RECENT DEVELOPMENTS ON POLICYHOLDER DIVIDEND ACCRUALS

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As part of the Deficit Reduction Act of 1984 (the "1984 Act"), life insurance companies are required to use the accrual method of accounting for tax purposes (except with respect to insurance reserves).[1] Previously, life insurance companies were able to claim a deduction for reserves for policyholder dividends that were to be paid in the following tax year.[2] Following the changes made by the 1984 Act, however, life insurance companies are now required to satisfy the same conditions as other accrual method taxpayers before they can claim deductions for policyholder dividends. For unpaid policyholder dividends on a single contract attributable to the current policy year, the Internal Revenue Service's ("IRS's") position is that the accrual standard is not met as of year-end because, under the terms of the policy, the company is not required to pay a dividend if the policy is surrendered prior to the anniversary date.

In general, an accrual method taxpayer may not claim a deduction for a liability it owes until the "all-events test" is met and "economic performance" occurs with respect to the item.[3] The all-events test requires that all events have occurred that determine the fact of the liability and the amount of the liability can be determined with reasonable accuracy.[4] When economic performance occurs depends on the nature of the liability. If the liability of the taxpayer is to pay a rebate or refund, for example, economic performance generally is treated as occurring when the rebate or refund is paid to the person to whom it is owed.[5] Similarly, when the regulations do not specify the time that economic performance occurs for a particular item, the default rule is that the deduction is deferred until the time that payment is made to the person to whom the liability is owed.[6] Under the recurring item exception, however, an item is treated as incurred, and thus deductible, in a taxable year if: (1) the all-events test is met; (2) economic performance with respect to the liability occurs within the first 8½ months following the close of that taxable year (or, if earlier, before the taxpayer files a timely (including extensions) return for that taxable year); (3) the liability is recurring in nature; (4) the amount of the liability is not material or the accrual of the liability for that taxable year results in a better matching of the liability with the income to which it relates than if the liability were accrued in the taxable year in which economic performance occurs; and (5) the liability is a type eligible for the recurring item exception.[7] A rebate or refund is a type of liability eligible for the recurring item exception.[8]

In response to the change in law in the 1984 Act, many companies that issue participating policies changed their business practices so that they could argue that policyholder dividends satisfy the accrual standards as of year-end. A typical way to accomplish this objective is for the board of directors, shortly before the end of the year, to adopt a resolution in which it declares unpaid policyholder dividends, specifies formulae on which policyholder dividends will be paid in the following year, and provides that the company is making an irrevocable commitment to pay dividends in all events of no less than a stated aggregate amount with respect to the entire block of post-1983 policies in force on their next anniversary date ("aggregate policyholder dividends").[9] The board's actions, in combination with the terms of the policies, establish the fact of the company's liability and the amount of that liability. To the extent the aggregate policyholder dividends are paid within the first 8½ months following the close of the taxable year in which they are declared, they meet the requirements of the recurring item exception as a rebate or refund of a portion of the premiums paid with respect to the policies. Thus, the company might claim a deduction for an accrued liability for the aggregate amount of policyholder dividends paid within the 8½-month period.

The IRS has challenged life insurance companies' tax treatment of aggregate policyholder dividends involving facts similar to those described above, and commonly has made four arguments.[10] First, the IRS, relying on Revenue Ruling 76-345,[11] has argued that the life insurance company has not established the fact of the liability because the company cannot identify the specific policies with respect to which it actually will pay or credit a policyholder dividend, nor can it

identify the specific amount of any such policy payment or credit. Rather, the life insurance company knows only that it eventually will pay no less than a certain aggregate amount to some portion of the current policyholders. Second, the IRS argues that the unilateral action of a life insurance company's board of directors in declaring aggregate policyholder dividends is unenforceable and thus does not represent a genuine obligation of the company for which a deduction is available. Instead, according to the IRS, the relationship between the life insurance company and the policyholders is governed exclusively by the policy terms, and only when the policy requires the company to pay a policyholder dividend (generally not until the policy anniversary date) does the company have a binding obligation. In other words, the IRS contends that the company's board resolution can be reversed. Third, the IRS argues that economic performance has not occurred, because the aggregate policyholder dividends have not yet been paid, and the recurring item exception is unavailable, because the aggregate policyholder dividends are "other liabilities," which are ineligible for the recurring item exception. According to the IRS, the aggregate policyholder dividends do not constitute rebates or refunds, which are eligible for the recurring item exception, because they are not merely a return of premiums but instead at least partially include a return on investment earnings. Finally, in more recent audits, the IRS has argued that the board resolution should be ignored because it lacks economic substance and a business purpose.

REVENUE RULING 2011-29[12]

This recent Revenue Ruling now appears to preclude the IRS from making the first argument. In the Revenue Ruling, the IRS held that a taxpayer could establish "the fact of the liability" under the all-events test for bonuses payable to a group of employees even though the taxpayer does not know the identity of any particular bonus recipient or the amount payable to any particular recipient until after the end of the taxable year. This holding represents a reversal of the IRS's previously long-held position, as expressed in Revenue Ruling 76-345, that the all-events test cannot be satisfied if a taxpayer's liability is fixed and certain only with respect to a group as a whole and not with respect to individual participants in the plan to which the liability relates. Accordingly, Revenue Ruling 2011-29 revoked Revenue Ruling 76-345.

The position expressed in Revenue Ruling 2011-29 is consistent with well-established case law. Those cases include *United States v. Hughes Properties, Inc.*,[13] in which the Supreme Court held that the taxpayer was entitled to a deduction at the end of its taxable year for the amount it was guaranteed to pay in its progressive slot machines notwithstanding that the eventual winner's identity and the time at which the jackpot would be paid were unknown, and *Washington Post Co. v. United States*,[14] in which the Court of Claims held the taxpayer could deduct amounts accrued to its dealer profit-sharing plan that it was irrevocably bound to pay, even though the ultimate recipients of the payments and the time of actual payout were indeterminate. Revenue Ruling 76-345 was issued in response to *Washington Post* and served to announce that the IRS would not follow that case's holding in similar circumstances.

Revenue Ruling 2011-29 is significant for life insurance companies that have claimed deductions for aggregate policyholder dividends. The Revenue Ruling essentially eliminates the first of the four arguments discussed above that the IRS has historically made in cases in which it has challenged a life insurance company's tax treatment of aggregate policyholder dividends. The IRS effectively has conceded that it is not necessary to identify specific policies, or a particular amount to be paid with respect to a specific policy, to satisfy the all-events test.

NEW YORK LIFE[15]—DECIDED APRIL 19, 2011

In this case, New York Life sought to deduct policyholder dividends in the year prior to the one in which they were actually paid. However, the facts of this case differ from the "typical" facts described above. Here, New York Life's board did not make an irrevocable guarantee to pay aggregate policyholder dividends in all events of no less than a stated amount. Instead, New York Life claimed deductions for two different types of dividends. The first were amounts actually credited to policyholder accounts in December that were paid on the policies' anniversary dates in January of the following year ("January dividends"). The second was the amount that New York Life estimated it would pay in the first 8½ months of the following year equal to the lesser of an annual dividend or termination dividend on each policy. In a relatively brief decision, the District Court for the Southern District of New York granted the government's motion to dismiss New York Life's com-

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plaint for failure to state a claim on which relief could be granted.

According to the Court, with respect to the January dividends, New York Life did not allege facts that could plausibly support a conclusion it was required to pay dividends once they were credited to a policyholder account. Under the terms of the policies, New York Life was obligated to pay a policyholder dividend only if all premiums due had been paid and the policy was still in force on its anniversary date. The Court stated that if a policy was surrendered the day before its anniversary date, New York Life was not obligated to pay an annual dividend. New York Life's internal recordkeeping practices did not alter this result. The Court similarly held that the annual or termination dividends were contingent until the policy anniversary date. Thus, New York Life was not entitled to deduct the policyholder dividend amounts until they were paid.

The District Court's decision in this case is unusual because it was entered without even permitting New York Life to put on testimony that its consistent practice of crediting policyholder dividends before year-end or paying termination dividends created binding obligations on the company payable in all events through its course of conduct. New York Life has appealed, and it would not be surprising if the decision is reversed and remanded for further findings as to the nature of the company's obligations.

MASSMUTUAL[16]—DECIDED JAN. 30, 2012

In this eagerly awaited decision, the U.S. Court of Federal Claims considered the proper tax treatment of aggregate policyholder dividend guarantees of the type described above, and held that MassMutual was entitled to deduct them. For each year of the three years at issue, MassMutual's board of directors approved a dividend scale in October for the following year, and the board then adopted a resolution in December that "absolutely and irrevocably commits and guarantees that … it will pay or cause to be applied during [the following year], in all events, annual dividends for participating individual life and annuity policies issued after December 31, 1983, in an amount not less than [a specified sum]." MassMutual then paid policyholder dividends in the following year that exceeded the guaranteed amount. MassMutual claimed a deduction for the aggregate policyholder dividends declared by the board near the end of the year, that were guaranteed by the board to be paid in the following year, and that were actually paid by the company in the first 8½ months of the following year. The government denied MassMutual's claim for refund resulting from these claimed deductions, making all four of the arguments described above. In an exhaustive opinion, the Court rejected each argument.

The Court stated that resolution of the case revolved around two issues: whether the board resolutions fixed MassMutual's liability to pay the guaranteed policyholder dividend amounts and whether the policyholder dividends were rebates, refunds or similar payments that qualified for the recurring item exception. In response to the government's argument that MassMutual's liability was not fixed because MassMutual could not identify specific policies or amounts to be paid with respect to specific policies, the Court stated that "neither is fatal to the fixing of liability." The Court cited *Washington Post*,[17] *Hughes Properties*[18] and Revenue Ruling 2011-29[19] in support of its holding that the liability could be fixed even though the board resolutions providing the dividend guarantee did not identify specific policies or amounts.

The Court also rejected the government's argument that the board could potentially revoke the resolutions, and therefore the resolutions did not fix the fact of the liability. The Court noted that the government had not identified any case, statute or regulation requiring irrevocability as a necessary condition to fix the fact of a liability and that the government admitted at oral argument in the case that this was a weak argument.

The government presented related arguments that were similarly unconvincing to the Court. First, the government argued that the policyholders were not made aware of the board resolutions, and thus could not rely on them. According to the government, policyholder reliance might have limited the board resolutions' revocable nature, possibly rendering them enforceable. The Court noted, however, that one of the dividend guarantees was disclosed in an annual statement. In addition, the Court stated that, despite the government's assertion to the contrary, in at least some of the prior court cases permitting accrual of expenses following board resolutions there was no indication that knowledge of the resolution by the beneficiary was necessary for the liability to be fixed. Second, the government argued that MassMutual's regulators did not approve the dividend guarantees, would not have monitored MassMutual's compliance with the guarantees, and would have been unlikely to enforce the guarantees. As the Court stated, in each of the years at issue, MassMutual notified its

regulators of the dividend guarantees in advance or shortly after they were adopted and, at no time, did any regulator object to the guarantees. Moreover, no testimony or other evidence was presented indicating that the regulators lacked the authority to enforce the guarantees. Finally, the government argued that if MassMutual had been required to make a payment under the dividend guarantees, that payment would have violated the contribution principle of policyholder dividends and state laws because the post-1983 policyholders would then be receiving a disproportionate share of the divisible surplus in relation to their contributions. In rejecting this argument, the Court stated that a liability need not be legally enforceable to be fixed, a point which the government acknowledged.

In its discussion of whether the fact of MassMutual's liability was fixed, the Court addressed *New York Life*[20] in a footnote stating that New York Life's lawsuit was dismissed for failure to state a claim following a review of New York Life's complaint, while the facts in *MassMutual* were more fully developed following a trial and led to a different result. Surprisingly, the *MassMutual* Court did not explicitly distinguish the *New York Life* facts on the basis that New York Life did not adopt a board resolution guaranteeing payment of the dividends. Instead, the Court noted that *New York Life* relies on a Supreme Court case, *United States v. General Dynamics Corp.*,[21] which the Court did not find particularly relevant to resolving the *MassMutual* case. Specifically, the Court noted that *General Dynamics* involved a taxpayer's attempt to deduct an estimate of its obligation to pay for employee medical care when all of the claims had not yet been received or processed, while *MassMutual* involved the deduction of an amount for policyholder dividends to be paid in the subsequent year pursuant to a board resolution that fixed the liability in the taxable year the resolution was adopted.

Having determined that MassMutual's liability to pay the guaranteed policyholder dividends was fixed, the Court next addressed whether the policyholder dividends constituted rebates, refunds or similar payments under Treas. Reg. § 1.461-4(g)(3), and were thus eligible for the recurring item exception. The government argued that they were other liabilities ineligible for the exception because they included, at least in part, a return on investment earnings. The Court found this specific issue to be one of first impression and engaged in an extended examination of the Code, regulations, dictionary definitions, industry understanding, testimony, tax and industry treatises, legislative history, and cases addressing policyholder dividends in other contexts for guidance. Following this review, the Court found policyholder dividends are a return of premiums and thus constitute rebates, refunds or similar payments.

The final argument addressed by the Court was the government's contention that the board resolutions guaranteeing the dividends lacked economic substance and should be ignored. The Court rejected the government's argument. The Court held that the facts of this case were different from those in the economic substance cases on which the government sought to rely. Here, there was no dispute that the transactions giving rise to the deduction sought by MassMutual—the payment of policyholder dividends—were legitimate and should be respected; the only issue was at what time should MassMutual account for the deductions. In such circumstances, economic substance analysis has no place.

CONCLUSION

Revenue Ruling 2011-29, *New York Life* and *MassMutual* all provide recent guidance on the proper tax treatment of policyholder dividends. Following Revenue Ruling 2011-29 and the decision in *MassMutual*, one might expect that the government will no longer challenge a deduction for aggregate policyholder dividends based on the fact that individual recipients of the dividends cannot be identified as of year-end. As for the other three arguments the government has commonly raised, they were all rejected in *MassMutual*.

MassMutual has particular importance because the Court of Federal Claims is a court of national jurisdiction, so any taxpayer seeking a refund as the result of aggregate policyholder dividend accruals may file suit there, where the decision is persuasive authority. If the government appeals the *MassMutual* decision, the Court of Appeals for the Federal Circuit's decision would be binding authority on the Court of Federal Claims in any subsequent case presenting the same issue. Accordingly, a decision by the Federal Circuit affirming the lower court's decision would effectively end disputes over aggregate policyholder dividends, at least in cases involving substantially similar facts.

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A company that wants to strengthen its position with respect to its ability to deduct aggregate policyholder dividends might take certain steps suggested by *MassMutual*. Although the Court of Federal Claims did not find it critical to the resolution of the case, the government suggested that notifying policyholders of a board resolution guaranteeing aggregate policyholder dividends may blunt an argument that the guarantee is somehow revocable and, therefore, not fixed. In addition, a company may want to communicate with its regulators in advance of adopting the board resolution and secure the regulators' approval. It may also be useful to have regulators clarify that they have the authority to enforce any such guarantee and will do so if it becomes necessary.

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END NOTES

[1] I.R.C. § 811(a).
[2] Former I.R.C. § 811(b).
[3] I.R.C. § 461(h)(1).
[4] I.R.C. § 461(h)(4); Treas. Reg. § 1.461-1(a)(2)(i).
[5] Treas. Reg. § 1.461-4(g)(3).
[6] Treas. Reg. § 1.461-4(g)(7).
[7] I.R.C. § 461(h)(3); Treas. Reg. § 1.461-5.
[8] Treas. Reg. § 1.461-5(a), (c).
[9] The board resolution generally applies only to policies issued after 1983 to avoid unfavorable tax consequences. Specifically, the 1984 Act included a transition rule providing that the change from a reserve to an accrual method of accounting for policyholder dividends was not to be treated as a change in method of accounting. Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 216(b)(1), 98 Stat. 758. As a result of this "fresh start," companies did not have to recognize any income or loss with respect to amounts in existing policyholder dividend reserves. The fresh-start benefit is recaptured, however, if a company changes its business practices to accelerate policyholder dividend deductions and thereby obtain tax benefits beyond those provided by the fresh start. The recapture provision does not apply to policies issued after 1983. I.R.C. § 808(f)(7).
[10] *See, e.g., Massachusetts Mutual Life Insur. Co. v. United States*, No. 07-648T (Fed. Cl. Jan. 30, 2012); Memorandum of Law in Support of the United States of America's Motion to Dismiss, *New York Life Insur. Co. v. United States*, 780 F. Supp. 2d 324 (S.D.N.Y. 2011) (No. 10 Civ. 4701 (VM)).
[11] 1976-2 C.B. 134.
[12] 2011-49 I.R.B. 824.
[13] 476 U.S. 593 (1986).
[14] 405 F.2d 1279 (Ct. Cl. 1969).
[15] *New York Life Insur. Co. v. United States*, 780 F. Supp. 2d 324 (S.D.N.Y. 2011).
[16] *Massachusetts Mutual Life Insur. Co. v. United States*, No. 07-648T (Fed. Cl. Jan. 30, 2012).
[17] 405 F.2d 1279 (Ct. Cl. 1969).
[18] 476 U.S. 593 (1986).
[19] 2011-49 I.R.B. 824.
[20] 780 F. Supp. 2d 324 (S.D.N.Y. 2011).
[21] 476 U.S. 239 (1987).