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November 13, 2014

Legend

Insurance Company N =

Insurance Company O =

Tax Year R =
Tax Year U =
Tax Year V =
Amount =

Dear :

This is in response to the letter submitted by your authorized representative requesting a ruling that the adjustments to Insurance Company N's ("IC N") and Insurance Company O's ("IC O") Tax Year V opening life insurance reserves attributable to certain contracts constitute changes in IC N's and IC O's bases for computing reserves under § 807(f) of the Internal Revenue Code.

FACTS

IC N is a U.S. branch of a foreign domiciled life insurance company. IC N is taxed as a life insurance company under Part I of Subchapter L and files a standalone Form 1120-

L, U.S. Life Insurance Company Income Tax Return. IC O is a U.S. domiciled life insurance company taxed under Part I of Subchapter L, and is a member of a consolidated group that files a life/nonlife return. IC N and IC O are ultimately 100 percent owned by the same publicly traded foreign parent corporation.

IC N entered into reinsurance agreements with unrelated third parties (the "Direct Writers") under which it assumed risks on both whole life insurance contracts and term life insurance contracts. In turn, IC N entered into a reinsurance agreement ("Treaty") with IC O under which IC N retroceded to IC O under a 100 percent quota share arrangement the risk on the term life insurance policies ("Term Life Contracts") it reinsured from the Direct Writers. The Treaty covered only the Term Life Contracts; IC N retained the risk on the whole life policies ("Whole Life Contracts") it assumed from the Direct Writers.

Pursuant to the reinsurance agreements, the Direct Writers send policy-level data for the ceded business to IC N. This data is translated into usable format and entered into two systems to account for the ceded business. The policy administration system ("Admin System") tracks premiums, benefit payments, and all accounting items relevant to the contracts other than life insurance reserves. Life insurance reserves are separately administered through the valuation system ("Valuation System"). The Admin System and Valuation System track relevant information on a contract-by-contract basis. The Admin System and Valuation System then transfer summary data into the general ledger systems for IC N and IC O. The general ledger systems are used to prepare financial statements, including the statutory financial statements required by the National Association of Insurance Commissioners, and the financial statements are used as the basis for preparing IC N's and IC O's U.S. Federal income tax returns.

In Tax Year U, it was determined that certain Whole Life Contracts were improperly coded in the Valuation System as term life insurance contracts (i.e., "Subject Whole Life Contracts"). Because of this coding, the Valuation System incorrectly treated IC O as assuming from IC N the Subject Whole Life Contracts in addition to the Term Life Contracts when, under the terms of the Treaty, IC O assumed only the Term Life Contracts. Consistent with this coding in the Valuation System, the life insurance reserves for the Subject Whole Life Contracts were reported as life insurance reserves by IC O, rather than by IC N, for both statutory accounting and U.S. federal income tax purposes. However, all other items of income or deduction, including premiums, claims, and administrative expenses, were properly allocated between the Whole Life Contracts retained by IC N and the Term Life Contracts ceded to IC O.

Due to the coding error, IC N overstated its taxable income in Tax Years R through U due to its exclusion of reserves on the Subject Whole Life Contracts. IC O correspondingly underreported its taxable income in Tax Years R through U due to its inclusion of reserves with respect to the Subject Whole Life Contracts. In theory, the effects of the inconsistent treatment of the Subject Whole Life Contracts in the Admin

System and Valuation System on IC N's and IC O's lifetime taxable income will ultimately reverse themselves by normal operation of the reinsurance contracts as benefits on the Subject Whole Life Contracts are paid. Accordingly, in theory IC N's and IC O's lifetime taxable income will not be affected by the accounting treatment of the life insurance reserves of the Subject Whole Life Contracts for Federal income tax purposes. Pursuant to § 807(d), the reserves for the Subject Whole Life Contracts have been valued at Amount.

Upon discovering the incorrect treatment of the life insurance reserves of the Subject Whole Life Contracts in the Valuation System, IC N and IC O recorded the reserves in the appropriate legal entity for statutory accounting purposes for Tax Year U.

REQUESTED RULING

Taxpayer requests a ruling that the adjustments to IC N's and IC O's Tax Year V opening life insurance reserves attributable to the Subject Whole Life Contracts constitute a change in IC N's and IC O's basis for computing reserves under § 807(f). Tax Year U will be treated as the year of change. Accordingly, IC N will increase its life insurance reserves by Amount as of January 1, Tax Year V and will deduct one-tenth of this increase for each of the next 10 taxable years beginning with the taxable year ended December 31, Tax Year V; IC O will decrease its reserves by Amount as of January 1, Tax Year V and will include in income one-tenth of this decrease in each of the next 10 taxable years beginning in the taxable year ended December 31, Tax Year V.

LAW AND ANALYSIS

Section 1.446-1(a)(1) of the Income Tax Regulations provides that taxable income shall be computed under the method of accounting on the basis of which a taxpayer regularly computes his income in keeping his books, and that the term "method of accounting" includes not only the over-all method of accounting but also the accounting treatment of any item. Under § 1.446-1(e)(2)(i), once a method of accounting has been adopted a taxpayer must secure the consent of the Commissioner before computing income upon a new method.

Section 1.446-1(e)(2)(ii)(a) provides that a change in method of accounting includes a change in the overall plan of accounting for gross income or deductions, or a change in the treatment of any material item used in such overall plan. A "material item" includes "any item that involves the proper time for the inclusion of the item in income or the taking of a deduction." In determining whether timing is involved, generally the pertinent inquiry is whether the accounting practice permanently affects the taxpayer's lifetime income or merely changes the taxable year in which taxable income is reported. See Rev. Proc. 97-27, § 2.01(1); Rev. Proc. 2002-9, § 2.01(1); Rev. Proc. 91-31, 1991-1 C.B. 566; Primo Pants Co. v. Commissioner, 78 T.C. 705, 723 (1982); Knight Ridder v.

United States, 743 F.2d 781, 798 (11th Cir. 1984); Peoples Bank & Trust Co. v. Commissioner, 415 F.2d 1341, 1344 (7th Cir. 1969).

Although a method of accounting may exist under the definition in § 1.446-1(e)(2)(ii)(a) without the necessity of a pattern of consistent treatment, in most instances a method of accounting is not established for an item without such consistent treatment. See § 1.446-1(e)(2)(ii)(a). The treatment of a material item in the same way in determining the gross income or deductions in two or more consecutively filed tax returns (without regard to any change in status of the method as permissible or impermissible) represents consistent treatment of that item for purposes of § 1.446-1(e)(2)(ii)(a). If a taxpayer treats an item properly in the first return that reflects the item, however, the taxpayer has adopted a method of accounting for that item. See Rev. Rul. 90-38, 1990-1 C.B. 57.

A change in accounting method does not include correction of mathematical or posting errors, or errors in the computation of tax liability. Also, a change in method of accounting does not include adjustment of any item of income or deduction that does not involve the proper time for the inclusion of the item of income or the taking of a deduction. For example, a change from treating an item as a personal expense to treating it as a business expense is not a change in method of accounting because it does not involve the proper timing of an item of income or deduction. See § 1.446-1(e)(2)(ii)(b).

Section 481(a) provides that if the computation of taxable income for any taxable year is under a method of accounting different from the method under which the taxpayer's taxable income for the preceding taxable year was computed, then there shall be taken into account those adjustments which are determined to be necessary solely by reason of the change in order to prevent amounts from being duplicated or omitted, except there shall not be taken into account any adjustment in respect of any taxable year to which this section does not apply unless the adjustment is attributable to a change in the method of accounting initiated by the taxpayer. See also, § 1.448-1(a) and § 481(c).

Section 807 provides general rules for the treatment of certain reserves. Section 807(a) and (b) provide for the treatment of the difference between the closing and opening balances of reserve items 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(f) provides that if the basis for determining any item referred to in § 807(c) 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 1/10 of the amount of the difference between (i) the amount of the item at the close of the taxable year, computed on the new basis, and (ii) the amount of the item at the close of the taxable year, computed on the old basis, that is attributable to contracts issued before the taxable year, is taken into account (either as an increase or decrease in taxable income), for each of the succeeding 10 taxable years. This rule was originally enacted as § 810(d)(3) of the Life Insurance Company Income Tax Act of 1959, P.L. 89-69, 73 Stat. 112 (1959) ("59 Act"). The Senate report accompanying this Act indicates that the provision "deals with the effect on deductions for increases in reserves (or amounts included in income for decreases in reserves) where there have been changes in the method of computing the reserves." S. Rep. No. 86-291, 1st Sess., 57, 1959-2 C.B. at 794. The rationale for this rule being in part that

> [i]f no limitations were imposed in these cases, the company could take a substantial additional deduction in computing gain or loss from operations for the year when the reserves were strengthened. To spread the effect of such adjustments, it is provided that, in the case of reserve strengthening, deductions relating to the additions in reserves are to be taken into account ratably over a 10-year period instead of entirely in the year of change. Conversely, in the case of reserve weakening, the increases in income relating to reductions in reserves are to be taken into account over a 10-year period.

Id. Cf. Rev. Proc. 64-16, 1964-1 C.B. 677 (this obsoleted revenue procedure illustrates that the 10-year spread of former § 810(d) was consistent with the § 481(c) allocation period of the era). See also, §§ 1.810-3 and 1.806-4 of the Income Tax Regulations.

This rule was carried over into § 807(f) by the Tax Reform Act of 1984, P.L. 98-369, 98 Stat. 494. The Senate report, S. Prt. 98-169, Vol. I, at 543 (1984), indicates that "[the 59 Act rule in § 810(d)] 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."

Accordingly, § 807(f) is properly viewed as a subset of accounting method changes otherwise subject to § 446; the subset being the population of accounting method changes which are those which are "the basis for determining any item referred to in subsection [807](c)."

This reading of the statutory scheme was articulated in Am. Gen. Life & Accident Ins. Co. v. United States, 71 AFTR 2d 93-3319 (M.D. Tenn. 1989):

> There need be no conflict between section 481 and the 10-year spread rule of section 810. Code section 481 is simply a much more general provision dealing with recapture of tax income in a broad variety of cases. It is a broad rule which generally authorizes recapture. Code section 810, on the other hand, is much more specific and deals with a very narrow and limited type of "change in method of accounting." It in no way contradicts the general rule that there should be recapture of tax loss. It simply

> provides a more specific manner of recapturing tax loss under one set of particular circumstances in which there was an accounting change, namely circumstances in which there was a change in the method of computing reserves. As usual, the specific controls the general. It is not a contradiction of the general rule. Accordingly, while the government is correct in classifying the change at issue as a change in method of accounting, it is also more specifically a change in the method of computing reserves."

The same interpretation was adopted in Rev. Rul. 94-74, 1994-2 C.B. 147, which provides:

> Under section 446, a change in method of accounting does not include correction of mathematical or posting errors. See, e.g., section 1.446-1(e)(2)(ii)(b). Because section 807(f) is a more specific application of the general rules governing a change in method of accounting, a circumstance that is not a change in method of accounting under the general rules cannot be governed by the more specific rules of section 807(f). Accordingly, consistent with section 446, the correction of reserves for a mathematical or posting error would not be treated as a change in basis under section 807(f).

The revenue ruling also points out that "regardless of the nature of a change in 'basis' or 'method' of computing reserves (i.e., whether the change results from a change in specified or nonspecified assumptions)", § 807(f) requires the change to be recognized ratably over 10 years, without requiring the consent of the Secretary.

Here, the life insurance reserves for the Subject Whole Life Contracts were incorrectly reported as reserves of IC O. This reporting involves the proper time for the recognition of a deduction (payment of benefit; recognition of life insurance reserve) and inclusion of an item of income (reduction in life insurance reserve). As such this reporting meets the general definition of a method of accounting under § 446(e). Because it is a change in the basis for determining an item in § 807(c), i.e., each of IC N's and IC O's life insurance reserves per § 807(c)(1), it is a change in basis as defined in section § 807(f). That is, the basis for determining the life insurance reserves of IC N and IC O as of the close of Tax Year U differed from the basis for determining such reserves as of the close of the preceding taxable year. As such, IC N will increase its life insurance reserves for the Subject Whole Life Contracts by Amount and will deduct one-tenth of this increase for each of the 10 taxable years beginning in Taxable Year V. And IC O will decrease its reserves for the Subject Whole Life Contracts by Amount and will include in income one-tenth of this decrease for each of the 10 taxable years beginning in Tax Year V.

RULING

The adjustments to IC N's and IC O's Tax Year V opening life insurance reserves attributable to the Subject Whole Life Contracts constitute a change in IC N's and IC O's basis for computing reserves under § 807(f). Tax Year U will be treated as the year of change. Accordingly, IC N will increase its life insurance reserves by Amount as of January 1, Tax Year V and will deduct one-tenth of this increase for each of the next 10 taxable years beginning with the taxable year ended December 31, Tax Year V; IC O will decrease its reserves by Amount as of January 1, Tax Year V and will include in income one-tenth of this decrease in each of the next 10 taxable years beginning in the taxable year ended December 31, Tax Year V.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. Specifically, no ruling has been requested, and none is expressed or implied, that Amount is the correct valuation of the life insurance reserves for the Subject Whole Life Contracts.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

John E. Glover
Senior Counsel, Branch 4
(Financial Institutions & Products)