Internal Revenue Service

Department of the Treasury

Index Numbers: 832.04-00
832.05.00
832.12-00
Number: **199922020**
Release Date: 6/4/1999

Washington, D.C. 20224

Contact Person:

Telephone Number:

In Reference to:
CC:DOM:FI&P:4 PLR-116638-98
DATE: February 23, 1999

Legend

Taxpayer =

State =

Statute1 =

Agency =

Dear :

This is in response to your authorized representative's August 21, 1998 letter requesting a ruling that Taxpayer's liability for certain payments is properly characterized as a liability for return premiums under a retrospective rating plan based on experience for purposes of Internal Revenue Code § 832(b)(4) and Treasury regulation § 1.832-4(a)(3)(ii), and to your representative's letters of September 17, October 8, 13, and 15, November 6**,** and December 22**,** 1998, and February 10 and 19, 1999 providing supplemental information respecting that request.

Facts

Under the workers' compensation law of State, employers meeting certain requirements may pay workers' compensation claims directly as an alternative to providing commercial insurance for their employees. See Statute 1. Taxpayer was established under a provision of that law which allows employers of common interest to establish a fund to share and distribute their risk for providing workers' compensation coverage.

Taxpayer is subject to the supervision of the Agency, the State agency

responsible for administering State's workers' compensation laws. Taxpayer is not a commercial insurance carrier or a company licensed by the State agency responsible for regulating and licensing insurance carriers. However, it computes its income based on the underwriting and investment exhibit of the National Association of Insurance Commissioners ("NAIC") Annual Statement applicable to Property and Casualty Insurance Companies, and files its federal income tax return as a nonlife insurance company. While Taxpayer is not required to file an NAIC Annual Statement, it prepares its financial statements in a manner consistent with that Annual Statement.

Taxpayer is governed by a Board of Trustees (Trustees) elected by and from its participating Members. The instrument governing Taxpayer is a Participation Agreement it enters into with each Member. The Participation Agreement sets forth the rights and obligations of Taxpayer and its Members, including the scope of the insurance coverage Taxpayer provides, and the premiums (Contributions) the Members must pay in return for that coverage. Each Participation Agreement is effective for a twelve-month period (January 1 - December 31) and is automatically renewed on each subsequent anniversary date unless 30 days written notice is provided by the canceling party. (That twelve month period is referred to in this ruling as a Fund Year.)

The model Participation Agreement Taxpayer has provided obligates Taxpayer to pay all amounts Members are entitled to receive relating to claims arising under State's Workers' Compensation Act with respect to injuries occurring during the Plan Year covered by the Agreement. Taxpayer makes payments directly to claimants. The Participation Agreement provides that Taxpayer and Members have joint and several liability for all covered claims. Thus, if the assets of Taxpayer are insufficient to pay a claim, the Members may be assessed additional Contributions. Any such additional Contributions are to be assessed against all Members on a pro-rata basis based on total Contributions for the Fund Year in which the additional Contributions are to be made.

Taxpayer intends that effective for its 1999 Fund Year, the Participation Agreement will incorporate a "Retrospective Rating" Plan (Plan), pursuant to which Members with favorable experience in a particular Fund Year may receive credits (Credits) against future required Contributions. The intent and the effect of the Plan is to provide for distributions to its Members of most of Taxpayer's cumulative underwriting and investment income. The amounts to be distributed are attributable to Taxpayer's entire experience, and not simply to its experience with respect to any particular policyholder or any particular group of policyholders. To date, Taxpayer has calculated the amount of the dividends it distributes utilizing essentially the same basis as the basis for distributions utilized in the Plan.

Only Eligible Members are entitled to receive Credits.[1] Eligible Members are persons who are Members during the Fund Year with respect to which the Credits are earned. The Plan provides that each Member consents to the authority of the Board of Trustees to amend or modify the terms of such Plan as the Board deems necessary in order to preserve the Taxpayer's reserves, provided, however, that any such amendment or modification may not reduce or eliminate Taxpayer's obligation to pay Credits accrued in prior Fund Years.

Credits are comprised of two parts, the Claims Fund Retrospective Return Amount (the Claims Fund Credit) and the Trustee Fund Retrospective Return Amount (the Trustee Fund Credit).

The total Claims Fund Credit for a particular year is determined by multiplying the total Contributions made by all of the Members to the Taxpayer for all years by 75% (the Claims Fund Percentage) and reducing that amount by Taxpayer's total historical and current losses (net of reinsurance recoverable, and discounted in accordance with Treasury Regulations and Internal Revenue Service guidelines) and by accrued Claims Fund Credits and dividends from all Fund Years.

The share of the Claims Fund Credit that is to be credited to each Eligible Member is an amount equal to that Credit (reduced by an amount equal to the discount on Taxpayer's losses computed pursuant to § 846) multiplied by a fraction whose numerator is equal to 75% of the relevant Member's audited Contributions for the relevant Fund Year, less claims paid and plus claims reserved with respect to that Member in that year, and whose denominator is equal to 75% of the audited Contributions of all of those Eligible Members whose Contributions during the relevant Fund Year exceeded the claims paid and the claims reserved with respect to those Members in that Year.

The Plan provides that each Member's share of the Trustee Fund Credit shall be returned to Eligible Members as a credit ratably on renewal Contributions for the fourth, fifth, and sixth years following the close of the Fund Year with respect to which the Credit is based.

The total Trustee Fund Credit is an amount equal to:

(a) 25% of the total Contributions made by all Members during all Fund Years; or,

---

[1]The amount distributed to the Members is attributable to the entire experience of the company; its allocation among the Members is determined by the ratio of the favorable experience of a particular Member in a particular Fund Year to the favorable experience of all of those Eligible Members with favorable experience in that Fund Year.

> (b) if undiscounted losses for all Fund Years as determined by Taxpayer's actuary, net of reinsurance recoverable, exceed the Claims Fund Percentage of the aggregate audited Member Contributions for all Years, the total amount of those Contributions less the total undiscounted amount of Taxpayer's losses incurred, as determined by its actuary, net of reinsurance recoverable,

less operating expenses, plus investment income, plus income other than investment income and underwriting income, and less accrued Trustee Fund Retrospective Returns and dividends from all Fund Years.

The share of the Trustee Fund Credit that is to be credited to each Eligible Member is an amount equal to that Credit multiplied by a fraction whose numerator is equal to 75% of the relevant Member's audited Contributions for the relevant Fund Year, less claims paid and plus claims reserved with respect to that Member in that year, and whose denominator is equal to 75% of the audited Contributions of all of those Eligible Members whose Contributions during the relevant Fund Year exceeded the claims paid and plus claims reserved with respect to those Members in that Year.

The Plan provides that each Member's share of the Trustee Fund Credit shall be returned to Eligible Members as a credit on renewal Contributions for the second Fund Year following the close of the Fund Year with respect to which the Credit is based.

Ruling Requested

Taxpayer requests a ruling that its liability for Credits is properly characterized as a liability for return premiums under a retrospective rating plan based on experience for purposes of Code § 832(b)(4) and Treasury regulation § 1.832-4(a)(3)(ii).

Law and Analysis

The term policyholder dividend is separately defined for nonlife and life insurance companies. For nonlife insurance companies, § 832(c)(11) permits a deduction for "dividends and similar distributions paid or declared to policyholders in their capacity as such." Section 834(e)(2) defines policyholder dividends as "dividends and similar distributions paid or declared to policyholders."

Section 834(e)(1) provides that amounts returned where the amount is not fixed in the insurance contract but depends on the experience of the company or the discretion of management shall not be treated as return premiums but shall be treated as dividends to policyholders under § 834(e)(2). The characterization of those amounts as policyholder dividends is not, by its terms, limited to payments to policyholders that depend "solely" on the experience of the company or the discretion of management; to the contrary, a more natural reading of the sentence suggests Congress intended that amounts that, in total, depend on the entire experience of the company would be treated as policyholder dividends rather than return premiums, even if allocation of

those amounts among policyholders is based on an additional factor, such as the experience of those policyholders.

Until 1984, the same definition of policyholder dividends applied for both nonlife and life insurance companies. The language now appearing in § 834(e)(2) to define "policyholder dividends" for nonlife insurance companies appeared in former § 811(a), defining dividends for life insurance companies. Section 1.811-2(a) of the regulations provided that for life insurance companies, the term "dividends to policyholders" includes amounts returned to policyholders where the amount is not fixed in the contract but depends on the experience of the company or the discretion of management." Former § 809(c)(1) provided that such amounts were not included in return premiums.

Applying these definitions, the fifth circuit concluded that certain amounts paid to nonparticipating policyholders in a life insurance company were return premiums and not policyholder dividends. In Republic National Life Insurance Company v. United States, 594 F.2d 530 (5th Cir. 1979), the Service asserted that certain amounts should be classified as dividends to policyholders and not return premiums. The amounts in question were fixed in the contracts and their payment was not subject to the discretion of Republic's Board or management. Liability for the amounts depended only on the experience of the group policyholders, and not on the experience of other policyholders, or of the company as a whole. Nonetheless, the Service argued the amounts in question were dividends because they were based on the "experience of the company."

The court could have dismissed the Service's argument on the basis that since the liability to pay the relevant amounts was "fixed in the contract" the amounts simply could never have constituted dividends for tax purposes. It did not. In deciding the amounts in question constituted return premiums and not dividends, the court stated:

> The most significant fact in the case of these group policyholders is that the insurer's liability for the group refund arises without regard to the experience of other clients or the overall profit and loss experience of the company itself. Section 809(c)(1) represents an attempt to distinguish return premiums from dividends and the definition was written in terms of classic dividend characteristics. In this context, the taxpayer's argument that Congress intended experience to mean profit and loss experience is a natural and persuasive reading of the statute.

594 F.2d at 535.

Likewise, in American National Insurance Company v. United States, 690 F.2d 878 (Ct. Cl. 1982), the Claims Court decided that a payment to a nonparticipating policyholder was a return premium and not a dividend because the payment did not depend on the profit and loss experience of the company. The court discussed, in detail, what distinguished a dividend from a return premium, and indicated that a

payment fixed in a contract but designed to distribute to the policyholder a portion of the insurer's surplus, as opposed to a return of a portion of the premium it paid, was to be treated as a dividend. The court indicated that since it held the amounts in question were fixed in the contract, it impliedly had determined they were not dependent on the experience of the company. It then went on to discuss what the term "experience of the company" means, noting that

> The [taxpayer] is obligated to pay the refunds on the basis of the claims and expense experience of the particular policyholder regardless of the [taxpayer's] overall profit and loss experience – it must pay the refund even when its investments lose money . . . .
>
> It is the profit and loss experience "at the level of the life insurance company," however, and not at the level of the individual policyholder that is relevant . . . . If the amount returned depends on the profit or loss of the company (even if the amount does not depend on management discretion) . . . it is to be treated as a policyholder dividend . . . . If, however, the amount returned depends only on the claims and expense experience of the insured, the amount returned represents only underwriting profits, and there is no danger that investment income will be distributed to policyholders.

690 F.2d at 686.

In 1984 Congress reacted to the decisions in Republic National and American National, by revising the definition of policyholder dividend for life insurance companies to ensure that payments dependent on the experience of a company with respect to a particular policyholder or group were classified as policyholder dividends. Section 808(b)(4) now includes experience-related refunds in the definition of dividends to policyholders. Section 808(d)(3) limits the term "experience related refund", however, to "any refund or credit based on the experience of the contract or the group." Those kinds of refunds are generally provided for (or fixed) in the contract that a policyholder or a group of policyholders enter into with an insurance company.

Nothing in the legislative history of § 808(b)(4) indicates Congress considered the term "experience-rated refunds" to include payments made to policyholders based on the entire experience of the company. Consequently, it does not appear that section 804(b)(4) includes payments that, in the aggregate, are based on the entire experience of the company. See H. Rept. 98-432 (Part 2), 98th Congress, 2d Session, p. 1421; and S. Prt. 98-169 (Vol. 1), 98th Congress, 2d Session, p. 548. Nevertheless, the amounts at issue in the present case, if paid by a life insurance company, would be policyholder dividends within the expanded definition in § 808, presumably under § 808(b)(1). For the reasons reflected above, we believe such payments by a nonlife insurance company would be policyholder dividends for purposes of § 832(c)(11).

In the present case, the total payments at issue are based on the entire

experience of the Taxpayer. Credits paid to an Eligible Member reflect not only a return of a portion of that Member's Contributions, but also a share, regardless of the Fund Year in which earned or incurred, of Taxpayer's investment income and other income, general corporate expenses, and favorable and unfavorable loss experience with respect to other Members. The formulas by which the payments are computed make clear that the payments are the primary mechanism for distributing Taxpayer's profits to Members.

We are aware of no tax rule that would limit the formula by which Taxpayer may allocate dividend payments among its Members. Accordingly, we conclude the payments at issue will constitute policyholder dividends for purposes of § 832(c)(11), and thus can not be properly characterized as a liability for return premiums under a retrospective rating plan based on experience for purposes of §§ 832(b)(4) and 1.832-4(a)(3)(ii).

We express no opinion regarding the proper timing of any deduction for the payments with respect to which Taxpayer has sought this ruling.

The rulings contained in this letter are based upon information and representations submitted by Taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

This ruling is directed only to the Taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

Assistant Chief Counsel
(Financial Institutions and Products)

By: SIGNED MARK S. SMITH
Mark Smith
Chief, Branch 4