

Part I

Section 807.—Rules for certain reserves

Rev. Rul. 2020-19

ISSUE

In the situations described below, is there a change in basis of computing life insurance reserves under § 807(f) of the Internal Revenue Code, as amended by section 13513 of Public Law No. 115-97, commonly referred to as the Tax Cuts and Jobs Act (TCJA), 131 Stat. 2054, 2143 (2017)?

FACTS

IC, a calendar year life insurance company within the meaning of § 816(a), issues life insurance and annuity contracts directly and also reinsures the risks on such contracts issued by other companies. IC is required to determine life insurance reserves under § 807(d) with respect to both directly written and reinsured contracts and to take net increases or decreases in the reserves into account in computing life insurance company taxable income. IC computes the amount of the life insurance reserve for a

contract in accordance with the net surrender value (NSV) floor of § 807(d)(1)(A) and (B) and the statutory cap of § 807(d)(1)(C).

Situation 1. Beginning in Year 1, IC issues variable annuity contracts within the meaning of § 817(d). On its Federal income tax returns for Years 1 and 2, IC computed the amount of the reserve with regard to each of those contracts under the Commissioners' Annuities Reserve Valuation Method (CARVM) prescribed by the National Association of Insurance Commissioners (NAIC) but incorrectly applied the 92.81% factor of § 807(d)(1)(B) to that entire amount, rather than only to the excess of that amount over the greater of each contract's NSV or the portion of the reserve separately accounted for under § 817.

Situation 2. In Year 4, the NAIC makes a change to the NAIC Valuation Manual 21 (VM-21) that imposes a new computational requirement as a component of CARVM on issuers of variable annuities with guaranteed minimum benefits. The requirement applies to the determination of statutory reserves as of December 31, Year 4, with regard to contracts issued after December 31, Year 1. On its Federal income tax returns for Years 2 and 3, IC determined its reserves for variable annuity contracts under the requirements of VM-21. As a result of the change in VM-21, IC's statutory reserves for these contracts as of December 31, Year 4, will be lower than they would have been had the change not been made.

Situation 3. The facts are the same as in Situation 2, except that the change to VM-21 applies to the determination of statutory reserves as of December 31, Year 4, with regard to contracts issued after December 31, Year 3.

Situation 4. The NAIC issues a new Actuarial Guideline that imposes a new computational requirement for the Commissioners' Reserve Valuation Method (CRVM) for universal life contracts issued before Year 1. The requirement applies to the determination of statutory reserves for these contracts as of December 31, Year 3. IC's statutory reserves for these contracts as of December 31, Year 3, will be lower than they would have been had the NAIC not issued the new Actuarial Guideline.

Situation 5. IC computes its reserves for a group of life insurance contracts under NAIC Valuation Manual 20 (VM-20). The group of contracts passes both the stochastic exclusion test and the deterministic exclusion test of VM-20, and the company elects to exclude the group from both the stochastic reserve calculation and the deterministic reserve calculation. Accordingly, the statutory reserve for the group is equal to the sum of the policy net premium reserves.

VM-20 prescribes the mortality standard to be used to compute the net premium reserves for the contracts. The NAIC changes the Valuation Manual to require the use of the Year 1 Commissioners' Standard Ordinary (CSO) mortality tables to compute the net premium reserves for all contracts subject to VM-20. The requirement applies to the determination of statutory reserves for these contracts as of December 31, Year 3. IC's statutory reserves for each of the contracts in the group of contracts as of December 31, Year 3, will be lower than they would have been had the NAIC not changed the Valuation Manual to prescribe the use of the Year 1 CSO mortality tables.

Situation 6. IC computes its reserves for certain life insurance contracts under VM-20. Under VM-20, the minimum statutory reserve for the contracts is equal to the

sum of the policy minimum net premium reserves for the contracts, plus the excess, if any, of the greater of the deterministic reserve for the contracts and the stochastic reserve for the contracts. For the taxable years ended December 31, Year 1, and December 31, Year 2, the deterministic reserve exceeded both the stochastic reserve and the sum of the policy net premium reserves for the contracts and thus was the statutory reserve reported on the NAIC annual statement. The excess of the deterministic reserve over the sum of the policy net premium reserves was allocated to individual contracts in the manner prescribed by VM-20. IC's statutory reserves at December 31, Year 3, were equal to the sum of the policy net premium reserves for the contracts because this amount exceeded the deterministic reserve and stochastic reserve as of that date. There was no change in the method of computing the deterministic reserve, the stochastic reserve, or the sum of the policy net premium reserves for the contracts in Year 3.

Situation 7. IC computes its reserves for certain life insurance contracts under VM-20. Under VM-20, the minimum statutory reserve for the contracts is equal to the sum of the policy minimum net premium reserves for the contracts, plus the excess, if any, of the greater of the deterministic reserve for the contracts and the stochastic reserve for the contracts. For the taxable years ended December 31, Year 1, and December 31, Year 2, the deterministic reserve exceeded both the stochastic reserve and the sum of the policy net premium reserves for the contracts, and thus was the statutory reserve reported on the NAIC annual statement. Pursuant to the requirements of VM-20, this excess was allocated to individual contracts. For purposes of computing

the deterministic reserve, section 9.c.2 of VM-20 requires that company experience mortality rates be determined for each mortality segment and that the company experience data used to determine those rates be updated at least every three years. Because of the VM-20 mandated update, the mortality rates used for certain segments to compute the deterministic reserve as of December 31, Year 2, differed from those used for purposes of computing the deterministic reserve as of December 31, Year 1.

Situation 8. On its Federal income tax return for the taxable year ended December 31, Year 1, IC reported tax reserves for certain fixed annuity contracts equal to 92.81% of the CARVM reserves for the contracts, because that amount for each contract exceeded the NSV for each contract. For the taxable year ended December 31, Year 2, IC instead reported tax reserves equal to the NSV of those same contracts because that amount for each contract was greater than 92.81% of the CARVM reserve for each contract. There was no change in the CARVM or in the method of computing the NSV for any contract in Year 2.

Situation 9. For purposes of computing its life insurance reserves under § 807(d), IC organizes its life insurance contracts into policy groupings or cells, each consisting of policies that are identical as to plan of insurance, year of issue or contract duration, age of issue, and other factors. In Year 2, after filing its Federal income tax return for the Year 1 taxable year, IC discovered that due to a computer programming error the policy cells for certain contracts issued during Year 1 had been omitted from the computation of IC's closing Year 1 tax reserves. Had the omitted policy cells been included in IC's closing Year 1 reserves, IC's life insurance reserves under § 807(d) at December 31,

Year 1, would have been greater than the amounts originally claimed. The computer programming error took place in Year 1 and affected no other taxable year.

Situation 10. In Year 2, IC announced to certain of its policyholders that their policies would, at no increase in premium, henceforth carry an additional indemnity benefit should death result from a non-occupational vehicular accident. At the end of Year 2, IC included in its reserves for the relevant contracts an additional amount for the present value of this additional future unaccrued obligation. The additional amount would be a life insurance reserve under § 816(b) and was determined under a tax reserve method within the meaning of § 807(d)(2).

LAW AND ANALYSIS

Section 811(a) provides that a life insurance company is required to compute its taxable income using an accrual method of accounting or, to the extent permitted under regulations prescribed by the Secretary of the Treasury or his delegate (Secretary), using a combination of an accrual method of accounting with another permissible method (other than the cash receipts and disbursements method). To the extent not inconsistent with the requirement in the preceding sentence or other Federal income tax rules applicable to life insurance companies, all such computations, however, are to be made in a manner consistent with the manner required for purposes of the annual statement approved by the NAIC.

Section 803(a)(2) requires income to be taken into account for any net decrease in reserves described in § 807(c). Similarly, § 805(a)(2) authorizes a deduction for any net increase in reserves described in § 807(c). Under § 807(c)(1), the reserves to which this

treatment applies include “life insurance reserves (as defined in § 816(b)).”

Section 807(d)(1) provides rules for determining the amount of life insurance reserves other than for purposes of § 816 (relating to qualification as a life insurance company). In general, the amount of the life insurance reserve with respect to any contract is the greater of the NSV of the contract or 92.81% of the reserve determined under § 807(d)(2). For a variable contract, the reserve is the sum of (1) the greater of the NSV of the contract and the portion of the reserve separately accounted for under § 817 plus (2) 92.81% of the excess of the total reserve determined under § 807(d)(2) over the NSV or § 817 reserve, as applicable.

Section 807(d)(2) provides that the reserve for any contract must be determined using the tax reserve method applicable to the contract. Section 807(d)(3) provides that the applicable tax reserve method is (1) in the case of a contract covered by the CRVM, the CRVM prescribed by the NAIC that is applicable to the contract and in effect as of the date the reserve is determined and (2) in the case of a contract covered by the CARVM, the CARVM prescribed by the NAIC that is applicable to the contract and in effect as of the date the reserve is determined.

Section 807(f) provides that if the basis for determining any item referred to in § 807(c), which includes life insurance reserves, as of the close of any taxable year differs from the basis for determining that item as of the close of the preceding taxable year, then so much of the difference between (1) the amount of the item at the close of the taxable year, computed on the new basis, and (2) the amount of the item at the close of the taxable year, computed on the old basis, as is attributable to contracts

issued before the taxable year, is taken into account under § 481(a) as an adjustment attributable to a change in method of accounting initiated by the taxpayer and made with the consent of the Secretary.

Section 1.807-4(a) of the Income Tax Regulations provides that a change in basis of computing an item referred to in § 807(c) is a change in method of accounting for purposes of § 1.446-1(e), unless § 1.446-1(e) provides otherwise. Accordingly, a change in basis under § 807(f) is a change in method of accounting subject to § 446(e) and the regulations thereunder. In accordance with § 446(e) and § 1.446-1(e), before computing an item described in § 807(c) under a new basis, a life insurance company must obtain the consent of the Commissioner of the Internal Revenue or his delegate (Commissioner) pursuant to administrative procedures prescribed by the Commissioner. See section 26.04 of Rev. Proc. 2019-43, 2019-48 I.R.B. 1107 (or successor) (generally providing the Commissioner's automatic consent for a life insurance company to change its basis of computing an item referred to in § 807(c)). Section 1.807-4(b) provides rules relating to the required adjustments under § 481(a). Section 1.807-4(c) describes how opening and closing balances of § 807(c) items are determined under § 807(a) and (b) when there is a change in basis under § 807(f).

As with the general rules for methods of accounting, a company adopts a basis of computing an item referred to in § 807(c) when it uses a permissible basis of computing the item on the first Federal income tax return that reflects the item. If a company uses an impermissible basis of computing an item on the tax return for one taxable year, such computation does not constitute the adoption of a basis of computing the item.

However, the consistent use of an impermissible basis of computing an item on two or more consecutively filed tax returns establishes the basis of computing the item. If a company has adopted a basis of computing an item, it may not change the basis by amending its prior tax returns. See Rev. Rul. 90-38, 1990-1 C.B. 57; Rev. Rul. 2003-127, 2003-2 C.B. 1245; Thrasys, Inc. v. Commissioner, T.C. Memo 2018-199.

Additionally, a change in an item referred to in § 807(c) resulting from a change in underlying facts or from the correction of mathematical or posting errors is not a change in basis of computing the item under § 807(f). See § 1.446-1(e)(2)(ii)(b).

In Situation 1, IC applied the 92.81% factor of § 807(d) impermissibly on two consecutively filed Federal income tax returns – those for Year 1 and Year 2. IC therefore adopted an impermissible basis of computing reserves (old basis). Applying the 92.81% factor to the correct portion of the reserve determined under § 807(d)(2) (new basis) for Year 3 (year of change) is a change in basis under § 807(f). For the year of change, IC must obtain the consent of the Commissioner to make this change following the applicable administrative guidance under § 446(e) and § 1.446-1(e) and account for the difference between the tax reserve computed on the new basis as of December 31, Year 3, and the tax reserve computed on the old basis as of December 31, Year 3, attributable to contracts issued before Year 3, as an adjustment under § 481(a).

In Situation 2, a change to VM-21 imposes a new computational requirement as a component of CARVM on issuers of variable annuities with guaranteed minimum benefits (new basis). The requirement applies to the determination of reserves as of

December 31, Year 4 (year of change), and revises the prior VM-21 requirements (old basis) with regard to contracts issued after December 31, Year 1. Because for Federal income tax purposes § 807(d)(3)(B)(ii) requires the use of the CARVM “which is applicable to the contract and in effect as of the date the reserve is determined,” the change to VM-21 is required to be taken into account for purposes of applying § 807(d). The new requirement represents a change in the methodology for satisfying the CARVM as prescribed by the NAIC. The change is therefore a change in basis under § 807(f). IC must obtain the consent of the Commissioner to make this change and must account for the difference between the tax reserve computed on the new basis as of December 31, Year 4, and the tax reserve computed on the old basis as of December 31, Year 4, attributable to contracts issued after Year 1 and before Year 4 as an adjustment under § 481(a).

In Situation 3, as in Situation 2, the new requirement (new basis) is a change in the methodology for satisfying CARVM and is therefore a change in basis under § 807(f). IC must obtain the consent of the Commissioner to make this change. Because the change only applies to contracts issued after Year 3, the change is made on a cut-off basis and no adjustment is required under § 481(a). See section 2.07 of Rev. Proc. 2015-13.

In Situation 4, a newly-issued Actuarial Guideline imposes a new computational requirement for the CRVM for universal life contracts (new basis). The requirement applies to the determination of reserves as of December 31, Year 3 (year of change), and revises the prior CRVM requirements (old basis) with regard to contracts issued

before Year 1. Because for Federal income tax purposes § 807(d)(3)(B)(i) requires the use of the CRVM “which is applicable to the contract and in effect as of the date the reserve is determined,” the new Actuarial Guideline is required to be taken into account for purposes of applying § 807(d). The new requirement represents a change in the methodology for satisfying the CRVM prescribed by the NAIC. The change is therefore a change in basis under § 807(f). IC must obtain the consent of the Commissioner to make this change and account for the difference between the tax reserve computed on the new basis as of December 31, Year 3, and the tax reserve computed on the old basis as of December 31, Year 3, as an adjustment under § 481(a).

In Situation 5, a group of contracts that is subject to VM-20 passes both the stochastic and deterministic exclusion tests of VM-20, and IC elects to exclude the group from both the stochastic and deterministic reserve calculations. As a result, the statutory reserve with regard to each contract is equal to the policy net premium reserve, and the tax reserve is the greater of 92.81% of this amount or the contract's NSV (old basis). The NAIC changes the Valuation Manual to require the use of the Year 1 CSO mortality tables to compute the net premium reserves for all contracts subject to VM-20 (new basis), effective for the determination of statutory reserves (and, as a result, tax reserves) as of December 31, Year 3 (year of change). IC's statutory reserves for each of the contracts in the group of contracts will be lower than they would have been had there not been a change in tables. The new requirement represents a change in the methodology for satisfying the CRVM prescribed by the NAIC. The change is therefore a change in basis under § 807(f). IC must obtain the consent of the

Commissioner to make this change and account for the difference between the tax reserve computed on the new basis as of December 31, Year 3, and the tax reserve computed on the old basis as of December 31, Year 3, as an adjustment under § 481(a).

In Situation 6, the comparison of the sum of the policy net premium reserves to the stochastic reserve and deterministic reserve is required under VM-20, which is the CRVM and the tax reserve method required to be used under § 807(d)(3). As a result, a change from using the deterministic reserve to using the sum of the policy net premium reserves is not a change in basis but rather a function of the year-over-year change in those amounts. The result would be the same if there had been a statutory deterministic reserve in Years 1, 2, and 3, and under the terms of VM-20 some contracts were not allocated any deterministic reserve in Years 1 and 2 but were allocated a portion of the deterministic reserve in Year 3.

In Situation 7, the statutory reserve for the relevant contracts was equal to the deterministic reserve, and the mortality rates that IC used for purposes of computing the deterministic reserve as of December 31, Year 2, differed from those used for purposes of computing the deterministic reserve as of December 31, Year 1. The rates were different, however, by reason of a requirement of VM-20 that the company experience rates be determined for each mortality segment and that experience data used to determine those rates be updated at least every three years. The update in mortality rates, therefore, was by operation of the reserve methodology of VM-20, which IC used consistently in both Year 1 and Year 2. The change therefore is not a change in basis of

computing reserves.

In Situation 8, IC reported tax reserves as of December 31, Year 1, equal to 92.81% of the CARVM reserve determined under § 807(d)(2) for certain of its fixed annuity contracts because that amount for each contract exceeded the NSV for each of those contracts. It reported tax reserves as of December 31, Year 2, equal to the NSV of the contracts because this amount for each contract exceeded 92.81% of the CARVM reserve determined under § 807(d)(2) for each contract. Just as in Situation 6, where the reserve methodology entailed a comparison of the deterministic reserve and the sum of the policy net premium reserves, here the reserve methodology entails a comparison of two amounts, in this case prescribed by § 807(d) itself. The fact that year-over-year changes in these amounts results in different calculated amounts being taken into account does not change the principle that the comparison is inherent in the reserve methodology itself, and applying that methodology consistently is not a change in basis of computing reserves.

In Situation 9, the understatement of IC's reserves at December 31, Year 1, caused by the omission of the policy cells for certain contracts issued during Year 1 is the result of a mathematical or posting error. Correction of IC's omission of reserves for certain contracts is not a change in basis of computing reserves. See § 1.446-1(e)(2)(ii)(b). Because this mathematical or posting error occurred only on its Federal income tax return for Year 1, IC should file an amended return for that taxable year, restating the closing reserves at December 31, Year 1, to reflect the correct reserve amounts and taking these recomputed reserves into account in redetermining its life insurance

company taxable income for that year.

In Situation 10, there was no reserve attributable to the new life insurance benefit at the close of Year 1 because the new life insurance benefit did not exist before the company became contractually liable for it in Year 2. The addition of the new benefit in Year 2 is a change in fact. An increase in reserve resulting from a change in fact is not a change in basis of computing reserves. See § 1.446-1(e)(2)(ii)(b). Accordingly, the increase in reserves solely to provide for the additional contractual obligation of IC pursuant to the additional benefits provided during Year 2 under existing policies is not attributable to a change in basis of computing reserves.

HOLDINGS

(1) In Situation 1, a change in the consistent, impermissible application of the 92.81% factor prescribed by § 807(d) is a change in basis.

(2) In Situation 2, an NAIC Valuation Manual change in the methodology for computing reserves on previously-issued contracts is a change in basis.

(3) In Situation 3, an NAIC Valuation Manual change in the methodology for computing reserves on contracts issued in the year of the change is a change in basis.

(4) In Situation 4, a change in Actuarial Guideline that results in a change in the methodology for computing reserves is a change in basis.

(5) In Situation 5, a change in the NAIC-prescribed mortality tables is a change in basis.

(6) In Situation 6, a change under VM-20 from the deterministic reserve to the sum of the policy net premium reserves due solely to the fact that the sum of the policy net premium reserves is greater is not a change in basis.

(7) In Situation 7, an experience-based update in mortality rates as required by VM-20 to determine the deterministic reserve is not a change in basis.

(8) In Situation 8, a change from tax reserves based on 92.81% of the reserve determined under § 807(d)(2) to tax reserves based on the contract NSV resulting solely from a year-over-year change in which is greater is not a change in basis.

(9) In Situation 9, an inclusion of policy cells that were previously omitted on a single return is a mathematical or posting error that is not a change in basis.

(10) In Situation 10, the increase in reserves to provide solely for new benefits on existing contracts is not a change in basis.

DRAFTING INFORMATION

The principal author of this revenue ruling is Ian Follansbee of the Office of the Associate Chief Counsel (Financial Institutions and Products). For further information regarding this revenue ruling contact Ian Follansbee at 202-317-4453 (not a toll-free number).