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ERRONEOUS TAX RESERVE COMPUTATIONS —YEAR OF CORRECTION

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A question that frequently arises is whether a life insurance company is permitted, or required, to retroactively correct a tax reserve error that has been made in a previously filed tax return. The answer to this question may depend upon the type of reserve error that has been made. For purposes of analysis, it is useful to classify errors into four general categories:

- Mathematical or posting errors
- I.R.C. § 807(d)[1] errors
- Judgmental errors
- Statutory reserve compliance errors.

Before analyzing the consequences of these four types of errors, a review of the basic tax reserve rules that come into play is warranted. Under I.R.C. § 807(d), most life insurance reserves are required to be computed in accordance with the tax reserve method prescribed by the NAIC in effect on the date of issuance of the contract. The tax reserve method for life insurance contracts is CRVM for contracts covered by CRVM, and for annuity contracts it is CARVM for contracts covered by CARVM. For contracts not covered by CRVM or CARVM, the reserve method prescribed by the NAIC as of the date of contract issuance must be used, or, if no method has been prescribed, a reserve method consistent with whichever of the prescribed methods is most appropriate must be used. In applying the tax reserve method, federally prescribed interest rates and prevailing state mortality tables also are required to be used, again, usually determined as of the issue date of the contract. The reserve is then capped by statutory reserves and floored by the net surrender value determined on a contract-by-contract basis. Where particular assumptions, other than interest or mortality, are not prescribed by the NAIC method, the legislative history states that, in general, life insurance reserves are computed by using assumptions made for statutory reserves.

A special rule may apply when a life insurance company changes its basis of computing reserves to correct an error. I.R.C. § 807(f) imposes a "10-year spread" under which the difference between the tax reserves computed under the new method and the reserves computed under the old method as of the end of the year of the change is reflected ratably over 10 years.[2] The 10-year spread rule of I.R.C. § 807(f) is applicable only when there otherwise would have been a change in method of accounting under general tax law principles.[3]

MATHEMATICAL OR POSTING ERRORS

Under the general provisions of the Internal Revenue Code and regulations relating to accounting methods, a mere mathematical or posting error is not a change in method of accounting.[4] Therefore, this type of error is not subject to the 10-year spread rule of I.R.C. § 807(f). The IRS takes the position that most corrections to tax reserves are in the nature of a change in method of accounting and 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 or posting mistakes, such as a defect in the computer program for computing reserves.[5] For example, omitting certain contracts in computing reserves could be considered an error.[6]

The Internal Revenue Code does not impose a duty on a taxpayer to file an amended return for a prior year to correct errors when the original return was filed in good faith. Nevertheless, as a practical matter, a failure to file an amended return to correct a material tax reserve error, or to disclose the error at the outset of an audit, could expose the company to accuracy-related penalties. In Rev. Rul. 94-74,[7] the IRS stated that a life insurance company "should" file an amended return to correct mathematical or posting errors.

When a mathematical error results in an inappropriate understatement of tax reserves, it is particularly important to correct the error in the earliest open year. Otherwise, there could be a permanent loss of a deduction. There is nothing in the tax law that permits the opening tax reserve balance for the year following the reserve error to carry over the prior year's closing reserve mathematical error. Both opening and closing tax reserves for the current year must be computed correctly.

As a result, it is possible that a deduction for the amount of the mathematical error could never be deductible unless the correction is made for the year the error, in fact, was made.

I.R.C. § 807(d) ERRORS

An error made in applying the tax reserve method, the interest rate or mortality table prescribed by I.R.C. § 807(d) almost always is a change in basis of computing reserves. This type of error affects the timing of recognition of the company's liability for benefits and would be a change in method of accounting but for the application of I.R.C. § 807(f). Because I.R.C. § 807(d) prescribes these tax reserve computational requirements, and consent of the IRS is not a precondition to changing to a proper method that complies with I.R.C. § 807(d), either the IRS or the company can insist that the tax reserve error be corrected in the earliest open year.[8] It appears, however, that the IRS does not believe that a retroactive correction is mandatory. Situation 1 of Rev. Rul. 94-74 described a situation where the company used an incorrect mortality table in computing tax reserves for reinsured contracts. The IRS concluded that the company "may" recompute its tax reserves for the earliest open year, implying that it was not required to do so. Presumably, this means that the company could choose to correct the error prospectively on the next return to be filed. Nevertheless, if the error is material and a failure to correct it retroactively would result in a substantial overstatement of tax reserve deductions, disclosure of the error at the outset of an IRS audit for the earlier year would be advisable to avoid penalties because the IRS can insist on a correction.[9]

JUDGMENTAL ERRORS

Tax reserve assumptions that are not specified by I.R.C. § 807(d) (*i.e.*, assumptions other than the tax reserve method, interest and mortality) should conform to the factors used for statutory reserves. As a result, when assumptions used for statutory reserves change, a conforming change usually should be made for tax reserves if the assumptions are not otherwise dictated by I.R.C. § 807(d). Material changes to tax reserve assumptions are subject to the 10-year spread rule of I.R.C. § 807(f).[10] Sometimes tax reserve assumptions set by actuarial discretion may not be grounded in statutory reserves. That is, an actuary may have to make an assumption in computing tax reserves even though statutory reserves are computed on a different basis. This could occur, for example, when statutory reserves are not computed using the tax reserve method required by I.R.C. § 807(d). Another instance when tax assumptions may be independent of statutory reserves could occur where mortality tables are "adjusted as appropriate" under I.R.C. § 807(d)(1) to reflect risks not considered in prevailing commissioners' standard tables.[11]

In these situations, circumstances could arise when the company decides that the tax reserve assumptions previously made were inappropriate and seeks to correct tax reserves to more accurately reflect the reserve liabilities. Can the company make the correction retroactively on a previously-filed return? The answer depends on whether the original assumption was an appropriate exercise of judgment at the time the tax reserve initially was established. If it was appropriate at the outset, the tax reserve cannot be corrected retroactively to reflect more accurate information that subsequently became available.[12] On the other hand, if the tax reserve computation contained an assumption that was unreasonable when it was made, or failed to reflect risks that should have been considered, correction can be made for the earliest open year even though this is not a mathematical error.[13] If the inappropriate assumption was made consistently for a series of years, however, a correction would still be subject to the 10-year spread rule of I.R.C. § 807(f).

STATUTORY RESERVE COMPLIANCE ERRORS

What if the reserve error was not made solely with respect to the federally prescribed reserves under I.R.C. § 807(d), but was made with respect to statutory reserves? Can a corrective change be made retroactively for purposes of determining the statutory reserves cap on tax reserves? Again, the answer depends on the type of statutory reserve error.

Where the statutory reserve error is merely the geography of where the reserve was reported on the Annual Statement or how it was labeled, the liability nevertheless should be included in statutory reserves for purposes of the contract-by-contract reserve comparison. From a tax perspective, this is not an error in the first place. The IRS has ruled that the fact that the reserves are not treated as life reserves on the Annual Statement is immaterial for federal income tax purposes.[14]

Statutory reserve errors that are improper because they violate the Standard Valuation Law are problematic. I.R.C. § 807(d)(6) provides that the term "statutory reserves" means the aggregate amount "set forth in the annual statement" with respect to reserve items for the contract. The IRS may argue that this statutory language precludes statutory reserves from being retroactively corrected to increase the statutory reserves

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cap. Despite this likely IRS position, it may be possible to correct improper statutory reserves and have them taken into account in the statutory reserves cap if steps are taken to acknowledge to insurance regulators that an error has been made in the Annual Statement and corrective action is taken. Statutory reserves reported on a refiled Annual Statement probably should be respected for tax purposes when the refiling was necessitated by statutory reserve errors.

Another situation that could cause a problem is a pure mathematical error that is made in statutory reserves. For example, suppose a computer error omits a class of policies and no statutory reserves are held. In this situation, it may be possible to fix statutory reserves for tax purposes to correct the mathematical or posting error whether or not the error is sufficiently material to warrant a refiling of the Annual Statement. This would have been the result under pre-1984 tax law when statutory reserves were required to be "held" in order to be deductible.[15] The same result may apply for purposes of the statutory reserves cap, even though technically the reserves must be "set forth in the annual statement" to be included in statutory reserves.

CONCLUSION

The lesson to be learned from this summary of the law relating to tax reserve errors is that in the majority of situations a retroactive correction in the earliest open year is permissible, if not required. In some circumstances, this probably should even apply to statutory reserves. Where an error has resulted in smaller deductions than otherwise should have been allowed, and tax reserves are growing, it is almost always better to pursue a retroactive correction. A retroactive fix can minimize the 10-year spread amount under I.R.C. § 807(f), or prevent a permanent loss of a deduction in the case of a mathematical error. Conversely, if the error overstated tax reserves in prior years or if the amount of tax reserves is declining, it usually is better to correct the error on the next tax return to be filed. It must be recognized, however, that without adequate disclosure this approach could expose the company to accuracy-related penalties because the IRS has the authority to require the error to be remedied in the earliest open year. ◂

END NOTES

1. "I.R.C. §" refers to a section of the Internal Revenue Code of 1986, as amended.
2. For a detailed discussion of I.R.C. § 807(f), *see* Winslow & Jones, *Change in Basis of Computing Reserves—Is It or Isn't It?* 9 TAXING TIMES, Vol. 6, Issue 1 (Feb. 2010).
3. *See* Rev. Rul. 94-74, 1994-2 C.B. 157; *American General Life & Accident Ins. Co. v. U.S.*, 71A A.F.T.R. 2d 93-3319 (M.D. Tenn. 1989).
4. Treas. Reg. § 1.446-1(e)(2).
5. IRS Coordinated Issue Life Insurance Industry, *IRS Section 807 Basis Adjustments Change in Basis v. Correction of Error* (Jan. 6, 1997).
6. Rev. Rul. 94-74, 1994-2 C.B. 157, Situation 4.
7. 1994-2 C.B. 157.
8. *Id.*, Situations 1 and 2.
9. *Id.*, Situation 2.
10. *Id.*, Situation 3.
11. PLR 9251005 (Sept. 9, 1992).
12. *Pacific Mutual Life Ins. Co. v. Comm'r*, 48 T.C. 118 (1967), *rev'd on another issue*, 413 F.2d 55 (9th Cir. 1969); Rev. Rul. 69-302, 1969-1 C.B. 186.
13. PLR 9251005 (Sept. 9, 1992).
14. Rev. Rul. 70-34, 1970-1 C.B. 149.
15. G.C.M. 39516 (June 10, 1986).