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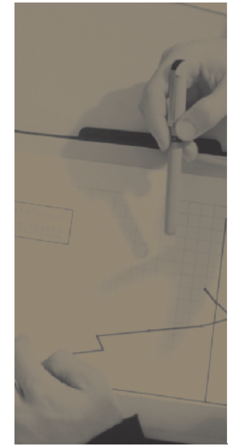
CHANGE IN BASIS OF COMPUTING RESERVES—IS IT OR ISN'T IT?



By Peter H. Winslow and Lori J. Jones

High on the list of the most frequently asked questions by tax professionals working for life insurance companies is whether a change in reserving methodology or assumptions will be subject to the "10-year spread" requirements of section 807(f) of the Internal Revenue Code. Section 807(f) applies where there is a change in basis of computing certain reserves of a life insurance company. When applicable, it requires that the difference between the deductible insurance reserves listed in section 807(c) computed under the new method and the reserves computed under the old method as of the end of the year of the change be reflected ratably over 10 years. Usually the question is posed as, "Is the reserve change reflected all at once or is it spread over 10 years?" Understanding when the 10-year spread rule applies is important because it is a favorite topic for Internal Revenue Service (IRS) agents and is included as a disclosure item in the standard tax reserve questionnaire presented by the IRS to life insurance companies at the beginning of audits. And, it is a coordinated issue at IRS Appeals, which means that an individual Appeals Officer cannot settle a section 807(f) issue that has been raised in an IRS audit without first coordinating the proposed settlement with the Appeals Insurance Industry Specialist.[1]

OVERVIEW OF GENERAL ACCOUNTING METHOD RULES VERSUS SECTION 807(f)

The starting place for any analysis of the tax consequences of a reserving change is to determine whether there would be a change in method of accounting for tax purposes in the absence of section 807(f). It is well-settled that section 807(f) is merely a special change-in-method-of-accounting rule for tax reserves and is intended to apply only when an accounting method change otherwise has occurred.[2] Although the application of section 807(f) is triggered by the same factors that give rise to a change in method of accounting, there are four differences in tax treatment. First and perhaps most important—unlike a change in method of accounting—IRS consent is not a prerequisite for recognizing a change in basis of computing reserves for tax purposes.[3] A second difference is that an accounting method change is implemented in full in the year of change with both opening and closing items for the taxable year computed on the new method. Under section 807(f), by contrast, only reserves for contracts issued in the year of change are determined under the new method and reserves for contracts issued prior to the year of change stay on the old method until the change for these contracts is implemented in the succeeding year when the opening and closing balances are computed using the new method. The third difference is the year of change in situations where the method from which the change is being made was erroneous. A taxpayer changing its method of accounting from an erroneous method cannot go back and correct the tax return for the first year in which the erroneous method was adopted unless the IRS agrees to the change on audit.[4] Under section 807(f) and, specifically under Rev. Rul. 94-74, the taxpayer is permitted, but apparently not required, to correct an erroneous basis of computing reserves in the earliest year open under the statute of limitations. The fourth way accounting method changes differ from section 807(f) reserve changes is the treatment of the transition adjustment for the amount by which the opening balance of the reserve computed on the old basis is greater or less than the opening balance computed on the new basis. In the case of a change in method of accounting, the Code generally requires that the difference between the old and new method's opening balances be reflected in taxable income all at once as a "481 adjustment,"[5] although the IRS may provide for a spread of a net positive 481 adjustment as a condition of granting its consent to the change.[6] In the case of section 807(f), the difference in opening reserves on the old and new methods for the taxable year succeeding the year of change is spread ratably over 10 years.

IS SECTION 807(f) APPLICABLE TO A NONLIFE INSURANCE COMPANY?

Before getting into specifics of when a reserve change is subject to section 807(f), it is useful to discuss two additional interrelated preliminary questions: what tax reserves are covered and what taxpayers are subject to section 807(f)? By its terms, section 807(f) applies to all tax reserve items for which life insurers are entitled to deductions on a reserve basis de-

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scribed in section 807(c). This includes not only life insurance reserves, but also reserves for other items including unearned premiums and unpaid losses, amounts held on deposit, advance premiums and premium stabilization reserves. Section 807(f) does not apply to reserve items other than those insurance reserves listed in section 807(c). For example, suppose a life insurance company deducted policyholder dividends on a reserve basis. This would be an erroneous accounting method for a life company because section 808(c) requires an accrual method for this item. To change to the correct accrual method, the life company would be required to obtain the consent of the IRS under section 446(e). The adverse 481 adjustment for the opening reserve balance would not be spread over 10 years under section 807(f), but would come into income all at once if the error is corrected by the IRS on audit or spread over four years if the life insurer identified the error on its own and alerted the IRS to the need for a change by filing a Form 3115, Application for Change in Accounting Method.[7]

The fact that section 807(c) is a Code provision that relates only to life insurance companies suggests that the 10-year spread rule only applies to life insurers. Other statutory provisions support this conclusion. For example, section 807(f) refers to part one of subchapter L which applies only to life insurers and section 807(f)(2) includes an acceleration rule for remaining section 807(f) adjustments if a company ceases to qualify as a life insurance company, with no reference to nonlife insurers. But, the IRS has long taken the position that the 10-year spread rule applies to changes in life insurance reserves by nonlife companies.[8] This ruling position perhaps is in recognition that the tax policy of not requiring IRS permission to change reserve methodology and assumptions for life insurance reserves should apply equally to nonlife companies. Although when the IRS adopted this position under the 1959 Act it had dubious technical merit, it finds some statutory support under current law because life insurance reserves are now included in "losses incurred" of nonlife companies under section 832 by cross-reference to the life insurance company tax reserve provisions in section 807. This cross-reference arguably includes section 807(f). In any event, regardless of the technical merits, as a practical matter, section 807(f) invariably applies to life insurance reserves of nonlife companies. For reserve weakening, nonlife companies would prefer the 10-year spread. For reserve strengthening, IRS consent for a change would be required if section 807(f) did not apply. However, if a request for a change in method were submitted, the IRS likely would follow its ruling position and conclude that section 807(f) applies, thus imposing a 10-year spread of the reserve increases.

To summarize, section 807(f) applies: 1) only where a change in method of accounting otherwise would occur; 2) for life companies for all insurance reserves described in section 807(c); and 3) for nonlife companies only for life insurance reserves described in section 807(c)(1).

WHAT IS A CHANGE IN ACCOUNTING METHOD TO WHICH SECTION 807(f) APPLIES?

Once we have determined that we are dealing with a reserve item to which section 807(f) could potentially apply, we now are ready to apply the general principles to determine whether we have what otherwise would be a change in method of accounting. Guidance on whether a change in tax treatment of an item rises to the status of a change in method of accounting can be found in regulations under section 446. A change in method of accounting includes a change in the overall plan of accounting for gross income or deduction or a change in the treatment of any material item used in such overall plan.[9] A material item is any item that involves the proper time for the inclusion of the item in income or the taking of a deduction. However, a change in method of accounting does not include correction of mathematical or posting errors, or errors in the computation of tax liability. A change in method of accounting also does not include adjustments that do not involve the proper time for the inclusion of the item of income or the taking of a deduction. Further, a change in method of accounting does not include a change in treatment resulting from a change in underlying facts.[10] In general, a change in basis of computing reserves occurs under these rules when there has been a systematic calculation of a reserve that has been changed, and both the old and new methods would yield the same total reserve amount at maturity of the contract. There are three general categories of adjustments to methods or assumptions that do not cause a change in method of accounting where reserve items are in question. These are: 1) correction of reserve mathematical or posting errors; 2) changes in the underlying facts; and 3) routine changes in estimates which are an integral part of the accounting method.

Correction of Error

Perhaps the most frequent issue that arises in dealing with section 807(f) is whether a reserve change is a correction of an error or a change from an erroneous method of accounting. The IRS takes the position that very few situations fall into the category of correction of an error. The IRS has stated that corrections of an error are limited to situations where there are pure mathematical mistakes, such as a defect in the computer

program for computing reserves.[11] For example, omitting certain contracts in computing reserves could be considered an error.[12]

It is a widely-held misconception that it is beneficial to classify reserve strengthening as a correction of an error so that a 10-year spread for the increase in reserves can be avoided and the entire increase deducted in the year of change. What frequently is overlooked is that typically there also is a corresponding reserve error in the opening reserves for the year—and this error in the opening reserve balance also must be corrected. When this is done, the difference between the opening reserves on the old basis and the new basis will be lost forever as a potential deduction if the change is classified as a correction of an error. It is a more favorable result either for the reserve error to be corrected in the first year the error was made (if it is still open under the statute of limitations) or for the change to be subject to section 807(f) with a 10-year spread equal to the amount of the strengthening. Of course, it would be beneficial for a decrease in reserves to be classified as a correction of an error, rather than reserve weakening subject to section 807(f), because there would be a permanent forgiveness of any opening balance of the reserve to the extent of the error. But, this result usually is too good to be true. Ordinarily, where both the opening and closing reserve balances for a year need to be corrected, a multi-year systematic error has been made—a situation that ordinarily should be characterized as a change from an erroneous method of accounting, not the mere correction of an error. As a general rule of thumb, it can be assumed that where there would be a positive or negative 10-year spread amount under section 807(f) as a result of a reserve change, the 10-year spread cannot be avoided by either the IRS or the taxpayer by asserting that a mere correction of an error is involved.

Change in Underlying Facts

An important exception to the application of section 807(f) is reserve increases (or decreases) that occur because the facts have changed. A change in method of accounting does not occur even if large one-year reserve adjustments are made if all that is happening is that the old accounting method is being applied to changes in circumstances. A good example where this has occurred is contract enhancements. When an insurance company adds benefits to the contract, the reserves must be increased to reflect the additional benefits guaranteed in the contract. These reserve increases are not subject to section 807(f) because the basis of computing the reserve has not changed—the only change is in the underlying facts.[13]

One unresolved issue is whether a change in Annual Statement reporting of reserves is a change in facts. Under section 807(d), the amount of federally prescribed reserves in section 807(d) taken into account for deduction purposes is limited by the statutory reserves for the contract.[14] What is the result where a company subject to the statutory reserves cap changes its statutory reserves for a contract, but the amount of the federally prescribed reserves for the contract does not change? Is this a change in basis of computing reserves subject to the 10-year spread? Legislative history suggests that a change to the net surrender value ordinarily will not be subject to section 807(f) presumably because the change is a mere change in facts relating to contract benefits.[15] Many, probably most, tax practitioners believe that this legislative history applies by analogy to the change in statutory reserves cap situation.[16] But, it is at least arguable that the computation of statutory reserves standing alone is an accounting method and a change in that method gives rise to the application of section 807(f). An interesting result would occur if section 807(f) were to apply in this situation. In such case, statutory reserves would have to stay on the old method for the year of change for contracts issued prior to the year of change with the result that the statutory reserves cap would apply to hypothetical statutory reserves that may not actually be held by the company.

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This issue may become important in the context of Actuarial Guideline XLIII (AG 43). Now that AG 43 is effective, it applies for statutory purposes to all contracts issued on or after Jan. 1, 1981. However, tax reserves for contracts issued prior to the National Association of Insurance Commissioners' (NAIC) adoption of AG 43 are still subject to the NAIC-prescribed reserve method in effect on the date the contract was originally issued.[17] When AG 43 results in a reduction of statutory reserves as compared to prior NAIC methodology, the statutory reserves cap could come into

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play. The ACLI has taken the position that this should not be considered a change in basis of computing reserves subject to section 807(f).[18]

Change in Reserve Estimates

Another source of confusion in the application of section 807(f) involves situations when the basic accounting method itself contemplates periodic changes in assumptions and methodologies. The classic situation in the insurance context is changes in loss reserve estimates. In adopting the loss reserve accounting method, it is understood from the outset that estimates will be adjusted constantly to reflect new data as it becomes available and that assumptions—and even the reserving methods—may change to provide a more accurate updated estimate. These periodic adjustments to a reserve estimate do not result in a change in method of accounting. This conclusion is supported by Treas. Reg. § 1.446-1(e)(2)(ii)(b) which provides that a change in method of accounting does not include an adjustment with respect to a reserve for a bad debt.

In a 2001 technical advice memorandum,[19] the IRS ruled that a change from a nonactuarial method to an actuarial method to estimate environmental claims was not a change in method of accounting.[20] Similarly, a 1992 private letter ruling involved a change in Annual Statement reporting by an insurance company dealing with the way it reported the value of foreclosed real estate from its mortgage activities.[21] Prior to 1990, the company valued foreclosed real estate at the uncollected mortgage balance, despite the fact that NAIC rules required that the value be reduced to the extent that the estimated realizable value of the property was less than the uncollected mortgage balance. Beginning with its 1990 Annual Statement, the taxpayer modified its valuation procedures to take into account the actual fair market value of the foreclosed real estate (determined by appraisal), where that value was less than the mortgage balance. Application of this revised valuation approach for tax purposes affected the taxpayer's calculation of gains and losses on mortgage foreclosures. The IRS concluded that the use of a different method to determine the fair market value of an asset does not rise to the level of an accounting method because the estimation method only goes to the amount rather than the timing of income. Thus, the IRS ruled that the taxpayer's change in estimation method on its Annual Statement to determine the fair market value of foreclosed real estate did not constitute a change of accounting for tax purposes.

Case law also supports the conclusion that a change in estimate is not a change in accounting. In *Cincinnati, New Orleans & Texas Pacific Ry. Co. v. United States*,[22] a railway company followed the method prescribed by the Interstate Commerce Commission (ICC) for expensing or capitalizing purchases of property. In accordance with the minimum capitalization rule of the ICC, the taxpayer changed from expensing items costing less than $100 to expensing items costing under $500. The Court of Claims held that, while the minimum capitalization rule is an accounting method, the change from $100 to $500 is not a change in that method. Also, in *Baltimore & Ohio R.R. Co. v. United States*,[23] the taxpayer changed from the use of one formula for computing fair market value of certain property to another valuation formula for computing fair market value. The court held that the taxpayer was entitled to change the valuation formula without seeking the IRS's consent, because the change was merely a change in the fair market value estimate.

The general rule that changes in loss reserve estimates does not result in a change in accounting method usually does not apply to changes in life insurance reserves because formulaic periodic updating of reserve estimates is not an integral part of the accounting method. This is not a hard-and-fast rule, however. For example, IBNR reserves for disability claims may qualify as life insurance reserves, and in some circumstances, may be computed using company experience. Where the company adopts a method for IBNR claims that incorporates periodic updates to its experience, a change in basis of computing reserves should not occur when the anticipated adjustments are made. This is a mere change in estimate similar to an adjustment to loss reserves and is not a change in basis of computing reserves. By contrast, a change in the interest rate assumption for the same reserves probably would be a change in basis of computing reserves subject to section 807(f).

This change-in-estimate exception to the application of section 807(f) and the change-in-method-of-accounting rules could become important when, and if, principle-based reserves (PBR) are adopted. An important aspect of PBR will be the unlocking of assumptions so that they are periodically updated to reflect the company's most recent experience. In Notice 2008-18,[24] the IRS questioned whether the unlocking could trigger the application of the 10-year spread rule of section 807(f) when reserve assumptions are changed. This would be the wrong answer, however. The unlocking in PBR is part of the accounting method itself and should not cause section 807(f) to come into play.

CONCLUSION

Resolution of virtually all reserve change issues can be resolved by correctly addressing the following basic questions outlined in this article:

1. Has a change in accounting occurred under general tax principles?
2. Is a section 807(c) reserve item or a life insurance reserve (for nonlife companies) involved?
3. Is a mere correction of an error, a change in facts or an anticipated periodic update in an estimate involved?

Section 807(f) will apply if the answers to Questions 1 and 2 are "yes" and the answer to Question 3 is "no."

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END NOTES

[1] Coordinated Issue Paper, *IRC Section 807 Basis Adjustment – Change in Basis v. Correction of Error*, Jan. 6, 1997.
[2] Rev. Rul. 94-74, 1994-2 C.B. 157, 159; *American General Life & Accident Insurance Co. v. U.S.*, 90-1 U.S.T.C. 50,010 (Mid. Dist. Tenn. 1989).
[3] Under section 446(e), a taxpayer is not entitled to make a change in method of accounting without first obtaining the IRS' consent. This is true even if the method from which the change is made is erroneous or does not clearly reflect income. E.g., *Witte v. Comm.*, 513 F.2d 391, 75-1 U.S.T.C. 9477 (D.C. Cir. 1975).
[4] *Diebold v. U.S.*, 16 Cl. Ct. 193, 63 A.F.T.R. 2d 89-599 (Cl. Ct. 1989). It takes two years of consistent treatment on tax returns to adopt a method of accounting for an erroneous method. *See also* Rev. Rul. 90-38, 1990-1 C.B. 57.
[5] I.R.C. § 481; *Security Benefit Life Insurance Co. v. U.S.*, 517 F. Supp. 740 (D. Kan. 1980), *aff'd*, 726 F.2d 1491 (10th Cir. 1984).
[6] Rev. Proc. 2002-19, 2002-1 C.B. 696. Under the revenue procedure, the section 481(a) adjustment period is four taxable years for a net positive adjustment and one taxable year for a net negative adjustment where IRS consent to the change in accounting has been properly requested by the taxpayer.
[7] Rev. Proc. 2002-19.
[8] Rev. Rul. 65-240, 1965-2 C.B. 236. *See also* TAM 200914022 (Dec. 2, 2008), where the IRS cited Rev. Rul. 65-240 favorably.
[9] Treas. Reg. § 1.446-1(e)(2)(ii)(a).
[10] Treas. Reg. § 1.446-1(e)(2)(ii)(b).
[11] Coordinated Issue Paper, Jan. 6, 1997.
[12] Rev. Rul. 94-74, 1994-2 C.B. 157, Situation 4.
[13] Rev. Rul. 69-444, 1969-2 C.B. 145 (where the IRS ruled that an increase in reserves because a life insurance company increased benefits is not attributable to a change of basis for computing reserves).
[14] Statutory reserves are defined in section 807(f)(6) as the aggregate amount set forth in the annual statement with respect to items described in section 807(c). Such term does not include any reserve attributable to a deferred and uncollected premium if the establishment of such reserves is not permitted under section 811(c).
[15] Joint Comm. on Taxation, 98th Cong., 2d Sess., *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* 604 (1984). On the other hand, the legislative history provides that changes in other reserve assumptions such as premium collection dates and claim payment dates cause differences subject to the 10-year spread.
[16] Edward L. Robbins & Richard N. Bush, U.S. Tax Reserves for Life Insurers 144-46 (Society of Actuaries 2006).
[17] Under section 807(d)(3)(A)(iv) the tax reserve method prescribed by the NAIC which covers such contracts as of the date of issuance must be utilized.
[18] ACLI letter dated October 24, 2008, to Chief Counsel Korb and Acting Assistant Secretary for Tax Policy Solomon. 2009 TNT 182-12, Doc. 2009-19684.
[19] TAM 200115002 (Dec. 21, 2000).
[20] *See also*, in PLR 8406001 (Mar. 11, 1983), where the taxpayer had been using a flawed "paid-to-paid" method to compute its reserves for unpaid loss adjustment expenses and changed to a different paid-to-paid method and the IRS concluded there was no change in accounting method.
[21] PLR 9222017 (Feb. 26, 1992).
[22] 424 F.2d 563 (Ct. Cl. 1970).
[23] 603 F.2d 165 (Ct. Cl. 1979).
[24] Notice 2008-18, 2008-5 I.R.B. 363.