court that the relinquished rights were insusceptible of valuation.

Due to differences between Federal rules and Pennsylvania rules, taxpayers may not rely on the Federal tax decision in *Fisher*, and as a result, taxpayers may not use the open transaction method of reporting for Pennsylvania purposes. Taxpayers must calculate gain by applying basis as determined in accordance with Section IV of this bulletin.

IV: Pennsylvania rules for calculating cost basis

A. Cost basis, generally

The basis of the property rights relinquished in a demutualization transaction is a necessary element for calculating recognized gain upon demutualization. Determining cost basis in the context of demutualization is a complex matter. This is due to the fact the ownership rights given up in demutualization typically were not purchased separately; instead, these rights were purchased as part of a larger bundle of rights including the insurance coverage.

The cost attributable to the entire bundle of rights must be separated and assigned to each of the taxpayer's rights, including the ownership rights.

Typically these ownership rights are not assignable or saleable apart from the underlying insurance policy; this means there would have been little or no market for the ownership rights apart from the insurance policy at the time of purchase of the original insurance contract. On the other hand, there may have been a market for the right to receive the proceeds from ownership rights upon demutualization, although the right to receive proceeds would be of minimal value.

Unless the taxpayer can establish he or she paid a premium (over the cost of non-mutual insurance) for the original insurance contract to receive the ownership rights, the taxpayer typically will be unable prove these rights should be assigned a cost basis of greater than $0.

As a result of these factors, it is the Department's position that the ownership rights relinquished in demutualization should be valued at $0.

B. Evidence accepted by the Department to rebut presumption of $0 cost basis

The taxpayer may challenge the Department's position, although the taxpayer bears the burden of establishing that the value of the ownership rights relinquished is greater than $0.

The taxpayer must establish the difference between the cost of mutual insurance policy premiums and the average cost of insurance policy premiums for identical or substantially similar coverage when purchased from a non-mutual insurance company. Acceptable evidence of identical or substantially similar coverage includes an affidavit from at least two regional or national non-mutual insurance companies stating the cost of such insurance as of the time of purchase of the original policy.

If the taxpayer satisfies the burden of proof, he or she may then use a basis equal to the cost of premiums for the policy at issue minus the average cost of insurance policies from two non-mutual insurance companies.

If the difference is greater than $0, this number will be divided by the entire cost of the policy at issue to determine the percentage of each premium which is used to purchase the ownership rights. This percentage will be multiplied by the cost of all premiums over the life of the policy, from the date of purchase until the date of demutualization, to arrive at the basis in the ownership rights.

If the difference is -0- or is negative, the basis in the ownership rights is $0; this is because a negative number indicates the mutual insurance was purchased for less than or the same price as non-mutual insurance. Under these circumstances, the taxpayer's premiums were not higher on account of the rights the taxpayer received by purchasing the insurance from a mutual insurance company, and therefore, there is no cost separately assignable to the ownership rights.

In addition, the Department may accept any other evidence which reasonably and reliably reflects the cost basis of the ownership rights at the time the underlying policy was purchased.