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Section 807(f) – Tax Impact of Statutory Reserve Change

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SUMMARY

The Internal Revenue Service (IRS) recently published a field attorney advice[1] (FAA)[2], which concluded that a change in the method for determining a company's statutory reserve should be treated as a change in reserve method under section 807(f).[3] Prior to the FAA, there had been limited guidance on whether a change in tax reserves resulting from a change in the taxpayer's statutory cap is a change in fact—so the full amount of the change would be taken into income in the year of change, or if the change should be treated under section 807(f) and spread into income over 10 years. This article examines the interplay of section 807(f) and the statutory cap in section 807(d).

> It is unclear whether the IRS's position that section 807(f) applies to the statutory reserve computation is an appropriate interpretation of section 807(f).

OVERVIEW OF TAX LAW

For tax purposes, life and annuity reserves are computed under section 807. The Code and related Treasury regulations outline the appropriate reserve methods and assumptions to use for the various types of life and annuity contracts. In general, the amount of the tax basis of life insurance reserves for any contract shall be the greater of the net surrender value of the contract or the reserves computed based on the tax reserving principles outlined in the Code.[4] Section 807(d)(1) provides that in no event shall the reserve determined under these principles for a given policy (the FPR)[5] be greater than the corresponding statutory reserve, as defined in section 807(d)(6). If the FPR is greater than the statutory reserve, the tax reserve is limited to the statutory reserve. This concept is referred to as "statutory capping."

For example, in some circumstances a company might find that it is using more conservative assumptions in calculating tax reserves than in calculating statutory reserves. In this circumstance, the FPR for those contracts will exceed the statutory reserve, but the tax reserve would be limited to the statutory amount. It is possible the company might then change its method of calculating the statutory reserve for such a contract so that the tax reserve is no longer subject to the statutory cap or the amount of the statutory reserve used for tax purposes increases or decreases.

The latest piece of guidance in this area was issued in December 2016, when the IRS released the aforementioned FAA. The taxpayer was the parent of a life-nonlife consolidated group that included two life insurance companies. The life insurance company subsidiary of the parent marketed a rider to specified annuities. In performing statutory and FPR reserve valuations for the first three years, the company understated its reserve liabilities. During these years, the understated statutory reserve served as a cap on the amount of the tax reserves. The understated statutory reserves were subsequently corrected in Year 4. Also in Year 4, the taxpayer amended the Year 2 and 3 tax returns, claiming to have changed the FPR method in Year 2 when it recomputed its tax reserves to correct for the improper application of Actuarial Guideline 33 (AG 33) for Year 2 and Year 3. However, there was no change to the taxable income for Years 2 and 3 because the tax reserve was limited under section 807(d)(1) to the understated statutory reserve. The taxpayer reported an increase in statutory reserves at the beginning of Year 4 due to the change in the understated reserve at the end of Year 3. The corrected (and higher) statutory reserves no longer capped the tax reserves. As recounted in the FAA, the taxpayer argued that the increase to the tax reserves as a result of the elimination of the statutory cap was not subject to section 807(f) because there was no change in Year 4 to the computation of the FPR under section 807(d).[6] The IRS, however, concluded that the change to the statutory reserve should be subject to section 807(f).[7]

CHANGE IN ACCOUNTING METHODS

Under general tax accounting policies, one must request permission from the IRS to change a method of accounting.[8] This impact is then spread into income over a period of one to four years, depending on whether the change is positive or negative.[9] Certain changes in accounting methods have been deemed by the IRS to be automatic, and in those cases the taxpayer does not need to request permission before changing the method.[10] Whether the change is automatic or non-automatic, the taxpayer must still file Form 3115.

In the case of reserves defined under section 807(c), neither "changes in basis" nor "corrections of errors" are governed by section 446 and permission to change is not required. Changes in basis are spread into income over a ten-year period.[11] These changes are often referred to as section "807(f) adjustments." Conversely, errors are corrected by adjusting the reserve in the year of the error.[12] For changes in basis, the section 807(f) adjustment is computed by taking the difference between (a) the amount of the reserve at the close of the taxable year, computed on the new basis and (b) the amount of the reserve at the close of the taxable year, computed on the old basis, both amounts computed with respect to contracts issued prior to the taxable year.

The statutory language indicates that a change in "the basis for determining any item referred to in [section 807(c)]" would be subject to section 807(f). Changes to the methods and assumptions underlying the FPR are fairly universally viewed as changes in basis, at least as long as the prior method or assumption was used for more than one taxable year; however, it is less clear whether a change in the statutory reserve computation that impacts the tax reserve would be subject to the 10-year spread. There are two ways to look at changes to the statutory reserve; such adjustments can be viewed as changes in fact or changes in reserve method.

CHANGE IN FACT

In its guidance,[13] the IRS has stated that section 807(f) applies to changes in reserve bases that would be changes in accounting methods under section 446 if section 807(f) were not part of the Code. But a change in fact isn't either a change in accounting method or a section 807(f) adjustment.[14] So if a change in the method for determining the statutory reserve for purposes of the statutory cap is a change in fact, section 807(f) would not apply.

As summarized by Edward Robbins and Richard Bush,[15] a change in fact occurs when there is a change in terms of an existing insurance contract such as: (1) changes in the net surrender value of a contract,[16] (2) increasing benefits under a policy,[17] (3) conversion of collectively renewable accident and health policies to guaranteed renewable policies[18] and (4) the addition of an indemnity benefit should death occur from a non-occupational vehicular accident, at no additional premium cost.[19] There have been a number of private letter rulings in which the IRS has addressed the tax consequences of policy update programs where the insurance company increased death benefits on policies at the same time as increasing the valuation interest rate on the reserves underlying the policy. The IRS concluded that these programs resulted in an

exchange of policies, and were not changes in basis that would require a 10-year spread under section 807(f).[20]

As discussed in an article by Peter Winslow and Lori Jones,[21] "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 a change in circumstances.... [For example, when] an insurance company adds benefits to the contract, the reserves must be increased to reflect 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."[22]

Relying on the correlation between the net surrender value and the statutory capping in computing tax reserves, an adjustment to the method for determining the statutory reserve could be viewed as a change in fact. As noted above, tax reserves may not be less than the net surrender value of the contract or greater than the statutory reserves. One could view the net surrender value as the floor and statutory capping as the ceiling when computing tax reserves. This view supports the position that a change in the statutory cap arising in the normal course of operations, similar to a change in the net surrender value floor, does not give rise to a section 807(f) adjustment. This position is further supported by the language in the 1984 Act Blue Book which provides that changes in net surrender value are not subject to section 807(f).[23] Specifically, the 1984 Act Blue Book states that changes in the net surrender value of a contract are not subject to the 10-year spread because, apart from its use as a minimum in determining the amount of life insurance tax reserves, the net surrender value is not a reserve but a current liability. The IRS considered this argument in the FAA, but rejected it.[24]

Similarly, the statutory cap may be characterized as a limitation on the amount of the reserve that may be deducted. Based on *Principal Mutual Life Insurance*,[25] a limitation on the amount of the deduction does not change the timing of the deduction. Instead, it simply limits the amount that is deductible. The IRS considered this argument in the FAA even though they did not ultimately follow this reasoning.[26]

The taxpayer in the FAA treated the adjustment as a change in fact, claiming that the only method of accounting involved in the computation of tax reserves was the method of computing the FPR under section 807(d), which changed in Year 2 but with an ultimate effect of $0 due to the operation of the statutory cap. The taxpayer most likely argued that a change in the statutory reserve limitation, and presumably also the net surrender value floor, was not a change in basis if the FPR did not change.[27]

CHANGE IN BASIS

As mentioned previously, the recently published FAA concluded that a change in the method for determining a company's statutory reserve should be treated as a change in reserve method under section 807(f). This section outlines the IRS's analysis in that FAA in reaching its conclusion.

Prior Code section 810(d), as enacted by the Life Insurance Act of 1959, had language similar to current section 807(f). However, under the 1959 Act, there was no FPR concept. Instead, tax reserves were based on statutory reserves. So the "change in basis" wording in former section 810(d) could only have applied to the basis of computing the statutory reserve. Thus, the IRS argued, perhaps the carryover of the former section 810(d) language to current section 807(f) indicates that Congress intended for the change in basis concept to apply to both the FPR and the statutory reserve.

Section 807(f) is properly viewed as a subset of accounting method changes otherwise subject to section 446[28] and the same interpretation was adopted in Revenue Ruling 94-74.[29] The IRS recently reiterated this connection between section 807(f) and section 446 in a 2015 private letter ruling,[30] which indicated that the section 807(f) change-in-basis rule was applicable where certain life insurance contracts were treated as being reinsured when they actually were not.

In the FAA, the IRS concluded that the adjustment to the statutory reserve should be treated as a section 807(f) adjustment.

In making this determination, the IRS relied on case law in *Huffman v. Commissioner*[31] and *American Mutual Life Ins. Co. v. United States*.[32] In the former case, the court determined that a change in method of accounting is an adjustment to the consistent treatment of an item that affects the timing for recognition of the item and does not permanently change lifetime income. In the latter, the court concluded that the computation of life insurance reserves does not have a permanent effect on the taxpayer's lifetime taxable income, as any deduction for the increase in reserves will ultimately be offset by the release of the reserve and the recognition of this amount of income. The IRS further asserted that, under section 807(d), the required tax reserve is generally the FPR unless the statutory reserve is lower. Thus, the IRS stated in the FAA that both the tax reserve computation and the statutory reserve limitation are components of the method of accounting for reserves, to the extent that the respective components are consistently applied, and determine the final tax reserve in any particular year.[33] Therefore, the IRS argued, a change in the reserve method under section 807(d) is subject to section 807(f) regardless of whether it arises from a change to the FPR or a change in the application of statutory capping.

APPLICABILITY OF SECTION 807(f)

It is unclear whether the IRS's position that section 807(f) applies to the statutory reserve computation is an appropriate interpretation of section 807(f). As summarized by Edward Robbins and Richard Bush, "the legislative history for section 807 supports the conclusion that the statutory cap is not a "method" of computing reserves. The 1984 Act Blue Book provides that, generally, section 807(f) applies "only if there is a change in basis in computing the [FPR] (as distinguished from the net surrender value)." This language suggests that only changes in the computation of the FPR are subject to the 10-year spread rules."[34]

In Notice 2010-29,[35] the IRS detailed the impact of Actuarial Guideline 43 (AG 43) on the calculation of tax reserves. For many taxpayers, the adoption of AG 43 resulted in lower statutory reserves for accounting purposes, which in turn decreased tax reserves due to statutory capping in section 807(d)(1). This notice provided interim guidance, including a rule that the effect of statutory capping as a result of the adoption of AG 43 must be spread over ten years. The notice was careful not to reference the change as being governed by section 807(f), and in fact explicitly stated that no inference can be drawn from the notice regarding any federal tax issues that arise under any actuarial guideline other than AG 43.

In addition, Rev. Rul. 94-74 provided an example where the IRS interpreted the scope of section 807(f) broadly. This ruling addressed the applicability of section 807(f) to four situations in which a life insurance company made changes to its reserves. The first situation involved a change in the mortality table used to compute the reserves; the second involved a change in the interest rate used; the third involved a changed assumption from a curtate to continuous function; and the fourth involved a computer program error which caused certain policies to be omitted from the computation altogether. In each of the first three situations, the revenue ruling concluded that the change was a change in basis subject to section 807(f) and, thus, the 10-year spread rule applied. Situation four postulates a fact pattern where a reserve is properly computed, but because of a computer error, is not included in the sum of total reserves for the year in question. The ruling concluded the change is the correction of an error and not subject to the 10-year spread rule. The revenue ruling was significant in that it concluded that even changes in the computation of reserves for items which are mandated by statute, such as interest rates or mortality tables, are changes in basis rather than corrections of errors.

> However, the FAA only constitutes field advice, which is relevant, but does not represent substantial authority on which a taxpayer can indisputably rely.

In the 2015 private letter ruling mentioned above,[36] the IRS concluded that the section 807(f) change-in-basis rule applied where certain life insurance contracts were treated as being reinsured when they actually were not, which resulted in the life insurance reserves for the contracts being recorded in the wrong legal entity. Perhaps the most important point from that PLR was that by treating the mislabeling of the life insurance reserves as *not* being a mere posting error, the IRS maintained its position that most changes to the calculations of a life insurance reserve are *not* errors.

None of the previous guidance, however, directly supports a conclusion that section 807(f) applies to the statutory reserve computation. The calculation of the statutory reserve is not governed by the Code, which merely references the statutory reserve as a ceiling for the reserve amount included in the determination of life insurance company taxable income.

CONCLUSION

There continues to be uncertainty as to whether a change to the statutory reserve could be subject to section 807(f). The recent FAA explicitly addresses the statutory capping issue and concluded that a change to the statutory reserve should be considered a change in the reserve method under section

807(d) and subject to section 807(f). However, the FAA only constitutes field advice, which is relevant, but does not represent substantial authority on which a taxpayer can indisputably rely.[37] To announce this position officially, the IRS should propose guidance and allow potentially affected taxpayers to comment on such proposal. And, any new rule developed should be applied on a prospective basis. ■

The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser. This article represents the views of the authors only, and does not necessarily represent the views or professional advice of KPMG LLP.

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ENDNOTES

1 20165101F (Dec. 16, 2016).

2 An FAA is a memo prepared by field attorneys in the IRS Office of Chief Counsel that is reviewed by an Associate Office. An FAA cannot be used or cited as precedent.

3 Unless otherwise noted, all references to sections are to the U.S. Internal Revenue Code of 1986, as amended (the Code), and to the Treasury regulations issued thereunder.

4 Section 807(d)(1).

5 Federally Prescribed Reserve under section 807(d).

6 Because the FAA is prepared internally within the IRS, the taxpayer does not have the opportunity to provide input. So all that is known is the IRS's interpretation of the taxpayer's position.

7 The IRS's position raises an interesting question: If a company amends its FPR in a year where it wasn't originally capped, but subsequently becomes capped after amendment, would the IRS determine that section 807(f) applies to both the change to the FPR starting in the year of the change and the statutory reserve starting in the year the reserve becomes capped?

8 Section 446(e)

9 Section 481(a).

10 Rev. Proc. 2016-29.

11 Section 807(f)

12 Rev. Rul. 94-74, 1994-2 C.B. 157, Situation 4.

13 *See* Rev. Rul. 94-74, 1994-2 C.B. 157. *See also* I.R.S. Priv. Ltr. Rul. 201511013 (March 13, 2015).

14 *See* Treas. Reg. §1.446-1(e)(2)(ii)(b) (a change in method also does not include a change in treatment resulting from a change in underlying facts).

15 Robbins Edward, and Richard Bush. 2014. *Tax Basis Assets and Liabilities of US Life Insurers*. New Hartford: Actex. 178–179.

16 Staff of the Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 604 (1984). ("The 1984 Act Blue Book").

17 Rev. Rul. 69-444, 1969-2 C.B. 145

18 I.R.S. Priv. Ltr. Rul. 8139036 (June 30, 1981).

19 Rev. Rul. 69-444, 1962-2 C.B. 145.

20 *See* for example I.R.S. Priv. Ltr. Rul. 8008048 (Nov. 28, 1979) and I.R.S. Priv. Ltr. Rul. 8431022 (Apr. 30, 1984).

21 Winslow, Peter and Lori Jones. 2010. "Change in Basis of Computing Reserves – Is it or isn't it?" *Taxing Times* 6 (1): 11.

22 *See* supra note 19.

23 The 1984 Act Blue Book, at p. 604.

24 *See* supra note 1.

25 *Principal Mutual Life Insurance Co. v. United States*, 48 Fed. Cl. 52 (Cl. Ct. 2000), aff'd F.3d 1241 (Fed. Cir. 2002). (Federal Circuit held that statutory reserves are not "computed" as such but are simply taken directly from the reserves in the annual statement).

26 *See* supra note 1.

27 *See* supra note 2.

28 This reading of the statutory scheme was articulated in *American General Life & Accident Ins. Co. v. United States*, 71AFTR 2d 93-3319 (M.D. Tenn. 1989): "There need be no conflict between section 481 and the 10-year spread rule of section 810. Code section 481 is simply a much more general provision dealing with recapture of tax income in a broad variety of cases. It is a broad rule which generally authorizes recapture."

29 "Under section 446, a change in method of accounting does not include correction of mathematical or posting errors. *See, e.g.*, section 1.446-1(e)(2)(ii)(b). Because section 807(f) is a more specific application of the general tax rules governing a change in method of accounting, a circumstance that is not a change in method of accounting under the general rules cannot be governed by the more specific rules of section 807(f). Accordingly, consistent with section 446, the correction of reserves for a mathematical or posting error would not be treated as a change in basis under section 807(f)."

30 I.R.S. Priv. Ltr. Rul. 201511013 (March 13, 2015).

31 126 T.C. 322, 343 (2006), aff'd., 518 F.3d (6th Cir. 2008).

32 267 F.3d 1344, 1350 (Fed. Cir. 2001).

33 *See* supra note 1, at p. 7.

34 Robbins Edward, and Richard Bush. 2014. *Tax Basis Assets and Liabilities of US Life Insurers*. New Hartford: Actex. 185.

35 I.R.S. Notice 2010-29, 2010-15 I.R.B. 547.

36 *See* supra note 30.

37 I.R.S Treas. Reg. §1.6662-4(d)(3)(iii)