1991 VALUATION ACTUARY SYMPOSIUM PROCEEDINGS

SESSION 6

Tax Issues

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TAX ISSUES

Prepaid Tax Asset Issue

MR. RICHARD S. MILLER: The prepaid tax asset question should be addressed. When we are required to include taxes in a projection of solvency within the evolving standards associated with the valuation actuary, those projected cash flows will certainly reflect the accumulated tax position of our company. If tested cash flows purport to include tax cash flows then the current net operating loss carryforwards, unamortized deferred acquisition cost (DAC), and the expected runoff of the difference between tax and statutory reserves should be recognized. There is little disagreement on assessing premium taxes in the liability cash-flow projection. However should premium tax recovery through amortization of guaranty fund assessments be included at the line of business?

Filed tax returns typically take the most aggressive position that the signing preparer is willing to propose. Surely cash-flow testing done by a valuation actuary should at least consider the best estimate of any tax deficiency and the reasonable worst case. However, these workpapers are probably subject to an IRS auditor's discovery, and their existence would violate one of the cardinal rules of tax work.

Interest in claiming a prepaid tax asset for statutory valuation questions will grow very real if, as I expect, the industry moves to a position where a reasonable valuation of the prepaid tax reaches 20% of statutory net worth but is not recognized in statutory valuations. By my calculations the unamortized DAC will exceed 6% of industry net worth by year-end 1993. At the same time I expect the effect of the applicable federal interest rate (AFIR) to produce a prepaid tax, relative to statutory accounting, in excess of 10% of industry net worth. Some clients have indicated that this element hurt 1990 results even worse than DAC would have at a full-year rate. Joe Sikora's charts indicate that the divergence between tax and statutory reserves will continue to grow before it begins to reverse with regard to the in-force business. New business will add to the problem.

From past experience, no tax evaluation can be trusted unless it is reconciled, and preferably determined, at the total company level, which should include new business. My

net advice is to not consider taxes, except for premium taxes, in your first cut on cash-flow testing. Plan to add tax cash flows coincident with the additions of new business and corporate surplus modules.

The question of a prepaid tax asset has been raised at the NAIC but no action has been taken for both legitimate and public relations reasons. The principal substantive reason is that no comprehensive treatment of income tax liability and prepaid asset has been presented.

That treatment will have to speak to such questions as:

- If no taxes have been paid, can there be a prepaid tax asset?

- May companies continue to show a tax status on their statutory blocks of reflecting returns as filed and tax deficiency assessments as paid? I don't think there is a practical alternative from a tax manager's standpoint, but will the valuation actuary be held to a higher standard of "best estimate" when it comes to projecting the tax cash flows?

Surely the valuation actuary will be required to reconcile his treatment of tax within his cash-flow projections with the GAAP deferred tax asset or liability.

If the future tax effect is not treated in a comprehensive fashion, then it will certainly be treated piecemeal and anomalies will result. My plea is that all of you start discussing and lobbying for consideration of an admitted asset by the NAIC for "net" taxes paid in advance.

Asset Allocation

A minimum expectation is that the premium taxes will be included as a negative cash flow into the liability projection. This raises the question of whether guaranty association assessments should be allocated to the line of business for testing purposes. Such an

allocation will produce a more accurate projection of cash flows but places a strain on the line due to the zero investment return inherent in the asset.

Consideration of premium tax leads to consideration of the DAC tax, which has an economic impact similar to a premium tax.

If income tax cash flows are incorporated into the cash-flow testing, then the question of projecting tax reserves according to the AFIR arises. If accuracy to this level is seriously attempted then the additional step of determining the federal income tax cash-flow effect at the total company level should be considered. Within the statutory, valuation-actuary, cash-flow-testing focus on in-force business only, very substantial negative cash flows will likely result from this analysis.

A practical alternative is to derive a marginal tax rate on statutory income from a traditional model office analysis and use this rate to derive the expected tax cash flow.

Several previous speakers have mentioned the question of appropriate treatment of emerging earnings: basically should you retain them in the line of business or distribute them? If they are retained, I prefer to attempt to determine an appropriate tax effect. If they are to be distributed to a surplus segment, then they can be distributed on a before-tax basis and let the surplus line deal with the tax consideration.

Appraisal Considerations

Statutory cash-flow testing can be modified to yield projections suitable for determining the economic value of the in-force business (i.e., an actuarial appraisal). The management questions that lead to this adaptation of the cash-flow-testing system will usually demand incorporation of new business.

At this point, from past appraisal experience, I caution you to somehow project every piece of your company and determine the tax effects at the total company level. This true-up of

the tax at the total company level will often lead to substantial differences between the total company tax cash flows and the sum of the tax cash flow of the separate line of business, including a separate surplus line of business.

CURRENT DEVELOPMENTS WITH RESPECT TO THE TAXATION OF LIFE INSURANCE COMPANIES

MR. RICHARD BROMLEY: I want to thank Dick Miller for being so kind as to invite me to speak to you. It is a real honor, and frankly, it's rather daunting to be in the presence of so many people who know so much more than I about the mathematical intricacies of the life insurance business.

But I want to thank Dick even more for all the help that he and his partner Waid Davidson rendered to us in trying, and ultimately winning, the *USAA Life* case. A good deal of that case, as is true with many insurance tax cases, involved gaining some measure of understanding of the actuarial concepts that underlie life insurance reserves, and translating those concepts into a jargon that is understandable to those of us who are not schooled in the science and art of higher mathematics. Dick was particularly adept at helping in that translation and was also very resourceful in explaining concepts in ways that aided us in putting on our client's case.

As I'm sure many of you know, the principal issue involved in the *USAA Life* case was whether or not USAA computed the life insurance reserves for its universal life (UL) contracts on a preliminary-term basis. If it did, then it was entitled to revalue the reserves under the approximate revaluation method under section 818(c)(2) of the Internal Revenue Code as it existed prior to 1984.

Stated briefly, that section of the Code provides that if a life insurance company taxpayer computes its reserves on a preliminary-term basis, it may elect for tax purposes to revalue those reserves either:

1. on an exact revaluation method as if the reserves had been computed on a net level basis, *or*
2. on an approximate revaluation method by increasing its preliminary-term reserve by $19 per $1,000 of insurance in force under the contracts, less 1.9% of reserves under the contracts.

The key question in the case, then, was whether USAA had actually used a preliminary-term reserve methodology in computing the reserves on its UL policies.

USAA began issuing UL policies in 1982. Under those policies, USAA computed cash values by imposing a periodic loading charge equal to 3% of each premium payment, plus an additional first-year charge of only $50 per policy. Compared to the rest of the life insurance industry, this front-end-load charge was obviously very low. In addition, USAA did not impose surrender charges on policyholders who cashed out in full, with the result that the cash-surrender values were equal to the full contractual cash values as computed each month. Therefore, USAA's cash-surrender liability to its policyholders was relatively greater than is the case with many -- if not most -- other life insurers.

USAA attempted to compute its universal life reserves on the basis of the commissioners reserve valuation method (CRVM) preliminary-term method of the NAIC model regulation. However, as was, I suspect, not uncommon, because of the complexity of the CRVM methodology, and because of a lack of adequate computer capability, USAA used a shortcut. Rather than computing a net level reserve, USAA substituted the aggregate cash-surrender values, and subtracted the unamortized expense allowance from that number.

USAA knew that the cash-surrender values of its policies were less than the amount that would have represented a net level reserve, but it also knew that this difference was relatively small, due to the front-end load of only $50. In fact, the difference between a computed net level reserve and the cash-surrender value was only approximately $250,000 in the aggregate.

USAA's cash-surrender values were approximately $9.1 million. After subtracting the unamortized expense allowance of $3.8 million, USAA arrived at what it considered a preliminary-term reserve of $5.3 million. This amount was reported on Exhibit 8, Part A of its annual statement as having been valued on the basis of a 4.5% assumed interest rate, a recognized mortality table (1958 CSO), and a preliminary-term method (CRVM).

However, because the cash-surrender value exceeded the computed 8A preliminary-term reserve, the excess was required by the states to be held in reserve, and was reported by USAA in Exhibit 8, part G, which, as you know, is captioned, "For surrender values in excess of reserves otherwise required and carried in this schedule."

For tax purposes, USAA then revalued this preliminary-term reserve under the approximate method of section 818(c)(2). It thereby had a revaluation deduction of $16.8 million, consisting of the $5.3 million computed preliminary-term reserve, plus an $11.4 million approximate revaluation.

In addition, in computing its gain or loss from operations, USAA claimed a deduction for the 8G excess cash-surrender value as an amount other than a life insurance reserve.

Unfortunately, USAA did not treat the amounts consistently on its tax return and, in addition, made computational errors in computing the reserve amount. For example, in reporting the reserve ratio that determines whether it was a life insurance company for tax purposes, USAA included the 8G excess surrender value in life insurance reserves. In another instance, we discovered that the person computing the reserve had read across a table, rather than down, and had come up with numbers that were slightly off.

On examination, the IRS allowed a deduction for the 8A CRVM reserve and for the 8G excess cash value, on the theory that the two were really one reserve, net level, and that USAA had artificially bifurcated that reserve in order to get the extra $11 million revaluation deduction.

Notably, as a result of the stipulations we entered into, several arguments that the IRS had made with respect to other taxpayers were not made in this case:

1. The IRS has often argued that "net level" and "preliminary term" are meaningless concepts for UL reserves, therefore no 818(c) adjustment is appropriate. In the *USAA*

Life case the government pretty well accepted the model regulation CRVM method as a valid preliminary-term methodology for UL.

2. The IRS also did not argue that UL is really renewable-term insurance plus a premium deposit fund, and that therefore only $5 per $1,000 adjustment is allowable under 818(c).
3. Finally, the IRS did not argue that UL reserves do not satisfy the Code definition of "life insurance reserves."

Main IRS Argument -- Substance over Form

The IRS's main argument was based on substance over form. It argued that:

1. Taxpayer's "life insurance reserves" were the entire surrender value.
2. The CRVM "life reserve" claimed by USAA, plus the excess surrender value, was, in substance, a net level reserve, because:
   a. They were close in amount;
   b. The taxpayer had assumed the difference of $50 per policy (about $250,000 in aggregate) to be unimportant for calculation purposes; and
   c. Life insurance reserves may be "computed or estimated," and the surrender value was USAA's true "estimate" of its life insurance reserves determined on the net level method.
3. USAA's purported CRVM reserve was merely a tax-planning device.

USAA's Position

USAA's position was as follows:

1. Its UL "life insurance reserves" included only the CRVM reserve reported in Exhibit 8A.
2. Life insurance reserves were computed on a preliminary-term basis, therefore the 818(c) adjustment applies.
3. The surrender values were not life insurance reserves.
4. Excess surrender value was a reserve liability other than a life insurance reserve.

5. This result is sensible within the statute. If a company has no excess surrender values and computes CRVM reserves, it would be allowed CRVM reserves, plus an 818(c) adjustment.

USAA argued that it should be allowed similar treatment and that it should also be allowed to deduct its excess surrender value because USAA's liabilities to its policyholders are greater by the amount of that excess surrender value.

IRS Alternative Argument

The IRS argued in the alternative that if USAA is allowed to take the 818(c) adjustment, then the excess surrender value must be disallowed as a double deduction.

Tax Court (Judge Featherston) Held for Commissioner

The Tax Court held that USAA computed its reserves using a net level method, and that it was not entitled to revaluation:

1. The court ruled that the state-mandated cash-value reserve was in essence a net level reserve.
2. The court also held that carrying two reserves -- CRVM plus excess cash value -- "carries no substantive weight." Judge Featherston reasoned that the purpose of the preliminary-term approximate revaluation was to give life companies using a preliminary-term method tax consequences comparable to those using net level. The election was intended to equalize treatment for companies that were getting surplus relief from use of preliminary term. The judge said that the measure of surplus relief in this context is the difference between a net level reserve and the reserve actually maintained under the preliminary-term method. He found that the relatively small difference between the amount of a computed net level reserve and USAA's combined preliminary-term and excess cash values "does not represent the kind of surplus relief that Congress had in mind in enacting § 818(c)." He suggested further that Congress had apparently targeted the typical situation in which a computed preliminary-term reserve provided dollar-for-dollar surplus relief.

Judge Featherston also held that the cash-surrender value satisfied the requirements of a life insurance reserve under §801(b). One of the requirements for a life reserve is that it be "computed or estimated on basis of recognized mortality tables and assumed rates of interest." The judge emphasized the close relationship in the amounts of the cash-surrender value and the net level reserve and asserted that they had the same actuarial foundation. He also found that the cash-surrender value was "set aside for future unaccrued claims" within requirements of §801. The Tax Court did not reach the government's alternative argument.

The Tax Court's decision case was appealed to the 5th Circuit in New Orleans.

USAA's Basic Arguments on Appeal

On appeal, USAA cited legislative history and a 1981 Government Accounting Office (GAO) report to show a Congressional awareness that, as reserving methodologies developed after the 1950s, when the preliminary-term revaluation election was enacted into the law, it became more advantageous for life companies to elect approximate revaluation under §818(c)(2). Congress specifically recognized that approximate revaluation was resulting in reserves greater than exact revaluation, and since virtually all companies use preliminary term, revaluation was no longer needed to equalize reserve deductions of various companies. The Congress had also recognized that the result was "to provide a vehicle for a subsidy for *all* taxpayers, regardless of need," so that by 1982-83, the prevailing circumstances were the opposite of what existed before 1959.

Before 1959, companies might have had nontax business reasons for preferring a preliminary term method, e.g., to obtain surplus relief. But, this preference was in conflict with the desire to enjoy the relative tax advantage of higher net level reserves. This the Tax Court had understood, as evidenced by its statement that net level is generally favored by life companies for tax purposes. But the Tax Court did not seem to comprehend that the world had changed by 1982-1983. Then, as recognized by Congress and the GAO, companies preferred the preliminary-term method from both a business and a tax

standpoint, because the approximate revaluation formula was far more favorable than net level. And in 1982, Congress nonetheless determined that this should continue, only at a slightly reduced rate of subsidy.

USAA argued that one can agree or disagree with Congress's wisdom in giving the industry this tax subsidy, but at least it did not create a competitive imbalance or unfairness among companies. The subsidy was equally available to all. That is the real-world context in which the case arose.

We also tried to demonstrate that the Tax Court's opinion upset this competitive equilibrium. We pointed out that the section 818(c)(2) revaluation formula is not affected by the presence or absence of excess surrender-value reserves. The only variables that come into play under the formula are:

1. the amount of insurance in force, and
2. the amount of computed reserve for the policies.

Insurance in force is by far the more material variable. Under this formula, two companies that issued policies with the same insurance in force and computed the same preliminary-term life reserve, would get the same tax benefit, even though one might have much lower cash-surrender value -- due, e.g., to high surrender charges. Under the Tax Court's approach, however, the presence of the excess cash value results in no revaluation of the preliminary-term reserve. The net result is that under the Tax Court's approach, USAA's more generous treatment of its policyholders causes it to lose the revaluation deduction. In a nutshell, its overall reserve deductions are lower because its overall liabilities to its policyholders are greater. USAA asserted that this result is not defensible legally or logically.

USAA also argued that the Tax Court's "surplus relief" standard is at odds with the plain language of the statute and with the Commissioner's published ruling position. (See Rev. Rul. 75-51). The life insurance reserve computed and reported by USAA was only the

CRVM insurance reserve; it did not include the excess cash-surrender value. USAA further argued that CRVM meets all tests of life insurance reserve, and cash value does not because:

1. It represents a currently accrued amount, not a future unaccrued claim;
2. It is not determined by predictive methods used for life reserves;
3. Assumed interest rates are not used; and
4. Mortality tables do not determine the timing or amount of surrenders -- they are not dependent on death, but on the policyholder's discretion.

We also argued that the Tax Court's holding that cash value is a life reserve because it is an estimate of a net level reserve is irrelevant and erroneous. USAA was entitled to select any permissible reserving method. It selected CRVM, and nothing requires it to select net level.

The case was argued before the 5th Circuit on April Fool's day of 1991. To the surprise of many, the Court of Appeals reversed the Tax Court. It has since also denied the government's motion for rehearing. The Court of Appeals stated that, "speaking plainly," the Tax Court's opinion was "utterly unpersuasive." It stated that the record in the case unambiguously demonstrates that USAA in point of fact used a preliminary-term method, citing its workpapers and its annual statement treatment of the reserve and excess cash value.

The Court of Appeals also stated that the IRS's arguments in support of the Tax Court's judgment "bordered on the casuistic" -- a term that sent many attorneys to the dictionary. It rejected out of hand the IRS's argument that USAA really had a net level -- rather than a preliminary-term -- reserve because its total reserves were close in amount to what net level would have been. It stated that under such logic, which treats a numerical similarity between bottom-line reserves as dispositive, any insurer that used a preliminary-term reserve, but whose aggregate cash-surrender value varies only slightly from net level is to be treated as having used net level. It found no cause to sanction such logic.

The Court of Appeals similarly rejected the IRS's argument that USAA was required to show a nontax reason for using separate reserves.

The Court stated that "it would be an exercise in superfluity to decide whether USAA's aggregate cash-surrender value had the characteristics of a life reserve for tax purposes." It did note, however, that the cash-surrender value was not calculated on the basis of mortality factors or assumed interest rates. What was important to the Court was how USAA in fact did the calculation.

The surplus relief standard enunciated by the Tax Court was also rejected. The Court of Appeals acknowledged that the preliminary-term election results in a deduction that dwarfs what a net level deduction would have produced, and speculated that this type of windfall may have caused Congress to repeal the deduction in 1984. It further accepted our argument that the surplus relief standard articulated by the Tax Court would disadvantage a company that imposes low surrender charges. Moreover, it emphasized that the Tax Court's surplus relief standard is not contained in section 818(c).

Finally, the Court of Appeals remanded the case to the Tax Court to decide the issues it had not addressed the first time around:

1. Whether USAA's computations contained errors, and if so, the amount of those errors and whether they can be corrected; and
2. Whether USAA is also entitled to deduct the 8G excess cash value in addition to the revalued preliminary term.

USAA argues that the 8G amount is properly deductible under either:

1. Section 810(c)(3), as amounts necessary to satisfy obligations under insurance or annuity contracts which do not involve life, health or accident contingencies, or
2. Section 810(c)(4) as amounts held at interest in connection with insurance or annuity contracts.

The hearing on remand has not yet occurred.

Implications of USAA Life

1. The decision is of only one circuit. The IRS may still pursue the issue in cases appealable elsewhere.
2. Surplus relief is not the defining characteristic of preliminary-term reserves.
3. It is very important for the taxpayer to be able to show as a factual matter what it intended to do and what it did in fact do. In this regard, the possible interplay of the *USAA Life* case and the *Central National Life* case is noteworthy.

One of the most difficult precedents we had to deal with in *USAA Life* was another case we had won, the *Central National Life* case, where the IRS argued that the taxpayer did not qualify as a life company for tax purposes because it had computed reserves on its credit life policies using a gross unearned premium method. We there successfully argued that the taxpayer had intended those reserves as estimates of life reserves, and thus it did qualify. We had factual evidence to back that argument up.

In *USAA* the government cited the *Central National Life* case against us, saying USAA had used aggregate cash value as an estimate of net level, and therefore it had not computed a preliminary-term reserve. We showed facts to the contrary.

It seems to me that *Central National Life* can be useful to taxpayers:

1. It shows, too, that what the taxpayer did factually is significant.
2. In other instances of which I'm aware, taxpayers did not go through any of the steps of trying to compute a CRVM preliminary-term reserve. Rather, they just tried their best to estimate it. And now the IRS has disallowed the deduction. I think both *USAA Life* and *Central National Life* should help. If you can show factually what was intended and what was done, you have a leg up.

Amortization of Intangibles

Well, I have probably said more than enough about *USAA Life* and 818(c). Let me now turn to a brief review of recent developments with respect to tax issues involving the amortization of intangibles.

Under current law, the value of an intangible asset that has been purchased may be amortized for federal income tax purposes if a two-part test is satisfied:

1. The value of the intangible asset must be established, separate and distinct from goodwill.
2. The useful life of the asset must be capable of being estimated with reasonable accuracy.

The regulations under section 167 say that no depreciation is allowable with respect to goodwill, which is generally defined as "the expectancy of continued patronage" or "that old customers will return to old places."

In the insurance arena, the right to amortize intangible assets generally arises in the context of an acquisition of a company's insurance in force or of insurance expiration lists under former section 334(b)(2) or section 338.

Generally, old section 334(b)(2) and section 338 provide that, if at least 80% of the voting power and 80% of the total number of shares of all other classes of stock are acquired within a 12-month period, the acquirer may treat the acquisition of stock as a purchase of assets. The acquiring company's basis in the acquired stock is generally equal to the purchase price of the stock plus liabilities assumed, which in the case of insurance, include the acquired company's reserves. The basis of the acquired stock is then allocated to the company's tangible and intangible assets based on their respective fair market values on the date of acquisition.

Insurance In Force

In the case of acquisition of a life insurance company, the major asset acquired is insurance in force. Since these contracts have an actuarially determinable useful life, one of the requirements for amortization is generally satisfied without too much question. However, on audit the IRS frequently challenges the value placed upon the acquired in-force business.

Insurance Expirations

With insurance expirations, both tests for amortization are brought into play: valuation and determination of useful life.

Insurance expirations are generally described as records that contain information on insurance policies covering fire, casualty and other risks. In effect, they are the records that provide information to aid in renewal of the policy. As I say, the IRS has tended to assert that insurance expirations are inseparable from goodwill and that they can therefore not be amortized. This position was specifically set forth in Rev. Rul. 74-456. However, in that ruling the IRS also said that, if in an unusual case, the asset does not possess the characteristics of goodwill, and if it is susceptible to valuation, and if it has a limited useful life, a depreciation deduction may be allowed. So the IRS ruling admitted some possibility of depreciation, but imposed a heavy burden of proof on the taxpayer.

IRS Coordinated Issue Paper

In 1990 the IRS issued a Coordinated Issue Paper in which it concluded that, if customer-based intangibles are acquired in connection with the purchase of an ongoing business, the requirements for amortization under Rev. Rul. 74-456 cannot be met. Therefore, in such cases, no amortization of the acquired intangibles is permitted. The paper did not focus just on insurance, but insurance expirations were specifically addressed. This issue has given rise to a number of litigated cases.

Recent Cases Involving Intangibles

In the insurance arena, the *Decker* case out of the Seventh Circuit is most notable. That case involved acquisition of insurance expirations in connection with the purchase of an insurance agency. There the Court, in affirming the Tax Court's ruling for the IRS, held that the insurance expirations were nondepreciable. The facts were particularly unfortunate. Among other things, the taxpayer had allocated the purchase price between covenants not to compete and the expirations. Nothing had been allocated to goodwill.

Since that decision, several cases have been resolved in the taxpayer's favor. These included the *Citizens & Southern* and *Colorado National Bankshares* cases, involving bank core deposits.

More recently, however, the IRS has had two significant victories: *Newark Morning Ledger* (involving newspaper subscriptions) and *Ithaca Industries* (involving assembled work force in place). In both cases, the taxpayer sought to distinguish the intangible asset it had acquired from goodwill. In both, the taxpayer did this by showing that the asset could be separately valued and that it had a limited useful life, the length of which could be estimated with reasonable accuracy.

In the case of *Newark Morning Ledger*, the asset was valued using the income approach, i.e., the present value of the gross revenue stream was first valued, and the projected costs of collecting the revenue was then subtracted. The resulting net revenue stream was said to be a reasonable estimate of the value of the intangible asset.

The IRS contested this methodology and urged instead that, even assuming for sake of argument that this asset was depreciable, it should be valued based on the cost of generating the asset -- a much lower amount than resulted under taxpayer's income approach.

The IRS conceded that the asset had an ascertainable value and a limited useful life. The taxpayer asserted that, in view of these concessions by the IRS, the asset was necessarily not goodwill. In a nutshell, the taxpayer was saying that goodwill is no more than the residual value that remains after all assets with determinable useful lives and ascertainable values have been accounted for. Anything possessing a determinable useful life and an ascertainable value is not goodwill.

The IRS disagreed. It argued that, in addition to proving these elements, the taxpayer must also demonstrate that the asset is not goodwill. In the IRS's view, the future stream of revenues to be generated by the asset is the very essence of goodwill value and, as such, cannot be depreciated.

The lower court agreed with the taxpayer. But on appeal, the Third Circuit reversed, saying that the overwhelming weight of authorities line up squarely behind the IRS's position.

In reaching its decision the Third Circuit also noted that, "the fact is that, when employed in the context of the sale of an ongoing concern, the income approach to valuing a list of customers inherently includes much or all of the value of the expectancy that those customers will continue their patronage -- i.e., the goodwill of the acquired concern."

Query what this might mean for valuing insurance in force. Will the IRS argue that by valuing the asset based on its projected income stream, you are picking up goodwill and deny depreciation for that reason or to that extent?

The other recent case of note is the *Ithaca Industries* case, which involved an attempt by the taxpayer to depreciate the value of an assembled work force as an asset separate and distinct from goodwill and going-concern value.

The taxpayer argued that the replacement-cost method could be used to value the assembled work force and that when it was valued on this basis, no part of the value of the

assembled work force is an integral part of the going-concern value. The taxpayer also urged that it was the assembled work force -- not each individual worker -- that was a wasting asset.

The IRS argued, however, that an assembled work force represents the value inherent in having a trained staff of employees in place, which enables the business to continue without interruption, and is nondepreciable, going-concern value.

The Tax Court agreed with the IRS, saying that case law supports a conclusion that, because an assembled work force is necessary to allow the business to operate and generate income without interruption during and after acquisition, it is generally not an asset that is separate and distinct from going-concern value. This could obviously impact the treatment of the acquisition of an agency force.

Interestingly, the Court stated that as a general rule an asset can be regarded as distinct from goodwill and going-concern value where the evidence shows the asset to be a wasting asset with a reasonably ascertainable useful life and value. This is, of course, directly contrary to the Court's holding in *Newark Morning Ledger*, which said that is not enough -- you must also show that it is separate and distinct from goodwill. In any event, the Court held in *Ithaca Industries* that the assembled work force was not a wasting asset.

Legislation

Notably, in the *Newark Morning Ledger* case, the Court acknowledged the analytic force behind the residual method of defining and calculating goodwill. But it indicated that, in view of the overwhelming case law, changes would have to come from Congress.

That seems to be in the offing. There has been a series of intangibles bills introduced in the Congress this year. The first, H.R. 563, which was introduced by Congressman Thomas J. Downey, would simply have denied amortization for any "customer-based, market share or similar intangible." That bill was followed by two bills that went in the opposite

direction: H.R. 1456 (sponsored by Congressman Guy Vander Jagt) and S. 1245 (sponsored by Senators Thomas Daschle and Steve Symms). Both of these bills would simply have codified existing law.

The most significant bill, H.R. 3035, was introduced by Congressman Dan Rostenkowski, Chairman of the House Ways and Means Committee. It probably renders the other bills moot. The Rostenkowski bill was intended to "simplify the tax treatment of intangible assets." It would specify a mandatory 14-year amortization period for most acquired (as opposed to created) intangibles. This 14-year recovery period would obviously mean slower cost recovery for some assets and faster cost recovery for others. The 14-year period was selected because it resulted in the bill being close to being revenue neutral.

The Treasury Department quickly indicated its support, as did the Commissioner of Internal Revenue. And the GAO released a report entitled "Tax Policy: Issues and Policy Proposals Regarding Tax Treatment of Intangibles," which generally supports the statutory amortization approach taken in the Rostenkowski bill. However, the GAO goes beyond the Rostenkowski bill in suggesting that the deductibility under current law of certain expenses that create goodwill (such as advertising) should be reevaluated.

In contrast to other bills that have been introduced, the Rostenkowski bill is quite detailed. It would create a new section 197 and a new category of intangible assets -- "section 197 intangibles." This category would expressly include most of the intangible assets that the IRS and taxpayers have fought over:

1. customer-based intangibles (which would be involved in an acquisition of insurance in force and insurance expirations);
2. supplier-based intangibles;
3. work force in place (which might be involved in an acquisition of an insurance company or an insurance agency);
4. trademarks and copyrights; and

5. covenants not to compete (which could be involved in acquisition of insurance company or insurance agency).

In addition, section 197 would specifically apply to goodwill and going-concern value. Therefore, it would for the first time be unnecessary to distinguish an asset from goodwill and going-concern value in order to obtain amortization. Instead, with certain exceptions, taxpayers would amortize on a straight-line basis over 14 years the amount paid for any section 197 intangible. The bill would thus resolve legislatively the issues giving rise to much of the present litigation in the intangibles area.

Section 197 would be the exclusive source for amortization of the intangibles to which it applies. Therefore, even if a given asset had a stated term shorter than 14 years, or could be shown to waste at an accelerated rate, the taxpayer would still be entitled only to straight-line, 14-year amortization.

The Rostenkowski bill contains a special rule for assumption reinsurance. The legislative report accompanying the bill would make clear that indemnity reinsurance is not implicated.

The bill contains a provision to deal with the DAC rules under section 848 of the Code. Essentially it is a "no double-counting" provision. It provides that the value of all the section 848 amounts, i.e., the amounts amortized under the DAC provisions, are first backed out. Then the balance is amortized under this bill over a 14-year period.

On balance, this bill may well treat the insurance industry unfavorably. In many, if not most cases, we have been able to amortize intangibles -- such as insurance in force -- over fewer than 14 years. Moreover, as a result of last year's Congressional override of the Supreme Court's decision in the *Colonial American Life* case, much of the cost of acquiring life insurance contracts in reinsurance transactions has been immediately deductible. As a result, 14-year amortization is going to substantially alter the economics of reinsurance

transactions. Given the support the bill has garnered, I expect it will be enacted in some form. However, I doubt that enactment will occur this year.