Second Circuit affirms district court decision that life insurance policyholder dividend deductions do not meet 'all-events' test

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In brief

In *New York Life Insurance Co. v. United States*, No. 11-2394 (August 1, 2013), the Second Circuit Court of Appeals affirmed a district court's decision that deductions for policyholder dividends did not satisfy the 'all-events' test under the principles of Section 461. The taxpayer, New York Life Insurance Company, deducted two types of policyholder dividends: (1) an annual dividend mandated by state law that was 'credited' but not paid until the policy's anniversary date; and (2) a voluntary termination dividend that was calculated and 'accrued' but not paid until death, maturity, or surrender. The court found that neither type of policyholder dividend deduction met the 'all-events' test.

In *Massachusetts Mutual Life Insurance Co. v. United States*, 103 Fed. Cl. 111 (2012), a case with almost identical facts, the Court of Federal Claims allowed a deduction for the guaranteed minimum amount of policyholder dividends in advance of actual payment. Companies that pay policyholder dividends under circumstances similar to those in *New York Life* and *Massachusetts Mutual* should consider carefully how the recent decisions might affect when those dividends may be deducted.

In detail

New York Life Insurance Company is a mutual life insurance company organized under the laws of the State of New York and is a calendar-year, accrual-basis taxpayer. New York Life issues participating insurance policies under which policyholders are eligible to receive a share of annual distribution of surplus (a policyholder dividend). New York Life paid two types of policyholder dividends: (1) an annual dividend paid upon the policy's anniversary date; and (2) a termination dividend paid upon death, maturity, or surrender.

Under the first type of policyholder dividend, New York Life paid its policyholders an annual dividend on the anniversary of the date the policy was signed. Its accounting system credited the annual dividends to policyholders' accounts up to 30 days before the payment was made. Although New York Life credited a policyholder's account before the policy's anniversary, in a majority of cases, it did not pay the annual dividend until the policy anniversary. For policies with anniversaries in February through December, the date that the policyholder account was credited and the payment date were in the same taxable year. For policies with January anniversaries, New York Life credited the policyholders' accounts in December, but did not pay the annual dividend until the following January.

Under the second type of policyholder dividend, New York Life distributed a portion of its surplus earnings as a one-time 'termination dividend' to policyholders when a policy was terminated by death, maturity, or surrender. Each December, New York Life estimated the minimum amount of dividends it expected to pay, which was comprised of the smaller of the annual or termination dividends to be paid on each policy in the following year. For tax years 1990 to 1995, New York Life deducted these amounts on its federal income tax return.

The IRS disallowed the deductions related to annual and termination dividends, limiting the deductions to policyholder dividends actually paid during the taxable year. New York Life paid the resulting deficiency but filed a claim for a refund of nearly $100 million, which was brought to the District Court for the Southern District of New York. The District Court dismissed the refund suit on the grounds that the deductions did not satisfy the 'all-events' test. See *New York Life Ins. Co. v. United States*, 780 F. Supp. 2d 324 (S.D.N.Y. 2011). New York Life appealed the case to the Second Circuit Court of Appeals.

Under Section 808(c), a life insurance company may deduct from gross income "policyholder dividends paid or accrued during the taxable year." Furthermore, under the timing rules for the deductibility of accrued but unpaid expenses, Treas. Reg. sec. 1.461-1(a)(2)(i) provides that a liability can only be taken into account when each of the following three conditions has been satisfied: (1) all the events have occurred that establish the fact of the liability; (2) the amount of the liability can be determined with reasonable accuracy; and (3) economic performance has occurred.

The IRS and District Court disagreed with New York Life that it satisfied the first condition, the 'all-events' test. In its analysis, the court cited two Supreme Court cases, *United States v. Hughes Props., Inc.,* 476 U.S. 593 (1986) and *United States v. Gen. Dynamics Corp.*, 481 U.S. 239 (1987), in support of the position that the 'all-events' test was not met. In *Hughes Properties* the Supreme Court ruled that the state law that prohibited reducing the jackpot on the taxpayer's progressive slot machines was enough to 'fix the liability' and satisfy the 'all-events' test. In contrast, in *General Dynamics*, the Supreme Court ruled that an accrued liability for medical expenses reimbursements did not meet the 'all-events' test because the filing of the claim form by the employee was 'crucial' to establishing the company's liability.

Similar to *General Dynamics*, the Second Circuit looked at "the last link in the chain of events creating the liability" to determine whether the 'all-events' test had been met. New York Life asserted that the last 'event' occurred when the January policyholders paid the final premium sufficient to keep their policies in force through their anniversary dates in January. However, the court viewed the last 'event' to be the policyholder's *decision* to keep the policy in force through the anniversary date versus surrendering the policy for its cash value, which did not occur until January of the following year. As the court stated, "New York Life could not know in December which course of action the policyholder would choose the following month." Additionally, New York Life was not obligated to pay an annual dividend if a policyholder chose to cash in the policy before the anniversary date.

As for the termination dividends, the court found that New York Life was under no contractual, statutory, or other obligation to pay a termination dividend when a policyholder surrendered the policy, and therefore found it to be a voluntary practice. Additionally, the court concluded that using the term 'liability' in connection with the 'all-events' test for accrued expenses implies that the taxpayer must be under some sort of obligation to pay. For New York Life, there was no source of obligation. The court found that even the Board of Directors approval of the payment could not 'convert' the voluntary expense into an accrued liability for federal income tax purposes.

Since the 'all-events' test was not satisfied for both the annual dividends and termination dividends, the court did not evaluate whether the other two conditions for deductibility were satisfied, and the case was affirmed.

The takeaway

Life insurance companies that pay policyholder dividends under circumstances similar to those in *New York Life* and *Massachusetts Mutual* should evaluate whether these cases change the timing for deductions for policyholder dividends. Particularly, companies should consider the nature of any contractual or statutory obligation to pay the dividend, and requirements that must be met in order for policyholders to receive those dividends. Companies also should consider the venue in which a challenge to claimed deductions for policyholder dividends would be litigated.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

Financial Services - Insurance

Anthony DiGilio, McLean VA
+1 703 918 4812
anthony.digilio@us.pwc.com