

APPEALS

Industry Specialization Program Coordinated Issue

Settlement Position

Industry: Life Insurance

Issue: IRC Section 807 Basis Adjustment –
Change in Basis v. Correction of Error

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SETTLEMENT POSITION

IRC Section 807 Basis Adjustment - Change In Basis v. Correction of Error

STATEMENT OF ISSUE

Whether a change in determining any of the reserve items referenced in IRC §807(c) as of the close of a post-1983 taxable year must be treated as a change in basis adjustment under section 807(f), which requires the change to be amortized over a 10-year period starting with the subsequent taxable year; or, whether the change must be treated as a correction of an error and therefore taken into account in full in the year of change.

EXAMINATION DIVISION'S POSITION

The Examination Division's position is that any change in a reserve item referred to in section 807(c) that is not due to a correction of a nonrecurring mathematical or posting error is a change in basis subject to the 10- year spread. This position is based on the plain language of section 807.

Rev.Rul. 94-74, 1994-2 C.B. 157, provides examples of four illustrative situations. The situations described therein are for guidance, and not exhaustive of all possible fact patterns.

In Situation 1, the life insurance company discovers in 1993 that for all prior tax years the company had computed its life insurance reserves for certain reinsured contracts using the prevailing Commissioners' Standard Ordinary Table ("CSO") at the time the reinsurance

agreement was entered into, rather than the CSO at the time the reinsured contracts were issued, as required by section 807(d)(5)(A). Its earliest open tax year for filing an amended return is 1989. In situation 2, an audit of the 1990 through 1992 taxable years revealed that a life insurance company computed its reserves under section 807(d) using the same interest rate as it had used to compute its statutory reserves, rather than using the higher of the applicable federal interest rate or the prevailing state assumed interest rate in effect when the contracts were issued, as specified by section 807(d)(2). In situation 3, the life insurance company changed in 1993 from using curtate to continuous functions in computing its life reserves. The prescribed tax reserve method under section 807(d)(3)(A) does not specify the use of function, only that the same timing assumption be used for federal tax purposes as for state statutory reserves. In situation 4, a life company discovers in 1993 that a computer programming error omitted certain policy groupings or cells issued in 1992 from the computation of the 1992 ending reserves.

In the Holding section of the revenue ruling, the first paragraph refers to situations 1 and 2:

The 10-year ratable adjustment rule of § 807(f) applies to the adjustments resulting from a recomputation of the reserves for a contract to correct for an erroneous application of the prescribed computational rules of § 807(d)(2), whether the recomputation is initiated by the taxpayer or the Service.

The year of change is the earliest open tax year, and the amount of the change in the reserves is taken into taxable income ratably over 10 taxable years, starting with the first taxable year following the year of change.

The second paragraph in the Holding section of the revenue ruling refers to situation 3:

The 10-year ratable adjustment rule of § 807(f) also applies when the amount of the reserves for a contract is changed as the result of a change in a computational assumption [other than the tax reserve method, interest rate, or the prevailing commissioners' standard mortality or morbidity table specified by § 807(d)(2)] used in determining the statutory reserves for a contract. For tax purposes, the year of change is the year for which the taxpayer changes the method of computing its reserves for the contract for state regulatory reporting purposes.

The last paragraph in the Holding section of the revenue ruling refers to situation 4:

An adjustment to the amount of a life insurance reserve under § 807(d) to correct for a mathematical or posting error is not considered a change in basis under § 807(f). Adjustments attributable to the correction of a mathematical or posting error must be made to both opening and closing reserves for the affected year, and are not subject to the 10-year ratable adjustment of § 807(f).

The Examination Coordinated Issue Paper states certain criteria for the treatment of reserve adjustments and concludes, commenting:

Consistent with Situation 4 of Rev. Rul. 94-74, such inadvertent errors are limited to nonrecurring errors that affect the determination of the

amount of a taxpayer's reserves only for a particular taxable year.

INDUSTRY POSITION

It has been asserted by some in the life insurance industry that the government takes too narrow a view of what constitutes an error in a reserve computation, and conversely, an overly broad view of what represents a change in basis requiring a 10-year spread.

DISCUSSION

The Appeals position does not differ from that of the Examination Division. Simply stated, changes in reserve amounts due to the correction of nonrecurring mathematical or posting errors are taken into account in full in the year of error. Any other change in a factor used in calculating a reserve is a change in "the basis for determining any item" within the meaning of §807(f)(1)(A) and is subject to the 10-year adjustment rule. See Rev.Rul. 94-74.

The 10-year adjustment rule in section 807(f), enacted by the Tax Reform Act of 1984 (The 1984 Act), P.L. 98-369, was originally codified as section 810(d), which was added to the IRC by the Life Insurance Company Income Tax Act of 1959, P.L. 86-69. For tax years ending before 1984, life insurance companies had greater discretion in determining reserves; current section 807(d) specifies rules for computing life insurance reserves.

In general, where a life insurance provision was carried over from prior law by the 1984 Act, Congress intended the new provision to be interpreted in a manner consistent with the prior law provision. See H.R. Rep. No. 432, 98th Cong. 2d Sess., Pt.2, 1402 (1984); Senate Committee on Finance, 98th Cong. 2d Sess., Deficit Reduction Act of 1984, Explanation of Provisions Approved by the Committee on March 21, 1984, Vol. 1, 524 (Comm. Print 1984).

Specifically, see Senate Committee on Finance, Deficit Reduction Act of 1984, at 543, regarding section 807(f) replacing section 810(d) : “The present law allowing income or loss resulting from a change in the method of computing reserves to be taken into account ratably over a 10-year period is retained”. The legislative history for the prior section 810(d) shows that Congress intended the term “basis” in the identically worded section 807(f) to be equivalent to “method.” The identical wording of prior section 810(d) and current section 807(f), and the legislative history firmly support the Examination Division position.

There are no reported decisions involving the definition of “basis” in section 807(f)(1)(A), nor any citing Rev.Rul. 94-74. The case law and rulings dealing with the prior section 810(d) uphold that a “change in basis” is a change in method subject to the 10-year spread, whether initiated by the taxpayer or the government, and regardless whether from a proper computation to another proper computation or from an improper to a proper computation. American General Life & Accident Ins. Co. v U.S. , 90-1 USTC 50,010; Rev Rul. 77-198, 1977-1 C.B. 190. Rev.Rul. 70-192 , 1970-1 C.B. 153, holds that a change in an actuarial assumption is a change in basis subject to the 10- year spread provisions. There are no special provisions in the Code limiting section 807(f), such as the courts held in applying prior section 810(d) to the special deduction for reserve strengthening for nonparticipating contracts under then section 809(d)(5). Jefferson Standard Life Ins. Co v. U.S., 408 F.2d 842 (4th Cir. 1969); National Life & Accident Insurance Co. v. U.S. ,524 F.2d 559 (6th Cir. 1975).

Settlement Guidelines

The conclusion in the Examination Coordinated Issue Paper is based on section 807. It is a logical and reasonable statement of what is a change in basis versus correction of an error. The Examination Coordinated Issue Paper is a useful supplement to understanding and applying section 807(f) as it contains a practical example of a change in basis, as well as a discussion of the application of Rev. Rul. 94-74. A revenue ruling is an official interpretation of tax law. While it does not have the force of Treasury regulations, a revenue ruling is precedential in other cases where the facts and circumstances are substantially the same [IRM 8(14)11].

The Service's position, nevertheless, is not free from litigating hazards. For example, given the substantial discussion that preceded publication of Rev. Rul. 94-74, 1994-2 C.B. 157, and the underlying coordinated issue paper, there may be hazards concerning the difference between an actuarial assumption and an error. Furthermore, potential disagreements could arise concerning CARVM and the calculation of tax reserves, possibly giving rise to litigation.

When considering a case, the Appeals Officer should scrutinize any proposed adjustment under section 807(f):

- to determine whether the change in the reserve is due to a change in actuarial assumptions or correction of an error
- to verify that the proposed adjustment resulting from a change in method is the difference between the ending reserves computed under the new method and the ending reserves computed under the old method to the extent the adjustment is attributable to

contracts issued before the beginning of the taxable year. [IRC §807(f)(1)(A)(i) and (ii)]

- to establish that the adjustment is proposed for the correct tax year [IRC §807(f)(1)(B)(i) and(ii)]