SOCIETY OF ACTUARIES Taxation Section

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POST-*WINDSOR* GUIDANCE ON THE TREATMENT OF SAME-SEX SPOUSES FOR FEDERAL LAW PURPOSES

By Mark E. Griffin

The previous issue of *Taxing Times* included an article on *United States v. Windsor*[1] and its impact on life insurance products. The Supreme Court in that case addressed the constitutionality of the Federal Defense of Marriage Act[2] ("DOMA") in a situation involving a claim for refund of federal estate taxes. The Court ruled that section 3 of DOMA, defining "marriage" and "spouse" as excluding same-sex couples, is unconstitutional. The Court expressly limited its opinion and holding to lawful marriages under state law. The case did not address the constitutionality of section 2 of DOMA, which generally recognizes states' rights to define "marriage" and "spouse," and allows states to refuse to recognize same-sex marriages entered into in other states. Hence, the Court in *Windsor* did not provide for the right to same-sex marriages in states that do not permit it.

As a result of the *Windsor* decision, same-sex couples who are married in jurisdictions that allow such unions are treated as spouses for purposes of federal law, including the Internal Revenue Code (the "Code"). As explained in the earlier article, the *Windsor* decision affects the treatment of same-sex spouses under certain provisions of the Code. These provisions relate to (1) the after-death distribution requirements that apply to non-qualified annuity contracts under section 72(s); (2) individual retirement arrangements ("IRAs") under section 408; (3) the required minimum distribution rules in section 401(a)(9); (4) the eligible rollover distribution rules in section 402(c); and (5) the treatment of family term coverage under a life insurance contract as a qualified additional benefit ("QAB") under section 7702(f)(5).[3]

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FROM THE EDITOR TO OUR READERS

By Brian G. King

As we enter 2014, I would like to welcome the readers to another edition of *Taxing Times*. It is with very mixed emotions that I reclaim my role as editor of *Taxing Times*. As many of you know, *Taxing Times* has suffered significant personal losses in the past two years with the passing of Christine Del Vaglio in August 2012, and Chris DesRochers this past September. Christine, Chris and I have been involved with *Taxing Times* since its inception back in 2005, when we started the journey of creating a newsletter for the Taxation Section. It is hard to imagine continuing on with this journey without my two close friends who've worked by my side for the past decade. Fortunately, I have the support of an amazing infrastructure that has evolved over the years, due in large part to the vision, dedication and hard work of Chris and Christine. A *Taxing Times* "team" has been built to support the development of each issue and has grown from its early days from a party of three to a cast of many, including section council members and friends, an editorial board, the SOA staff and many "friends" at EY. It is this infrastructure that allows for the continued success of *Taxing Times* even in the face of unexpected loss, as we introduce new members to the *Taxing Times* team as current team members rotate off. While the parting of Chris and Christine created a significant loss in so many ways, *Taxing Times* will carry on, thanks in large part to their immeasurable contributions to the development of our *Taxing Times* team.

The first calendar year issue of *Taxing Times* introduces readers to our new Taxation Section leader. This year is no different, as Brenna Gardino begins her campaign as the chair of the Taxation Section. As she discusses in her chairperson's column, one of Brenna's missions for the upcoming year is to attract younger actuaries to join our section and help them grow into the next generation of tax actuaries. *Taxing Times* can help play a role in the process. I understand that *Taxing Times* articles can be an intimidating read for those less knowledgeable on insurance tax matters. As editor, I must confess that certain articles present a challenging read for many of our less seasoned readers and can appreciate those who have commented that *Taxing Times* articles can be "dense" and "in the weeds." Brenna and I have agreed that introducing educational articles that target basic product or company tax concepts would be a welcome addition for our readers, particularly some of our younger Taxation Section members. Starting with the May issue, it is our intent to include one or more articles that target our younger members, providing basic educational content on insurance tax topics. We hope you will find these types of articles a welcome addition to *Taxing Times*.

This issue of *Taxing Times*, although small by historical standards, is again rich in content, including an article on the new Information Data Request (IDR) procedures issued by the Internal Revenue Service (IRS) to help make the process of collecting information from taxpayers more efficient and less time consuming; the latest installment of Peter Winslow's column *Subchapter L: Can You Believe It?* where he discusses the valuation of insurance in force; and the ACLI Update column discussing some of its recent activities. In addition, this issue also provides an update on three recent court decisions that may be of interest to our readers:

In a follow-up to his article in the last issue of *Taxing Times* that dealt with the Supreme Court decision on the Defense of Marriage Act (DOMA) in *United States v. Windsor,* Mark Griffin discusses the recently issued IRS guidance in Revenue Ruling 2013-17 that should help insurers navigate the various tax aspects of the decision reached in *United States v. Windsor.*

Manny Burstein provides readers with an update on the outcome of another recent court decision (*United States v. New York Life Insurance Company*) involving the deductibility of policyholder dividends.

In *Furnish v. Commissioner,* John Adney discusses how a prudent policyholder (who happens to be an actuary) was able win a court decision involving a dispute over the amount of taxable income reported by the insurance company on a life insurance policy that terminated due to a policy over loan.

I hope you enjoy this issue of *Taxing Times*!

Brian G. King, FSA, MAAA, is an executive director, Insurance and Actuarial Advisory Services with Ernst & Young LLP and may be reached at *Brian.King3@ey.com.*

FROM THE CHAIR
THE WALKING COMMERCIAL

By Brenna Gardino

As the current chair of the Taxation Section, I walk in some very large footsteps. I am excited to be in my current position and hope to make a contribution throughout the year. The Taxation Section continues to provide opportunities for me to meet and associate with professionals who are dedicated, knowledgeable and epitomize everything I love about our profession.

I would first like to thank Mary Elizabeth Caramagno, our outgoing chair, for her outstanding leadership, volunteer work, and personally, for getting me involved. I would not be here without you, Mary Elizabeth!

I would also like to welcome our newly elected council members: Larry Hersch, Jeff Stabach and Jacqueline Yang and also offer a thank you to our outgoing council members for their service: Mary Elizabeth Caramagno, Ann Delaney and Carol Meyer.

Our new council members have already stepped up and embraced new roles and this year promises to be an exciting one. Tim Branch will be the new vice chair of the section and Jim Van Etten has agreed to continue in his role as secretary/treasurer. We are blessed to have a great council that is strongly supported by amazing friends of the council.

My mission for the upcoming year is to attract and develop the next generation of tax actuaries. Kristin Norberg of EY will be the chairperson for a sub-committee that we have formed to focus on this mission. The sub-committee recently had its first call and it was inspiring to hear how many ideas everyone had. As a part of these efforts, we plan to:

1. Begin an initiative to reach out to and recruit new members, specifically targeting the younger actuarial members of the SOA
2. Use our flagship product, *Taxing Times,* as a way to provide educational content aimed at further engaging entry-level actuaries
3. Continue to sponsor basic education sessions at SOA meetings.

Additional ideas are also in the works, and I look forward to seeing these rolled out over the next year.

We will need everyone's help to make this initiative a success. Each of us can be a "walking commercial" and can encourage other SOA members to join the Taxation Section. I believe that understanding tax topics and remaining up-to-speed on hot issues is critical to most, if not all, members of the SOA. If you are interested in volunteering or have ideas to share, please contact me.

Brenna Gardino, FSA, MAAA, is assistant vice president and associate actuary, product management at Kansas City Life Insurance Company. She may be reached at *bgardino@kclife.com.*

This discussion supplements the prior article to consider guidance addressing the federal government's response to the *Windsor* decision. In particular, on Aug. 29, 2013, the Internal Revenue Service ("IRS") issued Rev. Rul. 2013-17 and two sets of related Frequently Asked Questions ("FAQs"), addressing various tax aspects of the *Windsor* decision and indicating that additional guidance is forthcoming on certain employee benefit plan issues.[4] In addition, the Department of Labor ("DOL") on Sept. 18, 2013, issued similar guidance in Technical Release 2013-04.[5]

REV. RUL. 2013-17

In Rev. Rul. 2013-17, the IRS held that for *all* federal tax purposes, the terms "spouse," "husband and wife," "husband," and "wife" include an individual married to a person of the same sex if the individuals are lawfully married under state law, and the term "marriage" includes such a marriage between individuals of the same sex.

1. The problem of differing state laws. Because some states (*e.g.*, Massachusetts and New York) recognize same-sex marriages, and other states (*e.g.*, Texas and Virginia) do not, there were questions about whether life insurance companies might need to determine which state's rules govern their contracts for purposes of administering the spousal rules that apply to their contracts. It was unclear how a same-sex couple would be treated for federal law purposes if they were lawfully married in a state that recognizes such marriages and later moved to a state that does not recognize such unions.[6]

The IRS in Rev. Rul. 2013-17 addressed this problem by adopting a so-called "state of celebration" rule recognizing for federal tax purposes a marriage of same-sex individuals that was validly entered into in a state whose laws authorize the marriage of two individuals of the same sex even if the married couple is domiciled in a state that does not recognize the validity of same-sex marriages. The FAQs provide an example involving a defined-benefit plan which states that the plan must treat a participant in a same-sex marriage that was validly performed as married for purposes of applying the qualification requirements that relate to spouses, even if the employer sponsoring the plan operates only in a state that does not recognize same-sex marriage. The revenue ruling clarifies that the state of celebration rule covers a same-sex marriage legally entered into in any of the 50 states, the District of Columbia, a U.S. territory, or a foreign country.

2. How to treat civil union partners and registered domestic partners. As noted above, the Court limited its opinion and decision in *Windsor* to lawful marriages under state law. A number of states extend spousal rights to civil union partners and registered domestic partners. Hence, a question exists whether such partners are treated as spouses under state law, and thus under federal law (at least for tax purposes). One question is the extent to which such couples might be viewed as lawfully married under state law, and thus the extent to which the *Windsor* decision applies to state laws which extend spousal rights to such couples.[7] Rev. Rul. 2013-17 addressed this issue by providing that for federal tax purposes, the terms "spouse," "husband and wife," "husband," "wife," and "marriage" do not cover individuals in registered domestic partnerships, civil unions, or "other similar formal relationships recognized under state law that are not denominated as a marriage under that state's law."[8] It should be noted that this position applies to civil union partners and domestic partners of the opposite sex or the same sex. There remains some uncertainty about whether civil unions and domestic partnerships are viewed as the equivalent of marriage for federal law purposes where spousal rights are extended to individuals in such relationships under state law.[9]

The revenue ruling clarifies that the state of celebration rule covers a same-sex marriage legally entered into in any of the 50 states, the District of Columbia, a U.S. territory, or a foreign country.

CONTINUED ON **PAGE 6**

3. Effective date of Rev. Rul. 2013-17. Rev. Rul. 2013-17 applies prospectively as of Sept. 16, 2013. Affected taxpayers also can rely on the revenue ruling retroactively for open tax years for purposes of filing original returns, amended returns, adjusted returns, or claims for credit or refund for any overpayment of tax resulting from the holdings in the guidance. However, with respect to any employee benefit plan (or arrangement or any benefit provided thereunder), taxpayers generally may rely on the revenue ruling retroactively for open taxable years only for purposes of filing original returns, amended returns, adjusted returns, or claims for credit or refund of an overpayment of tax concerning employment tax and income tax with respect to employer-provided health coverage benefits or fringe benefits that were provided by the employer and are excludable from income under sections 106, 117(d), 119, 129, or 132 based on an individual's marital status. The IRS indicated that it intends to issue further guidance on the retroactive application of *Windsor* to employee benefits and employee benefit plans and arrangements.

In addition, the IRS in Notice 2013-61[10] provided guidance to employers and employees for making claims for refunds or adjustments of overpayments of Federal Insurance Contributions Act ("FICA") taxes and federal income tax withholding with respect to certain benefits provided to, and remuneration paid to, same-sex spouses. The Notice also provides an optional special administrative procedure for employers to correct overpayments of employment taxes for 2013 and earlier years.

DOL TECHNICAL RELEASE 2013-04

The DOL's Technical Release 2013-04 sets forth guidance by the Department's Employee Benefits Security Administration ("EBSA") to plans, plan sponsors, fiduciaries, participants and beneficiaries on the impact of the Supreme Court's decision in *Windsor* on ERISA.[11] In particular, Technical Release 2013-04 addresses the meaning of the terms "spouse" and "marriage" as they appear in the provisions of ERISA and the Code that the DOL interprets (such as the prohibited transaction rules under section 4975). The technical release mentions that the DOL coordinated with the Treasury Department, IRS, and Department of Health and Human Services in developing the guidance. Not surprisingly, the guidance is consistent with the guidance provided by the IRS in Rev. Rul. 2013-17.

In particular the Technical Release provides that:

(1) The terms "spouse" and "marriage" will be read to cover any individuals who are lawfully married under any state law, including individuals married to a person of the same sex who were legally married in a state that recognizes such marriages, but who are domiciled in a state that does not recognize such marriages; and

(2) The terms "spouse" and "marriage" do not cover individuals (of the same sex or opposite sex) in a formal relationship recognized by a state that is not "denominated" a marriage under state law, such as a domestic partnership or a civil union, "regardless of whether the individuals who are in these relationships have the same rights and responsibilities as those individuals who are married under state law."

EBSA indicated that it intends to issue additional guidance in the future addressing specific provisions of ERISA and its regulations.

CONCLUSION

The guidance issued by the IRS and DOL reflects the federal government's efforts on a broader scale to address issues relating to the federal law treatment of same-sex spouses, civil union partners and domestic partners in light of the *Windsor* decision. Additional guidance addressing these issues is expected to be released soon. Although the government's consideration of these issues was interrupted by the recent government shutdown, issuing post-*Windsor* guidance remains a high priority. ◂

ENDNOTES

1 133 S.Ct. 2675 (2013).

2 1. U.S.C. section 7 (2013).

3 Unless otherwise indicated all section references are to the Internal Revenue Code of 1986, as amended.

4 An electronic copy of the press release containing links to Rev. Rul. 2013-17 and the FAQs can be found at http://www.irs.gov/uac/Newsroom/Treasury-and-IRS-Announce-That-All-Legal-Same-Sex-Marriages-Will-Be-Recognized-For-Federal-Tax-Purposes;-Ruling-Provides-Certainty,-Benefits-and-Protections-Under-Federal-Tax-Law-for-Same-Sex-Married-Couples.

5 Mark E. Griffin, *How the Supreme Court Decision on DOMA in U.S. v. Windsor Affects Life Insurance Products*, 9 Taxing Times, Issue No. 3, 18, 18 (2013).

ENDNOTES (CONT.)

6 This problem of differing state laws might be avoided with respect to employer plans that are subject to the Employee Retirement Income Security Act of 1974 ("ERISA"). The provisions of ERISA generally supersede state laws as they apply to employee benefit plans. *See* ERISA section 514, 29 U.S.C. 1144 (2013). Because of this preemption, spousal provisions of an ERISA plan (such as the ERISA rules requiring spousal consent and spousal annuities in certain circumstances) can apply to same-sex spouses who are covered by the plan even if they live in a state that does not recognize same-sex marriages.

7 *See* Letter from Sen. Benjamin Cardin to Jacob J. Lew, Secretary, Dep't of Treasury & Daniel Werfel, Acting Commissioner, IRS (Aug. 14, 2013) ("[I]t is important for the Service to address whether civil unions in states that consider parities to such unions as spouses will be treated as marriages for Federal tax purposes."); *see also Cozen O'Connor, P.C. v. Tobits, et al.*, No. 11-0045 (E.D. Pa. July 29, 2013) (finding that a same-sex couple married in Canada residing in Illinois (which has a civil union law) were considered married for purposes of an ERISA-governed retirement plan).

8 This position is consistent with the position the IRS took in an Aug. 30, 2011 letter to a senior tax advisor at H&R Block. In the letter, the IRS advised that if Illinois treats opposite-sex partners in an Illinois civil union as husband and wife, then they are considered as such for income tax filing purposes.

9 *See, e.g.*, Letter from Jeffrey A. Porter, Chair, Tax Executive Committee, AICPA, to Dianne Grant, Senior Advisor to Chief Compliance Officer, & Richard S. Goldstein, Special Counsel, IRS Office of the Chief Counsel (Oct. 31, 2013) (requesting, in part, that the IRS provide a list of states in which a civil union or registered domestic partnership is considered a marriage for federal tax purposes) (letter available at www.aicpa.org).

10 2013-42 I.R.B. 432.

11 An electronic copy of DOL Technical Release 2013-04 is available at *http://www.dol.gov/ebsa/newsroom/tr13-04.html*.

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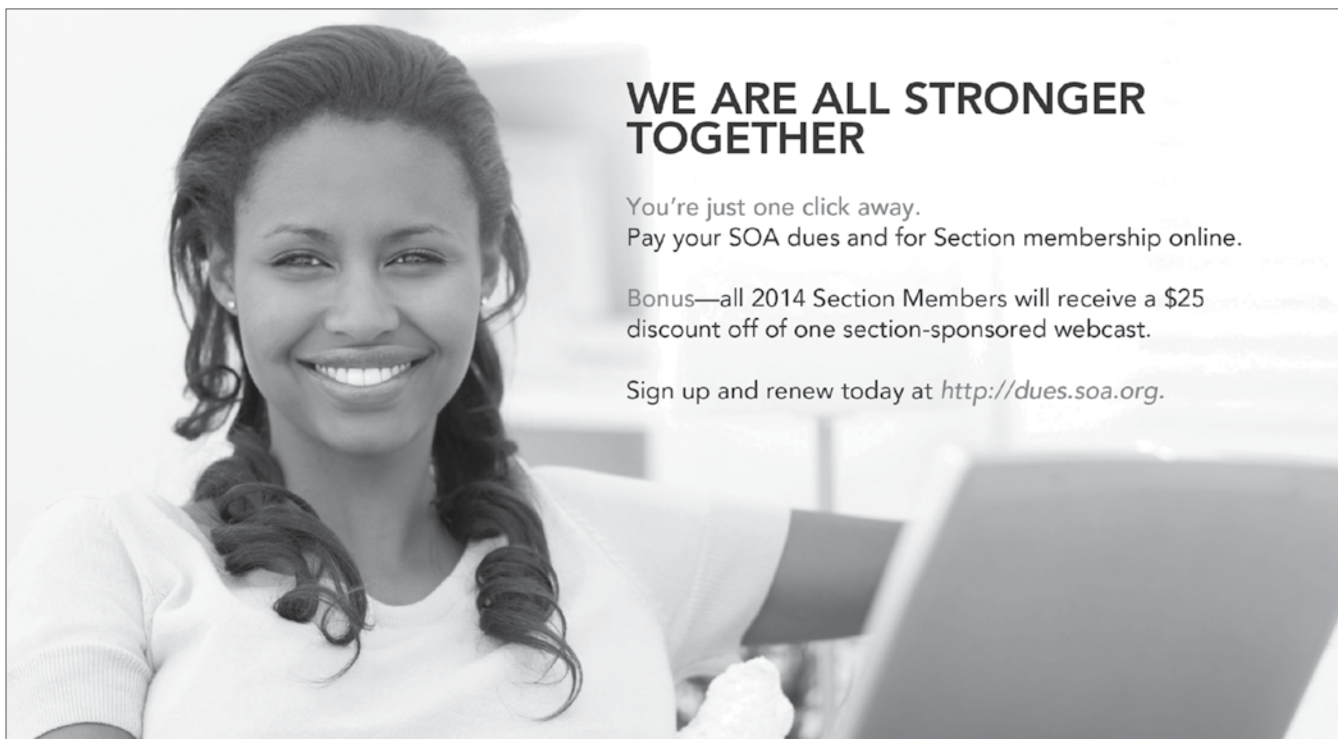

THE SECOND CIRCUIT ADDRESSES WHEN POLICYHOLDER DIVIDENDS ACCRUE IN *NEW YORK LIFE*

By Emanuel Burstein

Emanuel Burstein is the author of the forthcoming third edition of Federal Income Taxation of Insurance Companies and can be reached at *manny@insurancetax.com*.

ACCRUAL OF JANUARY ANNUAL AND TERMINATION DIVIDENDS IN *NEW YORK LIFE*

In *New York Life Ins. Co. v. United States*,[1] the Second Circuit addressed the timing of the deduction of certain policyholder dividends in two factual circumstances. Life insurers are accrual method taxpayers and therefore can deduct their policyholder dividends when they accrue; that is, when they satisfy the all events test and economic performance requirements.[2] A taxpayer satisfies the all events test when it (i) establishes the fact of liability, which effectively was the sole focus of the Second Circuit's opinion (addressed below), and (ii) determines the amount of liability with reasonable accuracy (which was not at issue in the case).

Economic performance generally occurs when the taxpayer makes the underlying payment. The economic performance requirement, however, can be satisfied for a given taxable year if, *inter alia,* the payment is made within the shorter of 8½ months or a "reasonable period" after the close of such year and the "recurring item exception" applies. In addition, the all events test has to be satisfied during the taxable year before the amount is payable and the accrual in the earlier year "results in a more proper match against income than accruing such item in the taxable year in which economic performance occurs."[3] A rebate of qualified items, such as excess premium income, is deemed to satisfy this matching requirement.[4]

> Life insurers are accrual method taxpayers and therefore can deduct their policyholder dividends when they accrue …

In the context of the first factual circumstance (dealing with "Annual Dividends," as described in the Second Circuit decision), New York Life argued that "the last 'event' for purposes of the all-events test occurred when, in the taxable year, the January policyholders paid the final premium sufficient to keep their policies in force through their anniversary dates in January."[5] The Second Circuit concluded that an Annual Dividend for January did not satisfy the all events test because a policy might not be in force on its anniversary date as a result of an earlier event, such as a surrender, that ends the coverage. No liability was fixed before the policyholder dividend was paid. A policyholder could surrender the contract before the anniversary date and there was no obligation to pay the dividend on surrender.[6] As noted below, the Second Circuit reasoned that because the terms of the policies indicated that a policy had to be in force on the policy anniversary date in order to receive an annual dividend, no obligation could arise before that date.

It did not matter whether it was highly probable at the end of a given year that New York Life would pay a significant amount of policyholder dividends to policyholders with January anniversary dates. The court referenced *General Dynamics*[7] in which the Supreme Court stated, "a taxpayer may not deduct a liability that is contingent, [reference omitted], or contested, [reference omitted]. 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."[8]

New York Life also paid "termination dividends" for certain policies that matured, were surrendered or ended because the insured died.[9] The declaration of New York Life's board to pay a policyholder dividend was not enough to constitute a legal obligation to pay the dividend, according to the court. It distinguished its reasoning in *Willoughby Camera Stores, Inc. v. Commissioner* [10] in which it allowed a company to deduct in one year the amount that the board set aside for employee bonuses to be paid in the following year. The company in *Willoughby* had "an 'implied contract' to pay the bonus, because employees were told upon hiring that they would receive the bonus [but the court did not find] an implied contractual obligation binding New York Life to pay a Termination Dividend on surrender."[11]

The court concluded that New York Life "failed to allege that it had a contractual, statutory, or other obligation to pay a Termination Dividend upon surrender, and we find unpersuasive its argument that no such obligation was necessary. Without establishing 'the fact of the liability,' the Company has not met the all-events test for its Minimum Dividend Liability."[12]

GUARANTEED POLICYHOLDER DIVIDENDS IN *MASSMUTUAL*

The Court of Federal Claims addressed the timing of the deduction for certain policyholder dividends by a life insurance company in *MassMutual v. United States.*[13] Unlike the arrangement in New York Life, MassMutual guaranteed by way of board resolution that at least a specified amount of policyholder dividends would be paid to policyholders whose post-1983 participating policies remained in force as of the anniversary date of the policy. In 1995, for example, MassMutual guaranteed that it would pay $185 million in such dividends, which was equal (approximately) to 85 percent of the dividends determined under the dividend scale for applicable policies.[14] The guarantees did not have a meaningful economic impact, however, because it was highly probable that MassMutual would pay at least the guaranteed amount with respect to the applicable policies.

The Court of Federal Claims concluded that MassMutual could accrue the minimum guaranteed policyholder dividend in the taxable year before the payment. The minimum guaranteed dividends satisfied both requirements of the all events test. The minimum guaranteed amount was a fixed liability. It:

> created an unconditional obligation to pay an aggregate group of policyholders the following year. The Dividend Guarantees were not subject to a condition precedent and neither defendant's concerns regarding enforceability or revocability of the Dividend Guarantee Resolutions prevents plaintiff's liability from being fixed in the year in which plaintiff enacted the Dividend Guarantees.[15]

The parties did not contest the second component of the all events test, that the taxpayer must determine the amount of liability with reasonable accuracy.

The guaranteed minimum payment satisfied the economic performance requirement in the taxable year before the payment. The payment qualified as a rebate so that the recurring item exception applied. Although there was no direct authority that policyholder dividends are rebates for purposes of the recurring item exception, the Court of Federal Claims referenced decisions in various other contexts in which the Federal Circuit indicated that policyholder dividends are rebates.[16]

CONCLUSION: WHEN IS AN OBLIGATION TO PAY A POLICYHOLDER DIVIDEND FIXED?

New York Life addressed when an obligation to pay a policyholder dividend is fixed for purposes of the accrual method. The Second Circuit concluded that the declaration of New York Life's board to pay a policyholder dividend was not enough to constitute a legal obligation to pay the dividend. In the case of the January anniversary policies, the Court concluded that the dividend liability could not be accrued before the anniversary date because the policies required that they be in force on that date in order to be eligible for a dividend. The Court ruled that a policyholder could surrender the contract before the anniversary date and there was no obligation to pay the dividend on surrender. New York Life had alleged in its complaint that it was legally obligated to pay these dividend amounts. As to the accrual of the liability to pay a minimum amount to policyholders eligible for termination dividends, the Court reasoned that because the policy forms did not refer to termination dividends, there was no contractual obligation for New York Life to pay them. In its petition for rehearing, New York Life asserted that the court's holding was inconsis-

CONTINUED ON **PAGE 10**

tent with *Hughes Properties*[17] and other cases in which a liability can accrue "even if it could be defeated by a later event."[18] The court denied the petition for a rehearing on Oct. 22, 2013.

The economics of the policyholder dividend arrangements in New York Life and MassMutual were very similar. Although MassMutual included guarantees to pay at least a specified amount of policyholder dividends for applicable policies, the guarantees had no meaningful economic impact. One can argue that the different tax treatment in the respective cases resulted from the application of different standards applied by the Second Circuit than those applied by the Court of Federal Claims. The Court of Federal Claims did not require the obligation to pay policyholder dividends to be legally enforceable in order for the liability to be fixed under the all events test. In the *New York Life* case, on the other hand, the Second Circuit held that a liability that is payable on a future date is not accrued until that date arrives, if the obligee can cause the liability to be extinguished. Thus, a policyholder's keeping a policy in force until the anniversary date was considered a condition precedent. The Court of Federal Claims expressly rejected this approach. Consequently, New York Life might have been able to accrue its policyholder dividends in the taxable year before they were paid if the factors that the Court of Federal Claims applied to determine whether a liability was fixed in *MassMutual* also applied in *New York Life*. ◀

ENDNOTES

1. Doc. No. 11-2394-cv (2nd Cir. Aug. 1, 2013), *aff'g*. 780 F.Supp.2d 324 (SDNY 2012). Internal Revenue Service (IRS) officials also addressed whether certain January Annual and Termination Dividends accrued in the taxable year before payment in TAM 200948042 (Aug. 4, 2009). The taxpayer's name was redacted in the technical advice.
2. Treas. reg. sec. 1.461-1(a)(2)(i).
3. Sec. 461(h)(3)(A).
4. Treas. reg. sec. 1.461-5(b)(5)(ii).
5. Doc. No. 11-2394-cv (2nd Cir. Aug. 1, 2013) at 14.
6. *Id.* at 15. IRS officials indicated in TAM 200948042 that the practice of the taxpayer addressed in the technical advice was to delay the surrender of certain contracts until the policyholder's anniversary date when a policyholder surrendered its policy before such date. The IRS officials concluded that the practice did not fix the taxpayer's obligation, however. TAM 200948042 at 5.
7. 481 US 239 (1987).
8. *Id.* at 243-244.
9. New York Life's complaint does not indicate that New York Life pays a dividend if the policy lapses, according to the court. *Id.* at 22 nt. 14. New York Life filed a petition for rehearing, in part, because it was not allowed to present evidence to the District Court that would have clarified that a lapse results in a surrender and the obligation to pay a termination dividend was not conditional. Petition for rehearing, New York Life (2nd Cir. 11-2394-cv) at 11-12. The Second Circuit denied the petition on Oct. 22, 2013.
10. 125 F.2d 607 (2nd Cir. 1942).
11. Doc. No. 11-2394-cv (2nd Cir. Aug. 1, 2013) at 25-26.
12. *Id.* at 26.
13. 103 Fed. Cl. 111 (2012).
14. *Id.* at 115. The guarantees applied only to participating policies issued after 1983 to avoid the impact of section 808(f), which denies the deduction of policyholder dividends, up to specified limits, for policies issued before 1984. *Id.* at 115-116.
15. *Id.* at 140.
16. *Id.* at 158-159. Federal Circuit decisions are mandatory authority for the Court of Federal Claims so the characterization of an item in a related context by the Federal Circuit has special significance for the Court of Federal Claims.
17. 476 U.S. 593 (1986).
18. Petition for rehearing, New York Life (2nd Cir. 11-2394-cv) at 11.

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LB&I RELEASES GOOD NEWS/BAD NEWS IDR PROCEDURES

By Samuel A. Mitchell

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In recent years, Internal Revenue Service (IRS) management has been taking steps to make the federal income tax examination process more focused and efficient. The Large Business & International Division (LB&I) has shown a willingness to resolve a number of thorny issues on a global basis through the Industry Issue Resolution process with the insurance industry and others.[1] This has greatly reduced the audit burden for both LB&I and large taxpayers, and particularly those in the insurance industry.[2] However, not every issue is subject to global resolution, and the IRS is still conducting robust examinations. As part of the effort to make the examinations more efficient and less time consuming, LB&I management is tightening up the procedures for issuing and enforcing Information Document Requests (IDRs). This effort has involved at least two rounds of mandatory training over the last year for all the Revenue Agents and specialists who examine large taxpayers. It also has resulted in two written directives outlining the procedures. The two directives present what some may consider a good news/bad news scenario for large corporate taxpayers.

THE FIRST DIRECTIVE—REQUIRING EXAMINERS TO EMPLOY ISSUE-FOCUSED IDRS

The good news came on June 18, 2013, when LB&I management released LB&I Directive No. 04-0613-004, which has the potential to narrow the focus of IDRs and result in efficiencies and more collaboration between the IRS and taxpayers during the course of examinations.[3] In the Directive, LB&I Management refers to mandatory IDR training that all LB&I revenue agents and specialists had recently completed at the time the Directive was released. The Directive reiterates three main points of the training and documents what is expected of the agents and specialists and of taxpayers going through the IDR process. The three main points of the training are that (1) agents and specialists must make their IDRs "issue-focused," meaning they must clearly state in the IDR what issue led to the IDR, (2) they must discuss each IDR with the taxpayer ahead of time, and (3) the agents and specialists and taxpayers must agree to reasonable deadlines for responses to the IDRs. The Directive applies to all IDRs issued after June 30, 2013, and overrides any existing Memoranda of Understanding between the company's tax department and the IRS examination team that are inconsistent with the required procedures.

THE FOLLOW-UP ENFORCEMENT DIRECTIVE—REQUIRING A RIGID, THREE-STEP ENFORCEMENT PROCEDURE

The potentially bad news came on Nov. 4, 2013, with the release of a follow-up Enforcement Directive (LB&I-04-1113-009) from LB&I management that refers to a second round of training and reiterates and expands on the earlier directive's IDR issuance requirements, but also introduces a rigid, three-step procedure for IDR enforcement.[4] Regarding issuance, the Enforcement Directive has an attachment (Attachment 1) outlining 13 requirements IRS agents and specialists must follow that should be very helpful in making the IDR process more efficient. The 13 requirements more fully develop the three main points from the June directive discussed above. In general, the requirements are designed to (1) inform the taxpayer of the issue the examiners are exploring, (2) ensure that the IDRs are concise, numbered and limited to one issue each, (3) allow the taxpayer to see a draft and have the opportunity to discuss in advance both the content and timing of the response, and (4) allow the taxpayer to close the door on the response by requiring the examiners to commit on the face of the IDR to a date on which they will inform the taxpayer whether the response satisfies the request in the IDR.

The 13 requirements in Attachment 1 to the Enforcement Directive are all very helpful and should result in efficiencies. The potentially bad news for taxpayers is contained in an inflexible, three-step enforcement process described in Attachment 2 to the Directive that applies when a taxpayer does not comply with the deadline for an IDR established during the issuance process. The Enforcement Directive states that the three-step enforcement "process is mandatory and has no exceptions." The mandatory enforcement process involves three "graduated" steps to deal with non-compliance. The three steps are (1) the issuance of a Delinquency Notice, followed by (2) the issuance of a Pre-Summons Letter, and, finally (3) the issuance of a Summons.

The Delinquency Notice step requires the examination team to discuss the IDR with the taxpayer, identify what is missing, make sure the taxpayer understands the next steps of the enforcement process if the taxpayer does not timely comply, and discuss the Delinquency Notice in an attempt to convince

the taxpayer to comply. The procedures require the "appropriate personnel" from the taxpayer and the IRS to take part in the discussion. The examination team is required to issue the Delinquency Notice (IRS Form Letter 5077) signed by the Team Manager no later than 10 calendar days after the original IDR due date and "should" set a deadline for compliance that generally is no more than 15 calendar days from the date of the Delinquency Notice. The examiner must have the approval of a Territory Manager if the due date is more than 15 days from the date of the Delinquency Notice. Furthermore, the examiner must provide a copy of the IDR and the Delinquency Notice to the assigned IRS Counsel.

If the taxpayer does not comply by the deadline set forth in the Delinquency Notice, the next step is a Pre-Summons Letter. This step elevates the discussion to the IRS Territory Manager and Counsel levels and to a higher level within the taxpayer's management structure. The examination team is required to discuss the non-compliance with respective Territory Managers and Counsel. Following this internal discussion, the Territory Manager must discuss the non-compliance with the taxpayer and make sure the taxpayer understands the next steps in the enforcement process. The Territory Manager then issues a Pre-Summons Letter (IRS Form Letter 5078). The Territory Manager is required to issue the letter "as quickly as possible" but no later than 14 days after the Delinquency Notice due date. The Territory Manager is required to sign the letter and address it to the taxpayer management official at a level equivalent to a Territory Manager and specifies that the management level should be above that of the level of the Delinquency Notice recipient. The letter generally has a deadline that is 10 calendar days from the date of the Pre-Summons letter. If the deadline is more than 10 days from the date of the Pre-Summons letter, a Director of Field Operations (DFO) must approve the extended response period. Furthermore, the DFO must be made aware of the Pre-Summons Letter prior to issuance.

The third "graduated" step in the enforcement process is a Summons. Prior to starting the Summons process, the team must discuss the matter with the Team Manager, Specialist Manager, respective Territory Managers and Counsel and coordinate with Counsel. The Summons procedure is described in the Internal Revenue Manual § 25.5 and is authorized under I.R.C. § 7602 for income tax matters. A Summons is not self-executing. However, the consequences for ignoring a summons can be severe. A taxpayer can be held in contempt or charged with a crime for failing to comply.[5] To enforce the Summons, the IRS must refer the matter to the Department of Justice (DOJ) to file a Petition to Enforce in a local Federal District Court.[6] In *United States v. Powell*, the Supreme Court held that the administrative standard of relevance is very low—the DOJ must establish in its Petition to Enforce that (1) the IRS examination has a legitimate purpose, (2) the summons seeks information that may be relevant to the legitimate purpose, (3) the IRS does not already possess the information, and (4) the IRS has followed all required administrative steps.[7] These four requirements are very easy for the DOJ to establish in the Federal District Court. Typically, the DOJ procures from the IRS examining agent and files what is known as a *Powell* declaration describing the examination and explaining the four requirements. Taxpayers rarely prevail in challenging summonses, and practically speaking the only effective defenses are legal privileges or the attorney work product doctrine.[8]

A Summons is not self-executing. However, the consequences for ignoring a summons can be severe.

STEPS FOR TAXPAYERS TO TAKE NOW

The Enforcement Directive took effect on Jan. 2, 2014, and examiners were not supposed to issue Delinquency Notices until Feb. 3, 2014. It remains to be seen how the IRS will apply the new procedures and whether the procedures will result in a souring of the good working relationships taxpayers and examiners have established in large case examinations. That

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certainly is not the intent of the Enforcement Directive, and the procedures for working with agents and specialists and elevating disputes to higher IRS management levels should lessen the potential for bad outcomes. Moreover, it seems unlikely that very many cases will result in the need for the IRS to go to the third step involving a Summons. Summons proceedings, and particularly summons enforcement proceedings, can be very expensive and time consuming for both sides. Taxpayers should focus on the good news and view the Directives as an opportunity to engage with the examination team and negotiate procedures and deadlines that will limit the scope of IDRs and make the process ultimately less painful.

This process of engaging the examination team must start early, at the opening conference. It seems there are at least four important things to discuss and lay the groundwork for during the opening conference and to reiterate throughout the course of the examination. First, it must be made clear to the examiners that the taxpayer intends to hold them to strict compliance with all the LB&I requirements for issuing an IDR. Second, if the examiners end up issuing IDRs that are difficult to answer in a timely fashion because they are unclear, onerous, etc., or the proposed response time is too short, the taxpayer should not hesitate to elevate the issue to a higher IRS management level before the IDR is issued. The taxpayer should establish a clear understanding of what the IDR appeal process within the IRS will be and obtain a commitment that the appeal process will be followed by the examination team before a draft IDR is issued in final form. Sometimes problems can arise in coordinating with specialists (e.g., IRS Financial Products Specialists and Actuaries) who may reside in a different city and report to different managers. Taxpayers should discuss with the examination team the involvement of specialists and clearly establish the identity of the contact manager if there is a problem with a specialist's IDR.

Third, the taxpayer should try to negotiate a process in which an IDR that is issued, and turns out to be difficult to respond to in the time originally agreed upon, can be withdrawn and reissued. Although the Exam IDR enforcement process is mandatory, the Enforcement Directive does not seem to preclude withdrawal of a difficult-to-answer IDR and issuance of a new, revised IDR. Fourth, the taxpayer should assert control over the designation of the taxpayer personnel to be involved in the enforcement process and make it clear during the opening conference to whom IDR enforcement correspondence should (and should not) be sent.

On balance, the Enforcement Directive should be viewed by compliant taxpayers as a net benefit. If a taxpayer handles the examination properly, the new procedures should deter the issuance of IDRs that are unreasonable either in terms of the required information and documents or the deadlines for compliance. However, the procedures may result in some uncomfortable negotiations with examination teams and some very tight, inflexible deadlines. Company actuaries who have to provide the information and answers to the IRS' IDR queries should bear this in mind when the corporate tax department comes calling. ◀

ENDNOTES

1 *See* Rev. Proc. 2003-36, 2003-1 C.B. 859 (Apr. 18, 2003).

2 *See* I.R.C. § 166: LB&I Directive Related to Partial Worthlessness Deduction for Eligible Securities Reported by Insurance Companies, LB&I-4-0712-009 (July 30, 2012). For a summary of issue resolutions in other industries, see the IRS website at http://www.irs.gov/Businesses/IIR-Guidance-Issued.

3 Large Business & International Directive on Information Document Requests (IDRs), LB&I-04-0613-004 (June 18, 2013).

4 Large Business & International Directive on Information Document Requests Enforcement Process, LB&I-04-1113-009 (Nov. 4, 2013).

5 *See* I.R.C. § 7604(b) (contempt) and I.R.C. § 7210 (criminal sanctions for failure to obey).

6 *See* I.R.C. § 7604(b).

7 379 U.S. 48, 57-58 (1964).

8 The IRS recognizes in its Internal Revenue Manual (I.R.M.) that the attorney-client and tax-practitioner privileges apply and that it cannot obtain covered materials with a Summons, but the taxpayer must be prepared to prove that the privileges apply and disputes frequently arise over whether particular documents, such as bills from attorneys, are subject to attorney-client privilege. *See* I.R.M. 25.5.5.4.3. Furthermore, the IRS has special procedures in the I.R.M. that circumscribe its ability to seek tax accrual workpapers (over which taxpayers typically assert the work-product doctrine). *See generally* I.R.M. 4.10.20. The Enforcement Directive does not provide any guidance on how the new mandatory enforcement procedures interrelate with these other I.R.M. provisions and no other guidance has been released as of the time this article was submitted for publication.

HIGHLIGHTS FROM TAXATION SECTION SESSIONS AT THE SOA FALL MEETINGS

By Brian G. King

The Taxation Section was active during the 2013 fall seminar season, sponsoring a number of sessions at the Valuation Actuary Symposium in Indianapolis on Sept. 23–24 and the SOA's Annual Meeting in San Diego, Calif. on Oct. 20–23. A number of topics covered in these sessions have been (or will be) the subject of *Taxing Times* articles, and provided our readers with excellent opportunities to network and learn from leading industry experts. Borrowing from the English proverb "many hands make light work," I would like to thank John Adney, Barbara Gold and Kristin Norberg for taking the time to provide summaries of sessions they presented at these meetings.

Taxation Section Sessions at the Valuation Actuary Symposium

The Taxation Section sponsored several sessions at the Valuation Actuary Symposium. Two of the sessions, 27 WS (Federal Income Tax Topics) and 45 PD (Taxation Section Breakfast: Washington Legislative Update), were organized by Chris DesRochers, who was also to be the moderator. With Chris' untimely passing, several members of the Taxation Section stepped forward to continue the sessions, as perhaps a way to honor Chris' memory. At the beginning of both sessions, as in the luncheon address by the then SOA president Tonya Manning, Chris was remembered as a fine individual and a tireless worker for the benefit of the actuarial profession.

27 WS—FEDERAL INCOME TAX TOPICS

John Adney, Davis & Harman LLP, Moderator
Vincent Zink, Internal Revenue Service
Barbara Gold, Prudential Insurance Company of America

This workshop session focused on selected federal corporate income tax topics of interest to life insurance companies. The discussion began with a review of valuation interest rates and their overall downward trend in recent years. Considerable time was next spent on the insurance company tax items in the Treasury-IRS Priority Guidance Plan, beginning with an extended discussion of the mortality table item on the Plan ("Guidance to clarify which table to use for section 807(d)(2) purposes where there is more than 1 applicable table in the 2001 CSO mortality table"). This item was placed in the Plan at the request of Internal Revenue Service (IRS) field auditors, who were faced with interpreting the word "generally" in IRC section 807(d)(5)(E). The remaining Plan items discussed were IRS Notice 2013-19, guidance on the application of the IRC section 812 proration rules for the separate account dividends received deduction, and guidance on whether the CTE Amount under Actuarial Guideline 43 is included in the IRC section 807(d)(1) "statutory cap." Notice 2013-19 concluded that deficiency reserves were includible in the statutory cap, generating debate over whether the import of the Notice was limited, reaching its conclusion based on legislative history directed at deficiency reserves, or was broader and potentially a prelude to the inclusion of the CTE Amount in the cap. With regard to the other two Plan items, it was noted that guidance on the proration issue was carried over from prior years but has since become an Administration proposal for legislative change, while the AG 43 guidance was actively being worked on at the IRS National Office and the Treasury Department. The session concluded with a discussion of Life PBR and how the AG 43 guidance, both as rendered in Notice 2010-29 and as will be forthcoming on the CTE Amount, ultimately may affect the tax treatment of the net premium floor as well as the deterministic and stochastic reserves.

45 PD—TAXATION SECTION BREAKFAST: WASHINGTON LEGISLATIVE UPDATE

John Adney, Davis & Harman LLP
Vincent Zink, Internal Revenue Service

At this breakfast session, the topics discussed ranged from the administration's current legislative proposals affecting life insurance companies and products to prospects for fundamental tax reform, along the way touching on regulatory issues as well. The four legislative proposals by the administration—revising the proration rules to restrict the separate account dividends received deduction (discussed in Session 27 WS), eliminating the IRC section 264(f)(4)(A) "safe harbor" for COLI, requiring reporting on so-called private separate accounts, and imposing reporting requirements attendant to

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sales of life insurance policies—have been outstanding for a number of years, with no congressional action forthcoming. It appears that this will continue to be the case, particularly in view of the partisan divide in Congress on tax issues generally. From a regulatory standpoint, the treatment of reserves under PBR continues to attract attention and is the subject of promised guidance, as also discussed in Session 27 WS, and the application of the hedging rules under the IRC section 446 regulations to derivative instruments used in connection with variable contract guarantees is currently the focus of an IRS Industry Issue Resolution program initiative. As for potential future legislative action, there is a continuing proposal to eliminate the restrictions on life-nonlife consolidation, which were prompted by the 1959 Act's three-phase approach repealed in 1984, as well as a new proposal to provide life insurers with ordinary rather than capital treatment of assets backing reserves, to align the companies' treatment more closely to that of banks. The session ended with a review of a Senate Finance Committee options paper that called for consideration of changes in the reserve, proration and DAC tax rules, among others, and with observations on the prospects for tax reform. In view of the partisan rancor in Washington, those prospects appear dim, although the leadership of the tax-writing committees in both houses of Congress promised progress on tax reform and possibly a mark-up of tax legislation by the end of 2013.

37 TS—UPDATE ON STATUTORY DEFERRED TAX ASSETS

Barbara R. Gold, FSA, MAAA, Prudential
Martin P. Chotiner, CPA, CLU, ChFC, Prudential

In this session, Barbara and Marty covered a number of topics related to statutory deferred taxes. They first discussed the basics of deferred taxes and that deferred taxes arise because taxable income and statutory income are calculated in accordance with different rules. These different rules give rise to both permanent and temporary differences in income; such temporary differences are the source of deferred taxes.

They then discussed the common temporary differences for insurance companies. Among the points they made was that actuaries should be interested in deferred taxes since the major sources of temporary differences are actuarial items, such as reserves and policyholder dividends.

The discussion then focused on which of these temporary differences constitute a deferred tax asset (DTA) and which constitute a deferred tax liability (DTL). Since DTAs represent taxes paid to the government earlier than had the calculation been based on statutory results, it was readily agreed that DTAs were "bad guys." Likewise, since DTLs represent taxes paid to the government later than had the calculation been based on statutory results, it was readily agreed that DTLs were "good guys."

However, once a DTA exists, the question is how much of that DTA should appear on the statutory balance sheet. Marty then discussed the current statutory rules for determining how much of the DTA can be admitted. These rules appear in SSAP 101, which was adopted for 2012 and later reporting.

Barbara then discussed the RBC charge applied to the admitted DTA. She reviewed the American Academy of Actuaries' conclusions on the appropriate RBC charge and then reviewed the current National Association of Insurance Commissioners (NAIC) rules on determining the RBC charge arising from the admitted DTA.

Taxation Section Sessions at the Annual Meeting

The Taxation Section sponsored three sessions at the SOA's Annual Meeting this past October in San Diego. As has been the norm for the past several years, the section sponsored two update sessions (24 PD—Company Tax Hot Topics and 59 PD—Regulatory and Product Tax Update) focusing on recent developments affecting the taxation of life insurance companies and the products they sell. In addition, the section also sponsored a teaching session (115 TS—Taxation Rules for Hedging) for those interested in learning about the tax rules applicable to hedging transactions, which has become an important issue in recent years for life insurance companies issuing variable annuities.

9—TAXATION SECTION HOT BREAKFAST

Mary Elizabeth Caramagno, FSA, MAAA, Prudential Insurance Company
Mark S. Smith, PricewaterhouseCoopers, LLP

In addition to the warm weather, San Diego provided another important benefit to East Coast members of the Taxation Section who were willing to get an early start to their 2013 Annual Meeting experience by attending the Taxation Section breakfast … a few hours of extra sleep! At the breakfast, outgoing section chair, Mary Elizabeth Caramagno, provided her parting comments to those in attendance and welcomed in the 2014 Taxation Section chairperson Brenna Gardino. Mary Elizabeth noted a few of the section accomplishments

from 2013 before introducing Mark S. Smith. Mark provided a Washington update, sharing his thoughts on the outlook for broad-based corporate tax reform, particularly as it might impact the insurance industry.

24 PD—COMPANY TAX HOT TOPICS

Kristin Norberg, ASA, MAAA, EY
Jean Baxley, KPMG
Mark S. Smith, PricewaterhouseCoopers, LLP

This Company Tax Hot Topics session was moderated by section council member Kristin Norberg and included presentations from Jean Baxley and Mark S. Smith. In the first half of the session, Mark discussed a number of different topics related to the calculation of tax reserves for both life and annuity products, including:

- A discussion of Notice 2013-19 confirming the long-standing view that deficiency reserves are included in the statutory cap when determining tax reserves
- An update on several of the unresolved issues related to the determination of tax reserves under AG 43
- The possibility that the IRS is considering issuing guidance on AG 39
- An update on the status of Life principles-based reserves ("PBR"), including areas where IRS guidance would be welcome to reduce some of the uncertainty around the calculation of tax reserves once Life PBR becomes the new statutory reserving standard.

Jean carried the second half of the session, providing updates on other recent company tax developments, including:

- The recent decision in New York Life Ins. Co. v. United States where the Second Circuit addressed the timing of the deduction of certain policyholder dividends payable to policyholders
- Provisions in the Affordable Care Act affecting life insurers
- Tax-related items on the IRS' Priority Guidance plan for 2013–2014
- Her perspective on the prospects for corporate tax reform generally and the items that could potentially be on the table for life insurers.

59 PD—REGULATORY AND PRODUCT TAX UPDATE

Brian King, FSA, MAAA, EY
Kristin Norberg, ASA, MAAA, EY
Craig Springfield, JD, Davis & Harman LLP
Sim Segal, FSA, CERA, SimErgy Consulting LLC

Like the Company Tax Hot Topics session, the Regulatory and Product Tax Update session addressed a number of current product-related topics. The session was moderated by Brian King. Craig Springfield opened up the session with a discussion on the definition of cash surrender value under IRC section 7702. Guidance on the definition of cash surrender value under section 7702 has been on the IRS Priority Guidance Plan for a few years now, so companies should be paying attention to the issue. Craig provided some cautionary advice to product developers, noting that certain product features such as a return of premium may provide enhanced cash surrender value that could affect qualification under section 7702. In addition, Craig also discussed:

- Issues associated with secondary cash surrender value guarantees under sections 7702 and 7702A
- PLR 201230009 dealing with the treatment of a reduction in death benefit under section 7702 that was not pursuant to a contractual right in the contract
- Accounting for accelerated death benefits under sections 7702 and 7702A
- The aftermath of same-sex marriage decisions on insurance product taxation in the wake of the decision in *Windsor v. United States,* where the Supreme Court ruled that section 3 of DOMA, defining "marriage" and "spouse" as excluding same-sex couples, is unconstitutional.

Following Craig, Kristin Norberg provided an AG 38 update. She touched on the tension that exists between the industry and regulators, and the game of "cat and mouse" that has resulted in numerous updates to the reserving standards under AG 38 for universal life insurance products with secondary guarantees. Her discussion focused largely on the methodology in Section 8E, which was adopted in September 2012 and generally is effective for contracts issued after Dec. 31, 2012 (readers are referred to Kristin's article in the February 2013 issue of *Taxing Times*, *AG38, ULSG and the Spirit of XXX*). She also described Interpretations released by the NAIC Emerging Actuarial Issues (E) Working Group addressing certain questions related to implementation of the 2012 revisions.

The session concluded with a discussion on ORSA (Own Risk and Solvency Assessment), where Sim Segal provided an overview of ORSA, and how ORSA will impact insurance companies' ERM programs, concluding with his thoughts on how ORSA might impact product designs, product pricing, reinsurance decisions and how these decisions will create downstream implica-

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tions on the type and amount of risks companies may be willing to undertake with the products they offer.

115 TS—TAXATION RULES FOR HEDGING

Kristin Schaefer, FSA, MAAA, Transamerica Life Insurance Company
Peter Winslow, Scribner, Hall & Thompson LLP
Craig Pichette, KPMG

In addition to the two update sessions, the Taxation Section also sponsored an in-depth session on one particular company tax issue that can have a major financial impact on life insurance companies: Taxation Rules for Hedging. The session was moderated by Kristin Schaefer and presented by Peter Winslow and Craig Pichette, using materials that Chris DesRochers and Peter had prepared together. This session included both a general discussion of tax rules relating to hedges and also an update on the ongoing Industry Issue Resolution initiative on hedging for variable annuities.

Peter and Craig started the teaching session with a discussion of the benefits of qualifying as a hedge under tax law, along with the criteria required to meet that definition. A key lesson for those familiar with hedge rules under statutory and U.S. GAAP accounting bases was that tax hedges are defined in terms of the specific risks being hedged, rather than by evaluating the effectiveness of the hedge. Tax hedge accounting is applicable only to a hedging transaction that manages risk of price changes or currency fluctuations with respect to ordinary property, or of interest rate or price changes or currency fluctuations with respect to ordinary obligations. Timely identification and documentation of the tax hedge are critical. Next, the presenters turned to the hedging of guaranteed death and living benefits on variable annuities ("VAs"). The IRS and industry representatives have been working diligently over the last three years to address these types of hedges and move toward greater certainty in their tax treatment. VA guarantees raise special questions, including:

- How do we reflect aggregate and dynamic aspects of the hedge program?
- The hedge risk is the contractholder's embedded option—an asymmetric risk—how does this impact matching?
- Hedge gain—should any gain be recognized when there is likely to be economic loss?
- Hedge loss—how is the anticipated periodic cost of the hedge taken into account?

Final guidance for VA hedging remains on the Priority Guidance Plan for 2013–2014, and Peter and Craig emphasized the positive nature of the Industry Issue Resolution process, with an open exchange of ideas and concerns between the IRS and the industry. The presenters concluded with a brief description of the Discussion Draft on Financial Instruments released in January 2013 by House Ways and Means Committee Chairman David Camp.

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ACLI UPDATE

By Pete Bautz, Mandana Parsazad, and Walter Welsh

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NOTICE 2013-35 AND CONCLUSIVE PRESUMPTION OF WORTHLESSNESS

In Notice 2013-35 (May 20, 2013), the Internal Revenue Service (IRS) requested public comments by Oct. 8 on section 1.166-2(d)(1) and (3) of the Treasury Regulations, the "conclusive presumption" regulations. In particular, the Notice asked whether (1) the changes that have occurred in bank regulatory standards and processes since adoption of the conclusive presumption regulations require amendment of those regulations; and (2) the application of these regulations continues to be consistent with the principles of section 166 of the Code. The IRS also sought comments on the types of entities that are permitted, or should be permitted, to apply a conclusive presumption of worthlessness. According to the IRS, comments received would determine whether the existing conclusive presumption regulations should be revised, and the content of any such revisions.

The insurance industry is very interested in the Notice and the conclusive presumption regulations. Please recall that on July 30, 2012, the IRS released Industry Director's Directive (IDD) LB&I-04-0712-009. The IDD instructed examiners not to challenge an insurance company's partial worthlessness deduction under section 166(a)(2) for eligible securities as long as the company complied with requirements outlined in the IDD. A question existed as to whether (and if so, how) the Notice or possible revisions to the section 166 regulations pursuant to the Notice might impact the IDD and/or future insurance company partial worthlessness deductions.

The IRS also sought comments on the types of entities that are permitted, or should be permitted, to apply a conclusive presumption of worthlessness.

On Oct. 8, the American Council of Life Insurers (ACLI) sent a comment letter to the IRS in response to Notice 2013-35. ACLI's comments highlight its strong belief that the ongoing availability of a conclusive presumption of worthlessness under the Code section 166 for financially regulated companies, such as insurance companies, continues to be appropriate. The letter also recommends specific and comprehensive changes to the conclusive presumption of worthlessness in the existing Treasury Regulations to better achieve key policy goals, like simplicity, transparency, administrability, auditability and a clearer reflection of income. In particular, the ACLI letter calls for the existing regulations to be revised based on the approach of the July 2012 IDD for insurance companies. The ACLI letter is supportive of, and emphasizes key points expressed in, an Oct. 8 comment letter on Notice 2013-35 submitted by Scribner, Hall & Thompson LLP (Scribner) and PricewaterhouseCoopers LLP (PWC). The Scribner/PWC letter was submitted on behalf of a group of insurance companies and insurance trade associations, including ACLI.

The ACLI looks forward to a continuing dialogue with the IRS on Notice 2013-35 and the ACLI and Scribner/PWC comment letters.

NEW IDENTIFIED MIXED STRADDLE REGULATIONS

On Aug. 2, 2013, the IRS and Treasury released proposed (REG-112815-12) and temporary (T.D. 9627) regulations that changed how unrealized gain or loss on a position in a section 1092(b)(2) identified mixed straddle (IMS) transaction must be treated. The prior rules had required unrealized gain or loss on a position in a section 1092(b)(2) IMS transaction to be recognized on the day before the transaction was established. The new rules raised several concerns because:

- They were issued without warning and generally were effective immediately (would apply to all section 1092(b)(2) IMS transactions established after Aug. 1, 2013);
- Despite the broad regulatory authority Treasury has been granted to write mixed straddle regulations, they were contrary to the legislative history of section 1092 which indicates that Congress intended for built-in gain or loss to be recognized at the time the mixed straddle was created; and
- They were inconsistent with the treatment of straddles in the Camp Financial Product Discussion Draft and President Obama's FY 2014 budget proposal. Specifically, under those proposals, a financial instrument that is not otherwise

marked to market but that is part of (or becomes part of) a straddle including a derivative contract would be marked to market, with preexisting gain recognized at that time, while loss would be deferred until the financial instrument was otherwise disposed of.

ACLI staff and several ACLI members were part of a group that met with IRS and Treasury in late summer to express concerns about the new regulations. As a follow-up to those meetings, ACLI and PWC filed comment letters in mid-September asking that, at a minimum, IRS and Treasury change the effective date of the regulations to apply only after the rules were finalized. This would provide taxpayers with notice and the opportunity to comment before the new rules became effective.

On Oct. 25, the IRS issued amendments to the temporary and proposed IMS regulations. The amendments deferred the effective date of the Aug. 2 regulations until after the regulations were made final, which the IRS stated would be no later than the end of the current IRS Priority Guidance Plan year on June 30, 2014. The IRS also stated that as part of that process, it would consider all comments received. Finally, the IRS noted that any requests to speak at a Dec. 4, 2013 public hearing on these rules had to be received by Oct. 31, 2013. On Oct. 31, ACLI and PWC separately notified the IRS of their intention to participate in the Dec. 4 public hearing. ACLI expects to use its time at the public hearing to address the appropriateness of IMS transactions and the importance of these transactions to life insurance companies.

ACLI LETTER TO IRS REQUESTING DOMA GUIDANCE

As noted in the article in this issue titled "Post-*Windsor* Guidance on the Treatment of Same-Sex Spouses for Federal Law Purposes," the U.S. Supreme Court, in a decision issued this summer, held Section 3 of the Defense of Marriage Act (DOMA) unconstitutional. Prior to the decision, same-sex spouses were not recognized for federal tax purposes because Section 3 of DOMA defined "spouse" as a partner of the opposite sex. The *United States v. Windsor* decision raised a number of questions for life insurers in the administration of life insurance and annuity contracts and retirement plans. Some of the basic issues, such as whether the state of marital celebration or state of marital domicile determine if a same-sex couple is regarded as being legally married, were subsequently addressed by Revenue Rule 2013-17.

In October, ACLI submitted a letter to Treasury and the IRS in which we identified a list of issues concerning the prospective application of the *Windsor* decision and requested IRS guidance on those issues with respect to life insurance and annuity contracts and retirement plans. Specifically, the industry requested that annuity payments in pay status continue to be covered by rules that existed prior to Sept. 16, 2013, the effective date established in Rev. Rul. 2013-17. The industry also sought future guidance providing that retirement plans not be disqualified, and plan sponsors and plan providers not be penalized, for pre-*Windsor* actions taken in compliance with DOMA, and for post-*Windsor* actions taken in good faith compliance with both *Windsor* and IRS guidance.

The issues discussed in the letter were not intended to be an exhaustive list; the ACLI continues to study how the *Windsor* decision impacts retirement plans and life insurance and annuity contracts and will continue its dialogue with Treasury, IRS and the Department of Labor to find solutions to any additional issues. The ACLI's state government relations team also has engaged the state departments of insurance in states where same-sex marriage is legal to assist member companies in updating contracts to reflect the *Windsor* decision.

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T³: *TAXING TIMES* TIDBITS

THE ACTUARY'S REVENGE: WINNING A POLICY LOAN CASE BY SHIFTING THE BURDEN OF PRODUCTION IN *FURNISH V. COMMISSIONER*

By John T. Adney

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Your mother told you that you should always do your homework. In a case decided by the U.S. Tax Court last fall—the latest in an extended series of cases litigating the tax bill that comes due when a life insurance policy collapses under the weight of heavy borrowing[1]—one party listened to that advice, while the other did not. The diligent party won.

In *Furnish v. Commissioner,* T.C. Summary Opinion 2013-81 (filed Oct. 23, 2013), the Tax Court held in favor of Jeffrey J. Furnish, an actuary who disputed the accuracy of a Form 1099-R sent to him and the Internal Revenue Service (IRS) by a life insurance company. According to the insurer, the 1099-R, showing a gross distribution of $74,414.14 and taxable income of $49,255.24 due to the distribution, was generated as the result of the termination in 2009 of two life insurance policies purchased in the 1970s. As recorded in the opinion of the Tax Court's Special Trial Judge, Daniel Guy, the distribution arose because Mr. Furnish borrowed against his policies to pay the premiums (apart from ones in the policies' early durations). By 2009, the insurer calculated that the total of the policy loans equaled the total of the policies' cash values, and so it notified Mr. Furnish that his policies would lapse unless he paid additional premiums without borrowing, which he opted not to do. Then came the formal lapse notice, followed by the fateful Form 1099-R.

Mr. Furnish did not believe the life insurance company's calculations to be correct, and he disputed both the insurer's conclusion that the policies lapsed in 2009 and the specific amounts on the 1099-R, asserting that he should not be taxed on a "phantom" distribution. To this end, being a diligent fellow, he pursued a variety of avenues in search of the truth. According to the chronology in Judge Guy's opinion:

- Mr. Furnish filed two tax returns for 2009 in August 2010, one without including the so-called phantom distribution—denominated the "A" return—and the other including the deemed distribution in income—the "B" return. Not surprisingly, the IRS accepted the B return and assessed the tax reported on it.

- Accompanying the filing of his two 2009 returns was a written statement by Mr. Furnish describing the events leading up to the lapse of the policies and the issuance of the 1099-R. The statement, said the Tax Court's opinion, included "his claim that it would be unfair to impose tax on what he considered an artificial distribution."

- In October 2010, Mr. Furnish asked the insurer for a statement confirming that he received no cash when the policies terminated. The insurer responded the following month with an explanation of how the taxable income shown on the 1099-R came about, setting forth the premiums and dividends on the policies (and hence their cost basis) and the loan amounts, and describing the policies' terms and the tax law's rules in a user-friendly way: "When a policy lapses to Extended Term, cash value is released from the policy to pay off the loan. To the extent that loans paid off exceed the cost of insurance [i.e., meaning the section 72(e)(6) investment in the contract], a taxable event takes place" which the insurer is required to report.[2]

- Not satisfied, Mr. Furnish promptly requested a clarification from the insurer. The insurer's response, according to the court, repeated its earlier statement and then added—significantly, as it turned out—"At the time the policy lapsed to Extended Term Insurance in 1999, any remaining cash value in the policy provided insurance coverage until" March 2010 for one policy and June 2010 for the other. (The record in the Tax Court also included a declaration from the insurer to the same effect.)

- In December 2010, Mr. Furnish took the matter to the IRS directly. He wrote to an IRS office in Fresno, Calif., saying that he questioned the insurer's calculations and adding, again significantly for his case, that the insurer had declined to provide him with a history of distributions under his

policies because its electronic records went back only to the 1990s. According to the opinion, Mr. Furnish told the IRS that "the company was unwilling to do the research necessary to respond fully to his request."

- In the ensuing months, Mr. Furnish "engaged in discussions with various IRS personnel" to resolve the matter, and in September 2011 he asked for assistance from the IRS' Taxpayer Advocate Service.

- None of this activity discouraged the IRS from sending a deficiency notice, which it did in August 2011. The notice determined that Mr. Furnish was liable for income tax on the $49,255.24 deemed distribution, and that this subjected him to alternative minimum tax as well.

- Finally, in August 2012, Mr. Furnish wrote to the IRS Office of Appeals asserting that he did not receive a distribution from the insurer, recounting his foregoing efforts, and again expressing doubts about the accuracy of the insurer's calculations underlying its conclusion that his policies had lapsed.

The next step on Mr. Furnish's search for truth was the timely filing of his petition with the Tax Court for a redetermination of the alleged tax deficiency. His petition asserted that he should not be subject to tax on the "phantom" distribution, and also expressed (in the opinion's words) disappointment that he had no chance to discuss the matter with IRS Appeals.

At this point, had the case proceeded in the manner of many that had gone before, the court would have sustained the deficiency and the IRS would have collected the tax, one way or the other. As Judge Guy's opinion observed, the payoff of a policy loan by applying the policy's cash value is a distribution from the policy, and such a distribution is includible in income for tax purposes to the extent it exceeds the investment in the contract.[3] That is all well settled law, and this rule had set the stage for a series of taxpayer losses on the issue as fully described in Dan Stringham's article, *After Going 0 for 6 in the United States Tax Court, Will Taxpayers Finally Give Up the Fight?* published in *Taxing Times* two and a half years ago.[4] My partner Bryan Keene and I took up the same subject in our own *Taxing Times* article, *It's About Basis ... and Moore,* published one year ago.[5] In that article, we discussed the decision of the Seventh Circuit Court of Appeals in *Brown v. Commissioner,*[6] which gave the IRS another victory. Since the decision in *Brown*, still other policy loans cases have been decided by the Tax Court, with taxpayers again coming out on the losing end.[7] This state of affairs prompted us to observe that the answer to the question Dan Stringham posed in the title of his article is, apparently, "no."

But fate had a different end in mind for actuary Furnish, one not unlike the result that the Tax Court reached in *Moore v. Commissioner*, also discussed in our year-old article.[8] In *Moore*, as described in our prior article, a policyholder who represented himself in front of the Tax Court purchased a level premium whole life policy and simultaneously elected the application of the policy's automatic premium loan provision to cover any premium payments due but unpaid. The policyholder paid only the first few years' premiums in cash and then stopped, apparently believing (as the Tax Court later found) that the policy eventually would terminate according to its terms. The insurer, however, treated the policy as lasting for some 30 years based on those few premium payments, and so it was a surprise to the policyholder when the insurer informed him that his policy had only recently lapsed and that he owed tax on a hefty deemed distribution when the loans were paid off at policy termination. The facts laid on the record raised sufficient question in the court's mind that it found in the policyholder's favor, reasoning that the insurer was in error and the policy in question had long since terminated.

Ordinarily, in a federal tax proceeding the burden of establishing the facts generally rests with the taxpayer, as the IRS' determinations in a notice of deficiency typically are presumed correct. In certain circumstances, however, under section 7491(a)(1) and (2) the burden of proof shifts to the IRS. The Tax Court found those circumstances to be present in *Moore*, where the policyholder introduced credible evidence regarding his policy's operation and why it should be viewed as having terminated decades earlier, while the IRS seemingly relied only on conjecture. So, the policyholder's diligence proved victorious over the IRS's reticence.

Whether or not Mr. Furnish knew about the proceedings in *Moore*, he followed virtually the same path. He represented himself in front of the Tax Court, operating under a small case rule in the Code that rendered the Tax Court's decision both non-precedential and non-appealable.[9] Happily for him, the IRS also followed the path it took in *Moore*, relying on the general presumption of correctness in its favor and what little was in the record of the case. The Tax Court again found that the circumstances for shifting the burden to the IRS were pres-

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ent, but this time it was due to a provision Congress added to the Code in 1996 as part of "Taxpayer Bill of Rights 2," section 6201(d).[10] Under that provision, in any court proceeding in which a taxpayer asserts a reasonable dispute regarding an income item reported by a third party on an information return like the Form 1099-R issued by Mr. Furnish's insurer, the burden of "producing reasonable and probative information" concerning the tax deficiency shifts to the IRS so long as the taxpayer has "fully cooperated" with the IRS.[11] Judge Guy's opinion found that Mr. Furnish fully cooperated with the tax collector, in that (1) as noted above, he had had detailed communications with the IRS both before and after the notice of deficiency was issued, (2) he was not accorded an opportunity to discuss his case with IRS Appeals, and (3) the IRS did not produce any evidence of non-cooperation, merely asserting that it did not know about the factual dispute until the day of trial.

As to whether there was in fact a reasonable dispute about the accuracy of the Form 1099-R issued by the insurer, the Tax Court cited a number of points in the taxpayer's favor, and none at all favoring the IRS. As noted in the chronology set out above, Mr. Furnish (said the court) tried but failed to persuade the insurer to provide him with the records needed to substantiate the timing of the lapse of his policies and the amount of the reported income. In particular, to do the relevant calculations, he needed but did not possess records showing the amounts of the premium loans, the interest accumulated thereon, and the dividends credited by the insurer. What's more, according to the opinion, the letters and annual policy statements provided by the insurer raised questions. In particular, the statements from the insurer that Mr. Furnish placed on the record showed "basic insurance coverage" under one of his policies in the amount of $22,000, whereas the policy itself showed coverage of only $20,000; they displayed a "seemingly anomalous" decrease in that policy's cash value between 2006 and 2008; and one of the letters sent to him by the insurer characterized the policies' lapse as occurring in 1999, while the court considered the record clear that the lapse had occurred in 2009. The court concluded that, on balance, the record raised doubt about the accuracy of the 1099-R, and the IRS did nothing to set it straight. To the contrary, said Judge Guy, in other recent cases before the court with similar fact patterns the IRS obtained detailed records of premium payments and policy loans, but in Mr. Furnish's case it arrived at trial with none.[12]

And so, the diligent actuary prevailed against the IRS's claim that he owed tax on the "phantom" distribution. One cannot tell whether other policyholders will be able to follow the path that Mr. Furnish pioneered, or possibly the one that gave the taxpayer a victory in *Moore*. After all, the IRS can read, too. But often in small case litigation, the time available to the IRS to marshal its resources is limited. Time will tell if the next *pro se* litigant in line on a policy loan case will enjoy benefits from the burden-of-proof or burden-of-production shift or will meet the fate of Mr. Brown and most of the other policyholder-borrowers who choose to litigate. ◂

ENDNOTES

1. Daniel Stringham, *After Going 0 for 6 in the United States Tax Court, Will Taxpayers Finally Give Up the Fight?* 7 TAXING TIMES 39 (Sept. 2011); John T. Adney and Bryan W. Keene, *It's About Basis … and Moore,* 9 Taxing Times 35 (Feb. 2013).
2. The reporting is required under section 6047(d). Unless otherwise indicated, references herein to "section" are to sections of the Internal Revenue Code of 1986, as amended (the "Code").
3. This assumes that the policy is not a "modified endowment contract" as defined in section 7702A.
4. *See* note 1, *supra.*
5. *Id.*
6. 693 F.3d 765 (7th Cir. 2012), *aff'g* T.C. Memo. 2011-83 (April 12, 2011).
7. *See, e.g.,* White v. Commissioner, T.C. Summary Opinion 2012-108 (Oct. 31, 2012).
8. T.C. Summary Opinion 2012-83 (Aug. 23, 2012).
9. Section 7463. This was also the provision used in the Moore case.
10. *See* Pub. L. No. 104-168, sec. 602(a).
11. As specified in section 6201(d), full cooperation includes "providing, within a reasonable period of time, access to and inspection of all witnesses, information, and documents within the control of the taxpayer as reasonably requested" by the IRS.
12. The opinion cited to Feder, T.C. Memo. 2012-10 (Jan. 10, 2012), and Sanders, T.C. Memo. 2010-279 (Dec. 20, 2010).

SUBCHAPTER L: CAN YOU BELIEVE IT? INSURANCE-IN-FORCE IS A VALUABLE ASSET

By Peter H. Winslow

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It is well understood among actuaries and insurance tax professionals that insurance-in-force is an intangible asset that can be purchased as part of the acquisition of an insurance business. In the context of reinsurance, the purchase price for insurance-in-force usually takes the form of a ceding commission. In many cases there is an expectation that the future net cash flows from in-force policies (premiums, plus investment earnings on future premiums, less benefits and expenses) will be negative, as usually would be the case for a closed block of single premium or paid-up life insurance contracts where there are no future premiums. In the real world, this block of contracts generating future negative cash flows would be considered a liability. Yet, in the insurance business, this block of business is considered a valuable asset called insurance-in-force. *Can you believe it?*

How can an economic liability be an intangible asset? As explained below, the answer lies in 1) insurance regulatory accounting conventions that require the establishment of reserves for future unaccrued claims, 2) the assumption that assets backing the reserves will be available to pay future claims, and 3) the fact that future net cash flows become available to the owner of an insurance business only as they become distributable under insurance regulatory accounting and capital requirements. Insurance accounting is different from accounting methods for other businesses because premiums are received before claims are paid out. Obviously, the entire premium charged is not earned economic income; a large portion must be set aside as a liability on the balance sheet to pay future unaccrued claims. Also, to account for the periodic emergence of profit or loss in gain from operations, it is necessary to offset premium income by a reserve liability for future claims so that premiums are considered earned over the entire period to which they relate, *i.e.*, the duration of the insurer's risk for which the premiums are charged.

These accounting concepts are taken into account in an actuarial appraisal. When an actuary uses the income approach to value insurance-in-force, he or she typically uses distributable earnings based on statutory accounting and capital requirements for the assumed future stream of income and expenses, instead of actual future cash flows expected to be generated by the block of business.[1] The reasoning behind this approach is that the use of actual cash flows would misstate the economic value to a purchaser because the cash received cannot be distributed to owners until profits emerge under statutory accounting principles and after taking into account capital requirements. The starting place for the appraisal based on distributable earnings is to assume that assets equal to statutory reserves have been set aside and will be available to owners in the future only as any reserves in excess of amounts needed to pay claims are released. That is, an actuarial appraiser starts from the assumption that assets backing the statutory reserves will be available to a willing buyer to pay claims. The value of insurance-in-force is the excess of the value of assets equal to statutory reserves over what a hypothetical purchaser will pay in light of the lower present value of the expected economic cost (net of future cash inflows) to satisfy the claims.

Several interesting observations flow from this analysis. First, it can be said that, if the statutory reserve liabilities set aside by the company for a block of business exactly equal the economic value of the future net cash flows, then, in theory, there would be no value assigned to an intangible asset called insurance-in-force. This is because the transfer of the policies to a willing seller would not yield any future distributable earnings. In fact, in this scenario the block of business probably would be considered to have a negative value because a hypothetical purchaser would insist on receiving compensation for its capital costs in assuming the liabilities and for assuming the risk that the reserves will turn out to be inadequate. A second observation is that the value of insurance-in-force varies depending on the level of statutory reserves; the higher the statutory reserves, the higher the value of insurance-in-force will be because the higher reserves will increase distributable earnings when they are released as claims are paid. But, does it really make sense that the value of insurance-in-force should depend so heavily on the level of statutory reserves? It certainly is possible to analyze the value of insurance-in-force from a different perspective other than statutory accounting. For example, we could start from an estimate of the present economic value of actual anticipated future net cash flows and ask ourselves what a hypothetical willing buyer would demand as compensation above that amount to assume the block of business, which presumably would include a risk premium and a charge for the cost of capital. This is not a bad way to think about the value of insurance-in-force as a theoretical matter, and, in fact, a similar approach was considered by the IASB in its initial exposure draft addressing the measurement of the value of an insurance contract under proposed changes to IFRS.

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This approach, which looks to the value of an insurance contract from the perspective of a hypothetical buyer, was later abandoned by the IASB as a proposed accounting standard, however, presumably because it was considered too difficult for the owner of a block of business to speculate on the amount of reinsurance premium (ceding commission) the marketplace would demand for assuming a particular contract or block of contracts. Current exposure drafts being considered by the FASB and IASB adopt a different approach and instead attempt to measure the value of an insurance contract by a building block approach with a margin designed to reflect the earning of premiums over time. To grossly oversimplify matters, the FASB/IASB proposals would value the contracts by amortizing the actual profit embedded in the premium over the period of risk and adding any unamortized profit amount to the present value of expected future net cash flows as of the valuation date. It is important to note, however, that these proposals derive values that are intended to be used to reflect the periodic earning of income for accounting purposes and are not intended to measure the amount a hypothetical willing buyer would pay for a block of contracts.

Let's summarize where we are so far. First, although purely from an economic perspective, a closed block of insurance-in-force may really be a liability, it is considered an intangible asset due to insurance regulatory accounting reserve requirements and assumptions about assets backing those reserves and the availability of statutory earnings as the reserves are released. Second, the value to be assigned to insurance-in-force depends on the accounting and valuation methods that are used to determine future income and reserve liabilities.

How does this analysis affect the value of insurance-in-force for tax purposes? A regulation dealing with assumption reinsurance has long taken a simplistic view of the value of insurance-in-force. Treas. Reg. § 1.817-4(d) basically provides that the value of insurance-in-force in an assumption reinsurance transaction is equal to a ceding commission measured by the difference between the reserve liabilities assumed and the fair market value of the assets transferred. The regulation also has been applied to indemnity reinsurance. Under this regulation, the ceding company is deemed to have transferred to the reinsurer assets with a value equal to the reserves, and the reinsurer to have paid a ceding commission for the insurance-in-force equal to the difference between the reserves assumed and the value of the assets (net of the deemed ceding commission) actually received in the transaction.

This assumption reinsurance regulation makes practical sense as an accounting matter, but does it make economic sense when the reserve liabilities assumed are not an accurate measure of the reinsurer's liability assumed? It just so happens my good friend and former partner, Ted Baker, and I raised just this question over 30 years ago in *Security Benefit Life Ins. Co. v. U.S.*[2] The case arose under pre-1984 tax law when tax reserves generally were based on statutory reserves. In the case, a ceding company transferred all of its assets (equal to approximately $6 million) and all of its tax-deductible statutory reserves (equal to approximately $8 million) relating to a closed book of policies to Security Benefit by assumption reinsurance. Security Benefit included the $6 million in income and claimed an increase-in-reserve deduction of $8 million, for an immediate $2 million tax loss. The Internal Revenue Service (IRS) sought to apply Treas. Reg. § 1.817-4(d) to deny most of the tax loss. The IRS deemed Security Benefit to have received assets included in taxable income equal to the assumed reserves and then to have paid a $2 million ceding commission for the transferred insurance-in-force. The IRS argued that the deemed ceding commission should be capitalized and amortized as required by Treas. Reg. § 1.817-4(d). We responded that a mechanical application of the regulation ignored the facts because there was no value of an asset for insurance-in-force. We proved through expert testimony that the ceding commission the IRS sought to impute to Security Benefit as the purchase price for insurance-in-force was really just the difference between the amount of statutory reserves and the amount of the true economic value of the liabilities assumed, *i.e.*, the conservatism in the statutory reserves. In our view, the real effect of the application of Treas. Reg. § 1.817-4(d) was to disallow the full deduction for Security Benefit's increase in reserves. The district court and the Tenth Circuit Court of Appeals agreed with our argument and held that Treas. Reg. § 1.817-4(d) could not be applied to impute a ceding commission in assumption reinsurance in these circumstances. The two courts did not buy into the notion that the excess of statutory reserves over the value of assets transferred in a reinsurance transaction is always a disguised ceding commission paid for an intangible asset called insurance-in-force.

In retrospect the holding in *Security Benefit* is somewhat surprising, and it is doubtful that a court would reach the same result today. More recent Supreme Court decisions require Treasury regulations to be given deference by the courts and there would be great reluctance to hold Treas. Reg. § 1.817-4(d) to be invalid. Nevertheless, as shown by the *Security Benefit* case, Treas. Reg. § 1.817-4(d) reflects an artificial

approach to determining the value of insurance-in-force. The regulation creates an irrebuttable presumption that the difference between the fair market value of assets equal to reserves for a block of policies less the fair market value of assets actually received by the reinsurer is an amount paid for acquired insurance-in-force. It does not matter that this difference may be attributable to other factors, such as the conservatism inherent in reserves.

Aside from this diversion into fond memories of my first trial, how do we determine the value of insurance-in-force now that tax reserves are no longer equal to statutory reserves, and are adjusted by I.R.C. § 807(d)? That is, how do we account for the fact that an actuarial appraisal typically starts from the assumption that assets equal to statutory reserves are available to satisfy future claims, but tax reserves are computed on a different basis? In a typical reinsurance transaction, when the only intangible asset transferred is insurance-in-force, application of Treas. Reg. § 1.817-4(d) would govern and is relatively straightforward. The acquired value of insurance-in-force should be equal to a deemed ceding commission measured by the difference between the tax reserves on the acquired block of policies less the fair market value of the transferred assets. But, matters become more complicated in an I.R.C. § 1060 acquisition of a business or an I.R.C. § 338 deemed asset sale where no specific value has to be assigned in arm's-length negotiations to insurance-in-force on a stand-alone basis. Treas. Reg. § 1.338-11(b)(2) gives some guidance, however. That regulation, specifically applicable to I.R.C. § 338 deemed asset sales, provides that the fair market value of insurance contracts "is the amount of the ceding commission a willing reinsurer would pay a willing ceding company in an arm's length transaction for the reinsurance of the contracts if the gross reinsurance premium for the contracts were equal to the [ceding company's] tax reserves for the contracts." This regulation is simple in concept, but difficult in application. Unless someone does an estimate of the present value of future net cash flows, and then conducts a market analysis of what a hypothetical buyer would charge as compensation for assuming the liabilities, it is difficult to estimate what a willing buyer actually would pay. This exercise typically is not done in these types of transactions, and its difficulty absent arm's-length negotiations for the acquisition of a stand-alone block of policies is probably one of the reasons why the IASB abandoned as unworkable a similar hypothetical willing buyer standard in its current value-of-insurance-contract project.

As this article indicates, determining the value of insurance-in-force, particularly for tax purposes, is not easy. The problem is that the intangible asset we are valuing is really a net amount that compares the value of liabilities to the assets available to satisfy the liabilities. To determine the intangible value, we first need to decide what accounting method we are using to measure the assets and liabilities before we can make a judgment about the net value. The value may differ depending on whether the liabilities are measured by statutory accounting, by tax accounting or on some other basis, such as GAAP or IFRS. ◂

ENDNOTES

[1] Actuarial Standard of Practice No. 19, par. 3.2.

[2] 517 F. Supp. 740 (D. Kan. 1981), aff'd, 726 F. 2d 1491 (10th Cir. 1984).

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