

Office of Chief Counsel  
Internal Revenue Service  
**Memorandum**

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to: Susan Delisle  
Revenue Agent

(

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subject:

This memorandum responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Taxpayer	=
Year 1	=
Year 2	=
Year 3	=
Year 4	=
Year 5	=
State	=
Life Insurance Company Subsidiary	=

ISSUE:

Whether any part of the increase in reserves in Year 4 for the \_\_\_\_\_ annuity rider is an adjustment due to a change in basis in computing reserves that should be taken into account under section 807(f) of the Internal Revenue Code?

CONCLUSION:

The difference between reserves computed as of the end of Year 4 computed without taking into account the proper application of AG 33, and reserves computed as of the end of Year 4 taking into account the proper application of AG 33 is a change in basis subject to section 807(f).

FACTS:

Taxpayer is the parent of a life-nonlife consolidated group that includes two life insurance companies. The adjustment at issue concerns Life Insurance Company Subsidiary (LIC), a State domiciled company.

LIC markets annuities as part of its product line. Starting in Year 1, LIC started marketing a rider to the annuities ( ) that would provide for a benefit. The rider is described as a

The primary statutory reserve guidance for the is *Actuarial Guideline 33, Determining CARVM Reserves for Annuity Contracts with Elective Benefits* (AG33). The statutory rule for the valuation of annuities is the Commissioners Annuity Reserve Valuation Method (CARVM), but AG33 contains some clarifications on the processes to be used when there are multiple optional benefits included in either the annuity form or in riders attached to the annuity form.

In performing statutory reserve valuations for calendar years Year 1, Year 2 and Year 3, the company understated its statutory reserve liability due to the use of incorrect for parts of the rider features. As a result of the understatement, the taxpayer did not report a reserve for the rider in Year 1 and Year 2. The taxpayer reported a reserve for the rider of \$ on its Year 3 annual statement. The understatement was corrected (with state regulatory approval) in the Year 4 calendar year, with the company reporting an increase in statutory reserves of \$ at the beginning of Year 4 due to a change in computing the understated reserve at year end Year 3. The company reported this increase as a change in valuation basis on line 43 of the Summary of Operations (as an adjustment to surplus).

For tax years Year 1, Year 2 and Year 3, the tax reserve was equal to its statutory reserve. In addition, its tax reserve was calculated using the statutory reserve method as used in those years, using the interest rate assumptions reflected in the understated statutory reserve calculations. Thus, on taxpayer's Year 1, Year 2 and Year 3 tax returns, taxpayer reported \$ reserves, \$ reserves, and \$ reserves, respectively, because the tax reserve was limited to the understated statutory reserve per section 807(d)(1). In Year 4, the taxpayer filed amended tax returns for Year 2 and Year 3. The taxpayer claims it recomputed its tax reserves under section 807(d)(2) to

correct for the improper application of AG 33 for Year 2 and Year 3 per the amended returns. However, there was no change to the amount of the tax reserves reported for the rider because the tax reserve was still limited per section 807(d)(1) to the understated statutory reserve. Taxpayer notations indicate the tax reserves at year end Year 3 were calculated correctly under AG33, but the tax reserve held for determination of Year 3 taxable income due to growth in reserves was properly limited to the statutory ceiling, or in other terminology, the statutory cap. Thus, the ending reserve balance, and the amount of the deduction for increase in reserves, did not change. Because the ending tax reserves did not change, the taxpayer did not report an adjustment due to a change in basis in computing reserves.

On its originally filed Year 4 tax return, the taxpayer calculated its tax reserves with the proper . Because there was a change in the computation of the statutory reserves to take into account the proper application of AG 33, the taxpayer's tax reserves for the rider were no longer subject to the statutory reserve limitation. Thus, tax reserves using the proper pursuant to AG33 were reflected in the final reserve computation. In Year 4, the taxpayer's reserves increased from \$ to \$ . Of that amount, \$ was attributable to the application of the change in to the Year 3 year-end balance, and the remaining amount was attributable to the current year increase in reserves when reserves were consistently computed as of the beginning and end of the year. The taxpayer did not consider any portion of the reserve increase as a change in basis. It recognized the increase in reserve in full as a deduction in Year 4.

#### LAW AND ANALYSIS

Section 805(a)(1) includes in general deductions all claims and benefits accrued, and all losses incurred (whether or not ascertained), during the taxable year on insurance and annuity contracts.

Section 805(a)(2) includes in general deductions the net increase in reserves which is required by section 807(b) to be taken into account under this paragraph.

Section 803(a)(2) includes in gross income each net decrease in reserves which is required by section 807(a) to be taken into account under this paragraph.

Section 807(a) provides that if for any taxable year the opening balance for the items described in subsection (c), exceeds the closing balance for such items, reduced by the amount of the policyholders' share of tax-exempt interest and the amount of the policyholder's share of the increase for the taxable year in policy cash values (within the meaning of section 805(a)(4)(F)) of life insurance policies and annuity and endowment contracts to which section 264(f) applies, such excess shall be included in gross income under section 803(a)(2).

Section 807(b) provides that if for any taxable year the closing balance for the items described in subsection (c), reduced by the amount of the policyholders' share of tax-

exempt interest and the amount of the policyholder's share of the increase for the taxable year in policy cash values (within the meaning of section 805(a)(4)(F)) of life insurance policies and annuity and endowment contracts to which section 264(f) applies, exceeds the opening balance for such items, such excess shall be taken into account as a deduction under section 805(a)(2).

Section 807(c) provides that the items referred to in subsections (a) and (b) includes the life insurance reserves (as defined in section 816(b)).

Section 807(d)(1) provides that for purposes of this part (other than section 816), the amount of the life insurance reserves for any contract shall be the greater of --

807(d)(1)(A). -- the net surrender value of such contract, or

807(d)(1)(B). -- the reserve determined under paragraph (2).

In no event shall the reserve determined under the preceding sentence for any contract as of any time exceed the amount which would be taken into account with respect to such contract as of such time in determining statutory reserves (as defined in paragraph (6)).

Section 807(d)(2) provides that the amount of the reserve determined under this paragraph with respect to any contract shall be determined by using the tax reserve method applicable to such contract, the greater of the applicable Federal interest rate or the prevailing State assumed interest rate, and the prevailing commissioners' standard tables for mortality and morbidity adjusted as appropriate to reflect the risks (such as substandard risks) incurred under the contract which are not otherwise taken into account.

Section 807(f)(1) provides that, for purposes of this part, if the basis for determining any item referred to in subsection (c) as of the close of any taxable year differs from the basis for such determination as of the close of the preceding taxable year, then so much of the difference between --

807(f)(1)(A)(i). -- the amount of the item at the close of the taxable year, computed on the new basis, and

807(f)(1)(A)(ii). -- 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 shall be taken into account under the method provided in subparagraph (B).

Section 807(f)(1)(B)(i) provides that if the amount determined under subparagraph (A)(i) exceeds the amount determined under subparagraph (A)(ii), 1/10 of such excess shall

be taken into account, for each of the succeeding 10 taxable years, as a deduction under section 805(a)(2).

Section 807(f)(1)(B)(ii) provides that if the amount determined under subparagraph (A)(ii) exceeds the amount determined under subparagraph (A)(i), 1/10 of such excess shall be included in gross income, for each of the 10 succeeding taxable years, under section 803(a)(2).

Section 807(d)(1) provides a "three prong test" for determining the amount of the life insurance reserve for any contract. The reserve is first computed using the tax reserve computation required by section 807(d)(2) (hereinafter, "federally prescribed reserve" or "FPR"). The reserve is then increased, if the net surrender value of the contract is higher. Finally, the reserve is reduced, if applicable, so that it does not exceed the amount of the statutory reserve. The final amount so determined is the amount of the life insurance reserve at the end of the year, and the difference between the ending balance at the end of the year and the ending balance at the end of the prior year is the amount of the deduction or increase in income.

In the instant case, the taxpayer changed its method of computing the FPR in Year 2 when filing an amended return, but due to the statutory reserve limitation, the change did not affect the amount of the tax reserve until a parallel change was made in the method of computing statutory reserves in Year 4. See Rev. Rul. 94-74, 1994-2 C.B. 157. The issue in this case is whether a change in basis subject to section 807(f) occurred in Year 4.

There is no dispute that a change in the computation of reserves to take into account the factors required by AG 33 is a change in basis subject to section 807(f). See Rev. Rul. 2002-6, 2002-1 C.B. 460. The issue is whether that change in basis occurred in Year 4 when Taxpayer changed its method of computing the statutory reserves limitation or "cap."

The taxpayer contends that the change in basis attributable to AG 33 occurred when the taxpayer filed its amended returns in Year 2 and Year 3. The taxpayer claims that the only method of accounting involved in the computation of the tax reserve is the method of computing the FPR without regard to the statutory reserve limitation (or, presumably, the net surrender value floor). It characterizes the application of the statutory reserve limitation as a mere limitation or cap on the tax reserve accounting method. It argues that there is no change in basis when there is a change in the method of computing statutory reserves, if, in the year of change, the computation of the FPR has not changed. The taxpayer thus contends that in Year 4, all that happened was a change in the computation of the statutory reserve limitation, and the change was not a change in basis in computing reserves.

The Internal Revenue Code does not expressly define the phrase "method of accounting." However, case law has held that the phrase includes "the consistent treatment of any recurring, material item, whether that treatment be correct or incorrect."