INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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CASE-MIS No.: TAM-115470-09

Taxpayer's Name:

Taxpayer's Address:

Taxpayer's Identification No
Year(s) Involved:
Date of Conference:

LEGEND:

Taxpayer =

State W =

State W Statutes =

Q =

X =

Y =

Z =

Individual A =

Year A =

Year B =

Year C =

Year D =

Year E =

Year F =

Year G =

Year H =

Year I =

Year J =

Date a =

Date b =

Date c =

Date d =

r =

x =

y =

z =

ISSUE:

Whether the "general declaration" of Taxpayer's surplus made on Date a of Year I constitutes a deductible policyholder dividend within the meaning of § 811(c)(11) of the Internal Revenue Code for the Year I tax year?

CONCLUSION:

The "general declaration" of Taxpayer's surplus made on Date a of Year I does not constitute a policyholder dividend within the meaning of § 811(c)(11) of the Code deductible in the Year I tax year.

FACTS:

Taxpayer is a workers' compensation self insurance trust formed pursuant to a State W statute in Year A. For Federal income tax purposes it files a Form 1120-PC, U.S. Property and Casualty Insurance Company Income Tax Return. Taxpayer has a large number of employer members, each with a positive net worth, involved in Q enterprises within State W, which group of employers are allowed under the State W Statute to pool their liabilities and form a self insurance fund. Each member of the group becomes jointly and severally liable for the workers' compensation liabilities of each other member of the group.[1] Taxpayer's tax year is a calendar year.

The group of employer/members is required by State W Statute to meet certain financial and investment requirements. For example, the group must have at least $1r of net worth. Taxpayer, in turn, is restricted to certain investments such as United States Treasury Securities, deposits that are insured by the Federal Deposit Insurance Corporation and corporate bonds having a minimum rating of "A" by the X, Y or Z rating agencies.

While the workers' compensation self insurance organizations operating in State W are not considered to be insurance companies for state regulatory purposes, under a separate State W Statute, the State W Department of Insurance (the Department) has certain authority over these organizations. Further, if a fund's operating expenses are kept low in relation to the fund's premium and investment income, such funds often provide for policyholder dividends.

To assist in keeping track of a fund's items of income and expense, the Department requires the funds to account for these items on a "fund year" basis. All policies have a common anniversary date which coincides with the fund year concept. A fund year will typically remain open and reflect activity until all claims are closed and paid with no remaining reserve liabilities, all expenses are paid and any remaining funds

[1] If such a self insurance fund is properly organized and implemented, participation in the self insurance fund satisfies a member/employer's responsibility under State W's workers' compensation law.

are returned to members. This means that premium income from a given year is matched against expenses for that year, although, expenses may actually be paid in later years. Taxpayer has a history of distributing policyholder dividends to its members over the years of its existence.

For the Year I calendar tax year under consideration, the State W Statute is silent as to whether Taxpayer has any need to notify the Department of its intent to declare a dividend. The State W Statute is also silent as to what particular time when a distribution of dividends must be made. A portion of State W Statute provides that:

> any monies for a fund year in excess of the amount necessary to fund all obligations of the fund may be declared as refundable to the members of the fund by the board of trustees. The board of trustees shall be authorized to distribute the refund at their discretion, in accordance with the agreement establishing the fund and the following limitations:
>
> (a) The amount of the distribution shall not exceed the surplus funds available in the fund year as indicated by the most recently completed audited financial statements of the fund.
>
> (b) The board of trustees shall notify the department in writing of their intent to make a refund to the membership, the fund year to which the distributions apply, and the amount of the distribution for each fund year, thirty days prior to distribution.
>
> (c) No distributions shall be paid if an open fund year has a deficit.[2]

As set forth in paragraph (b) above, in the Year I year, Taxpayer was required to notify the Department in writing of its intent to distribute dividends from excess proceeds, 30 days prior to distribution. According to Individual A, an official of the Department, the notification is for actuarial purposes, so that the Department's actuaries can verify that a fund has excess funds from which to pay the dividends. A fund does not need the Department's approval to make the distribution. However, the purpose of the notification is to give the Department an opportunity to evaluate a fund's ability to pay the dividends. Until the Department agrees that the fund has the ability to pay, no distribution is made. Furthermore, if the Department objects in whole or in part, then no distribution objected to by the Department is made.

[2] For the Year I tax year, the State W Statute provided that if a deficit exists in a fund year, the fund shall eliminate the deficit or submit a plan for elimination of the deficit pursuant to regulations promulgated by the Department.

The Trust Agreement and By-laws establishing Taxpayer provides for a loss fund and this document describes the Trustees' responsibility, in part, as follows:

The Trustees are required to maintain a separate Loss Fund for the payment of loss claims. With respect to such loss fund, the Trustees' responsibility is solely that of a fiscal agent to pay loss claims, to provide periodic reports thereof to the (State W Insurance) Commissioner, and, after making provision for open and incurred but not reported claims, to hold and distribute all surplus monies in the Loss Fund to only those qualified member Participants and defined in this Trust Agreement and the Indemnity Agreement, all in accordance with any applicable Rules and Regulations of the Commissioner. In addition, the Trustees shall:

… Make and collect such assessments as may be required to maintain actuarial soundness of the separate Loss Fund for each Fund Year.

… Provide for the deficit, if any, for any Fund Year to be made up from either unencumbered surplus from another Fund Year, by assessment, or from Trustees' funds, as may be ordered by the Commissioner, or by such other methods as the Commissioner may approve.

Only that portion of the premiums received in excess of the amount allocated to the Loss Fund (described above) shall be deemed to be Trustees' funds. Such Trustees funds shall be disbursed as follows:

(a) For aggregate and specific reinsurance premiums and premium receipt taxes.

(b) Trustees obligation for the Second Injury Fund (if not chargeable against the Loss Fund), and administrative costs of the Commissioner.

(c) For payment of the Administrator's fee and expenses incurred by the Administrator.

(d) The balance of such Trustees' funds shall be retained by the Trustees for general use in discharging other obligations as may be reasonably related to providing Workers' Compensation insurance, however, any surplus (if any) including investment income, and after payment of all authorized expenses and losses, shall be returned to those qualified participants as defined in this Trust Agreement and Indemnity Agreement and in accordance with any by-laws, policy rules and regulations established by the Trustees, and in accordance with any applicable Rules and Regulations of the Commissioner.

With regard to policyholder dividends, the Indemnity Agreement (which has a function with regard to the State W funds comparable to a policy of insurance) provides, in part, as follows:

> The Trustees are authorized to set aside from the premiums collected a reasonable sum for the operating expenses or administrative expenses of Taxpayer. All remaining funds coming into their hands during any one year of Taxpayer shall be set aside and shall be used only for the following purposes:
>
> Distribution to Participants in such manner as the Trustees shall deem to be equitable of any excess monies remaining after payment of claims and claims expenses and after provision has been made for open claims and outstanding reserves; provided, however, that no such distributions shall be made prior to the approval of the Commissioner, and after complying with the applicable law and rules; provided, further, that undistributed excess funds from previous years may be distributed at any time if not required for reserves and if approved for distribution by the Commissioner.

Immediately prior to Year I, Taxpayer had several years from Year C until Year H which were open and had outstanding tentative balances due to those members of these open fund years who remained eligible to receive such distributions.

At the Board of Trustees' meeting of Date a of Year I the following resolution was passed substantially as follows:

> Be it … resolved that the Board does hereby approve the declaration of a distribution to the members of Taxpayer for Year I in the amount of Year I book income which amount shall be quantified by Taxpayer's certified public accountants after the completion of the audit of Taxpayer's books for Year I. While this distribution has been declared no payment or distribution shall be made until Taxpayer has otherwise complied with applicable law with respect to the payment of such distribution.

At the same meeting, the Board approved a resolution to fund a deficit for the Year B fund year by transferring amounts from the Year C fund year to the Year B fund year. The Board also made a specific declaration of amounts to be paid with respect to the Year E fund year through the Year H fund year which amounts were to be paid when Taxpayer has complied with all requirements of applicable law for the payment of such distribution. Both proposed actions involved prior submission to the Department.

At a meeting held on Date b of Year J the Board adopted the following resolution:

> RESOLVED that the Board of the Trustees of Taxpayer did previously approve the declaration of a distribution to the members of Taxpayer for the Year I in the amount of the Year I book income as calculated by Taxpayer's certified public accountants. It has now been determined that that Year I book income was the amount $x. While this distribution has been declared, the distribution shall not be

paid or distributed until such time as Taxpayer has complied with all requirements of applicable law for the payment of such distribution.

On its Federal income tax return (Form 1120-PC) for Year I, Taxpayer deducted $x as a policyholder dividend. The Year I deducted policyholder dividend was not paid out in the year declared or in the subsequent year. Generally, Taxpayer does not pay out the declared dividend for several years. For example, for the E fund year only y percent of the deducted dividend has been paid out as the end of Year J, which was z years later.

Taxpayer made submissions of Date c and Date d which included Exhibits C, D, and E attached to this document. These Exhibits included hypothetical illustrations showing how a State W group self insurance fund can operate and the distinction between activities on the taxpayer entity (or fund) level versus the fund year level.

Exhibit C sets out sets out the base period assumptions. Fund Years 1-3 are set out showing a net income of zero for each year after income is reduced by expenses including policyholder dividends declared. The § 832(c)(11) amount for Year 1 is $3,000, Year 2, is $3,350 and Year 3 is $3,200. At the end of Year 3 no actual dividends have been paid out.

Exhibit D shows the activity at the end of Year 4 for all four years. The Exhibit assumes that Year 3 had a $2,000 unfavorable development of loss reserves in Year 4 and that Taxpayer paid out dividends in Year 4 of $1,000 for each of Fund Years 1 and 2. The additional claims development expense of $2,000 was deducted as part of losses incurred in Year 4 and it reduced the member's dividends payable for Fund Year 3 from $3,000 to $1,200 as the balance at the end of Year 4. The members' dividend balance for Fund Years 1 and 2 at the end of Year 4 is each reduced by $1,000 paid out in Year 4 resulting in a balance of $2,000 and $2,350, respectively.

Exhibit E is the same as Exhibit D but assumes that Fund Year 3's adverse loss development in Year 4 is $3,500. The same $2,000 in dividends is paid out. Also there is a member assessment of $300 imposed in Year 4 on the Fund Year 3 members. As a consequence of these assumptions, the dividend payable balance at the end of Year 3 of $3,200 is reduced by $3,200 resulting in a $0 balance with respect to Fund Year 3 at the end of Year 4. The balances at the end of Year 4 for Fund Years 1 and 2 are the same as in Exhibit D.

LAW:

Section 461(a) provides that the amount of any deduction or credit allowed by this subtitle shall be taken for the taxable year which is the proper taxable year under the method of accounting used in computing taxable income.

Section 1.461-1(a)(2)(i) of the Income Tax Regulations provides, in part, that under an accrual method of accounting, a liability (as defined in § 1.446-1(c)(1)(ii)(B)) is incurred, and generally is taken into account for Federal income tax purposes, in the taxable year in which all the events have occurred that established the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability. (See paragraph (a)(2)(iii)(A) of this section for examples of liabilities that may not be taken into account until a taxable year subsequent to the taxable year incurred, and see §§ 1.461-4 through 1.461-6 for rules relating to economic performance.)

Section 461(h)(1) provides that for purposes of this title, 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.

Section 1.461-4(g)(3) provides, in part, that in the case of rebates or refunds, economic performance occurs when payment is made.

Section 461(h)(3) provides, in part, that notwithstanding paragraph (1) an item shall be treated as incurred during any taxable year if (i) the all events test with respect to such item is met during such taxable year (determined without regard to paragraph (1)), economic performance with respect to such item occurs within the shorter of a reasonable period after the close of such taxable year, or 8 ½ months after the close of such taxable year.

Section 461(h)(5) provides that section 461(h) shall not apply to any item for which a deduction is allowable under a provision of this title which specifically provides for a deduction for estimated expenses.

Section 832(c)(11) provides for a deduction for dividends and similar distributions paid or declared to policyholders in their capacity as such, except in the case of a mutual fire insurance company described in § 832(b)(1)(C). For purposes of the preceding sentence, the term “dividends and other similar distributions” includes amounts returned or credited to policyholders on cancellation or expiration of policies described in § 832(b)(1)(D). For purposes of this paragraph, the term “paid or declared” shall be construed according to the method of accounting regularly employed in keeping the books of the insurance company.

Section 834(e)(2) provides that the term “dividends to policyholders” means dividends and similar distributions paid or declared to policyholders. For purposes of the preceding sentence, the term “paid or declared” shall be construed according to the method regularly employed in keeping the books of the insurance company.

Section 1.822-12(b) provides, in part, as follows: if, on the other hand, the method of accounting so employed is the accrual method, the deduction, or a reasonably accurate estimate thereof, for dividends and similar distributions declared to policyholders for any taxable year will, in general, be computed by adding the amount of dividends and similar distributions declared but unpaid at the end of the taxable year to dividends and similar distributions paid during the taxable year and deducting dividends and similar distributions declared but unpaid at the beginning of the taxable year. If an insurance company using the accrual method of accounting does not compute the deduction for dividends and similar distributions declared to policyholders in the manner stated, it must submit with its return a full and complete explanation of the manner in which the deduction is computed.

In Rev. Rul. 57-134, 1957-1 C.B. 210, the insurance company on November 15th of the taxable year declared a dividend to policyholders of all company profits in excess of $2,500x dollars for such taxable year payable after the close of the year. The dividend was paid on January 20th of the following year. Rev. Rul. 57-134 stated that the declaration cannot create a debt at the time the resolution therefor is adopted by the board of directors because losses may occur during the remainder of the year which would more than offset the corporation's prior earnings for such year. Accordingly, under such resolution, no debt between the corporation and the policyholders can be created until the taxable year has closed, since only then would it be clear whether there would be earnings available for the purposes of the dividend declaration. At the end of the taxable year during which the dividend is declared, pursuant to a resolution of the board of directors, however, all events will have occurred which fix the company's liability for the dividend and such liability cannot be affected by anything transpiring after that time.

In Commercial Fishermen's Inter-Insurance Exchange v. Commissioner, 38 T.C. 915 (1962), acq. in result in part, 1966-2 C.B. 4, the taxpayer was an accrual basis unincorporated mutual marine insurance association. The taxpayer's board of governors passed a resolution to distribute a specific amount of earnings. The Service and the taxpayer agreed and so stipulated "that the dividends deductible in any year are the dividends actually declared in that year." However, the issue under consideration was the amount of dividends declared by the taxpayer. That is, the amount distributed to each policyholder was reduced by a predetermined percentage which was set aside as a contribution to taxpayer's surplus. The Service argued that the declaration of the dividend was deductible only to the extent of the amount actually paid. The Tax Court held that there was no binding and enforceable obligation to pay with respect to the loss retentions and thus there was no declaration of dividend for those amounts; however, the policyholder did acquire a continuing interest in the amount set aside as contributions, and therefore such amounts could be considered part of the dividend declaration.

In Bituminous Casualty Corp. v. Commissioner, 57 T.C. 58 (1971), acq., 1973-2 C.B. 1, among other matters, the Tax Court considered the deduction for policyholder dividends.[3] For example, certain policies written by a subsidiary included an endorsement, which formed a part of that contract, that provided for dividends. The amounts of dividends payable pursuant to such endorsements are not related to the policyholder's loss experience or to the insurance company's expenses with respect to the risks covered by the policy, except in the case of workmen's compensation policies subject to the jurisdiction of the Coal Mine Compensation Rating Bureau of Pennsylvania, and except as expenses may affect surplus where the existence of surplus is a condition to the payment of a dividend. Bituminous itself issues certain policies (Minnesota Dividend Policies) which include an endorsement which forms a part of each such policy providing for dividends to the policyholder. The dividends for which provision is made in the dividend endorsement were declared prospectively on such policies in May of each year pursuant to a resolution of Bituminous' board of directors. Bituminous made an estimate, as of each December 31, of the amount pertaining to the earned premiums on Minnesota Dividend Policies (determined on a pro rata basis without regard to any reserve for retrospective rate credits, premium discount or policyholder dividends) which would thereafter be payable to policyholders as policyholder dividends based upon the dividend resolutions previously adopted by Bituminous. The Tax Court reasoned that the certainty of petitioners' obligation to pay these was in practical fact as great as the certainty that they would be required to pay retro credits and premium discount. The commitment to pay such dividends was made to policyholders at the time the policies were written and was expressed in advance resolutions at the time the policies were written and was expressed in advance resolutions declaring such dividends. Under the resolutions the dividends were expressed in percentage of premium and as premium was earned the obligation became fixed. The Tax Court concluded that Bituminous could deduct the policyholder dividends in the tax year in which they were declared.

ANALYSIS

In summary, the Service believes the amount declared as a policyholder dividend for Year I is not deductible under § 832(c)(11) because (1) the fact of liability under the accrual method of accounting is contingent, and (2) the economic performance requirement of § 461(h) has not been met.

Accrual accounting-contingency

Section 832(c)(11) provides a deduction for policyholder dividends "paid or declared." The statute states that the term "paid or declared" shall be construed

[3] Acquiescence in result with respect to issues relating to whether estimated retrospective rate credit reserves for policies expiring beyond the current taxable year are property includible in "unearned premiums" and whether unpaid premium discount on the unexpired portion of policies are allowable as deductions or includible in unearned premiums.

according to the method of accounting regularly employed in keeping the books of the insurance company. Under the accrual method of accounting, a liability is incurred in the taxable year in which (1) all the events have occurred that establish the fact of the liability, and (2) the amount of the liability can be determined with reasonable accuracy. § 1.461-1(a)(2)(i). Although expenses may be deductible before they have become due and payable, liability must first be established. United States v. General Dynamics Corp, 481 U.S. 239, 243 (1987). If all the events necessary to establish the fact of liability have not occurred, the liability is "contingent" upon the prior occurrence of a particular event (a condition precedent) and may not be accrued for purposes of deduction. ABKCO Industries, Inc. v. Comm'r, 56 T.C. 1083 (1971), aff'd, 482 F.2d 150 (3d Cir. 1973); Field Enterprises, Inc. v. United States, 172 Ct. Cl. 77, 348 F.2d 485 (1965), cert. denied, 382 U.S. 1009 (1966). In our view the required "fact of liability" has not been established by the "general declaration" for Year I made by Taxpayer on Date a of that year. Such a liability is at that point contingent on the existence of Taxpayer's profits which in turn is dependent on the future claims loss development. If the loss reserve set up for Year I proves inadequate in future years, profits will be reduced to pay claims and in turn reduce Taxpayer's liability to pay Year I declared dividends.

In American Bemberg Corp. v. United States, 253 F.2d 691 (3rd Cir. 1958), aff'g. 150 F. Supp. 355 (D. Del. 1957), cert. denied, 358 U.S. 827 (1958), the Court considered a corporation's contingent obligation to repay its two major shareholders for providing advances to the corporation which were used to pay dividends on preferred stock to other shareholders. The agreement between the parties provided for their reimbursement conditioned upon (1) the declaration of the semi-annual current dividend on the preferred stock and (2) the existence of profits. These conditions were required to be met before the corporation's liability to pay principal and interest to the two major shareholders became absolute. The Court held that only after the regular dividend for the current semi-annual period was declared on outstanding preferred stock, liability to repay the interest on advances accrued when profits, excluding consideration of dividends accumulated but not paid, was sufficient to enable taxpayer to repay with interest the advances made by the majority shareholders.

The facts of the present case bear certain similarities to the situation in American Bemberg in that there are certain conditions precedents or benchmarks that must occur before the fact of liability exists. As to the members of a particular fund year there has be a profit in that particular fund year. For example, at the same (Date a of Year I) Board meeting in which the general declaration under consideration was made it was resolved to propose a transfer of amounts from the Year C profitable fund year to Year B deficit fund year. Thus, it is possible that a portion of any dividends subject to a general dividend declaration made in Year C will, in fact, not be distributed to the eligible participants of the Year C fund year.[4] This is the basic contingency problem,

[4] It would seem that no policyholder member of Taxpayer would receive any of the amounts declared as a dividend for the Year C fund year as those amounts went to pay for the adverse claims development (or perhaps, other expenses) associated with the Year B fund year.

i.e., the amounts subject to the general declarations but held for long periods of time by Taxpayer without being actually paid out to the participants are subject to being paid to claimants because of unfavorable loss development which could cause initially anticipated profits to not come to fruition.

In practice, there are also other benchmarks that are important in moving from contingent to non-contingent liability status. For example, the setting aside of amounts in the more specific declarations as illustrated by the resolution in the (Date A of Year I) Board meeting relative to amounts to be paid with respect to the Year E through Year H fund years. Associated with this action is the involvement of the Department in providing feedback to the funds with respect to actuarial and financial matters and that might have a bearing on their ability to actually pay the amount of the dividends they propose.[5]

Taxpayer has addressed the legal issue of whether Taxpayer's declared dividends do not satisfy the all events test of the accrual method of accounting because they are subject to a contingency. Taxpayer argues that it satisfies the fact of liability because a legal obligation is created by Taxpayer's declaration and the declaration is consistent with § 832(c)(11). As further authority, Rev. Rul. 57-134 and the three cases cited therein are relied upon by Taxpayer. Also cited is Commercial Fishermen's, supra. It is argued that there is no provision of law or regulation requiring a taxpayer to predict his future before recording and deducting such perfected liability. Finally, several cases and a revenue ruling are cited about the integrity of the tax year, that is, future economic conditions do not affect the accruals.

The Service disagrees that Rev. Rul. 57-134 is authority supporting Taxpayer. The ruling does not contain any facts regarding contingencies as to fact of liability as is present in this case. Indeed the taxpayer in the ruling paid the dividend in January of the year following the year in which the dividend declaration was made which would suggest that no contingency existed at the end of the year of declaration. Consequently, it is appropriate to ask Taxpayer why it keeps the declared dividend for so long before actually paying it out to members?

The three cases cited in Rev. Rul. 57-134 also do not support Taxpayer. In United States v. Anderson, 269 U.S. 422 (1926) and Anderson-Clayton Securities Corp. v. Comm'r, 35 B.T.A. 795 (1937) the amount in question was paid in the following year. In Uncasville Mfg. Co. v. Comm'r, 55 F.2d 893 (2d Cir. 1932) the dispute was as to when the increase in the state tax may be taken as a deduction, whether in the year state taxes were originally accrued, or when it was finally fixed as a tax upon the income as increased by the Service. The cases all deal with computing the amount of liability not the fact of liability.

[5] An illustration of a financial issue that might be raised by the Department that could have an impact is its role in enforcing the statutory requirement that only "A" rated bonds are entitled to treatment as admitted assets for regulatory purposes.

The Service disagrees that Commercial Fishermen's, supra lends further support as to whether Taxpayer has properly deducted dividends in the year of declaration. The court held that the amount of declared dividends was properly deductible in the year declared except for the adjustment for "loss retention." The court found that the "contributions" were a fixed liability of the taxpayer but the "loss retention" amounts were not a liability. The Service's acquiescence in the opinion does not resolve the present case. We would also note the enactment of § 832(f) dealing with interinsurers that was added by § 1024 of the Tax Reform Act of 1986 (Pub. L. No. 99-514) addressed the issue raised in the cited case.

Taxpayer cites Buhl Land Co. v. Kavanagh, 223 F. 2d 265 (1955), Rev. Rul. 81-176, 1981-2 C. B. 112, United States v. Hughes Properties, Inc., 476 U.S. 593 (1986), and Newhouse Broadcasting Corp. v. Comm'r., T.C.Memo 2000-244 as supporting an argument that it has satisfied the fact of liability component of the accrual method of accounting. These authorities deal with various subsequent events after the close of the taxable year such as insolvency of the lessee, Medicare desk audits, cessation of business by a casino operator, and the return of books. The all events test has been met in those authorities even though the liability was subject to a "condition subsequent". These authorities are materially distinguishable from the case at hand.

Whether a business expense has been "incurred" as to permit an accrual basis taxpayer to deduct it under § 162 is governed by the "all events" test that originated in Anderson, supra. That test is contained in § 1.461-1(a)(2) which provides that "[u]nder an accrual method of accounting, an expense is deductible for the taxable year in which all the events have occurred which determine that fact of the liability and the amount thereof can be determined with reasonable accuracy." In United States v. General Dynamics Corp, supra, the Court held that where filing is a condition precedent to liability, an accrual basis taxpayer providing medical benefits to its employees cannot deduct at the close of the taxable year an estimate of its obligation to pay for medical care obtained by employees or their qualified dependents during the final quarter of the year, claims for which have not been reported to the employer.

> It is fundamental to the "all events" test that, although expenses may be deductible before they have become due and payable, liability must first be firmly established. This is consistent with our prior holdings that a taxpayer may not deduct a liability that is contingent, see Lucas v. American Code Co., 280 U.S. 445, 452 (1980), or contested, see Security Flour Mills Co. v. Commissioner of Internal Revenue, 321 U.S. 281, 284 (1944). Nor may a taxpayer deduct an estimate of an anticipated expense, no matter how statistically certain, if it is based on events that have not occurred by the close of the taxable year. Brown v. Helvering, 291 U.S. 193, 201 (1934), cf American Automobile Assn. v. United States, 367 U.S. 687, 693 (1961).

United States v. General Dynamics Corp., id. at 243.

If all the events necessary to establish the fact of liability have not occurred, the liability is "contingent" and may not be accrued for purposes of deduction. ABKCO Industries, Inc. v. Comm'r, supra; Field Enterprises, Inc. v. United States, supra. In these cases the Court held that the taxpayer's liability for the payments in question (in ABKCO Industries., royalties; and in Field Entersprises, Inc., "quality bonuses") was contingent upon the prior occurrence of a particular event (a condition precedent).

In this case Taxpayer's business is insuring workers' compensation risks and thus is liable for all appropriate claims under the insurance policies sold to its members. Taxpayer's excess surplus is returned to members as policyholder dividends but this excess surplus is net of all workers' compensation claims for a fund year. The condition precedent to Taxpayer's fact of liability for policyholder dividends is the satisfaction of all legal responsibility to pay claims for a particular fund year.

"The [Taxpayer's] Board has developed a policy of paying declared dividends over the claims development period of the life of the claims for each year. This practice is in part to provide for the inherent uncertainty of the long-tailed insurance the [Taxpayer] covers. In determining the amount of dividends to pay each year, the Board considers actuarial expertise and financial consideration including the number of open claims, amount of case base incurred claim reserves, amount of incurred but not reported claims reserves, maturity of the fund year and age of claims, adverse or favorable development over time as well as other financial factors." Taxpayer's submission of Date c, Exhibit A at 4. "Accumulating and tracking financial activity by fund year basis is used to measure results for members, premiums, and loss activity incurred in each fund year. A fund year will typically remain open and reflect activity until all claims are closed and paid with no remaining reserve liabilities, all expenses are paid and any remaining excess funds are returned to members." Taxpayer's submission of Date c, Exhibit A at 20.

"Both [State A statutes], and the governance documents of [Taxpayer] anticipate that monies in excess of the amount necessary to fund all obligations of [Taxpayer] are to be returned as dividends to the members of the [Taxpayer]..." Taxpayer's submission of Date c at 4. "While the inherent uncertainty and variability of the loss reserve setting process is not subject the IRS TAM, losses incurred and therefore loss reserves are considered in determining how much each member is to receive in declared dividends…. Since the estimation of loss reserves in the first couple of years are considered too green, it is prudent practice to allow the loss reserve experience to develop based on better subsequent loss development. This practice provides for a more accurate loss experience to determine how much each member is to receive from the declared dividends payable." Taxpayer submission of Date c at 12-13.

In Taxpayer's submission of Date c in Exhibit D the contingency of the declared dividend is evidenced by the reduction in the dividend payable for Fund Year 3 due to the adverse claims development in Year 4. Furthermore, in Year I Taxpayer transferred an amount from the Year C surplus sufficient to eliminate the Year B deficit that arose during the Year H. Taxpayer submission of Date c, Exhibit A at 21-22.

In the year that Taxpayer declares a policyholder dividend it also sets up (and deducts for tax purposes) a loss reserve for workers' compensation claims (both case reserve and incurred but not reported (IBNR)). Only a loss reserve that is "fair and reasonable" may be deducted. § 1.832-4. If that reserve proves to be inaccurate, then a taxpayer can take a tax deduction in a subsequent year either when it increases its reserve or pays a claim. Policyholder dividends are also deductible, in general, if paid. Thus, a taxpayer could offset its entire income by ordinary business expenses, workers' compensation claims, and policyholder dividends. The tax problem is one of timing because the current "fair and reasonable" estimate of losses is most likely inaccurate. Taxpayer keeps the declared dividend in order to pay for future unanticipated claims. Taxpayer's dividend declaration amount is a solvency reserve retained to pay those increased claims. Only when the claims activity of a particular fund year are settled or final, can the excess surplus, if any, of a fund year be accurately determined and actually paid out to members. "The prudent business man often sets up reserves to cover contingent liabilities. But they are not allowable as deductions." Lucas v. American Code Co. Inc., 280 U.S. 445, 452 (1930).

Economic performance-§ 461(h)

The Service believes that the economic performance provision of § 461(h) (enacted in 1984) literally applies to all accrual basis taxpayers and in this case would require the postponement of the claimed deduction until an actual cash payment of the dividend is made to members. As regard to the exceptions made available in § 461, the recurring item exception provide in § 481(h)(3) does not apply because the general declaration made by Taxpayer is not followed by payment within the time frames allowed by § 461(h)(3) and the exception provided by § 461(h)(5) does not apply because the § 832(c)(11) does not specifically provided for a deduction for estimated expenses.

The Taxpayer makes several arguments regarding the applicability of the economic performance rule of § 461(h). It is Taxpayer's position that there is long standing authoritative support for its tax accounting for the dividend declared deduction. To change such long standing settled authoritative guidance will require action by Congress or the judicial process.

Taxpayer first of all argues that Congress has in the past considered changes in the dividend declared deduction allowed in § 832(c)(11) but has not made a change that alters the requirements that provide for such deduction. Except for the addition of a

sentence[6] and redesignation of Code section numbers, § 832(c)(11) reads the same as it did 70 years age when enacted in the 1939 Code. Since the recodification in 1954, Congress has considered in some way § 832(c)(11) in the following public laws: Pub. L. No. 429 (Life Insurance Company Tax Act of 1955), Pub. L. No. 87-834 (Revenue Act of 1982), Pub. L. No. 88-272 (Revenue Act of 1964), Pub. L. No. 89-809 (Foreign Investors Act of 1966), Pub. L. No. 90-240 (1968), Pub. L. No. 93-483 (1974), Pub. L. No. 99-514 (Tax Reform Act of 1986), Pub. L. No. 10-647 (TAMRA 1988), Pub. L. No. 101-508 (OBRA 1990). On nine specific occasions, not to mention that studies requested and other observations, Congress has considered § 832(c)(11) and yet it reads essentially and interpretively the same as it did 70 years ago.

The Service disagrees. The argument that Congress has not specifically amended § 832(c)(11) by addressing self insurance funds by name does not answer the issue of whether § 461(h) is applicable to Taxpayer. The Service position is that § 832(c)(11) requires a taxpayer to follow its method of accounting which generally is the accrual method and under such method includes the all events test. Section 461(h) states that the all events test is not satisfied until economic performance occurs. Arguably, Congress has not amended § 832(c)(11) because it is satisfied with current accrual/economic performance conditions for allowing a policyholder dividend deduction.

More specifically, Taxpayer cites the Conference Report to the Technical and Miscellaneous Revenue Act of 1988 (Pub. L. No. 100-647) (H. Conf. R. 100-1104 at 171 (1988) (Conf. Rep.)), regarding the definition of certain workers' compensation funds, as supporting its position. The Conference committee deleted § 345(b)(4) of the House bill which stated "that the group be bound by state law or regulation or by its governing documents to promptly return to its members all monies not needed to pay, or reserve against, claims under the State workers' disability compensation laws and expenses." Thus, the opportunity to apply economic performance requirements for the return of the excess of earnings and profits in the form of declared dividends was specifically deleted by Congress.

The Service disagrees. In addition to the various Service arguments made above, the Service would note that the application of § 461(h) would grant a taxpayer a long time period to pay the dividend that under the "promptly return" condition in the rejected legislation because of the recurring item exception in § 461(h).

The Taxpayer cites the "1986 Act Bluebook" as supporting its position (Staff of the Joint Committee on Taxation, 100th Cong., General Explanation of the Tax Reform Act of 1986 at 621 (Joint Comm. Print, 1987)). Section 1025 of the 1986 Act required the Treasury Department to conduct a study of several issues including the treatment of policyholder dividends by mutual property and casualty insurance companies. The

[6] Sec. 832(b)(1)(D), Revenue Act of 1962 (Pub. L. No. 87-834).

1986 Bluebook noted that "[u]nder prior and present law, property and casualty insurance companies are generally permitted to deduct dividends and similar distributions paid or **declared** to policyholders in their capacity as such". (emphasis added by Taxpayer) Taxpayer reasons from this quote that because current law is unchanged, dividends declared are deductible. Thus the ability to deduct a dividend declared is clearly outside the requirements of economic performance. While economic performance may be generally required post-1984 for deductions, it is clearly not an element applicable to § 832(c)(11).

The Service disagrees with this argument. First of all, the 1986 Bluebook description of present law merely made a brief general description of § 832(c)(11) by paraphrasing the first sentence of the section. Neither the 1986 Bluebook nor the Taxpayer refer to the third sentence of § 832(c)(11) which defines "paid or declared" to include the accrual method of accounting which in turn includes by statute the economic performance rule of § 461(h). Also important is the rest of the language in the 1986 Bluebook not quoted by the Taxpayer and the context of that language in the 1986 Bluebook's description of prior law. The concern was the apparent different tax treatment of policyholder dividends and shareholder dividends at both the entity level and the distributee level. Congress recognized that any inequity might be addressed by applying the § 809 rule in the life insurance company area to property and casualty insurance companies. Because that rule was complex and controversial, Congress wanted a study done before it took any action. There is no indication that the Staff of the Joint Committee on Taxation was addressing the issue in the present tax matter, that is, whether a taxpayer can deduct a declared dividend in year 1 but not pay out the dividend for 5 to 10 years later. We would note that § 809 was repealed in 2004.

Finally the Taxpayer cites Bituminous Casualty and a 1996 IRS Field Service Advice (FSA) as holding that the all events test is not applicable to the dividend declared deduction and therefore the economic performance rule is not applicable.

The Service disagrees. With regard to the FSA, § 6110(k)(3) states that such document is not precedential.[7]

The Service believes that Bituminous Casualty is materially distinguishable from the present case. In Bituminous Casualty certain policies were sold with dividend endorsements. The amount of dividends payable pursuant to such endorsements was not related to the policyholder's loss experience or to certain expenses, and except as expenses may affect surplus, the existence of surplus is a condition to the payment of a dividend. The company estimated the amount pertaining to the earned premiums on dividend policies which would thereafter be payable as policyholder dividends. The dividends were a form of price discount. It was necessary for the insurer to commit itself to the policyholder in advance as to the amount of the dividends. It was the

[7] Section 6110(k)(3) would also apply to any PLR or GCM cited by Taxpayer.

industry practice to declare such dividends as much as a year in advance. There was certainty in the company's obligation to pay. The commitment to pay such dividends was made to policyholders at the time the policies were written and was expressed in advance resolutions declaring such dividends. Under the resolutions the dividends were expressed in percentage of premium and as the premium was earned the obligation became fixed. The Service would first note that the case was decided prior to the enactment of § 461(h) and thus not applicable to this issue. The Service would also note that the case is materially different from the case at hand. In Bituminous Casualty the dividend was not affect by policyholder losses, the computation of the dividend was more mechanical (percentage of earned premium) and was not dependent on net income. The fact of liability was clearly established. Although the Court stated that the dividend estimate was allowable under the regulations even though such dividends would not have been accrued under the "all events test", the rationale is somewhat confusing as to why the Court referred to the "all events" component of the accrual method and why the facts did not meet the second component of the accrual method (the amount of liability can be determined with reasonable accuracy). See § 1.461-1(a)(2)(i). It would seem the case is consistent with Rev. Rul. 57-134.

Taxpayer also argues the economic performance rule of § 461(h) is not applicable because of the exception in § 461(h)(5). Taxpayer states that it satisfies the two components of § 461(h)(5), namely, "reserve" and "estimate expenses". As to the first component, Taxpayer reasons that dividends which will be paid in future years are appropriately considered a "reserve". As authority, Taxpayer mainly relies on Bituminous Casualty. Also, it argues that declared but unpaid dividends clearly fit the definition of a reserve in the context for insurance companies as defined in Maryland Casualty Co. v. United States, 251 U.S. 342, 350 (1920) which stated:

> The term 'reserve' or 'reserves' has a special meaning in the law of insurance. While its scope varies under different laws, in general it means a sum of money, variously computed or estimated, which, with accretions from interest, is set aside – 'reserved' – as a fund with which to mature or liquidate, either by payment or reinsurance with other companies, future unaccrued and contingent claims and claims accrued, but contingent and indefinite as to amount or time of payment.

As to the second component, Taxpayer argues that it satisfies this item citing § 1.822-12(b), Bituminous Casualty, Rev. Rul. 57-134, and various IRS documents (an FSA and several PLRs).

The Service disagrees that the above cited authorities are dispositive of the issue. Section 832(c)(11) does not "specifically' provide for a deduction for a reserve for estimated expenses. The last sentence of § 832(c)(11) requires that the section by interpreted according to a taxpayer's method of accounting which generally means the accrual method and not a reserve for estimated expenses. Although § 1.822-12 uses

the phrase "reasonable accurate estimate", the regulation should not be interpreted to be in conflict with the statute (§ 832(c)(11)), does not use the phrase "reserve for estimated expenses", and was written prior to the enactment of § 461(h)(5).

A copy of this technical advice memorandum is to be given to the taxpayer. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

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