INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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CASE MIS Number: TAM-113939-98

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Release Date: 4/2/1999

District Director
Gulf Coast District

Taxpayer's Name:

Taxpayer's Address:

TIN:
Years Involved:
Date of Conference:

LEGEND:

Taxpayer	=
VV	=
WW	=
XX	=
YY	=
ZZ	=
AA	=
BB	=
Amount 1	=
Amount 2	=
Amount 3	=

Amount 4	=
Amount 5	=
Amount 6	=
Amount 7	=
Amount 8	=
Amount 9	=
Amount 10	=
Amount 11	=
Amount 12	=
Amount 13	=
Amount 14	=
State A	=
<u>A</u>	=
Month 1	=
Month 2	=
Month 3	=
Date 1	=

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Date 6 =

Date 7 =

Date 8 =

ISSUE:

What amounts are deductible by Taxpayer as policyholder dividends for tax years 19XX, 19YY and 19ZZ under section 832(c)(11) of the Internal Revenue Code.

CONCLUSION:

Under Code section 832(c)(11), Taxpayer is entitled to a deduction for policyholder dividends paid or declared in each of the taxable years at issue. Amounts declared as dividends by the Board of Trustees which are subject to a contingency do not constitute declared dividends for purposes of section 832(c)(11) until that contingency is satisfied. Under the facts as provided, Taxpayer is thus entitled to deductions for policyholder dividends as follows:

Tax Year	Deduction
19XX	
Amount 1	
19YY	
Amount 2	
19ZZ	
Amount 3	

FACTS:

Taxpayer is a workers' compensation self-insurance trust organized pursuant to State A Code. Taxpayer is subject to regulation by the State A Workers' Compensation Commission (hereafter, "Commission"). Rule A of the Commission's "Laws and Rules of the Commission" provides, in pertinent part:

> Surplus funds for a fund year in excess of the amount necessary to fulfill all obligations under the Law for that fund year may be declared refundable by the Trustees, provided that such amount shall not be paid to the members until approved by the Commission.

Taxpayer's Trust Agreement provides:

> 6.7 Surplus Funds. The Trustees shall make a distribution of the surplus monies to participating Members subject to the following restrictions:
>
> (a) Any surplus monies for a fund year in excess of the amount necessary to fulfill all obligations under the law shall be declared refundable to Members by the Trustees.
>
> (b) In making a distribution of surplus monies, the Trustees, in their sole and complete discretion, shall establish the criteria for determining the amount refundable to each Member. These criteria may include underwriting considerations which adjust the size of each Member's refund for the year in question according to the loss ratio and premium contribution.

The Trust Agreement provides that surplus funds for any fund year in excess of the amount necessary to fulfill all obligations of the fund may be declared refundable by the trustees one year after the close of the fund year and are payable to the members after the Commission approves the distribution for payment.

For each taxable year at issue, the trustees made a general declaration at the close of the taxable year. A trustee moved that "any and all surplus funds that may exist" as of the close of the taxable year be declared payable to members. For tax year 19XX, Taxpayer had already paid a dividend to members in the amount of Amount 1 at the time the general declaration was made. No formal declaration was made regarding the dividend paid during tax year 19XX. The dividend was simply distributed once permission was received from the Commission.

At the time the year-end declarations occurred regarding tax years 19YY and 19ZZ, Taxpayer had already received permission from the Commission to distribute certain of the surplus funds it was holding. At the end of tax year 19YY, Taxpayer had permission to distribute Amount 12 of surplus funds to members. At the end of tax year 19ZZ, Taxpayer had permission to distribute Amount 7 of surplus funds to members.

For each taxable year at issue, a contingency was added to the general declaration regarding surplus prior to trustee vote. "The actual timing of such distribution would be subject to trustee discretion and review by the State A Workers' Compensation Commission."[1] Thus, while the surplus relative to any particular fund year belongs to the members according to the terms of the Trust Agreement, the general dividend declaration recognizing this fact contains a contingency which must be satisfied prior to the creation of any binding obligation on the part of the trustees to distribute any of amount of surplus to the members. Indeed, members will lose the right to receive distributions of some of the surplus relative to a particular fund year if losses exceed actuarial estimates. The general declaration does not provide for all of the surplus relative to any particular fund year to be distributed because some of the surplus will be held by Taxpayer in order to cover excess losses, if necessary.

Immediately after the motion stating surplus be declared payable to members is passed, a second declaration is made. This second declaration removes the contingency on the general dividend declaration. For tax year 19XX, the second declaration states that Taxpayer will "pay dividends totalling Amount 5 on the 19VV calendar year . . . and Amount 6 on the 19WW calendar year . . . ". Permission had not yet been received from the Commission to distribute any amounts other than Amount 1, which had already been distributed. For tax year 19YY, the second declaration states that Taxpayer will "make dividend payments during calendar year 19ZZ amounting to Amount 11 which will cover all years for which dividends are being paid." For tax year 19ZZ, the second declaration states that Taxpayer will refund to members in 19AA specific amounts attributable to fund years 19VV, 19WW, 19XX and 19YY, which amounts total Amount 3.

<u>Tax Year 19XX</u>

Taxpayer did not claim a deduction for policyholder

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[1]For the Board of Trustees meeting at the end of tax year 19XX, the statement erroneously contains the word "reviews" instead of "review." For the meeting at the end of tax year 19ZZ, the statement omits the term "Compensation" in the phrase "State A Worker's Compensation Commission." Otherwise, the statement is identical in each year.

dividends on its original Form 1120-PC for tax year 19XX. Taxpayer subsequently filed a Form 1120X for tax year 19XX claiming a policyholder dividend deduction in the amount of Amount 7.[2] Taxpayer now concedes that the proper amount of the deduction for policyholder dividends for tax year 19XX is Amount 1. Taxpayer paid a dividend in the amount of Amount 1 during tax year 19XX after receiving permission from the Commission. Taxpayer did not have permission from the Commission to distribute any additional amounts.

Tax Year 19YY

Taxpayer did not claim a deduction for policyholder dividends on its Form 1120-PC for tax year 19YY, but now claims it is entitled to a deduction for policyholder dividends in the amount of Amount 12. Amount 12 represents the sum of Amounts 9 and 10. Amount 9 was approved by the Commission for distribution on Date 4. Amount 10 was approved by the Commission for distribution by separate correspondence also dated Date 4. Thus, the Commission had given permission for surplus funds in the amount of Amount 12 to be distributed to members as of the close of tax year 19YY. However, in the Commission’s Date 4 correspondence regarding Amount 10, the Commission noted:

> . . . While we understand that a **good portion** of this surplus is scheduled to be retained by the Fund and a **smaller portion** to be paid out in cash dividends to the members, we can advise that payment under this authority in whole or in part may be made now (emphasis added).

Subsequently, in Month 1 of 19YY, a dividend was paid out which approximates the two dividend amounts declared at the Board of Trustees meeting held on Date 2 the previous year (Amount 5 plus Amount 6). The actual amount paid out (Amount 13) was slightly more than Amount 5 plus Amount 6. Taxpayer has not explained the discrepancy. Amount 2 equals Amount 13 plus Amount 11 (the amount contained in the second declaration in year 19YY).

Tax Year 19ZZ

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[2]Taxpayer claimed this amount as a policyholder dividend deduction on its amended tax return for 19XX, which was filed in Month 3 of 19ZZ. The figure represents the surplus funds relative to the 19XX fund year as calculated by Taxpayer in 19ZZ. Taxpayer now concedes that it cannot retroactively revise its tax liability for a particular tax year based on the subsequent performance of the corresponding fund year surplus.

Taxpayer claimed a deduction for policyholder dividends on its Form 1120-PC for tax year 19ZZ in the amount of Amount 7. Taxpayer argues that this amount is deductible as it represents the total surplus funds Taxpayer had received permission to distribute in tax year 19ZZ to its members.

In Month 2 of 19ZZ, a dividend was paid out in the amount of approximately Amount 11, the amount approved at the Date 5 Board of Trustees meeting the previous year.[3]

During the Date 8 Board of Trustees meeting, a trustee moved that Taxpayer pay dividends totalling Amount 3 in 19AA. This motion was passed.[4]

LAW AND ANALYSIS:

Taxpayer argues that the amount calculated actuarially to represent the surplus attributable to a specific fund year is deductible in its entirety in the year the amount is reviewed and approved for distribution by the Commission. Taxpayer thus suggests that the following amounts are properly deductible:

Tax Year	Deduction
19XX	Amount 1
19YY	Amount 12
19ZZ	Amount 7

Revenue Agent argues that to permit Taxpayer to deduct the entire amount of estimated surplus in the year it is reviewed and approved by the Commission for distribution results in a gross mismatching of income and expenses. As of Month 2 of 19BB, Taxpayer was still purportedly paying dividends relative to the 19VV fund year surplus distribution approval granted by the Commission on Date 4. Revenue Agent argues that declared dividends must be paid within a reasonable time after the Commission approves the distribution. Revenue Agent believes twelve months after the close of the taxable year in which the distribution was approved to be a reasonable time. Revenue Agent suggests that the following amounts are properly deductible since they were paid within twelve months after the close of the taxable year in which approval was obtained:

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[3]The actual payment was one dollar less, apparently due to rounding.

[4]Dividends totalling Amount 3 plus $1.00 were paid in Month 2 of 19AA.

Tax Year	Deduction
19XX	Amount 1
19YY	Amount 13
19ZZ	Amount 14

LAW

Section 832(c)(11) of the Internal Revenue Code provides for a deduction for policyholder dividends as follows:

> (11) 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 subsection (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 subsection (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 1.822-12 of the Treasury Regulations provides:

> . . . 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.

Rev. Rul. 57-134, 1957-1 C.B. 210, analyzed whether dividends to policyholders, declared during a taxable year by certain insurance companies employing the accrual method of accounting, are deductible from gross income for the taxable year of declaration where the dividends are declared as an amount representing all or a portion of the net profits of the company as of the end of the taxable year.

The pertinent facts are as follows: In November, the taxpayer, through its board of directors, declares a dividend to policyholders of all the company's profits in excess of 2,500x dollars for such taxable year payable after the close of the taxable year. On January 20th of the following year, the dividend is paid.

The ruling centers on whether the dividends declared by the company are in a determined or undetermined amount. The ruling states that dividends of "all the company's profits in excess of 2,500x dollars" cannot create a debt at the time the resolution is adopted by the board of directors in November. This is true because losses may occur during the remainder of the year which would more than offset the corporation's prior earnings for the year. No debt is created between the corporation and the policyholders until the taxable year has closed, since only then is it clear whether there are earnings available for the purposes of the dividend declaration.

The ruling holds that such a declaration may be treated as an accrued liability for the taxable year during which the resolution is adopted by the board of directors, provided there are sufficient earnings for such year available for dividends at the close of the taxable year.

In the case at hand, Taxpayer argues that it may deduct the entire amount of estimated surplus as a policyholder dividend deduction in the year the estimated surplus is approved for distribution to members by the Commission. However, the facts of the instant case can be distinguished from those relied upon in Rev. Rul. 57-134.

The facts herein clearly establish that the amount of available surplus as estimated by Taxpayer and approved for distribution by the Commission for any particular fund year bears no relationship to the specific amount of policyholder dividends payable in any particular taxable year. In fact, the Commission's letter of Date 4 establishes that Taxpayer requested approval to distribute amounts of surplus that it intended to hold, rather than distribute.

The approval of the Commission is necessary for Taxpayer to be able to distribute dividends to its members under State A law. The fact that actuarial estimates of surplus are submitted to the Commission and the Commission reviews these calculations and approves the distribution of such surplus to the members is not dispositive of the issue. The Commission's approval permits Taxpayer to distribute dividends; it does not <u>require</u> Taxpayer to do so.

The trustees have discretion to determine when payment will be made and in what amount. Under the facts of the case at hand, the trustees exercise this discretion by making first a general declaration subject to a contingency, then a second specific dividend declaration satisfying the contingency. The general declaration, by itself, does not qualify as a dividend declaration for purposes of section 832(c)(11) because it is not an enforceable obligation until the contingency contained therein is satisfied.

Thus, pursuant to section 832(c)(11) of the Code and section 1.822-12 of the Regulations, and based on the above analysis, we hold that Taxpayer is entitled to a deduction for policyholder dividends only in the amounts listed under Conclusion.

CAVEAT(S)

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