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ITB 12-06

Policyholder dividends deductible in the year declared

In *Massachusetts Mutual Life Insurance Company v. United States*, the United States Court of Federal Claims (the "Court") ruled that the Plaintiff, Massachusetts Mutual Life Insurance Company (the "Taxpayer"), is allowed a deduction for the declared guaranteed minimum amount of policyholder dividends in the year of declaration.

The Taxpayer is a mutual life insurance company that operates for the benefit of its policyholders and issues participating insurance policies which are eligible to receive a share of any annual distribution of surplus, as approved by the Taxpayer's Board of Directors. At year-end, the Taxpayer determines the amount of "divisible surplus" which is to be returned to participating policyholders. In this case, the policyholder dividends were declared at the end of each year and payments were made to participating policyholders whose premiums are paid through the anniversary date of the policy.

For the years in question, the Taxpayer determined an amount of dividend to guarantee, obtained approval from the Insurance Commissioner of the state of domicile for the guarantee and had the Board of Directors approve both the minimum dividend amount and the "guarantee". The Taxpayer elected to apply the dividend guarantees only to policies that were issued after December 31, 1983, because applying the guarantees to policies issued before December 31, 1983 would have led to adverse tax consequences under Section 216(b) of the Deficit Reduction Act of 1984 (the fresh-start provisions). In each case, the Taxpayer verified that in the years immediately following the years in question, that Taxpayer had, in fact, paid out all of the dividends guaranteed.

The issue the Court addressed was not whether the Taxpayer was entitled to a deduction for the declared policyholder dividends, but whether Taxpayer was entitled

a deduction in the year the policyholder dividends were declared and guaranteed by Board resolution.

The Court examined the individual requirements of the "all events test" under Section 461, searched for a definition of "rebates and refunds" and considered the economic substance of the matter.

"While in some cases, 'timing is everything,' here timing is the only thing...."

The Court reviewed the impact of the Deficit Reduction Act of 1984 regarding the implications of policyholder dividends to insurance companies and its relation to the all events test by referring to an insurance industry treatise:

[T]he 1984 Act [the Deficit Reduction Act of 1984] permitted the deduction for policyholder dividends to equal the policyholder dividends paid or accrued during the tax year. Thus, the concept of a reserve for policyholder dividends contained in prior law has been eliminated and replaced by a more stringent accrual standard. The intent of the provision was likely to place the liability for dividends declared on a par with other liabilities subject to the "all events" tests.²

The "All Events Test"

The Taxpayer concluded that establishing the liability of a guaranteed amount of policyholder dividends satisfied the requirements of the "all events test," specifically that ***the fact of the liability was established with reasonable accuracy*** and ***that economic performance had occurred***, and as such they were entitled to the deduction for policyholder dividends. The Internal Revenue Service (the "Service") disagreed.

✓ *the fact of the liability was established:*

The Service, in support of their position that the liability was not established until the subsequent year on the policyholder anniversary, argued the following cases:

United States v. Hughes Props. Inc., where the Supreme Court ruled that the liability must be "fixed and absolute," and "unconditional" to be currently deductible, rather than "contingent."

United States v. Gen. Dynamics Corp., where the Supreme Court ruled that even though expenses may be deductible before they become due and payable, a liability must be firmly established first.

Union Pac R.R. Co. v. United States, where the Court ruled that as long as a liability remains contingent or if the liability has attached but the amount cannot be reasonably estimated, a business expense deduction is not allowed.

¹ *Massachusetts Mutual Life Insurance Company v. United States*, _____, Ct. Of Fed. Cl. (January 30, 2012), at page 1, citing *Vulcan Basement Waterproofing of Illinois, Inc. v. NLRB*, 219 F.3d 677, 688 (7th Cir. 2000) (quoting *N.L.R.B. v. Joy Recovery Tech. Corp.*, 134 F.3d 1307, 1314 (7th Cir. 1998)).

² *Id.* at pages 20-21.

Burnham Corp. v. Commissioner, where the Court ruled that if the existence of a liability depends on satisfaction of a prior condition, the liability is not unconditionally fixed and liability does not in fact arise until the condition is satisfied. As such, the taxpayer is therefore prevented from obtaining the benefit of a deduction for an expense that they have no liability to pay until some event, other than the passage of time occurs.

and

Hallmark Cards, Inc. v. Commissioner, where the Court ruled that taxpayer did not possess a fixed and definite right to a payment. [This Court distinguished the Hallmark Cards case as factually different by stating that case addressed the accrual of income to the taxpayer, whereas the case at hand addresses the accrual of liability.]

PwC Observation: Noticeably absent from the Service's analysis was *New York Life Insurance Company v. United States*. A footnote details that the Court found that in that case, "...the liability was contingent upon...an internal recordkeeping practice that was not required by law, [and that in the case currently at hand], the facts [were] more...developed..., and in [this] Court's view, results in a different result."³

In sum, the Service argued that the Taxpayer was unable to demonstrate that at the end of each tax year they were obligated to pay the entire guaranteed amount under the facts as they stood at the end of that year and that there was not an identifiable group of policyholders eligible to receive the dividend guarantee in the year the resolutions were adopted. Moreover, the Service stressed that the Taxpayer had no liability to pay the entire guaranteed amount until a later event occurred -- and that event was not simply the passage of time and the preservation of the status quo, observing that the Board could reverse itself and the Insurance Commissioner could prevent the payment.

The Taxpayer countered the Service arguing:

United States v. Consol. Edison Co., where the Supreme Court determined that the all events test is a fundamental principle of tax accounting and quintessential in determining the year in which an item of deduction accrues.

United States v. Hughes Props. Inc., where the Court determined that a guaranteed jackpot was deductible and stating that *the government misstates the need for the identification of the winning player. That is, or should be, a matter of no relevance to the casino operator. The obligation is there, and whether it turns out the winner is one patron or another makes no conceivable difference as to basic liability.*

Washington Post Co. v. United States in which the Court declared that although a liability does not accrue as long as it remains contingent; uncertainties unrelated to the fixing of the amount of the liability do not prevent the Taxpayer from meeting the all events test.

³ *Massachusetts Mutual Life Insurance Company v. United States*, *supra*, at note 16.

Gold Coast Hotel & Casino v. United States, where the Court ruled that the existence of an absolute liability is critical, not an absolute certainty that the liability will be discharged by payment.

Eastman Kodak Co. v. United States, where the Court ruled that a liability need not be legally enforceable to be fixed under the "all events test."

and

Willoughby Camera Stores, Inc. v. Commissioner, where the Court ruled that the resolutions of the Board of Directors can fix liability for purposes of the all events test.

In sum, the Taxpayer argued that the liability was, in fact, fixed with the Board's resolution.

PwC Observation: While a number of the cases cited by both parties pre-dated the Deficit Reduction Act of 1984, the legislative history to the Act indicates that the addition of the economic performance to the all events test was to complement the existing two prongs of the all events test, and did not call into question the precedential value of cases determining either the fact of liability or if the liability could be determined with reasonable accuracy.

✓ ***liability could be established with reasonable accuracy***

The Service did not allege at trial or argue in filings submitted that the Dividend Guarantees did not satisfy the second element of the all events test.

✓ ***economic performance has occurred***

The Court noted that both parties stipulated that the Taxpayer took the necessary administrative steps to elect the recurring item exception with respect to the policyholder dividends for the years at issue, that the 'liability to pay policyholder dividends is a payment liability within the meaning of Treas. Reg. 1.461-4, and that all tax returns were timely filed. The issue for consideration was whether or not the Taxpayer satisfied the matching requirement of the recurring item exception for economic performance.

The general rule under the Internal Revenue Code of 1986, as amended ("IRC", "Code"), Section 461(h)(1) provides that in determining whether an amount has been incurred with respect to any item during any taxable year, the all events test shall not be treated as met any earlier than when economic performance with respect to such item occurs.

IRC Section 461(h)(3)(iv)(ii) provides an exception in situations where the accrual of such item in the taxable year in which the requirements of clause (i) are met results in a more proper match against income than accruing such item in the taxable year in which economic performance occurs.

The debate among the parties in this area focused on Treas Reg 1.461-5(b)(5)(ii) which provides that the matching requirement may be deemed satisfied in the case of certain liabilities, stating further that *"...in the case of a liability described in paragraph (g)(3) (rebates and refunds)...the matching requirement of paragraph (b)(1)(iv)(B) of the section shall be deemed satisfied."*

The central issue was thus whether the policyholder dividends were "rebates and refunds" within the meaning of Treas. Reg. 1.461-5(b)(5)(ii). The Taxpayer stated that the policyholder dividends are returns of premium, and argued that the Code does not treat policyholder dividends as taxable income to individual policyholders until the policy reaches the point where aggregate dividends paid to the policyholder exceed the aggregate premiums paid by the policyholder. The Service countered that policyholder dividends are not rebates or refunds because the Code treats them (for a time) as a return of the policyholder's basis in the insurance contract.

The lengthy analysis by the Court on this topic included: (1) in depth consideration of language in the Code and Regs, not just the sections at issue, but throughout, (2) cites from insurance specific case law, (3) respected industry treatises (Black's law among others), and (4) expert testimony one of whom stated that "*...the conclusion that policy dividends are simply a return of premiums paid in prior periods is an oversimplification of material facts...*"⁴

Moreover, the Court considered the "Chevron doctrine", which stands for the proposition that where Congress has left a gap, there is an express delegation of authority to fill that gap by Treasury. Searching in vain for a clear definition, the Court referred to a Federal Circuit court ruling that absent a defined meaning, it is a basic principle of statutory interpretation that they are deemed to have their ordinary meaning.

Ultimately, the Court concluded that the policyholder dividends constituted rebates, refunds or similar payments and therefore, the matching requirement under Section 461(h) was satisfied, and the requirements of economic performance had been fulfilled.

With the economic performance issue addressed, the Court thus concluded that the Taxpayer had demonstrated that it met the all events test, as the fact of liability had been determined with reasonable accuracy and economic performance had occurred.

Specifically the Court concluded that the dividend guarantees created an unconditional obligation to pay dividends the following year and were not subject to a condition precedent. Moreover, that neither the defendant's concerns about enforceability or revocability prevented the liability from being fixed in the year in which the dividend guarantees were enacted.

With that, the Court ruled that the deductions the Taxpayer claimed with regards to policyholder dividends were allowable.

PwC Observation: The Court noted in its analysis that Rev Rul 2011-29, which was released after testimony, held that an employer could establish the fact of the liability for bonuses payable even though the identity of the particular recipient was not known and the bonus is not paid until the following year

Economic Substance

The Service also argued that the dividend guarantee resolutions had no economic effect and served no non-tax business purpose, and therefore lacked economic substance. The Service, citing *Coltec Industries, Inc. v. United States* alleged that the economic substance doctrine prevents taxpayers from engaging in transactions that are fictitious or lack economic reality simply to reap a tax benefit. The Taxpayer,

⁴ *Massachusetts Mutual Life Insurance Company v. United States*, *supra*, at page 60.

citing *Dana Corp v United States*, countered that the economic substance doctrine does not apply in tax accounting cases where the legitimacy of the underlying transaction is not challenged, reminding the Court that the Service did not contest the Taxpayer's entitlement to deduct the policyholder dividends. The Taxpayer concluded that "...the United States' preoccupation with economic substance should not blur the clarity of that distinction."⁵

The Court determined that as the central issue was one of timing, and the case is unique for those with typical economic substance concerns. As such, the Taxpayer should not be precluded from accounting for the dividend guarantees in the years in which they were declared.

PwC Observation: This is a significant win for the industry and while it is not yet known if the Service will appeal, it certainly appears that the issue was fully vetted.

For further information, please feel free to contact Anthony DiGilio at (703) 918-4812 or contact your local insurance tax professional.

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⁵ *Id.* at page 77.