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Rev. Proc. 2019-10: New Guidance on Changes in the Basis of Determining Life Insurance Reserves

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The Tax Cuts and Jobs Act (TCJA)¹ modified the treatment of changes in the basis for determining life insurance reserves, as governed by Internal Revenue Code (I.R.C.)² § 807(f). This article summarizes the treatment of such changes in basis under prior law and describes the changes enacted by the TCJA. It further summarizes the procedures for changing the basis of computing reserves as outlined in Revenue Procedure 2019-10,³ the IRS's most recent guidance on the subject.

PRE-TCJA TREATMENT OF CHANGES IN THE BASIS OF DETERMINING LIFE INSURANCE RESERVES

Section 807(f) of the I.R.C. prescribes rules for accounting for changes in the basis for determining tax reserves. Under these rules, the impact of a change in the basis for determining life reserves for contracts issued before the year of change equals the difference between (a) the amount of the reserve as of the end of the final day of the tax year, computed on the new basis; and (b) the amount of such reserves, computed on the old basis. Prior to the TCJA, this difference (the “§ 807(f) spread”) was includible in income ratably for each of the 10 succeeding taxable years.⁴ This treatment was consistent regardless of whether the § 807(f) spread was favorable or unfavorable.

CHANGES TO I.R.C. § 807(f) UNDER THE TCJA

The TCJA did not modify the method of computing the § 807(f) spread, but it *did* alter the timing for inclusion of the corresponding

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income or deduction items by aligning it with the rules applicable to changes in method of accounting pursuant to § 481.⁵ For taxable years beginning after Dec. 31, 2017, § 807(f) spreads that are favorable to the taxpayer (*i.e.*, that decrease taxable income by strengthening tax reserves) are generally taken as a reduction of taxable income in the current tax year, while unfavorable § 807(f) spreads are generally includible in taxable income ratably over four years, also beginning in the current tax year.⁶ The inclusion of § 807(f) spreads beginning in the current tax year is a departure from prior law I.R.C. § 807(f), under which the effects of such adjustments were deferred to the following year.

The provision results in the acceleration of both favorable and unfavorable § 807(f) spreads, reducing the spread period from 10 years to one year and four years, respectively. The Joint Committee on Taxation estimated that this would increase revenues by approximately \$1.3 billion over 10 years.⁷

REV. PROC. 2019-10: NEW AND CLARIFYING GUIDANCE

On Dec. 13, 2018, the IRS released Rev. Proc. 2019-10 in order to provide procedures for an insurance company changing its basis of computing reserves pursuant to I.R.C. § 807(f), as amended by

the TCJA. To do so, the procedure modifies Rev. Proc. 2018-31⁸ to add changes in basis under I.R.C. § 807(f) to the List of Automatic Changes for which consent is automatically granted by the Commissioner of Internal Revenue.⁹

Rev. Proc. 2019-10 provides that taxpayers that modify the basis for computing life reserves must now comply with IRS procedures related to automatic method changes, including the requirement to report such method changes on Form 3115, *Application for Change in Accounting Method*. Rev. Proc. 2019-10 states that all changes in basis made during the same taxable year, for the same contract type, are considered a single change in basis. As such, the effects of all changes in basis for a particular type of contract are netted and treated as a single § 481(a) adjustment. However, it remains unclear how contract types are defined. Taxpayers will file a single Form 3115, but each change in basis by contract type must be explained within the form.

Under Rev. Proc. 2019-10, taxpayers that have been using an impermissible method and that follow applicable procedures will receive audit protection for post-2017 taxable years prior to the year of change. However, unlike some other changes in method of accounting, the revenue procedure states that a method change pursuant to I.R.C. § 807(f) does not qualify the new method for audit protection in the year of change or in any subsequent year, meaning that the IRS may force a taxpayer to change its basis for computing reserves under exam if the new method used is found to be impermissible.

Rev. Proc. 2019-10 also clarified the treatment of reserve basis changes made for taxable years ending on or before Dec. 31, 2017, for which the § 807(f) spread is still being amortized. The revenue procedure provides that any changes in reserve basis made in taxable years beginning before Jan. 1, 2018, should continue to be accounted for over the 10-year period provided by prior law I.R.C. § 807(f). In addition, when computing the transition relief amount under the TCJA's transition relief rule,¹⁰ the guidance advises taxpayers to factor any changes in reserve basis into their pre-TCJA closing reserve balance in order to avoid the duplication or omission of income as a result of such changes.

MORE TO COME?

Substantial guidance has been issued over the years to clarify whether a reserve change is a change to which § 807(f) applies. Guidance specific to changes in basis under prior law I.R.C. § 807(f) includes Revenue Ruling 94-74¹¹ and Revenue Ruling 2002-6.¹² These rulings are modified by Rev. Proc. 2019-10 to the extent that they are inconsistent with the rules applicable to changes in method of accounting.

While Rev. Proc. 2019-10 does not resolve all open questions with regards to changes in basis of tax reserves pursuant to § 807(f) as amended by the TCJA, it does provide clarity for some of the key considerations. We expect that the IRS and Treasury will provide additional guidance in the future. For example, revisions to Rev. Rul. 94-74 might be appropriate (1) to remove fact situations that are no longer applicable post-TCJA (e.g., those dealing with improper computation of the pre-TCJA “federally prescribed reserve”), (2) to add new fact situations directed at recent NAIC reserve guidance (e.g., VM-20 and VM-21), and (3) to focus the ruling more directly on what is or is not a method change, rather than on how the adjustments are taken into account. ■

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ENDNOTES

- 1 Pub. L. No. 115-97, 131 Stat. 2054 (Dec. 22, 2017).
- 2 References to the I.R.C. or Code are to the Internal Revenue Code of 1986, as amended. Unless otherwise specified, this includes the amendments made by the TCJA.
- 3 Rev. Proc. 2019-10, 2019-2 I.R.B. 296 (Dec. 13, 2018).
- 4 I.R.C. § 807[2017](f)(1).
- 5 I.R.C. § 481(a); Rev. Proc. 2015-13, 2015-5 I.R.B. 419 (Jan. 17, 2015).
- 6 *Id.*
- 7 Joint Committee on Taxation. JCX-63-17, Estimated Revenue Effects of the “Tax Cuts and Jobs Act,” as Passed by the Senate on December 2, 2017 (Dec. 6, 2017).
- 8 Rev. Proc. 2018-31, 2018-22 I.R.B. 637 (May 9, 2018).
- 9 *Id.* Sec. 26.04.
- 10 See Note 1, Sec. 13517.
- 11 Rev. Rul. 94-74, 1994-2 C.B. 157 (Dec. 5, 1994).
- 12 Rev. Rul. 2002-6, 2002-1 C.B. 460 (Feb. 11, 2002).