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# IS IRS CONSENT NEEDED TO CONFORM TAX ACCOUNTING TO A CHANGE IN STATUTORY ACCOUNTING?

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Life insurance companies are accrual basis taxpayers subject to the same general tax accounting rules applicable to other corporate taxpayers.[1] There are a few exceptions to this general rule. One exception is that accrual accounting does not apply to items that are unique to insurance company accounting, most notably insurance reserves.[2] Another exception is that life insurance companies are not subject to generally applicable accrual rules for original issue discount (OID) or amortization of bond premium.[3] For these items, in general, life insurance companies are entitled to use statutory accounting.

When a life insurance company changes its basis for computing tax reserves, a special 10-year spread rule found in section 807(f) of the Internal Revenue Code applies to the change.[4] But, what happens if the statutory accounting for OID or bond premium changes? Is the company required, or even permitted, to change its tax accounting method to conform with the new statutory accounting method? The answer to this question is determined by identifying the tax accounting method being used by the company and whether there has been a change to that method.

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. The regulations broadly define the term "method of accounting" to include not only the overall method of accounting but also the accounting treatment of any item.[5] This general rule is not very helpful. Fortunately, the regulations provide additional guidance and state that 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.[6] 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. Importantly, a change in method of accounting does not include an adjustment in the treatment of an item resulting from a change in underlying facts.[7]

If we can define OID or bond premium as a "material item" and define the accounting method for the item broadly as following statutory accounting, then it can be argued that a change to statutory accounting treatment is merely a change in facts and does not rise to the status of a change in method of accounting. There would be two principal consequences from this conclusion. First, a change in method of accounting can be made for tax purposes only after a request for the change has been made by filing a Form 3115, Application for Change in Accounting Method, and consent to the change from the IRS has been secured.[8] If the accounting method is defined broadly as merely following statutory accounting for the item, then a change for tax purposes to conform with a statutory adjustment would not need IRS approval. Second, when a change in method of accounting is involved, a "section 481 adjustment" may be necessary to reflect the permanent difference that otherwise would occur as a result of the change. As a rule of thumb, the section 481 adjustment is equal to the difference between the accrual or amortization of the item on the new method as compared with the old method as of the beginning of the year of the accounting method change. Under Rev. Proc. 97-27,[9] as modified by Rev. Proc. 2002-19,[10] the true-up adjustment (the positive section 481 adjustment) is spread over four years if it is adverse to the taxpayer. If instead, the company were to conform its OID accrual or bond premium amortization to a new statutory accounting treatment without treating it as a change in accounting, the true-up to the new accounting treatment would presumably be reflected all at once in the year of the statutory change.

A recent Chief Counsel Advice reflects, in analogous circumstances, the IRS's likely rejection of the position that a change in the statutory treatment of an item is not a change in method of accounting. Instead, the IRS probably would contend that such a change requires the IRS's consent for tax conformity. In C.C.A. 201151022 (Dec. 1, 2011), the taxpayer received advance payments for providing bundled products and services to customers under Multiple Deliverable Contracts (MDCs).

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For financial statement purposes, the taxpayer deferred recognition of the advance payments until all of the products and services had been provided. For tax purposes, the taxpayer had elected to defer recognition of the advance payments under Rev. Proc. 2004-34.[11] That revenue procedure allows deferral of recognition of advance payments provided certain conditions are satisfied, one of which is conformity to the recognition method used on the "applicable financial statement." FASB issued new standards as to how to account for advance payments under MDCs. The taxpayer sought to comply with Rev. Proc. 2004-34 and conform its tax accounting method for advance payments to the new method required by the FASB. The question faced by the IRS Chief Counsel's Office was whether the taxpayer was required to seek the consent of the IRS before making the conforming change because a change in method of accounting would be involved.

The court held that IRS consent for conforming tax accounting to the new ICC standard was not required because this change was not "substantial or material."

The C.C.A. concludes that prior consent of the IRS is required. It cites, and quotes from, regulations[12] that generally provide a taxpayer must obtain the IRS's permission before adopting for tax purposes a change to conform with the taxpayer's new book method of accounting:

> Except as otherwise provided in Chapter 1 of the Code and the regulations thereunder, a taxpayer who changes the method of accounting employed in keeping his books shall, before computing his income upon such new method for purposes of taxation, secure the consent of the Commissioner. Consent must be secured whether or not such method is proper or permitted under the Internal Revenue Code or the regulations thereunder.

The IRS can be expected to take a similar position for a life insurance company's change in statutory reporting and require prior consent to a conforming change for tax purposes. Nevertheless, there is some authority for the position that such consent would not be required in all circumstances. In *Cincinnati, New Orleans and Texas Pacific Railway Co. v. United States*,[13] the Interstate Commerce Commission (ICC) changed its accounting requirements for purchases of property by railroads. The ICC's previous requirement for property acquisition costs was to expense them if the cost was less than $100. The ICC raised the expensing threshold to $500. The court held that IRS consent for conforming tax accounting to the new ICC standard was not required because this change was not "substantial or material." The court noted that the change had only a very slight effect on the taxpayer's net income and the ICC adopted the new accounting standard as a result of a change in the overall industry's circumstances (a change in facts).

It may be possible to rely on the rationale of the *Cincinnati, New Orleans and Texas Pacific Railway* case to avoid filing a Form 3115 with the IRS where the change to statutory accounting would have a minimal current tax effect. However, if the change would cause a significant section 481 adjustment, seeking the IRS's consent is probably required, and also advantageous. As discussed above, a change to statutory accounting treatment that is not a change in method of accounting would presumably require that the true-up to the new accounting treatment be reflected wholly in the year of change. This would not be the case, however, if a change in method of accounting is involved and the section 481 adjust-

ment would increase taxable income. Then, the adverse true-up adjustment is spread over four years. As a result, although it may be inconvenient to treat changes in statutory treatment as an accounting method change and file a Form 3115 seeking the IRS's consent before making the change, it actually may be more favorable to do so.

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## END NOTES

1 I.R.C. § 811(a).
2 *Commissioner v. Standard Life & Accident Ins. Co.*, 433 U.S. 148 (1977).
3 I.R.C. § 811(b).
4 See Peter H. Winslow & Lori J. Jones, Change in Basis of Computing Reserves – Is It or Isn't It?, *Taxing Times*, Feb. 2010.
5 Treas. Reg. § 1.446-1(a).
6 Treas. Reg. § 1.446-1(e)(2)(ii)(a).
7 Treas. Reg. § 1.446-1(e)(2)(ii)(b).
8 I.R.C. § 446(e).
9 1997-1 C.B. 680.
10 2002-1 C.B. 696.
11 2004-1 C.B. 991.
12 Treas. Reg. § 1.446-1(e)(2)(i).
13 424 F.2d 563 (Ct. Cl. 1970).

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