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IRS Chief Counsel Advice Addresses Interest Rate Election for Life Insurance Reserves

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In late September 2019, the Internal Revenue Service (IRS) released a chief counsel advice memorandum (CCA 201939003) that would limit an insurer's ability to make an election for determining the interest rate used to compute tax-deductible life insurance reserves. Although the election itself was repealed for taxable years after 2017 by the Tax Cuts and Jobs Act of 2017,[1] a number of companies made the election for purposes of determining their reserves as of Dec. 31, 2017.

BACKGROUND

Section 807 of the Internal Revenue Code governs the computation of tax-deductible life insurance reserves. Before the Tax Cuts and Jobs Act of 2017, section 807 required an insurer to compute a federally prescribed reserve, based on a tax reserve method and prescribed interest rate and mortality tables. The federally prescribed reserve was compared to a cap (the statutory reserves with regard to the contract) and a floor (the contract's net surrender value) to determine what portion was tax-deductible.

The interest rate used to compute the federally prescribed reserve was the higher of the Applicable Federal Interest Rate (AFR), a defined term under the Internal Revenue Code, or the Prevailing State Assumed Interest Rate (PSAIR), the highest rate permitted to be used under the laws of 26 states, determined at the time the contract was issued. In recent years, low interest rates resulted in a low AFR, such that companies were required to use the PSAIR instead. For contracts issued in earlier years (generally, 1988 through 2004), however, the AFR often dominated.

Under section 807(d)(4), a company could elect to redetermine the AFR every five years for contracts issued in each year for purposes of the comparison. As a result, if the AFR increased in the future, life insurance reserves could decrease for existing business; if the AFR decreased, life insurance reserves could increase (provided the change was at least 50 basis points and the redetermined AFR was greater than the PSAIR for the year the contract was issued). The purpose of the election was "to take account of the fluctuations in market rates of return that companies experience with respect to life insurance contracts of long duration."[2] An election made under the provision resulted in a more current economic measure of an insurer's obligations under a contract, because the interest rate used was more current and resulted in a closer match to current market earnings on investment assets than to historic earnings on investment assets at the time the contract was issued.

The election applied to all contracts issued during the calendar year for which the election was made, or during any subsequent calendar year. A company that made the election could revoke that election only with IRS consent. Although the IRS never published guidance on the mechanics of making the election, it released two private letter rulings in 2016 granting permission for the particular companies involved to revoke previously made elections. The revocations applied only with regard to contracts for which no interest rate redetermination had been reached (that is, contracts issued less than five years before the year of revocation).[3]

THE CCA

In the CCA, the insurance branch of the IRS Office of Chief Counsel provided legal advice to the IRS Large Business & International (LB&I) division on a company that attempted to make the election on an original 2017 return and amended returns for three earlier years. The company intended the election to make the election for all contracts issued after 1987, the year in which Congress enacted the election, or at least to four of the five quinquennial bands associated with the election.[4] The difference between the Dec. 31, 2017, reserve computed with the election and the reserve computed without the election would have been reported in 2017.[5]

The CCA concludes that (1) an election under the provision cannot be made on an amended return, and (2) the election on the company's original 2017 return applied only with regard to contracts issued in 2012. Because the PSAIR exceeded the AFR in 2012, the election as allowed by the CCA would have no effect on the company's Dec. 31, 2017, reserves.

Because there is no published guidance on making the election, the analysis in the CCA depends entirely on a generally applicable

doctrine called the "Doctrine of Election," which has been developed by the courts. Under that doctrine, a taxpayer is bound to an initial choice on a tax return between two or more inconsistent alternatives.[6] The doctrine consists of two elements: (1) a free choice between two or more alternatives, and (2) an overt act communicating the choice to the IRS. In the case of the section 807(d)(4) CCA, the choice was between computing reserves based on the AFR in effect when a contract was issued and computing reserves based on the AFR redetermined every five years after the contract was issued. The CCA's analysis begins by asserting that, once five years had passed from the date a contract was issued, it was too late to make the election with regard to that contract because a company had overtly communicated to the IRS its choice instead to apply the AFR as of the contract issuance date.

The CCA discusses the rationale for the Doctrine of Election, as well as reasons why that rationale applied in the case of section 807(d)(4). In particular, the CCA asserts that

- allowing the election after the fifth-year return deadline would invite accounting distortions, resulting in a loss of revenues (due to a decrease in tax rates after 2017);
- allowing the election would lead to disparate treatment of similarly situated life insurance companies;
- allowing the election would create undue administrative inconvenience for the IRS; and
- allowing the election would invite a flood of amended returns, increasing the IRS's administrative burden and requiring a recalculation of prior years' tax liabilities.

The CCA does not address potential counterarguments to these rationales. Ordinarily, a taxpayer that is the subject of a CCA does not participate in its development.

Although the CCA does not cite authorities specific to section 807(d), it does discuss Rev. Rul. 94-74,[7] which governs changes in basis for computing reserves. Under Rev. Rul. 94-74, and section 807(f) as in effect in 2017, a change in basis applied to all previously issued contracts could be made on an amended return and entailed a catch-up adjustment to account for the difference between reserves computed under the old and new basis. According to the CCA, Rev. Rul. 94-74 was not relevant to the analysis because the Doctrine of Election applies only to taxpayers and because Rev. Rul. 94-74 applies only to permissible changes in basis.

WHAT COMES NEXT?

A CCA may not be used or cited as precedent,[8] is not accorded deference by courts, and is not binding on Appeals. Rather, it is an internal communication between the IRS Office of Chief Counsel (in this case, the National Office insurance branch) and a field office in connection with the examination of a single case. Importantly, a CCA provides a strong indication of how the IRS likely will approach the issue in the next case in examination. A CCA also provides an opportunity for companies and advisors to weigh the strength of the IRS's arguments.

Even before the CCA's release, opinions on the election varied among companies and among advisors. Among companies understood to have made the election, some did so by amended return (as in the CCA), while others did so by an original return for 2017. The CCA may be viewed differently by different companies and by different advisors.

The last year for which the election is relevant is 2017. The development of the issue therefore will be limited to prior years and will depend on the course of multiple examinations, multiple cases in Appeals and possibly litigation. Some of these developments will be publicly known, but most will not be disclosed. Those developments that become public likely will be discussed in future issues of *Taxing Times*, although the relevance to future years will be limited. ■

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ENDNOTES

1 More precisely, "An Act to Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018," Pub. L. No. 115-97, enacted Dec. 22, 2017. For additional discussion concerning changes made by the Tax Cuts and Jobs Act, *see generally* James W. Kress, Surjya Mitra, and Mark S. Smith, "Overview of the Tax Cuts and Jobs Act: Major Changes in the Taxation of Life Insurers," Taxing Times Vol. 14, Issue 2 (June 2018), *https://www.soa.org/globalassets/assets/library/newsletters/taxing-times/2018/june/tax-2018-vol-14-iss2.pdf* (accessed Dec. 18, 2019).

2 H.R. Rep. No. 100-495, at 979 (Conference Report), 1987-3 C.B. vol. 2, 979.

3 PLR 201645010 (Aug. 5, 2016); PLR 201640008 (July 1, 2016).

4 As a practical matter, the election would have affected only contracts issued before 2005, because the PSAIR has exceeded the AFR for more recent years.

5 As in effect for 2017, section 807(d)(4)(A)(IV) of the Internal Revenue Code provided that the 10-year spread rule of section 807(f) did not apply to an adjustment required by reason of the election.

6 *Pac. Nat'l Co. v. Welch,* 304 U.S. 191, 194-95 (1938).

7 1994-2 C.B. 157.

8 As stated in CCA 201939003 (June 27, 2019), this advice may not be used or cited as precedent.