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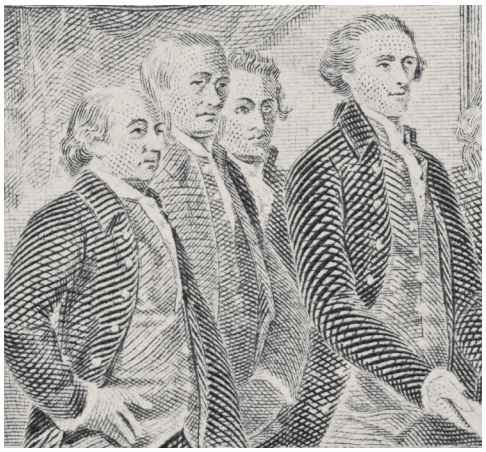
IN THE BEGINNING …
A COLUMN DEVOTED TO TAX BASICS



WHAT ARE THE SOURCES OF THE FEDERAL TAX LAW?

By John T. Adney

When seasoned practitioners of federal tax law see PowerPoint slideshows and like materials that reference "the IRS Code," describe "regulations passed by Congress," or discuss private letter rulings with a sense of awe, they immediately become skeptical (or more skeptical than usual) and begin hunting for errors. It is obvious to them, from the terms used, that the author is at best a novice when it comes to tax authorities, repeating information (and perhaps misinformation) obtained from others.

In the interest of avoiding such misadventures, this column—the first in a series intended to provide basic education on the federal tax law, with a focus on the rules applicable to life insurance products and companies—spells out in brief the hierarchy of authorities that establish and interpret that body of law. The reader will recall, from his or her seventh or eighth grade civics class, that under the U.S. Constitution federal laws emanate from acts of the two houses of Congress, subject to approval by the President. The federal tax laws are such laws, enacted by Congress and collected (since 1939) in an extensive statute known as the Internal Revenue Code or, for short, the "IRC" or the "Code." This statute, divided into chapters and parts and sections, today is called the "Internal Revenue Code of 1986, as amended" and is reputed to be the largest body of tax legislation in world history. It constitutes all of title 26 of the United States Code, which contains most federal statute law.

Despite the mistaken allegations of various blogs and tax protestors, the Internal Revenue Service (IRS) does not write the rules contained in the Code. Only Congress can do that.

The IRS, as part of the executive branch of the government, has the job of enforcing the statute as written by Congress, and so in the first instance it must read and interpret what Congress has ordained. The IRS does have the role, working in conjunction with officials of the U.S. Treasury Department under grants of authority from Congress to the Secretary of the Treasury, of framing regulations that describe how the Code's provisions should be interpreted. These regulations sometimes expand on more general concepts that appear in the Code and, where required or permitted by the Code, add some rules of their own. For example, the Code may use terms like "reasonable" or "substantial," and the regulations may provide more detailed definitions and practical applications of those terms. Before being finalized, these regulations generally must first be published in proposed form ("proposed regulations") in the Federal Register and be made available for formal comment by the general public, and the IRS and Treasury must review and provide written reactions to such comments, all following a process spelled out in the Administrative Procedures Act (the "APA"). Because all "final regulations" are issued in this manner and under authority granted in the statute, they typically are treated as having the force and effect of law under a doctrine the courts call "Chevron deference." In urgent circumstances, "temporary regulations" may also be issued and take immediate effect, but these usually are published as proposed regulations, too.

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In the absence of controlling regulations, and on occasion to determine whether a regulation contradicts the statute law—which it is not allowed to do—it is necessary to interpret the statute law itself. Indeed, where there is ambiguity in the

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John T. Adney is a partner with the Washington, D.C. law firm of Davis & Harman LLP and may be reached at *jtadney@davis-harman.com*.

statute as written by Congress (a situation that is not uncommon), interpretation is needed in order to frame regulations in the first place. Courts and commentators have written much on the techniques of interpreting legislative enactments, sometimes called the "canons of construction," which range from using the rules of grammar to avoiding conflicts with the Constitution. In this connection, the interpreter can look to certain official explanations of congressional intent at the time the statutes were enacted, referred to as "legislative history." This legislative history consists of published reports of the House Ways and Means Committee, the Senate Finance Committee, and the Conference Committee (which officially has the wondrous title, "The Committee of Conference on the Disagreeing Votes of the Two Houses"). It also includes floor statements of the members of Congress who are managing legislation and so-called "colloquies." A colloquy is an orchestrated discussion that occurs on the floor of the House or Senate between the chairman of the committee of jurisdiction and another committee member for the purpose of clarifying or expanding on the wording of the legislation. These floor statements are preserved in the Congressional Record, the official journal of the proceedings of Congress. Materials prepared by the staff of the Joint Committee on Taxation are also useful as a form of (or as reflective of) legislative history. These include background materials prepared as a part of the legislative process as well as General Explanations, or Blue Books (so named because of their color), which are prepared after the passage of major tax legislation. Because of their status as after-the-fact summaries, Blue Books do not have the same authoritative standing as contemporaneous legislative history (see the article "Blue Book Blues" in this issue).

A step down from the statutes, regulations, and legislative history are IRS pronouncements made in the course of administering the tax law. These include revenue rulings, revenue procedures, and notices, all of which are published in the *Internal Revenue Bulletin* and can be relied on by taxpayers. A revenue ruling states the IRS' view of how the tax law should be interpreted and applied to specific facts; a revenue procedure describes the process a taxpayer can use to obtain a particular tax treatment, e.g., to change a method of accounting or correct a life insurance contract that violated applicable tax rules; a Notice makes an important announcement, such as outlining what future regulations will say or asking public input on a tax administration issue. In recent times, unfortunately, substantive guidance from the IRS in the form of revenue rulings has diminished. In litigation involving whether IRS positions are correct, the courts will not necessarily defer to this class of pronouncements, but will examine the matter independently. Reacting to a court decision of significance, the IRS also will publish an Action on Decision (or "AOD"), indicating whether the agency will "acquiesce" in a holding adverse to its view of the matter or will continue to argue for its position in future litigation. One famous acquiescence relevant to insurance involved a case called *Conway v. Commissioner*, 111 T.C. 350 (1998), in which the Tax Court held that a partial exchange of an annuity contract for another annuity could be tax-free under section 1035 of the Code. The IRS acquiescence in that case has spawned a number of revenue procedures and other items of guidance in its wake.

In addition, the IRS issues rulings relating to a single taxpayer, including private letter rulings ("PLRs") requested by taxpayers and technical advice memoranda ("TAMs") requested in the course of an audit. PLRs and TAMs are issued by the IRS Chief Counsel's office in Washington, address the facts placed in front of the IRS, and have no precedential value beyond the taxpayers involved in them. However, they are disclosed to the public (after redacting taxpayer-identifying information), and tax practitioners read them because they serve to indicate the IRS' thinking on the subject involved at the time they are issued. It is important to remember that a PLR is binding on the IRS only as to the taxpayer who sought it; in future circumstances, the IRS can change its mind. More recently, the IRS has tightened its rules on the issuance of PLRs,

and fewer appear to be emanating from the agency. Still other forms of non-precedential pronouncements appear from time to time. One is called the "FSA," not to be confused with the SOA-awarded designation. This FSA stands for "field service advice," in which Chief Counsel office lawyers outside of Washington advise revenue agents on various legal matters.

The reader will recall that there is also a third branch of the federal government: the judiciary. A taxpayer who disputes legal or factual determinations made by the IRS in an audit has the right to ask a federal court to review those determinations and reach an independent judgment as to the tax liability in question. A taxpayer may bring such a dispute to the Tax Court, and may do so without the need to pay the asserted tax deficiency up front. A case also may be filed in a federal district court or the Court of Federal Claims in Washington, although in those courts the tax (with interest and any penalties) must first be paid and a refund claimed. Occasionally, such a dispute can even reach the U.S. Supreme Court (again, see "Blue Book Blues"). The courts' decisions typically are explained in opinions, sometimes called "case law." Case law consists of judicial decisions, which usually have value as legal precedent and may be binding on the IRS and other courts depending on the circumstances. If and when called upon to interpret the Code, courts will first look to the statute, then to regulations, and then to the statute's legislative history, and they will follow any prior case law that is binding in the matter. As noted above, IRS rulings and like pronouncements will be accorded a lesser status in judicial proceedings.

With this in mind, the reader may consider himself or herself duly educated in the sources of the federal tax law, and thus may join those practitioners who are suspicious of talk of the IRS Code and similar questionable phenomena. ◂

Do you have a question for a future installment of "In the Beginning... A Column Devoted to Tax Basics"?

Is there something about insurance tax that you've wondered but haven't known where to turn?

- What are corridor factors and why do they exist?
- Where does the interest rate come from for computing tax reserves?
- What's this 1.75% "DAC" input in the pricing model I'm running?
- How do you determine the taxable income from a partial withdrawal of a life insurance or annuity contract?
- I learned that my company isn't actually a life insurance company for tax purposes—how can that be?

We welcome your questions and suggestions, and our expert panel will consider them for a future issue of *Taxing Times*!

Submit your questions to the editor at *kristin.norberg@ey.com*.