Office of Chief Counsel
Internal Revenue Service

# memorandum

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MASullivan

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to: District Director, New England District
Attn: Louis F. Bourke, Team Coordinator

from: District Counsel, New England District, Boston

subject: [redacted]
Section 807(f)
U.I.L. #807.05-00

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This responds to your request for advice on the 10-year spread rule of section 807(f) of the Internal Revenue Code.

Issue

Does the rule of section 807(f) of the Internal Revenue Code requiring a 10-year spread of the adjustment for a change in the basis of life insurance reserves apply to the taxpayer's strengthening of its tax reserves on noncancellable individual disability insurance policies in [redacted]?

Conclusion

A 10-year spread of the adjustment is required under section 807(f).

Facts

[redacted] including [redacted] and [redacted], file a consolidated return on Form 1120. [redacted] and [redacted] are insurance companies subject to tax under section 831.

During [redacted], [redacted] and [redacted] strengthened the approved claim reserves for noncancellable individual disability income contracts for statutory purposes because claim experience had deteriorated. The federally prescribed reserve (FPR) determined under section 807(d)(2) for the contracts exceeded the statutory reserves both before and after the strengthening, and under section 807(d)(1) the amount of the reserves before and after strengthening was limited to the amount of the statutory reserves. The item "Tax Reserves" on the return for "Approved open pay claim reserves" was increased. The statutory reserves for approved claims of [redacted] was increased by $[redacted]. You have not indicated the amount of the increase in the reserves of [redacted]. The taxpayer [redacted] argues that because the federally prescribed reserve did not change, section 807(f) does not require the adjustment for the change in computing the reserves to be spread.

Law & Analysis

Section 832(b)(1) provides that the gross income of an insurance company subject to the tax imposed by section 831 includes underwriting income. Section 832(b)(3) provides that underwriting income means the premiums earned on insurance contracts during the taxable year less losses incurred and expenses incurred. See also § 1.832-4(a)(1).

Section 832(b)(4) provides that premiums earned on insurance contracts means an amount computed (in relevant part) as follows:

> (A) From the amount of gross premiums written on insurance contracts during the taxable year, deduct return premiums and premiums paid for reinsurance.
>
> (B) To the result so obtained, add 80 percent of the unearned premiums on outstanding business at the end of the preceding taxable year and deduct 80 percent of the unearned premiums on outstanding business at the end of the taxable year.

Section 832(b) further provides that unearned premiums include life insurance reserves, as defined in section 816(b), but determined as provided in section 807. Section 832(b)(7)(A)in effect provides that the reduction of unearned premiums otherwise required by section 832(b)(4)(B) does not apply with respect to life insurance reserves treated as unearned premiums. Section 816(b) provides that life insurance reserves include amounts set aside to mature or liquidate, either by payment or reinsurance, future unaccrued claims arising from noncancellable accident and health insurance contracts involving, at the time with respect to which the reserve is computed, life, accident, or health contingencies.

Section 807(d) concerns the method of computing reserves for purposes of determining the income of a life insurance company. Section 807(d)(1) provides that the amount of the life insurance reserve for any contract is the greater of -- (A) the net surrender value of such contract, or (B) the reserve determined under section 807(d)(2). However, under section 807(d)(1), the reserve cannot exceed the amount that would be taken into account with respect to such contract in determining statutory reserves (as defined in section 809(b)(4)(B)).

Section 807(d)(2)(C) provides that the amount of the reserve under section 807(d)(2) is determined by using the prevailing commissioners' standard tables for mortality and morbidity adjusted as appropriate to reflect the risks incurred under the contract which are not otherwise taken into account.

If the basis for determining the life insurance reserves of a life insurance company as the close of a taxable year differs from the basis for such determination as of the close of the preceding taxable year, section 807(f) requires a spread of the difference between the amount of the item at the close of the taxable year, computed on the new basis, and 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. A positive difference, such at the one that resulted in this case, is taken into account ratably over the ten succeeding years as a deduction under section 805(a)(2). A negative difference is included in gross income ratably over the ten succeeding years under section 803(a)(2).

Rev. Rul. 65-240, 1965-2 C.B. 236, considers the proper treatment of an increase in the life insurance reserves of an insurance company subject to tax under section 831. Rev. Rul. 65-240 holds that any increase or decrease in the basis of life insurance reserves of an insurance company subject to tax under section 831 is taken into account in accordance with the predecessor of section 807(f), former section 810(d). Because the applicable laws have not materially changed, see Rev. Rul. 94-74, 1994-2 C.B. 157, 159, we conclude that section 807(f) of current law likewise applies to the life insurance reserves of an insurance company taxable under section 831.

The taxpayer responded to your question about why it did not spread the adjustments in this case variously that because it changed nothing in calculating reserves for tax purposes, and because the federally prescribed reserve for the disability policies of [redacted] and [redacted] did not change, section 807(f) does not require a spread of the change in reserves. To support its position, the taxpayer apparently relies on language (quoted below) from the General Explanation of the Tax Reform Act of 1984 prepared by the Staff of the Joint Committee on Taxation (Blue Book).

Under section 1.806-4(a), a change in basis of computing life insurance reserves is not a change in method of accounting requiring the consent of the Secretary under section 446(e). It was in the 1984 Act that Congress retained the rule of former section 810(d), which had required an adjustment for a change in method of computing life insurance reserves to be spread ratably over a 10-year period, by enacting new section 807(f). In explaining the enactment of section 807(f), the Blue Book comments that "[g]enerally, the rule for a change in basis in computing reserves will be applied to life insurance tax reserves only if there is a change in basis in computing the Federally prescribed reserve (as distinguished from the net surrender value)." Blue Book at 603-04.

Rev. Rul. 94-74, 1994-2 C.B. 157, explains that under section 807(f), a spread is required when there is a change in specified or unspecified assumptions used in computing the life insurance reserve for tax purposes. Rev. Rul. 94-74 at 159. However, the correction of reserves for a mathematical or posting error is not change in basis to which the 10-year spread rule of section 807(f) applies. Rev. Rul. 94-74 at 159-60. In this case, the taxpayer changed the assumptions used in computing its life insurance reserves. It did not correct a mathematical or posting error. As a result, the adjustment required by section 807(f)(1) must be spread under the rule of section 807(f)(2).

The taxpayer has not argued that the change to its life insurance reserve was the result of a mathematical or posting error. It instead apparently interprets the quoted statement from the Blue Book to mean that section 807(f) cannot apply when the statutory life insurance reserves exceed the life insurance reserve amount determined under section 807(d)(2) and become the measure of the tax life insurance reserve, because in that case there is no change in basis in computing the Federally prescribed reserve. We disagree with this argument.

Section 807(f) applies if a taxpayer changes its basis for computing its tax life insurance reserve. The statute by its terms applies without regard to whether the tax life insurance reserve equals the amount determined under section 807(d)(2), or is instead limited by the statutory cap imposed by section 807(d)(1). If there were a conflict between the statute and the Blue Book, the statute would control. However, they do not conflict.

It can accurately be said that the federally prescribed reserve did change in this case. The amount computed under section 807(d)(2) with respect to the taxpayer's life insurance reserves would change with the addition of the load.

More importantly, the sentence from the Blue Book quoted above is introduced by the word "generally," indicating that the Joint Committee contemplated the typical case in which the statutory life insurance reserve exceeds the Federally prescribed reserve. Furthermore, the aim of the sentence is to indicate that if the net surrender value is the measure of the tax life insurance reserve under section 807(d)(1)(because it exceeds the federally prescribed reserve) and the net surrender value of the contracts changes, section 807(f) does not require a spread of the change because the net surrender value is really a current liability rather than a reserve. See Blue Book at 604. What is at issue in this case is a change in a reserve, not an increase in a current liability because of a change in net surrender value.

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