



SOCIETY OF ACTUARIES

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## CONVERSATION WITH SHERYL FLUM

*By the Taxation Section*

**S**heryl Flum, is the chief, Branch 4, IRS Office of Associate Chief Counsel (Financial Institutions and Products) at the Internal Revenue Service (IRS). *TAXING TIMES* sat down with Sheryl for a conversation about her role at the IRS, and to share thoughts about current tax issues facing the life insurance industry.

### 1. CAN YOU PROVIDE OUR READERS WITH A SUMMARY OF YOUR BACKGROUND?

Most people don't know this, but being a lawyer is my second career. I graduated from college with degrees in Finance and Accounting. I worked for a decade as an accountant, mainly in the broker/dealer area. I spent three years as an auditor with Arthur Young. My main client during that time was Morgan Stanley, and I became fascinated by the brokerage industry. For the next seven years, I worked for CS First Boston in the regulatory reporting and analysis area. My team was responsible for ensuring that the company complied with the various SEC provisions, as well as other regulatory rules issued by the Exchanges (such as the NYSE) and other regulatory agencies (like the CFTC). When I left First Boston in 1994, I was vice president of Regulatory Reporting and Analysis. I spent three blissful years in law school at the University of Miami School of Law, where I earned a full scholarship. I really enjoyed the intellectual stimulation of learning the law, and also enjoyed being in a non-work environment. When I went to law school, I intended to break away from the business world and become a public interest lawyer. But during a summer internship with a Legal Services provider, I found that the specialty wasn't right for me. Given my background, and my desire to further public good, I applied to the Department of Justice's (DOJ's) Honors Program and was offered a position with DOJ's Tax Division. I was a litigator representing the United States in tax refund cases for a little more than seven years. I joined the Office of Chief Counsel in November 2004, and became the branch chief of the Insurance Branch in March 2007.

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## 2. WHAT LED YOU TO YOUR CURRENT POSITION AT THE IRS?

I really enjoyed litigation. As a DOJ litigator, I was responsible for handling all aspects of the cases assigned to me from discovery, to brief writing, and to court appearances. I handled tax cases in the Court of Federal Claims, which is a court of national jurisdiction. My cases ranged from individual issues such as whether tax returns were timely mailed, to complex corporate issues such as whether an oil company was entitled to a credit for producing oil from tar sands. I also worked on a few insurance tax issues, including one of the last § 809 DER cases. Litigation, especially during the discovery phase, requires a lot of traveling. After I started a family, I wanted a job that would mainly let me sleep in my own home. The Office of Chief Counsel was the perfect segue for me—I could still practice tax law, but with almost no work travel. I enjoyed the insurance tax cases, and sought a position in the Insurance Branch.

## 3. DID YOU HAVE PRIOR EXPERIENCE WITH THE INSURANCE INDUSTRY BEFORE YOU JOINED THE INSURANCE BRANCH?

None, other than the few insurance litigation cases I worked on. It was a bit of a “leap of faith.” I enjoyed the very technical nature of the insurance tax law, and my background working on Wall Street made the financial institutions and products area a good fit.

## 4. CAN YOU TELL OUR READERS WHAT YOUR PRINCIPAL RESPONSIBILITIES ARE?

The main function of the Insurance Branch is to interpret Subchapter L of the Internal Revenue Code, which provides the rules for insurance companies to determine their taxable income, as well as sections 72, 101, 7702, 7702A and 7702B, which provide the rules for determining taxable (or tax-exempt) income from life insurance products. We issue private letter rulings to individual taxpayers on how to determine taxes on proposed transactions. We issue technical advice memoranda to the IRS Exam personnel on legal tax issues that come up during audits of insurance companies. The Insurance Branch also facilitates closing agreements between life insurance companies and the IRS to remediate inadvertent failures of life insurance contracts to comply with sections 101, 7702 and 7702A, as well as separate accounts that are improperly diversified under section 817. We process change in method of accounting requests related to Subchapter L issues for taxpayers who discover that they have been using an improper method or wish to change to a different appropriate accounting

method. The Insurance Branch participates in drafting published guidance on issues that have broad impact on insurance company taxpayers or on those who purchase insurance products. The Branch also responds to requests for Chief Counsel Advice from the IRS, responds to inquiries from Congress, and assists government litigators related to issues of taxation of insurance companies or products. As branch chief, I work on the technical issues, assign cases to the other attorneys in the branch, and deal with personnel and branch administration issues.

## 5. CAN YOU SHARE WITH OUR READERS HOW GUIDANCE IS DEVELOPED?

Guidance is worked on cooperatively among the Insurance Branch, the Office of Tax Policy and the IRS. The first step in developing guidance is to identify issues for which guidance is appropriate. Sometimes, when Congress passes new tax legislation, guidance is needed to implement that legislation. A recent example of such legislation is the Pension Protection Act of 2006 which, among many other provisions, amended the tax law for business-owned life insurance and allowed for

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the exchange of an annuity for qualified long-term care insurance or to add a rider to an annuity to provide long-term care coverage. Suggestions for new guidance come from taxpayers when new business practices or new types of products are developed. A good example of this was the request for guidance on the adoption of Actuarial Guideline 43 by the National Association of Insurance Commissioners (NAIC). The IRS also suggests guidance subjects based on audit experience.

Once an issue is designated as the subject of guidance, an Insurance Branch attorney researches the issue and makes recommendations for the scope of the guidance and the position. After consulting with others in Chief Counsel and with the Treasury's Office of Tax Policy, the branch attorney starts drafting the actual guidance (that is, the regulation, revenue ruling, revenue procedure or notice). Before the guidance is published, it must be approved by the affected divisions of the Office of Chief Counsel, the Chief Counsel, the IRS Commissioner's office and Treasury. The amount of time it takes to publish guidance depends on many factors, including the complexity of the issues and the significance of the guidance to the industry.

#### 6. WHAT IS THE MOST INTERESTING PART OF YOUR JOB?

My favorite thing to do, which is to me the most interesting part of my job, is interacting with taxpayers and their representatives answering questions and discussing issues. In addition to opportunities for interaction in connection with rulings and other individual taxpayer matters, I get a number of opportunities to do this at American Bar Association and Federal Bar Association programs, as well as insurance member organizations such as the American Council of Life Insurers (ACLI). I've also spoken on panels for the Society of Actuaries. It is both very edifying, as well as extremely helpful, to hear from insurance company tax practitioners about emerging issues and product development. When we were working on updating the remediation procedures in 2008, we had several helpful and fascinating meetings with various interested parties. We are currently working with taxpayers on what guidance will be needed when the new Valuation Manual, adopted by the NAIC in 2012, is effective.

#### 7. WHAT ARE THE BIGGEST CHALLENGES THAT YOU FACE IN YOUR JOB?

My biggest challenge is to ensure that all of the Insurance Branch's work is completed. Fortunately, I am privileged to work with some very talented and smart people.

#### 8. WHAT ARE SOME OF THE KEY ISSUES THAT YOU SEE RELATED TO ADMINISTERING THE CURRENT RULES UNDER SUBCHAPTER L?

The majority of the framework of Subchapter L was enacted in 1984. The insurance industry and insurance products have changed since then, which makes administering the current rules challenging. One area that raises many difficult issues is in determining the federally prescribed reserve for life insurance products. Section 807 provides a formulaic approach to computing reserves for federal tax purposes incorporating a reserve method (generally the CRVM or CARVM), a prescribed interest rate, and a specified mortality table. Determining what method must be used for a particular product can be difficult—especially as the industry moves toward a more stochastic approach. Another challenge is distinguishing between insurance products and investment products (such as options or other derivatives). A few years ago, the branch struggled with how best to treat contracts that provided a guaranteed lifetime benefit, but were separate from the investment vehicle. After a significant amount of research and debate, we determined that these contracts were annuities for federal tax purposes.

#### 9. ARE THERE SOME ISSUES THAT YOU FIND MORE INTERESTING THAN OTHERS?

Of course. But I must admit that there have been many times when I started working on an issue that I initially pegged as uninteresting, but as I learned more about it, I ultimately found it fascinating. For instance, when we were working on the implementation of section 101(j), which was added to the Code by the Pension Protection Act of 2006 and provides rules for when death benefits on business-owned life insurance would be tax exempt, I thought the issue of employee notification somewhat boring. But once I started to learn about the variety of real-life applications, the issue became decidedly less boring.

#### 10. HOW ABOUT PRODUCT TAX? ARE THE CURRENT RULES FOR REMEDIATION OF FAILED CONTRACTS AND INADVERTENT MODIFIED ENDOWMENT CONTRACTS (MECS) WORKING WELL?

I find the development of new life insurance products to be very interesting, and especially enjoy working on private letter rulings establishing the appropriate federal tax treatment for new products. It's a challenging area because even if the products are developed for non-tax business reasons, tax issues are often implicated. During the process of developing the current rules for remediating failed contracts and inadvertent MECs,

I learned a great deal about how complex it is for insurance companies to monitor each contract to ensure compliance with some very complex tax rules. At one meeting with taxpayer representatives, I remember a practitioner brought in a large sheaf of computer printouts. I thought the papers were a printout of contracts on a particular system, but they turned out to be the printout of a single contract's history. That was a real eye-opener for me. Ensuring compliance with the tax definition of life insurance is a very difficult job. I went into the project to update the remediation rules wondering why so many contracts failed, and came out wondering why so few

failed. Because the current remediation rules were written with input from the industry, we have found them to work especially well.

#### 11. ANYTHING ELSE THAT YOU WOULD LIKE TO SHARE WITH OUR READERS?

I am very satisfied with my work. When I became a lawyer, I didn't set out to become an expert in insurance tax. But I am very happy that I found my niche in this area. The very best part of my job is interacting with and getting to know some wonderful people working in the insurance industry. ◀

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**Sheryl B. Flum** is Branch 4 chief, IRS Office of Associate Chief Counsel (Financial Institutions and Products) and may be reached at [Sheryl.B.Flum@irs.counsel.treas.gov](mailto:Sheryl.B.Flum@irs.counsel.treas.gov).

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