



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
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MEMORANDUM FOR DEPUTY AREA COUNSEL (SBSE/2)
Attn: David A. Breen

FROM: Chief, Branch 7 CC:IT&A:7

SUBJECT: Significant Service Center Advice: Holding Period on Gains
from Proceeds of Insurance Company Demutualization

This responds to your request for Significant Advice dated March 26, 2001, in connection with a question posed by the Centralized Quality Review Site.

ISSUES

- 1) How to determine the holding period for the interests of Taxpayers who are former policyholders and annuitants of mutual life insurance companies who received stock in a stock life insurance company or cash upon the demutualization of the mutual life insurance company.
- 2) Whether Taxpayers who received cash are entitled to long-term capital gain treatment.

CONCLUSIONS

- 1) If the demutualization transaction by which Taxpayer received stock in a stock life insurance company in exchange for his equity interests in a mutual life insurance company qualifies as a tax-free reorganization under § 368(a)(1) of the Internal Revenue Code, 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.

If the demutualization transaction by which Taxpayer received stock in a stock life insurance company in exchange for his equity interests in a mutual life insurance company does not qualify as a tax-free reorganization under § 368(a)(1), then Taxpayer's holding period for the stock runs from the date the Taxpayer received the stock.

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The holding period for the interests of a Taxpayer who received cash in exchange for his equity interests in a mutual life insurance company upon demutualization runs from the date that Taxpayer first held an equity interest in the mutual life insurance company as a policyholder or annuitant.

- 2) If the Taxpayer who received cash held an equity interest in a mutual life insurance company as a policyholder or annuitant for more than one year, then Taxpayer is entitled to long-term capital gain treatment.

FACTS

Service Center Representatives (“SCRs”) answer calls and emails from taxpayers from across the country. The Centralized Quality Review Site that oversees questions received and answers given has noticed that SCRs receive many questions regarding the holding period for the interests of Taxpayers who are former policyholders and annuitants of mutual life insurance companies (“mutual company or companies”) that have been demutualized. That is, mutual companies have gone through a conversion from a mutual company to a stock life insurance company (“stock company”) which, in most cases, qualifies as a reorganization within the meaning of § 368(a)(1). As a result of demutualization, these Taxpayers received either stock in the stock company or cash in exchange for their equity interests in the mutual company.

All of the proprietary interests in the mutual companies were owned by Taxpayers. Taxpayers had a zero basis in their respective equity interests in the mutual companies.

DISCUSSION

Section 354(a)(1) provides that no gain or loss shall be recognized on the exchange of stock or securities in a corporation a party to a reorganization for stock or securities in the company resulting from the reorganization.

Section 358(a)(1) provides that in the case of an exchange to which § 354, among other sections, applies, the basis of the property permitted to be received without the recognition of gain or loss shall be the same as that of the property exchanged, with certain adjustments.

Rev. Rul. 71-233, 1971-1 C.B. 113, holds that a merger of a mutual life insurance company into a newly organized stock life insurance company under state law, pursuant to which policyholders exchange their proprietary interests in the mutual company for stock, is a reorganization within the meaning of § 368(a)(1). The ruling also holds that (1) pursuant to § 354(a)(1), no gain or loss will be recognized by taxpayers upon the exchange of their interests in the mutual life insurance

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company for stock, and (2) pursuant to § 358(a)(1), taxpayers have the same basis in their stock as they had in their interests in the mutual life insurance company.

Section 1223(1) provides that in determining the period for which a taxpayer has held property received in an exchange, there shall be included the period for which he held the property exchanged if, under Chapter 1 of the Code, 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, and the property exchanged at the time of such exchange was a capital asset as defined in § 1221 or property described in § 1231.

Section 1221 defines the term "capital asset" as property held by the taxpayer, regardless of whether it is connected with the taxpayer's trade or business, unless the property meets one of eight listed exceptions. None of the exceptions are relevant here. Section 1231 applies to property of a character which is subject to the allowance for depreciation provided in § 167 or real property used in a trade or business that does not fall within certain exceptions generally equivalent to the exceptions in § 1221.

Section 1222(3) provides that long-term capital gain is gain from the sale or exchange of a capital asset held for more than one year.

A. Taxpayers Receiving Stock

If the demutualization transaction by which Taxpayer received stock in a stock company in exchange for his equity interests in a mutual company qualifies as a tax-free reorganization under § 368(a)(1), then, pursuant to § 354(a)(1), no gain or loss will be recognized by Taxpayer on the exchange. Rev. Rul. 71-233. In addition, pursuant to § 358(a)(1), Taxpayer has the same basis in his stock as he had in his equity interest in the mutual company (here, zero). Id. Taxpayer's equity interest in the mutual company is a capital assets within the meaning of § 1221.

Accordingly, pursuant to § 1223(1), the holding period for the stock received by Taxpayer in exchange for his equity interests in the mutual company upon demutualization runs from the time that Taxpayer first acquired an equity interest in the mutual company as a policyholder or annuitant.

If the demutualization transaction by which Taxpayer received stock in a stock company in exchange for his equity interests in a mutual company does not qualify as a tax-free reorganization under § 368(a)(1), then §§ 354(a)(1), 358(a)(1), and 1223(1) do not apply. In such a case, Taxpayer's holding period for the stock runs from the date the Taxpayer received the stock.

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Many mutual companies have received a letter ruling from the Service stating that their demutualization transactions qualify as reorganizations within the meaning of § 368(a)(1). However, prohibitions on disclosures by the Service prevent us from informing former policyholders and annuitants whether the demutualization of the mutual company in which they held an equity interest is a reorganization within the meaning of § 368(a)(1). Accordingly, Taxpayers must obtain this information from the mutual company.

B. Taxpayers Receiving Cash

Taxpayers received cash in exchange for their equity interests in the mutual company. As stated above, a Taxpayer's equity interest in a mutual company is a capital asset. Taxpayer's holding period for his equity interest in a mutual company runs from the date that Taxpayer first acquired an equity interest in the mutual company as a policyholder or annuitant.

Accordingly, if Taxpayer held an equity interest in the mutual company as a policyholder or annuitant for more than one year, then Taxpayer would be entitled to long-term capital gain treatment.

If you have any additional questions, please call Amy Pfalzgraf at 622-4930.