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THE BENEFIT OF THE BARGAIN: IRS CHALLENGES TO SETTLEMENT ALLOCATIONS

By Kevin T. Leftwich

Sometimes you need to be careful what you bargain for. The corporate taxpayer in *Healthpoint Ltd. v. Commissioner*[1] learned this lesson the hard way after the Tax Court held that the company could not recast a jury award of punitive damages as "damage to goodwill and reputation" in a final settlement agreement. The holding prevented the taxpayer from characterizing the reallocated amount as capital gains instead of ordinary income. In reaching its decision, the court found that the allocation of damages in the settlement agreement was not reached through an adversarial process but instead was designed specifically to allow the taxpayer to treat the damages as capital gains. Adding insult to injury (or, as the case may be, penalties to damages), the court found the taxpayer liable for substantial understatement penalties under I.R.C. §6662(a). The case teaches important lessons for insurance companies that participate in drafting settlement agreements designed to achieve favorable tax treatment of the settlement payments.

The general rule is that the tax treatment of a settlement depends on the nature of the claims being settled.[2] The allocation contained in a settlement agreement will usually be respected for federal tax purposes if the agreement was reached through an adversarial, arm's-length process.[3] However, it is accepted that an allocation is not controlling where facts indicate that the allocation is inconsistent with the parties' actual economic intentions underlying the settlement.[4]

Healthpoint, Ltd., ("Healthpoint") received a jury award against Ethex Corporation ("Ethex") at the end of litigation concerning Ethex's marketing of an ineffective product as a generic version of one of Healthpoint's products. The jury awarded Healthpoint $16.1 million, $3.1 million of which was characterized as punitive damages. Ethex appealed. Additionally, prior to the jury's decision in the first litigation, Healthpoint filed a second suit relating to a different product sold by Ethex.

Healthpoint and Ethex negotiated extensively to settle the two suits before the first case was decided on appeal and before a jury decision in the second, and eventually agreed to a global settlement covering all claims from both cases. Healthpoint and Ethex agreed to settle for a total of $16.5 million— $12 million for the first suit and $4.5 million for the second. Healthpoint proposed allocating $1.1 million of the proposed settlement to punitive damages, as opposed to the $3.1 million in punitive damages awarded by the jury in the first litigation. Ethex, however, rejected the proposal and indicated that it would not agree to *any* allocation that characterized the company's actions as "willful misconduct." Healthpoint, believing that Ethex would not agree to any settlement that included punitive damages, agreed to an allocation that did not include any punitive damages.

The Internal Revenue Service (IRS) examined Healthpoint's tax return and challenged the characterization of the majority of the settlement amount as long-term capital gains. The IRS argued that the allocation of damages made by the jury should be applied to the settlement amount to determine its character for tax purposes, resulting in a significantly larger portion of the payment being ordinary income. The IRS further argued that the reallocation resulted in a substantial understatement and that a 20 percent penalty under I.R.C. §6662(a) should apply. The Tax Court, in interpreting the judicial precedent regarding the level of deference to be given to settlement allocations, stated that deference "is not warranted where circumstantial factors reveal that the designation of the settlement proceeds was not the result of adversarial, arm's-length and good faith negotiations and is incongruous with the 'economic-realities' of the taxpayer's underlying claims."[5]

The court was not persuaded by Healthpoint's argument that Ethex's refusal to agree to Healthpoint's proposed allocation of punitive damages was proof that the allocation was the product of adversarial, arm's-length negotiations. Instead, the court reasoned that Ethex's willingness to recharacterize the original punitive-damages award without decreasing the total settlement amount indicated that Ethex was not opposed to paying punitive damages; it merely refused to label the damages as punitive. The court further reasoned that, although Healthpoint and Ethex were clearly adverse with regard to their opposing claims and the amount of the settlement, their interests were not at odds with respect to the allocation of the settlement. Additionally, the court concluded that Healthpoint was motivated to agree to the final allocation because of tax considerations. The resulting settlement, therefore, according to the court, deviated from the "economic-realities" of the underlying claims. Because the settlement agreement should not be respected, the court determined that the best way to allocate the settlement amount was based on the percentages set forth in the original jury award.

Despite the citation of cases supporting the argument that settlement allocations should be respected for tax purposes, the court determined that Healthpoint's position was not adequately supported by substantial authority. Additionally, the court held that Healthpoint failed to show that it relied on the advice of tax counsel that the allocation was reasonable. As a result, the accuracy-related penalties of 20 percent were affirmed.

Taxpayers engaged in future settlement negotiations should heed the lessons learned from this ruling. Because tax consequences should be an important consideration in all settlement negotiations, and because a reallocation by the IRS can significantly alter the economics of the agreement the taxpayer anticipated receiving, it is important for taxpayers to evaluate whether the settlement allocation and, thus, the resulting tax treatment, is reasonable. Bringing the lessons learned from the *Healthpoint* case to the negotiating table hopefully can ensure that future taxpayers get the benefits they believed they bargained for. It is also important, however, to consider whether an allocation contained in an agreed-upon settlement should always form the basis of the recipient's return position (or an insurance company's Form 1099 information reporting position). The court's decision to uphold the substantial understatement penalty should motivate taxpayers to ensure that they have considered not only the settlement allocation, but also the subsequent tax positions taken based on the settlement. After all, a 20 percent substantial understatement penalty certainly was not one of the benefits Healthpoint believed it had bargained for.

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END NOTES

1 T.C. Memo 2011-241.
2 United States v. Burke, 504 U.S. 229, 237 (1992); Robinson v. Commissioner, 102 T.C. 116, 126 (1994); Raytheon Production Corp. v. Commissioner, 144 F.2d 110, 113 (1st Cir. 1944).
3 Robinson, *supra* note 2, at 126.
4 Bagley v. Commissioner, 105 T.C. 396, 406 (1995).
5 Healthpoint, Ltd. v. Commissioner, T.C. Memo 2011-241, at 1647.

TAX HEDGE ACCOUNTING MATCHING PRINCIPLES AND REVENUE RULING 2002-71

By Peter H. Winslow and Samuel A. Mitchell

Tax hedge accounting is one area of life insurance tax law that is not well understood. There are several reasons for this, not the least of which is limited Internal Revenue Service (IRS) guidance and the fact that in many companies the investment department and risk managers do not communicate well with the tax department. The purpose of this article is to clear up some common misconceptions about the matching requirement for tax hedge accounting as interpreted by one of the few relevant revenue rulings. In the authors' experience, the matching principle frequently is misapplied by IRS agents on audit and by life insurance companies themselves.

What Qualifies as a Tax Hedge?

In general, realized gains and losses on financial instruments must be recognized for tax purposes, unless the instrument is part of a hedging transaction as defined in the Internal Revenue Code and regulations.[1] Gain and loss relating to a derivative that is part of a tax hedging transaction must be accounted for as ordinary income or loss in a manner that clearly reflects income.[2] A hedging transaction for tax purposes includes a transaction that a taxpayer enters into in the normal course of its trade or business primarily to manage the risk of (1) price changes or currency fluctuations with respect to ordinary property that is held or to be held by the taxpayer, or (2) interest rate or price changes or currency fluctuations with respect to borrowings made or to be made, or ordinary obligations incurred or to be incurred, by the taxpayer.[3] Whether a

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transaction manages a taxpayer's risk is determined based on all of the facts and circumstances surrounding the taxpayer's business and the transaction.[4] A taxpayer's hedging strategies and policies, as reflected in its business records, are evidence of whether a hedging transaction manages risk.[5] The general test for whether there is risk management is determined at the macro level. Thus, a hedging transaction designed to manage risk with respect to a particular ordinary asset or liability generally is treated as a tax hedging transaction only if it also manages overall risk of the taxpayer's operations.[6]

Several other observations about the tax hedge qualification rules are worth noting. First, a qualified hedging transaction includes a hedge of an anticipatory acquisition of an ordinary asset or issuance of a liability. Second, tax hedge treatment can apply even if the hedge is for less than all the risk or for less than the entire period of the risk.[7] Third, unless a separate company election is made, the determination of whether a transaction qualifies as a tax hedge is made by treating all members of a consolidated tax return as if they were divisions of the same company.[8] Fourth, there are same-day tax hedge identification requirements that must be satisfied.[9] Finally, and significantly for life insurance companies, it is the IRS's position that whether a so-called "gap hedge" qualifies as a hedge of ordinary liabilities is a question of fact and depends on whether the hedge is more closely associated with liabilities than with capital assets. This more closely associated standard is not found in the Code or regulations, but only in the preamble to Treas. Reg. § 1.1221-2(b), and has led to much controversy in recent years.[10]

There are several advantages of tax hedge qualification: Regulated futures that are part of a tax hedging transaction are not required to be marked to market under I.R.C. § 1256;[11] the character of gain and loss on the hedging instrument is ordinary rather than capital; and a tax hedging transaction is not subject to the straddle rules of I.R.C. § 1092, under which losses realized on the disposition of a straddle position generally are deferred to the extent of unrecognized gain in positions open at year-end.[12] Most important for purposes of this tidbit, tax hedge qualification requires the adoption of an accounting method that clearly reflects income.

Tax Hedge Accounting

Treas. Reg. § 1.446-1(a) sets forth the general tax accounting rule and provides that, although no uniform method of accounting applies to all taxpayers, no method of accounting is acceptable unless, in the opinion of the IRS, it clearly reflects income. The requirement to clearly reflect income is reiterated specifically for tax hedges in Treas. Reg. § 1.446-4(b). The regulation states that clear reflection of income is achieved by matching, as follows:

> To clearly reflect income, the method used must reasonably match the timing of income, deduction, gain, or loss from the hedging transaction with the timing of income, deduction, gain, or loss from the item or items being hedged. Taking gains and losses into account in the period in which they are realized may clearly reflect income in the case of certain hedging transactions. For example, where a hedge and the item being hedged are disposed of in the same taxable year, taking realized gain or loss into account on both items in that taxable year may clearly reflect income. In the case of many hedging transactions, however, taking gains and losses into account as they are realized does not result in the matching required by this section.

The regulations go on to provide flexibility in choosing an appropriate tax hedge accounting method as long as it satisfies the matching principle. They state that different methods of accounting may be used for different types of hedging transactions and for transactions that hedge different types of items. However, once a taxpayer adopts a method of accounting, that method must be applied consistently and can only be changed with the consent of the IRS.[13]

To comply with the regulations, the objective of a tax hedge accounting method should be to clearly reflect income by matching the timing of tax recognition of gains, losses, income and deductions attributable to the hedging instruments with the tax recognition of comparable items attributable to the hedged item. The regulations contemplate that ordinary tax rules will apply to the hedged item with the timing of recognition of gain/loss, etc., relating to the hedging instrument adjusted to match the hedged item. Thus, the regulations provide, in general, that tax accounting for the hedging instrument will supersede accounting rules that otherwise would apply under regulations so that proper matching to clearly reflect income occurs.[14]

Rev. Rul. 2002-71

Perhaps the most often misunderstood IRS guidance on the tax hedge accounting matching principle is Rev. Rul. 2002-71.[15]

In that ruling, a taxpayer issued a 10-year debt instrument and acquired a derivative with a five-year term that effectively converted the fixed rate payments on the debt into floating rate payments. In accordance with Treas. Reg. § 1.446-4(e)(4), the hedge was accounted for as if it had adjusted the yield over the first five years of the hedged debt. In the ruling's Situation 1, the taxpayer terminated the derivative at the end of the second year. The issue addressed in the ruling was how to account for the termination payment. The IRS concluded that the gain or loss arising from the termination should be accounted for over the remaining period to which the terminated hedge relates.

Some taxpayers and IRS agents have relied on this ruling to conclude that gain or loss on derivatives that are terminated should always be spread over the period that the derivative would otherwise have been outstanding, but this is not what the ruling says or means. In the ruling, the termination payments were properly reflected over what would have been the remaining five-year term of the derivative, but that is only because the hedge related only to the first five years of risks relating to the hedged 10-year debt.

For many hedges routinely entered into by life insurance companies, the facts are not the same as in Rev. Rul. 2002-71. For example, suppose a company has a block of immediate annuity obligations with a duration of 10 years that the company would like to shorten. It decides to hedge the aggregate interest rate risk of the block of liabilities and selects a two-year receive-fixed/pay-floating interest rate swap with a notional amount that is greater than the present value of the annuity obligations. If the swap is terminated after one year at a gain or loss, Rev. Rul. 2002-71 does not support the conclusion that the gain or loss should be recognized in full in year two—when the swap otherwise would have terminated. Instead, because the hedge related to the aggregate interest rate risk in the hedged liabilities, it should be matched to the tax recognition of the entire hedged liabilities—probably a spread over the remaining nine-year duration of the liabilities. In short, a clear reflection of income requires a matching of gain or loss on a terminated hedge to the tax recognition of the hedged risks, whether or not that is the same as the remaining term of the hedge. Rev. Rul. 2002-71 does not hold otherwise. ◄

END NOTES

1 I.R.C. § 1221(a)(7); Treas. Reg. § 1.1221-2(b).
2 Treas. Reg. § 1.446-4.
3 I.R.C. § 1221(b)(2); Treas. Reg. § 1.1221-2(b).
4 Treas. Reg. § 1.1221-2(c)(4).
5 Treas. Reg. § 1.1221-2(c)(4).
6 Treas. Reg. § 1.1221-2(d)(1)(ii).
7 Treas. Reg. § 1.1221-2.
8 Treas. Reg. § 1.221-2(e)(1).
9 Treas. Reg. § 1.1221-2(f).
10 T.D. 8555, 1994-2 C.B. 180. A typical gap hedge seeks to close a duration gap between liabilities and assets (which may be capital) that are held to fund the liabilities. Because the company's risk primarily relates to the company's ordinary liabilities, one would think that the hedge should qualify as a tax hedge under I.R.C. § 1221(a)(7) whether or not capital assets also are considered in the hedge program. But, as indicated in the regulations' preamble, the IRS disagrees at least in some cases where the hedge is more closely associated with the capital assets funding ordinary liabilities.
11 I.R.C. § 1256(e).
12 I.R.C. § 1092(e).
13 Treas. Reg. § 1.446-4(c).
14 Treas. Reg. § 1.446-4(a).
15 2002-2 C.B. 763.

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