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IRS guidance limits reach of life insurance reserve election

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Introduction

In a recently released Chief Counsel Advice (CCA) memorandum—CCA201939003—the IRS analyzed the effect of an election to update the discounting interest rate when calculating tax reserves under prior law section 807(d)(4)(A).

The IRS concluded that the doctrine of election limited the taxpayer's election on its 2017 tax return to contracts issued in 2012. Under the IRS's view, the taxpayer's attempted election on amended prior year returns was invalid. Similarly, the taxpayer's election on its 2017 tax return was limited to contracts issued in 2012 and was not valid for contracts issued prior to 2012.

Read **CCA201939003** [PDF 80 KB] (released September 27, 2019, and dated June 27, 2019)

Background

Under former section 807(d), the amount of a life insurance reserve with respect to any life insurance contract is the greater of: (1) the net surrender value of such contract; or (2) the value of the reserve determined as follows:

a) The tax reserve method applicable to such contract (e.g., the Commissioner's Reserve Valuation Method ("CRVM") in effect on the issuance date of the contract);
b) The greater of the applicable federal interest rate or the prevailing state assumed interest rate ("PSAIR"); and
c) The prevailing commissioner's 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.[1]

Tax reserves are also capped by the statutory reserves.[2] In other words, the interest rate used in discounting future obligations is an essential component of adjusting statutory reserves into tax reserves.[3] Generally, the applicable federal interest rate is initially determined by reference to the average federal mid-term rate determined over the 60-month period ending before the beginning of the calendar year in which the contract was issued, except that any month before August 12, 1986, is disregarded.[4]

Generally, then, a five-year trailing average AFR provides the applicable federal interest rate used to determine the amount of the life insurance reserve on a given contract or block of contracts. Absent an election under prior law section 807(d)(4) (discussed below) that is the subject of the CCA, that AFR remains unchanged over time, notwithstanding any year-by-year changes in the applicable federal interest rate going forward.

Section 807(d)(4)(A)(ii), effective for tax years after December 31, 1987, and repealed for tax years beginning after December 31, 2017, provides an exception to that rule—effectively giving taxpayers a

[1] IRC § 807(d)(1)-(3).
[2] IRC § 807(d)(1).
[3] Mortality assumptions can also drive tax to statutory reserve differences.
[4] IRC § 807(d)(4)(A)(i) (incorporating IRC § 846(c)(2)).

one-time election to reset the applicable federal interest rate every five years (the "Election").[5]

The Internal Revenue Code and subsequent IRS publications provide only nominal guidance on the terms and scope of the Election. In general, in computing the amount of the reserve with respect to any contract to which the Election applies for a period during any recomputation period, the applicable federal interest rate is the annual rate determined under section 846(c)(2) for the first year of such period.[6] No change in the applicable federal interest rate is made unless the change would equal or exceed one half (½) of one (1) percentage point.[7] The term "recomputation period" means, with respect to any contract, the five calendar year period beginning with the fifth calendar year beginning after the calendar year in which the contract was issued (and each subsequent five calendar year period).[8] The Election applies 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 by the consent of the Secretary.[9] Section 807(f) does not apply to any adjustment required pursuant to an Election.[10]

Taxpayers who make an Election must recalculate the applicable federal interest rate beginning on the fifth year after the calendar year of the contract issuance (i.e., the first year of the initial "recomputation period").[11] The recalculated rate then applies for the duration of the initial recomputation period, which is five calendar years. Following the initial recomputation period (i.e., the 10th year after the calendar year of the contract), another recomputation period begins, and the applicable federal interest rate is recomputed as above for the extent of the recomputation period.

For example, if the contract issuance year is 1990, the applicable federal interest rate for that contract would be used to calculate the reserve from 1990 through 1994. If the taxpayer made an Election, in 1995, (i.e., the fifth year after the calendar year of the contract issuance), the taxpayer would use the appropriate rate for 1995 to determine the reserve and continue to use that rate through the rest of the recomputation period (i.e., 1995-1999). The taxpayer would then redetermine the applicable federal interest rate for each subsequent recomputation period at five-year intervals.[12]

CCA 201939003

Under the facts of CCA 201939003, Taxpayer was an affiliated group of corporations that filed a consolidated federal income tax return on a calendar year basis. Parent was the common parent of Taxpayer. Certain members of Taxpayer were life insurance companies subject to tax under section 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 certain life insurance contracts (the "Contracts") in accordance with section 807(d)(2), using the 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 made Elections under section 807(d)(4)(A)(ii) to recompute reserves for Life Members for Contracts issued five or more years before

[5] The legislative history to the Revenue Act of 1987, Pub. L. No. 100-203, provides that "the election is provided to take account of the fluctuations in market rates of return that companies experience with respect to life insurance contracts of long duration." Conf. Rep. 100-495, at 979, 1987-3 C.B. 259.
[6] IRC § 807(d)(4)(A)(ii).
[7] IRC § 807(d)(4)(A)(ii)(I).
[8] IRC § 807(d)(4)(A)(ii)(II).
[9] IRC § 807(d)(4)(A)(ii)(III).
[10] IRC § 807(d)(4)(A)(ii)(IV).
[11] IRC § 807(d)(4)(A)(ii)(II).
[12] *See also* PLR 201645010 (Aug. 5, 2016) (The Election would also apply to all contacts issued in years subsequent to the year for which the Election was made).

2017 using the greater of: (1) the applicable federal interest rate applicable to the first year of the current recomputation period (defined in section 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 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. The revised interest rates were applied to all contracts issued since the effective date of section 807(d)(4)(A)(ii) Election (i.e., 1988-2012). These increased reserve deductions were reported as negative adjustments to Taxpayer's consolidated taxable income.

Additionally, Parent attached to Taxpayer's originally filed 2017 return a "protective election" for Contracts, to be operative in case its Elections on the amended returns were considered invalid.

IRS analysis

The IRS concluded that Taxpayer's Election made on the 2017 original return was only valid for contracts issued in 2012. The IRS based its analysis on its interpretation of the doctrine of election.

Under the IRS's analysis, 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 alternative or inconsistent rights, and if nothing suggests that Congress intended to allow the taxpayer to change the initial choice after the tax return filing deadline.[13] The IRS interpreted the doctrine of election as it applies to federal tax law to consist 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.

The IRS noted several rationales supporting the general principle that elections are considered binding, including: (1) preventing administrative burdens and inconvenience on 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 taxpayer 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.[14]

The IRS recognized that the Code, Treasury regulations, and legislative history provide neither an explicit due date nor procedures for making a section 807(d)(4)(A)(ii) election. However, the IRS concluded that, 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. For the IRS, the appropriate time for an election under section 804(d)(4)(A)(ii) is no later than on the original return for the fifth year after the year a contract was issued, because the fifth year is the first time when a taxpayer is faced with the necessity of choosing whether to continue to determine its life insurance reserves using the greater of the applicable federal interest rate or the PSAIR for the year the contract was issued or to make a section 807(d)(4)(A)(ii) election to recompute the applicable federal interest rate every five years with respect to Contracts issued for the calendar year for which the election is made and subsequent calendar years.

[13] *See Pac. Nat'l Co. v. Welch*, 304 U.S. 191, 194-195 (1938) (concluding the 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).
[14] *See J.E. Riley Inv. Co. v. Commissioner*, 311 U.S. 55, 59 (1940); *Mamula v. Commissioner*, 346 F.2d 1016, 1018-1019 (9th Cir. 1965); *Barber v. Commissioner*, 64 T.C. 314, 319-20 (1975); *Estate of Curtis v. Commissioner*, 36 B.T.A. 899, 906-907 (1937).

The IRS concluded that Taxpayer overtly communicated its free choice between these two alternatives to the Commissioner by computing its reserves and its taxable income under section 807(d)(2) on its returns for the fifth year after each Contract was issued for all tax years prior to 2017 and for all Contracts issued before 2012. In other words, Taxpayer could not reverse that choice for any Contracts issued before 2012 by filing amended returns, the tax years which are each subsequent to the first year after the Contracts are issued. Similarly, Taxpayer could not reverse that choice for any Contracts issued before 2012 on an original return for 2017.

The IRS also concluded that its conclusion in the CCA is supported by the four enunciated rationales supporting the doctrine of elections, noted above.

KPMG observation

The time and manner for making the Election has been a topic of discussion within the life insurance industry in the wake of its repeal. The lack of guidance around the Election has generated uncertainty since the enactment of the election provision in 1987. Specifically, there is nothing set forth in the legislative history, the Code, the Treasury regulations, or any other authoritative guidance discussing the time and manner of an election under section 807(d)(4). As such, it is helpful to have the IRS set out its position in the CCA, even if the CCA does not rise to the level of authoritative guidance.

In the CCA, the IRS includes a general discussion of the doctrine of election and the rationale underlying the doctrine. However, the doctrine of election does not bind taxpayers to their original tax return positions in all cases. In other contexts, both the IRS and courts have allowed taxpayers to make elections after they have filed their original returns, especially when neither the Code nor the regulations limit the timing or scope of the election in question. The CCA does not discuss the relationship between these authorities and the doctrine of election.

Additionally, in the CCA, the IRS leaves unstated its starting assumption that the failure to make an Election under section 807(d)(4)(A)(ii) in any given year is, in fact, an election that is subject to the doctrine of election. This assumption is arguably in tension with other authority and settled practice under prior law on changes in basis of calculating life insurance reserves pursuant to section 807(f).

Taxpayers and the IRS have long understood that changes to the methods of calculating reserves are a subset of the larger category of changes of tax accounting methods.[15] Accounting methods are generally not subject to the doctrine of election because the Code, Treasury regulations, and administrative guidance issued thereunder set forth explicit guidance on when and how method changes may be made.

Indeed, the CCA attempts to distinguish Rev. Rul. 94-74, which generally provides that both the IRS and taxpayers may make a change in basis to recompute reserves for in-force contracts issued in prior, closed years in the earliest year open for assessment. One situation in the ruling cites an involuntary change in interest rates as the change in basis. For that change, Rev. Rul. 94-74 indicates that there is no requirement for a taxpayer to obtain consent (automatic or otherwise) from the Commissioner. In the CCA, IRS noted that taxpayers may argue that the doctrine of election may not apply to Rev. Rul. 94-74 and then attempted to distinguish Rev. Rul. 94-74 from the CCA by noting that the doctrine of election would not foreclose the IRS from requiring a

[15] *See, e.g. Am Fin. Group v. United States*, 678 F.3d 422 (6th Cir. 2012).

taxpayer to change from an improper method of computing reserves to a proper one. However, the CCA does not clarify the IRS's position with respect to the application of the doctrine of election to a change in basis required by section 807(f), nor does it clarify the application of the doctrine of election when a taxpayer is not attempting to move from an improper method to a proper method (e.g., when an election is made under section 807(d)(4)).

Furthermore, the CCA charges taxpayers who make the Election with using hindsight to gain a "now certain benefit." As generally understood by tax practitioners, however, hindsight means taking advantage of a change in facts—not law—that occur after the due date for making an election.[16] The potential benefit in this context is solely a function of a change in law—Congress eliminated the downside future risk of making the Election by amending section 807.

One can expect the IRS and the life insurance industry to continue this discussion on the application of the Election in the years prior to the 2017 tax law known as the "Tax Cuts and Jobs Act" (TCJA). As the CCA notes, this issue "invite[s] a flood of amended returns."

[16] *E.g.,* Reg. § 301.9100-3(b)(3)(iii). Note, however, IRS Chief Counsel Michael J. Desmond indicated that it is his position that the 2017 passage of the Tax Cuts and Jobs Act is a change in fact rather than a change in law for purposes of so-called 9100 relief, and that his position "is consistent with our historic practice." Nathan J. Richman, *TCJA Doesn't Justify Missed Election Relief*, 2019 Tax Notes Today 121-7 (Jun. 24, 2019).

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