assert the disclaimer is required by Circular 230 or the IRS, calling such disclaimers "misleading." It seems more likely that the disclaimers will go the same way that they came, suddenly and universally. ◂

LB&I REVISES IDR DIRECTIVES

By Samuel A. Mitchell

The February 2014 *Taxing Times* edition covered the Large Business & International Division's (LB&I's) issuance and enforcement procedures for Information Document Requests (IDRs) contained in two Directives that were issued in 2013.[1] After the February *Taxing Times* edition went to press, LB&I delayed the implementation of the procedures outlined in the Directives. Then, on Feb. 28, 2014, LB&I released a revised IDR Enforcement Directive that "incorporates and supersedes" the earlier Directives in order to "clarify" the IDR enforcement process.[2] This administrative hiccup evidently resulted from complaints by the National Treasury Employees Union, which asserted that LB&I did not adequately consult the union before issuing Directives that remove discretion from managers and agents.[3] Not surprisingly, the new Directive allows for some additional discretion on the part of LB&I managers, agents and specialists in the enforcement process. However, the new Directive still incorporates what can fairly be described as a rigid process. It repeats the admonition that the process "is mandatory and has no exceptions."

The changes to the earlier Directives described in the February 2014 *Taxing Times* for the procedures agents and specialists must follow in order to issue an IDR are relatively minor. The earlier Directives did not expressly acknowledge that agents still need to issue general IDRs at the beginning of the examination seeking books and records and general information about the company. The new Directive clarifies that agents are permitted to issue the same types of general opening IDRs they have always issued. After the general IDRs are issued, however, all subsequent IDRs must be issue-focused, as previously described. In another change, the new Directive provides that the process for providing and discussing a draft IDR with the taxpayer before issuing the final IDR "should be completed in 10 business days." The earlier Directives did not suggest or require a time period for reviewing the draft IDR. Fortunately, the new 10-day period is not mandatory; however, agents may be inclined to read a "should" as a "must." For this reason, tax department personnel should promptly engage the exam team regarding not only the content of an impending draft IDR but also the timing of the issuance of the draft.

The changes to the enforcement procedures add a layer in which the agents and specialists have a little more discretion in dealing with non-compliance. The new Directive still involves three steps after the enforcement procedures are triggered by non-compliance or perceived non-compliance by the taxpayer—a Delinquency Notice, a Pre-summons Letter, and a Summons. However, the new Directive gives the agent or specialist the discretion to extend the time for compliance before triggering the three-step process. If a taxpayer does not respond or provides an incomplete response to an IDR, the agent or specialist is supposed to discuss the non-compliance with the taxpayer and determine if an extension of up to 15 days from the date the extension decision is communicated to the taxpayer is appropriate. The Directive advises that the agent or specialist "should" have the discussion, make the decision, and communicate it to the taxpayer within five business days after the IDR due date.

The triggering of the enforcement process depends on whether the taxpayer does not respond to the IDR by the due date or, on the other hand, provides an incomplete response. If the taxpayer does not respond to the IDR by the due date and no extension is granted, the enforcement process begins on the date the agent or specialist communicates to the taxpayer the decision not to grant an extension. If the taxpayer does not respond on or before the due date, an extension is granted, and the taxpayer does not respond on or before the extended date, the enforcement process begins on the extended due date.

If the taxpayer provides a response, the agent or specialist must determine if the response is complete and "should" do this by the date specified in the IDR for this determination. If the response is complete, the agent or specialist must notify the taxpayer that the IDR is complete and closed. If the response is incomplete, the enforcement trigger depends on whether or not an extension is granted. If the response is incomplete and no extension is granted, the enforcement process begins on the date the decision not to allow an extension is communicated to the taxpayer. If the IDR response is not complete, an extension is granted, and the taxpayer does not provide an additional response, the enforcement process begins at the end of the extension period. If the IDR response is not complete, an extension is granted, and the taxpayer provides an additional response, the agent or specialist must review the supplemental response for completeness and "should" complete the process "as soon as possible" or "in most cases not more than 15 business days from receipt of the response." If after all this the response is still incomplete, the enforcement process is triggered on the day the examiner or specialist informs the taxpayer. If the response is complete, the examiner or specialist should notify the taxpayer and close the IDR.

Once triggered, the three-step enforcement process is generally the same as described in the earlier Directives. There are no changes to the third and final step, the issuance of a summons. However, perhaps because of the potential delay from the extension process discussed above, the new Directive reduces some of the compliance periods and timelines for steps one and two—the Delinquency Notice and the Pre-Summons Letter. Specifically, for step one, taxpayers have only 10 business days (subject to an extension by the Territory Manager) to respond to a Delinquency Notice, not the 15 calendar days (subject to extension by the Territory Manager) previously provided. For step two, LB&I has "generally no more than" 10 business days to issue a Pre-Summons Letter after the due date in the Delinquency Notice, as opposed to 14 calendar days. Taxpayers have 10 business days to respond to the pre-summons letter (subject to extension by a Director of Field Operations), as opposed to 10 calendar days (subject to an extension by a Director of Field Operation) previously provided.

The positive observations regarding the IDR process discussed in the February 2014 *Taxing Times* remain the same. The new Directive still provides that agents and specialists must identify issues for all IDRs issued after the initial IDRs in which they ask for books and records and general information about the company. Gone are the days when agents and specialists tried to use the IDR process to compel taxpayers to provide PowerPoint presentations discussing particular transactions. This may still occur for taxpayers in the Compliance and Assurance Process (CAP taxpayers) or in regular examinations for other taxpayers, but it will occur on terms negotiated by the taxpayer and only after an issue has been identified. As an aside, a CAP Q&A on the IRS website states that the requirements for issuing IDRs apply to agents and specialists examining taxpayers in the CAP process, but that the three-step enforcement process does not apply during the pre-filing phase—the enforcement process applies only during the post-filing phase.[4] The Q&A also states that the "CAP Memorandum of Understanding requires timely, open, cooperative, and transparent interactions between the IRS and the CAP taxpayer."[5] It reiterates that taxpayers who do not live up to this standard are subject to termination from the CAP program.[6]

Four recommendations made in the February 2014 *Taxing Times* regarding how taxpayers should deal with the new IDR process bear repeating. First, taxpayers should make it clear at the opening conference that they intend to hold the exam team strictly to the requirements for issue-focused IDRs described in the Directives. Second, taxpayers should no longer hesitate to elevate problem IDRs to higher levels of LB&I management. They should discuss in the opening conference whether specialists will be involved and verify the identity and contact information of managers who supervise the specialists. Third, taxpayers should consider requesting that IDRs that are difficult or impossible to respond to be withdrawn. The Directive does not rule this out, and it makes practical sense. No matter how much advance work is done to try to determine whether information is available and estimate how much time it will take to gather, it is very common to run into situations where it is just not feasible to meet an agreed-to deadline, either because the information is not as accessible as previously thought or does not exist. Anyone who has ever gone through the discovery phase of litigation knows this to be true. Fourth, taxpayers should assert control in the opening conference over the designation of taxpayer personnel who will be involved in the process and clarify to whom enforcement correspondence should, and should not, be sent.

It is still too early to pass judgment on the wisdom and effectiveness of the IDR issuance and enforcement process. However, the revised Directive still, on balance, represents what can be a positive development for compliant taxpayers that have good working relationships with examination teams because of the elimination of fishing-expedition IDRs. Nevertheless, problems from time to time are inevitable. The best way to avoid and resolve the problems is to emphasize effective communication between taxpayer personnel and the examination teams starting as early as possible in the examination process. Perhaps most importantly, this process of communication should extend beyond the tax department to the business people and actuaries who ultimately may be responsible for gathering the information in response to IDRs. ◂

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END NOTES

1 Samuel A. Mitchell, *LB&I Releases Good News/Bad News IDR Procedures*, TAXING TIMES, Vol. 10, Issue 1 (Feb. 2014) (describing LB&I Directive No. 04-0613-004 (June 18, 2013) regarding IDR issuance and LB&I Directive No. 04-1113-009 (Nov. 4, 2013) regarding IDR issuance and enforcement).

2 Updated Guidance for Examiners on Information Document Requests, LB&I-04-0214-004 (Feb. 28, 2014).

3 *See* Amy S. Elliott, *LB&I Delay Mandatory IDR Enforcement Procedures in Response to Criticism*, *Tax Notes Today*, 2014 TNT 27-4 (Feb. 10, 2014).

4 *See* http://www.irs.gov/Businesses/Corporations/Compliance-Assurance-Process-(CAP)---Frequently-Asked-Questions-(FAQs) – Q & A No. 37. See also id., Q & A 40 (noting that a summons cannot be issued before the tax return is filed).

5 *Id.*, Q & A No. 39.

6 *Id.*

IRS RULES ON THE DEFINITION OF INSURANCE BUSINESS FOR PURPOSES OF COMPUTING LICTI

By Laura Homan

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On March 21, 2014, the Internal Revenue Service (IRS) released Private Letter Ruling 201412001 (the PLR) regarding the characterization of an activity as insurance or noninsurance business for purposes of computing life insurance company taxable income (LICTI) under Section 806(b). One significance of the characterization of the activity as insurance or noninsurance is that in computing LICTI, a life insurance company's losses from noninsurance business, or "nonlife losses," are limited to the lesser of 35 percent of the nonlife losses or 35 percent of the life income. The amount calculated is entered on the return as an increase to LICTI in the determination of the life insurance company's total taxable income.

The taxpayer in the PLR requested a ruling that the passive investment activities of its wholly-owned nonlife subsidiary were properly treated as an insurance business following the subsidiary's check-the-box election and therefore the subsidiary's income and expenses should be included in computing tentative LICTI without the above-described loss limitation.

BACKGROUND ON THE COMPUTATION OF LICTI

Section 806(b)(3)(A) defines "noninsurance business" as "any activity which is not an insurance business." Section 806(b)(3)(B) further provides that any activity which is not an insurance business is treated as an insurance business if it is of the type traditionally carried on by life insurance companies for investment purposes but only if the carrying on of such activity (other than in the case of real estate) does not constitute the active conduct of a trade or business.

There are no Treasury Regulations interpreting Section 806(b)(3)(B)(i), nor is the term "active conduct of a trade or business" specifically defined for purposes of that section. However, the legislative history to Section 806 confirms that investment activities that are held to support contracts issued or reinsured by the taxpayer should be taken into account in computing LICTI. Further, a business that is not an insurance business but is of a type traditionally carried on by life insurance companies for investment purposes is to be treated as an insurance business so long as it is not the active conduct of a trade or business (however, real estate activities are not subject to the active trade or business standard).

FACTS STATED IN THE PLR

As discussed in the PLR, the passive investment activities were conducted by a subsidiary that taxpayer indirectly owned through members of its life insurance subgroup. The taxpayer proposed that the subsidiary, after segregating certain consulting activities in a separate company owned by the taxpayer or a non-life subsidiary, would make an election to be disregarded as a separate entity (check-the-box election). Following the election, the assets relating to the passive investment activities will continue to support life insurance and annuity contracts issued by the life insurance subsidiary.

IRS CONCLUSION IN THE PLR

The IRS concluded that the investment activities are properly treated as an insurance business following the check-the-box election. The PLR is redacted and does not describe the nature of the activities in question, other than to describe the activities as passive investment activities, and "of the type traditionally carried on by life insurance companies for investment purposes." Further, the ruling confirmed that the carrying on of the passive investment activities did not constitute the active conduct of a trade or business. As a result, the income and expenses of the subsidiary should be included in computing tentative LICTI and not limited by Sections 806(b)(3)(C) or 1503(c).

The ruling sheds additional light on the meaning of "insurance business" for purposes of Section 806 and the computation of LICTI. ◂

END NOTES

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2 Section 801(a) imposes a tax for each taxable year on the LICTI of every life insurance company.

3 Sections 806(b)(3)(C), 1503(c).

4 For a discussion of the Section 806(b)(3)(C) limitation, see I.R.M. § 4.42.4.15 (May 29, 2002).

5 H.R. Rep. No. 432, 98th Cong., 2nd Sess. 1407-1408 (1984).

6 *Id.* In a 1994 Field Service Advice, 1994 FSA LEXIS 446, the IRS applied Section 806(b)(3) to determine whether certain activities engaged in by a life insurance company constituted "noninsurance business" as defined in Section 806(b)(3), thus subjecting the losses from the enterprise to the loss limitation provisions of Section 1503(c). The IRS concluded that the nature and level of activity engaged in by the life insurance company (and its predecessor) did not constitute "noninsurance business" as defined in Section 806(b)(3), therefore the loss limitation contained in Section 1503(c) was not applicable.

SUBCHAPTER L: CAN YOU BELIEVE IT? TAX HEDGE ACCOUNTING FOR EQUITY-INDEXED UNIVERSAL LIFE INSURANCE

By Peter H. Winslow

Equity-indexed universal life insurance (EIUL) contracts typically allow the policyholder to allocate all or a portion of premiums to either a fixed account which provides for interest credited to the contract measured at a minimum fixed rate or to one or more indexed accounts which provide for interest credited at a rate determined by an equity index. This contract feature effectively provides the policyholder with an embedded equity option. Life insurance companies purchase derivatives (generally equity call options) to hedge the risks related to the policyholder's embedded option.

Actuarial Guideline 36 (AG 36) provides several optional methods to comply with CRVM in computing statutory reserves for EIUL contracts, but many companies use the Updated Market Value (UMV) method. The UMV method applies the general approach of the Universal Life Insurance Model Regulation, but modifies the regulation to take into account the present value of the policyholder's embedded equity option. The present value of future guaranteed policy benefits is calculated at the valuation date by projecting a fund equal to the greater of the Guaranteed Maturity Fund (GMF) or the policy value (policy accumulated value). In addition, under the UMV method, a current "option cost" at the valuation date is accumulated and added into the projected fund at the end of the current indexed segment term. The option cost for each indexed segment may be calculated using the same formula and assumptions (risk-free rate, volatility, strike price, current equity index value, time to maturity) as used to value the hedging instrument for statutory purposes. Thus, the amount taken into account for the option cost for a policy's indexed segments under the UMV method is the indexed segment's accumulated value at the valuation date. As a result, the option cost used in the AG 36 reserve calculation is valued consistently with, and moves with, the market value of the hedging asset. For this reason, the hedge accounting method used by many companies for statutory purposes is to mark the hedging instruments to market (MTM).

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