MassMutual Victory May Pave the Well for Earlier Deductions

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Earlier this month, Massachusetts Mutual Life Insurance Company (MassMutual), represented by Skadden, won a federal appeal permitting the company to deduct policyholder dividends in the year the dividends were declared, even though the dividends were not actually paid until the following year, on the anniversary dates of each renewed policy. The decision, *Massachusetts Mutual Life Insurance Co., et al v. United States*, No. 14-05019 (Fed. Cir. 2015), is potentially relevant to any taxpayer using an accrual method of accounting (which includes almost all corporations) that guarantees a liability to a group in the year before the liability will be paid, and to many different types of liabilities including, for example, deferred compensation. MassMutual's victory is important because it confirms that, under the right circumstances, a guaranteed minimum amount of a liability payable to a class of recipients (such as renewing policyholders) can be deductible in the year the liability is declared, even though it may not be known until after the year ends who in the class will actually receive a payment, or how much they will get.

Mutual insurance companies like MassMutual typically collect premiums from policyholders in excess of what the company's actual costs turn out to be, in which case the mutual insurance company may return some of the excess to the policyholders in the following year in the form of policyholder "dividends." If the company decides to pay such dividends, such dividends are typically declared in the year the premiums were collected and payable on each policyholder's policy anniversary date in the following year. In *Massachusetts Mutual*, the government agreed that MassMutual was entitled to claim a deduction for its policyholder dividends. The only issue was in which year: the year of declaration or the year of payment.

An accrual method taxpayer can deduct a liability only when, among other things, the liability is "fixed" (meaning that the last event has occurred to establish the fact of the liability). MassMutual's board of directors attempted to fix a liability in Year 1 to pay policyholder dividends by declaring in that year a guaranteed minimum amount of policyholder dividends to be paid to the class of policyholders whose policies remained in effect on their respective anniversary dates in Year 2. Thus, theoretically, if there was only one such policyholder, he or she would be paid the entire guaranteed minimum amount. The government argued that there was no fixed liability at the end of Year 1, because it was unknown as of the close of Year 1 whether any particular policyholder would renew or surrender his or her policy before its anniversary date in Year 2. The U.S. Court of Appeals for the Federal Circuit, however, held that so long as there was at least one member of the class remaining, the guaranteed dividend amount would be paid. The court found that the company had shown that as of the end of Year 1, thousands of policies were paid up with no risk of lapse before the anniversary dates in Year 2.

In addition to a liability having to be "fixed," a liability is deductible only when certain other requirements (termed "economic performance") have been met. In *Massachusetts Mutual*, the court held that the policyholder dividends were "rebates or refunds" to the policyholders that were recurring expenses of the company every year, which meant that the economic performance requirement was met in Year 1, rather than in Year 2 when the dividends were paid.

In reaching this conclusion, the court rejected the government's argument that its position on the rebate question was entitled to deference because it reflected the IRS' interpretation of its own regulation. As an initial matter, the court found that the terms "rebate" and "refund" had already been defined by previous Federal Circuit cases to apply to policyholder dividends like MassMutual's, and that therefore deference to the government's contrary definition of the terms was inappropriate. The court then noted that the government had not argued for deference to its position at trial in the Court of Federal Claims, and it declined to "excuse the government's failure to raise the … deference argument below." Finally, the court held that even if the government had raised the issue, its position would not have been entitled to deference because no evidence indicated that the position reflected considered judgment of the IRS or was anything more than the IRS' litigating position in the case.

Another interesting issue in the case was whether MassMutual's guaranteed minimum dividend declaration was required to have "economic substance" (or a nontax "business purpose"). The Court of Federal Claims had addressed and rejected the government's argument that the board's declaration of a guaranteed amount had no economic substance and was done solely for tax purposes. The lower court had explained that the purpose of the economic substance doctrine is to prevent taxpayers from taking improper deductions, which was not a concern in MassMutual's case, and that the typical economic substance analysis was inapplicable in a case where the dispute is only about the timing of the deduction. On appeal, the government did not challenge that conclusion.

While the court's opinion specifically concerned a mutual life insurance company, it addressed an issue that applies broadly: the criteria for deduction under the accrual method of accounting. Nothing in the court's opinion limits the application of its logic to specific industries or businesses. As such, the reasoning underlying its holding could apply to any accrual method taxpayer that guaranteed a payment to a class of recipients where the economic performance requirement could be met with respect to a portion of that payment being made in the year of the guarantee.