

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

Number: **201939003**

Release Date: 9/27/2019

CC:FIP:B02:BJAudet

POSTF-113135-19

UICL: 807.03-00, 807.03-03

date: June 27, 2019

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subject: Election to Apply Updated AFIR

This Chief Counsel Advice responds to your request for assistance dated February 25, 2019. This advice may not be used or cited as precedent.

LEGEND

Taxpayer =  
Parent =  
Year 1 =  
Year 2 =  
Year 3 =  
Amount 1 =  
Amount 2 =  
Amount 3 =

ISSUES

May Taxpayer use amended Year 1, Year 2, and Year 3 returns (“Amended Returns”) to make an election under former<sup>1</sup> § 807(d)(4)(A)(ii) of the Internal Revenue Code to

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<sup>1</sup> Unless otherwise noted or clear from the context, Internal Revenue Code references in this memorandum refer to Code sections as they existed prior to the enactment of “An Act to provide

recompute the applicable Federal interest rate (“AFIR”) every five years for life insurance contracts issued during taxable years beginning after December 31, 1987 (“Contracts”)?

May Taxpayer use an original 2017 return to make an election under § 807(d)(4)(A)(ii) to recompute the AFIR every five years for Contracts?

### CONCLUSIONS

The doctrine of election precludes Taxpayer from making § 807(d)(4)(A)(ii) elections on Amended Returns.

Taxpayer’s § 807(d)(4)(A)(ii) election on its originally filed 2017 return is valid for Contracts issued in 2012. However, the election has no effect on Taxpayer’s reserves for any taxable year because, for Contracts issued in 2012, the interest rates computed under §§ 807(d)(2) and (d)(4)(A)(ii) (computed as Interest Rate A and Interest Rate B in the Table below) were equal, and the recomputation under § 807(d)(4)(A)(ii) does not apply after December 31, 2017.

The doctrine of election also precludes Taxpayer from making a § 807(d)(4)(A)(ii) election on its originally filed 2017 return with respect to Contracts issued five or more years prior to 2017. Permitting Taxpayer to make the § 807(d)(4)(A)(ii) election on Amended Returns or an original 2017 return with respect to Contracts issued five or more years before 2017 would allow Taxpayer to benefit from the use of hindsight to claim additional deductions for increases in reserves due to decreases in the AFIR, while not having to bear any risk of increases in the AFIR in future years (due to a change in law). Further, permitting Taxpayer to make the § 807(d)(4)(A)(ii) elections for Contracts issued five or more years prior to 2017 would impose an undue administrative burden on the Commissioner, would promote inconsistent accounting practice among taxpayers, and would hinder the provision of an equitable and fair tax system by treating similarly situated taxpayers dissimilarly. Therefore, Taxpayer may not apply § 807(d)(4)(A)(ii) to compute reserves with respect to Contracts issued five or more years prior to 2017.

### FACTS

Taxpayer is an affiliated group of corporations that files a consolidated federal income tax return on a calendar year basis. Parent is the common parent of Taxpayer. Certain members of Taxpayer are life insurance companies subject to tax under § 801 (“Life Members”). Parent, on Taxpayer’s originally filed Year 1, Year 2, and Year 3 returns, computed life insurance reserves for Life Members for Contracts in accordance with § 807(d)(2), using the greater of (1) the AFIR, or (2) the prevailing State assumed

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for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018,” P.L. 115-97 (the “Act”).

interest rate (as defined in § 807(d)(4)(B)) (“PSAIR”), for the calendar year in which each Contract was issued (“Interest Rate A”).

In 2018, Parent filed Amended Returns for Taxpayer on which Parent purported to make § 807(d)(4)(A)(ii) elections to recompute reserves for Life Members for Contracts using the greater of (1) the AFIR applicable to the first year of the current recomputation period (defined in § 807(d)(4)(A)(ii)(II)) for each Contract, or (2) the PSAIR applicable to the calendar year in which each Contract was issued (“Interest Rate B”).

As a result of these purported § 807(d)(4)(A)(ii) elections, Taxpayer took into account on Amended Returns the difference between the life insurance reserves computed using Interest Rate A and the life insurance reserves computed using Interest Rate B. Specifically, Taxpayer claimed increased life insurance reserves of Amount 1, Amount 2, and Amount 3 for Year 1, Year 2, and Year 3, respectively. These increases in life insurance reserves were reported as negative adjustments to Taxpayer’s consolidated taxable income. See §§ 807(b)(1) and 1.1502-47.

Additionally, Parent attached to Taxpayer’s originally filed 2017 return a purported “protective election” under § 807(d)(4)(A)(ii) for Contracts, to be operative in case its elections on Amended Returns were considered invalid.

The following table shows, for a given contract year, relevant figures and deadlines for making the § 807(d)(4)(A)(ii) election, including Interest Rate A, the proper tax year to make the § 807(d)(4)(A)(ii) election, the first year of the current recomputation period, Interest Rate B, and the current recomputation period benefit from making the § 807(d)(4)(A)(ii) election for the taxable years 1988-2012.

<u>Contract Year</u>	<u>AFIR for Contract Year</u>	<u>PSAIR for Contract Year</u>	<u>Interest Rate A</u>	<u>Tax Year Return on Which § 807(d)(4)(A)(ii) Election Could Have Been Made</u>	<u>Year of Current Recomputation Period</u>	<u>AFIR for Year of Current Recomputation Period If Election Made in Proper Year</u>	<u>Interest Rate B</u>	<u>Current Recomputation Period Rate Reduction if Election Made in Proper Year</u>
1988	7.77	6.00	7.77	1993	2013	2.16	6.00	(1.77)
1989	8.16	6.00	8.16	1994	2014	1.79	6.00	(2.16)
1990	8.37	5.50	8.37	1995	2015	1.68	5.50	(2.87)
1991	8.42	5.50	8.42	1996	2016	1.56	5.50	(2.92)
1992	8.40	5.50	8.40	1997	2017	1.46	5.50	(2.90)
1993	8.10	5.25	8.10	1998	2013	2.16	5.25	(2.85)
1994	7.45	5.00	7.45	1999	2014	1.79	5.00	(2.45)
1995	6.99	4.50	6.99	2000	2015	1.68	4.50	(2.49)
1996	6.63	4.50	6.63	2001	2016	1.56	4.50	(2.13)
1997	6.33	4.50	6.33	2002	2017	1.46	4.50	(1.83)
1998	6.31	4.50	6.31	2003	2013	2.16	4.50	(1.81)
1999	6.30	4.50	6.30	2004	2014	1.79	4.50	(1.80)
2000	6.09	4.50	6.09	2005	2015	1.68	4.50	(1.59)
2001	6.00	4.50	6.00	2006	2016	1.56	4.50	(1.50)
2002	5.71	4.50	5.71	2007	2017	1.46	4.50	(1.21)
2003	5.27	4.50	5.27	2008	2013	2.16	4.50	(0.77)
2004	4.82	4.50	4.82	2009	2014	1.79	4.50	(0.32)
2005	4.44	4.50	4.50	2010	2015	1.68	4.50	None
2006	3.98	4.00	4.00	2011	2016	1.56	4.00	None
2007	3.97	4.00	4.00	2012	2017	1.46	4.00	None

2008	4.06	4.00	4.06	2013	2013	2.16	4.00	(0.06)
2009	4.06	4.00	4.06	2014	2014	1.79	4.00	(0.06)
2010	3.81	4.00	4.00	2015	2015	1.68	4.00	None
2011	3.46	4.00	4.00	2016	2016	1.56	4.00	None
2012	2.89	4.00	4.00	2017	2017	1.46	4.00	None

## LAW

Section 801(a) imposes a tax on the life insurance company taxable income of every life insurance company. Section 801(b) defines life insurance company taxable income to mean life insurance gross income, reduced by life insurance deductions. Under § 803(a)(2), life insurance gross income includes a net decrease in reserves as required by § 807(a). Under §§ 804 and 805(a)(2), life insurance deductions include a deduction for a net increase in reserves as required by § 807(b).

Section 807(a) provides generally that any decrease during the taxable year of items described in § 807(c) is included in gross income under § 803(a)(2). Section 807(b) provides generally that any increase during the taxable year of items described in § 807(c) are taken into account as a deduction under § 805(a)(2). The items described in § 807(c) include life insurance reserves.

For taxable years beginning after December 31, 1987, and before January 1, 2018,<sup>2</sup> § 807(d)(2)(B) provides that the interest rate used in the computation of life insurance reserves is the greater of (i) the AFIR or (ii) the PSAIR. Section 807(d)(4)(A) defines the AFIR as the interest rate prescribed under § 846(c)(2) for the calendar year in which a contract is issued. However, a taxpayer may elect under § 807(d)(4)(A)(ii) to recompute every five years the AFIR to be used in the computation of life insurance reserves.

Section 807(d)(4)(A)(ii) provides:

(l) In general. In computing the amount of the reserve with respect to any contract to which an election under this clause applies for periods during any recomputation period, the [AFIR] shall be the annual rate determined by the Secretary under section 846(c)(2) for the 1st year of such period.

<sup>2</sup> Section 13517(a)(2) of the Act amended § 807(d) for years beginning after December 31, 2017. For years beginning after December 31, 2017, new § 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.” Sections 13517(c)(2) and (3) of the Act provide that for the first taxable year beginning after December 31, 2017, the difference in the amount of the reserve with respect to any contract at the end of the preceding taxable year and the amount of the reserve determined as if the amendments made by section 13517 of the Act had applied for that year is taken into account for each of the eight taxable years following that preceding year, one-eighth per year. H.R. REP. NO. 115-466, at 478-79 (2017) (Conf. Rep.). Additionally, section 13001(b) of the Act lowered the corporate tax rate to 21 percent of taxable income.

No change in the [AFIR] shall be made under the preceding sentence unless such change would equal or exceed 1/2 of 1 percentage point.

(II) Recomputation period. For purposes of subclause (I), the term “recomputation period” means, with respect to any contract, the 5 calendar year period beginning with the 5th calendar year beginning after the calendar year in which the contract was issued (and each subsequent 5 calendar year period).

(III) Election. An election under this clause shall apply to all contracts issued during the calendar year for which the election was made or during any subsequent calendar year unless such election is revoked with the consent of the Secretary.

Section 807(d)(4)(A)(ii)(IV) provides that the 10-year spread that applies under § 807(f) to adjustments resulting from changes in the basis of calculating reserves does not apply to any adjustment required as a result of the use of a recomputed AFIR.

The legislative history to the § 807(d)(4)(A)(ii) election explains how the election is to be applied:

In general, under the provision, the interest rate to be applied in determining the amount of the life insurance reserves for any contract is the greater of the [AFIR] or the [PSAIR] for the calendar year in which contract is issued. Under the election, this rate continues to be applied in the 4 succeeding years after the year the contract is issued. For the 5th through 9th year after the contract is issued, the rate to be applied in determining reserves for such years (but not for any prior years) with respect to the contract is the greater of the [AFIR] for such 5th year, or the [PSAIR] for the calendar year in which the contract was issued. Thus, the rate for determining life insurance reserves with respect to any contract cannot be lower than the [PSAIR] for the calendar year in which the contract was issued.

H.R. REP. NO. 100-495, at 979 (1987) (Conf. Rep.).

The doctrine of election binds a taxpayer to an initial choice on a return if the taxpayer had the right to choose one or more alternatives or inconsistent rights, and if nothing suggests that Congress intended to allow the taxpayer to change the initial choice after the return filing deadline. Pac. Nat'l Co. v. Welch, 304 U.S. 191, 194-95 (1938) (concluding taxpayer made a binding election regarding timing of income recognition by reporting the income from the transactions in question on its return according to a particular method). The doctrine of election as it applies to federal tax law consists of two elements: (1) a free choice between two or more alternatives; and (2) an overt act by the taxpayer communicating the choice to the Commissioner, that is, a manifestation

of choice. Grynberg v. Commissioner, 83 T.C. 255, 261 (1984). A taxpayer may overtly communicate its elective choice to the Commissioner by computing taxable income on a return in a manner consistent with the elective choice. See Grynberg, 83 T.C. at 262; Vischia v. Commissioner, 26 T.C. 1027, 1029 (1956).

Courts have articulated several rationales supporting the general principle that elections are considered binding, including: (1) preventing administrative burdens and inconvenience in administering the tax laws, particularly if the new method requires a recalculation of tax liability for several years or for other taxpayers; (2) protecting against loss of revenues by preventing taxpayers from using the benefit of hindsight to choose the most advantageous method of reporting; (3) promoting consistent accounting practice (foreclosing adjustments based on hindsight), thereby securing uniformity in the collection of revenue; and (4) providing an equitable and fair tax system by treating similarly situated taxpayers consistently. See J.E. Riley Inv. Co. v. Commissioner, 311 U.S. 55, 59 (1940); Mamula v. Commissioner, 346 F.2d 1016, 1018-19 (9th Cir. 1965); Barber v. Commissioner, 64 T.C. 314, 319-20 (1975); Estate of Curtis v. Commissioner, 36 B.T.A. 899, 906-07 (1937).

## ANALYSIS

The Code, regulations, and legislative history do not provide explicit procedures for making a § 807(d)(4)(A)(ii) election. In the absence of an explicit deadline, the appropriate time to make an election is when a taxpayer is first faced with the necessity of making the election or choice in computing taxable income on a return. See Bayley v. Commissioner, 35 T.C. 288, 298 (1960) (concluding that deferral election made after the Service determined gain was includible in income was timely), acq., 1961-2 C.B. 4. As indicated by the legislative history, a life insurance company that makes a § 807(d)(4)(A)(ii) election must use the greater of the AFIR for the fifth year after the year the contract is issued, or the PSAIR for the year in which the contract is issued, in determining its reserves for the fifth through ninth year after the contract is issued. Thus, Taxpayer must have made the § 807(d)(4)(A)(ii) election no later than on its original return for the fifth year after the year a Contract was issued, because the fifth year is the first time when Taxpayer is faced with the necessity of choosing whether to continue to determine its life insurance reserves using the greater of the AFIR or the PSAIR for the year the Contract was issued (under § 807(d)(2)), or to make a § 807(d)(4)(A)(ii) election to recompute the AFIR every five years with respect to Contracts issued for the calendar year for which the election is made and subsequent calendar years. Taxpayer overtly communicated its free choice between these two alternatives to the Commissioner by computing its reserves and its taxable income under § 807(d)(2) on its returns for the fifth year after each Contract was issued for all taxable years prior to 2017 and for all Contracts issued before 2012. See Grynberg, 83 T.C. at 262. Taxpayer cannot reverse that choice for any Contracts issued before 2012 by filing Amended Returns, the tax years for which are each subsequent to the fifth year after Contracts were issued. Taxpayer also cannot reverse that choice for any Contracts issued before 2012 on an original return for 2017.

Moreover, all of the rationales underlying the doctrine of election support the application of the doctrine to the § 807(d)(4)(A)(ii) election in this case. Allowing Taxpayer to make a § 807(d)(4)(A)(ii) election subsequent to the fifth year return deadline would invite accounting distortions leading to a loss of revenues. For years beginning after December 31, 2017, the AFIR and PSAIR are no longer used in determining life insurance reserves, and the Act lowered tax rates for post-2017 years. See § 807(d)(2); see also § 11. Thus, after the passage of the Act, Taxpayer would have been able to determine that had it made a timely § 807(d)(4)(A)(ii) election for any Contracts issued in 2009, 2008, and 2004 and prior years, it would have been entitled to an increased level of aggregate § 807(b) deductions across all relevant pre-Act years, which would have offset income taxable at higher, pre-Act rates. However, Taxpayer was unable to benefit from the increased § 807(b) deductions in years prior to the passage of the Act because it had not made a § 807(d)(4)(A)(ii) election. Thus, Taxpayer seeks to make the § 807(d)(4)(A)(ii) election for Contracts on Amended Returns and an original 2017 return in order to claim the difference between the opening reserve with and without the election as a deduction on the Amended Returns or original 2017 return. In turn, by claiming the increased deductions on the Amended Returns or original 2017 return, Taxpayer ensures that the countervailing increased taxable income stemming from the subsequent reduction in reserves would be recognized in post-Act years subject to lower rates. The doctrine of election forecloses this attempt to obtain through an untimely § 807(d)(4)(A)(ii) election both the benefit of additional deductions for increases in reserves due to decreases in the AFIR without bearing any risk of increases in the AFIR in future years (due to a change in law), and the benefit of paying tax at a reduced rate on the offsetting future income resulting from the repeal of § 807(d)(4)(A)(ii).

Allowing Taxpayer to make § 807(d)(4)(A)(ii) elections more than five years after the year in which a Contract is issued would also lead to the disparate treatment of similarly situated life insurance companies and create undue administrative inconvenience for the Commissioner. A life insurance company that made a timely § 807(d)(4)(A)(ii) election took on the risk that the AFIR might increase in a future recomputation period (which reduces reserves and increases taxable income) in exchange for the reward resulting from an AFIR decrease (which increases reserves and reduces taxable income). Under § 807(d)(4)(A)(ii)(III), the life insurance company could not opt out of this risk/reward tradeoff without the Commissioner's consent. Allowing Taxpayer to make an § 807(d)(4)(A)(ii) election for pre-2012 Contracts following the passage of the Act would allow Taxpayer to attain the now-certain benefit without taking on any of the risk that those life insurance companies that made a timely election bore, in effect rendering the § 807(d)(4)(A)(ii)(III) consent requirement superfluous and unfairly rewarding the use of hindsight. Additionally, allowing Taxpayer's § 807(d)(4)(A)(ii) election would invite a flood of amended returns, unfairly increasing the Commissioner's administrative burden and, in the case of amended returns, requiring a recalculation of tax liability based on items from tax years more than five years prior.

Moreover, we note that in Rev. Rul. 94-74, 1994-2 C.B. 157, Situation 2, the taxpayer was required on examination to change its basis of computing § 807(d) reserves for certain life insurance contracts from using the same interest rates as the taxpayer used to compute statutory reserves for state regulatory reporting purposes, to using the higher of the AFIR or PSAIR in effect for the year the contracts were issued. The Service ruled that the change in the manner of computing reserves was treated as a change in basis under § 807(f) even though the recomputation was made on an involuntary basis. Taxpayer may claim<sup>3</sup> that Rev. Rul. 94-74 stands for the proposition that a taxpayer may, without being subject to the doctrine of election, change the interest rate used to compute reserves in any post-issuance year. Rev. Rul. 94-74 is distinguishable from this case because the doctrine of election applies to taxpayers only. That is, the doctrine would not foreclose the Service from requiring a taxpayer to change from an improper method of computing reserves to a proper one. Moreover, in this case, Taxpayer is not attempting to move from an improper method to a proper method.

For all of these reasons, once Taxpayer chose on its original return for the fifth year after the year in which a Contract was issued to continue to compute its reserves under § 807(d)(2), the doctrine of election applies to prevent Taxpayer from changing its election with respect to the Contract, either on an amended return for that fifth year or on a subsequent year original or amended return. Taxpayer's § 807(d)(4)(A)(ii) election on its originally filed 2017 return is valid for Contracts issued less than five years prior to 2017. However, the election has no effect on Taxpayer's reserves because Interest Rate A and Interest Rate B were equal for the first recomputation period for Contracts issued in 2012, and the recomputation under § 807(d)(4)(A)(ii) does not apply after December 31, 2017.

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Please contact Bernard Audet of this office at (202) 317-4415 if you have any further questions.

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<sup>3</sup> Taxpayer has not raised Rev. Rul. 94-74, but may in the future.