T³: *TAXING TIMES* TIDBITS

SUBCHAPTER L: CAN YOU BELIEVE IT? CHANGE IN TAX STATUS OF AN INSURANCE COMPANY—IRS ELIMINATES CATCH-22 SITUATION

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An insurance company is taxed as a life insurance company under Part I of Subchapter L of the Internal Revenue Code (the "Code") only if it satisfies a reserve ratio test found in I.R.C. § 816(a). Under this test, an insurance company is taxed as a life insurance company for its entire taxable year if the company's life insurance reserves plus unearned premiums and unpaid losses on noncancellable life, accident or health policies exceed 50 percent of its total insurance reserves. This test is performed on the basis of the mean of the opening and closing reserves for the taxable year. Because of this bright-line 50 percent reserve ratio test, insurance companies may sometimes shift tax status from nonlife to life company status and vice versa. This most frequently occurs for companies that issue a significant amount of both group cancellable and individual noncancellable accident and health insurance policies.

There can be material differences in the tax treatment of several items depending on whether the company is taxed as a nonlife company under Part II of Subchapter L or as a life company under Part I. To the extent the varying tax treatments result in timing differences, it is the Internal Revenue Service's (IRS') position that a change in tax status will result in changes in methods of accounting for these timing differences. Why does this matter? Before a taxpayer can implement a change in method of accounting, I.R.C. § 446(e) requires the taxpayer to secure the consent of the IRS. The IRS has detailed procedures for taxpayers to follow to secure the IRS' consent for a change in accounting, but until recently these procedures did not permit an insurance company that changed its tax status to secure the necessary IRS consent in time to file a correct tax return. This created a classic Catch-22 situation. The Code requires the taxpayer to change to different accounting methods when it changes insurance company status, yet also precludes compliance until IRS consent is granted, which under former IRS procedures could be difficult to obtain in a timely manner.

Let's take a typical example. Suppose an insurer issues both group cancellable disability insurance and individual noncancellable disability insurance policies. For many years, the company's group business was dominant, but the individual market gradually expanded to such an extent that it became likely, but not certain, that the 50 percent reserve ratio test for life company qualification would be satisfied for the first time. If this were to occur, the company would shift its tax status from nonlife to life company treatment for the entire taxable year, even though it could not make an accurate calculation of mean reserves until after the year of the shift.[2]

Among other tax consequences, this situation could result in several timing differences. The most likely would be for experience-rated refunds on the group products, loss adjustment expenses (LAEs) and guaranty fund assessments. For life companies, experience-rated refunds are treated as policyholder dividends and deductible when accrued under the general accrual provisions of I.R.C. § 811(a). I.R.C. § 808(b)(1) specifically includes experience-rated refunds as policyholder dividends which are deductible when paid or accrued during the taxable year under I.R.C. § 808(c). For nonlife companies, experience-rated refunds may be deductible before they accrue as return premiums or policyholder dividends on a reserve basis.[3]

LAEs are costs that are incurred in connection with the adjustment or recording of losses.[4] These expenses include legal expenses, salaries and expenses of the claims department as well as all other claims-related expenses whether or not specifically allocable to particular claims. For a life company, it is the IRS' position that these expenses are deductible when accrued under I.R.C. § 811(a). Thus, according to the IRS, life companies may not deduct reserves for LAEs that do not meet the "all-events" test under I.R.C. § 461.[5] For nonlife companies, different treatment applies for LAEs. Unpaid LAEs reported on the Annual Statement are included in the calculation of a company's undiscounted unpaid losses under I.R.C. § 846(f)(2) and, therefore, are deductible on a reserve basis as part of discounted unpaid losses. Similarly, for guaranty fund assessments, life companies generally are required to deduct these amounts on an accrual basis.[6] However, nonlife companies are entitled to deduct the unaccrued liability for guaranty fund assessments on a reserve basis as premium-acquisition expenses.[7]

For each of these items, the shift from nonlife to life company status would have the effect of deferring the deduction from an estimated reserve basis (nonlife treatment) to an accrual basis under the tax "all-events" test (life treatment)—a change in method of accounting according to the IRS.[8] This has significant consequences. First, under I.R.C. § 446(e), the company would need to file a Form 3115, Application for Change in Accounting Method, with the IRS to make the required accounting method change for each item. A failure to request the change and continuation of the now-erroneous reserve method of accounting could result in an IRS audit adjustment and the imposition of an accuracy-related penalty.[9] Second, if the changes in accounting are implemented, they would result in adverse I.R.C. § 481 adjustments[10] to the extent the current and future deductions for the experience-rated refunds, LAEs and guaranty fund assessments on an accrual basis duplicate the deductions for these items claimed in prior years on a reserve basis.

The general rule for securing the IRS' consent to a change in method of accounting is that a Form 3115 must be filed with the IRS before the close of the year of the change. For taxpayers under audit by the IRS, under prior IRS procedures, a Form 3115 was required to be filed within one of two window periods—either during the first 90 days of the change year or within the 120-day period after the IRS' audit ended.[12]

Here's what the problem was. At the time the Form 3115 request for change in accounting was required to be filed, the company may not have known whether it would satisfy the 50 percent reserve ratio test. This was particularly the case for a company under audit by the IRS that had to file the Form 3115 in the first 90 days of the year. To repeat, it is a test that depends on the amount of year-end reserves that may not be determined with accuracy until after year-end. In these circumstances, the company had several options to comply with the Code.

The first option was to file a Form 3115 requesting the change within the specified window periods explaining that the request for changes in accounting would be withdrawn if it turned out the 50 percent reserve ratio test was not satisfied. The problem with this approach was that the IRS National Office would not process Form 3115 because it has a policy not to accept accounting change requirements that have contingencies or are based on hypothetical future events.

A second option was to ignore the due date of the Form 3115 and file the form after the mean reserves had been calculated after year-end. The problem with this approach was that the year of change technically was shifted to the year after the status shift, creating the need to file a tax return using the prior now-erroneous methods for the shift year.

A third possible approach was to ignore the requirement to file a Form 3115 and unilaterally implement the change in accounting methods without the IRS' consent. While the IRS on audit was unlikely to insist that the company go back to the more favorable nonlife accounting methods, the problem with this approach was that the company would not be able to obtain the advantageous four-year spread of the adverse I.R.C. § 481 adjustment permitted under prior (and current) IRS guidance.[13]

None of these options provided a good solution to the company's dilemma. Fortunately, the IRS has recently alleviated this problem. In February 2015, the IRS published comprehensive changes to the procedures for securing IRS consent for accounting method changes.[14] In doing so, the IRS added to its list of automatic changes in accounting any changes that result from an insurance company's shift in tax status.[15] Because the IRS has now designated these changes in accounting as automatic, they can be initiated by the taxpayer without the IRS' prior consent by filing the Form 3115 with the tax return for the year of change and following the procedures in Section 6.03(1) of Rev. Proc. 2015-13. Using this approach, a taxpayer can achieve the desired four-year spread of any adverse I.R.C. § 481 adjustment. In other words, the company can wait to see what the outcome of the 50 percent reserve ratio test is after year-end, file the shift-year tax return correctly, and achieve all the benefits of a taxpayer-initiated change. So, the IRS fixed this taxpayer dilemma on its own initiative—a nice surprise. ■

END NOTES

1 Rev. Proc 2015-14, 2015-5 I.R.B. 450, Section 25.03.

2 This situation creates problems with determining the appropriate quarterly estimated tax deposits if tax differences between nonlife and life status are material.

3 *See Bituminous Casualty Corp. v. Commissioner*, 57 T.C. 58 (1971), acq. 1973-2 C.B. 1.

4 Statement of Statutory Accounting Principles No. 55, Unpaid Claims, Losses and Loss Adjustment Expenses.

5 *See* H.R. Rep. No. 99-841, at II-361 (1986); (Conf. Rep.); Staff of the J. Comm. on Tax'n, 99th Cong., General Explanation of the Tax Reform Act of 1986, at 614; but see Peter H. Winslow, *Loss Adjustment Expenses for Life Insurance Companies, Taxing Times*, Vol. 7, Issue 3, at 40 (Sept. 2011).

6 *See* I.R.C. § 811(a); *Principal Life Ins. Co. v. United States*, 97 A.F.T.R. 2d 2006-1542 (Fed. Cl. 2006).

7 *See* Rev. Proc. 2002-46, 2002-2 C.B. 105; Peter H. Winslow and Lori J. Jones, *When are Guaranty Association Assessments Deductible? Taxing Times*, Vol. 2, Issue 2, at 24 (Sept. 2006).

8 Arguably, the shift in tax status is a change resulting from a change in the underlying facts and does not result in a change in method of accounting under Treas. Reg. § 1.446-1(e)(2)(ii)(b). This is not the IRS' position.

9 I.R.C. § 446(f).

10 When there is a change in accounting method, post-change taxable income is computed as if the taxpayer had always been on the new method for prior years. As a result, a change in accounting that defers deductions results in a duplication of deductions to the extent the items were deducted in prior years under the old method and will be deducted again under the new method. This is fixed by a one-time adjustment required by I.R.C. § 481 to reverse the tax effects of the duplication. Although the statute provides that the entire adjustment is made in the year of the accounting change, the IRS has the discretion to permit or require a spread of the adjustment over several years as a condition to its consent to the accounting change.

11 Treas. Reg. § 1.446-1(e)(3)(i).

12 Rev. Proc. 97-27, 1997-1 C.B. 680, Section 6.

13 Rev. Proc. 97-27, 1997-1 C.B. 680, Section 5.02.

14 Rev. Proc. 2015-13, 2015-5 I.R.B. 419.

15 Rev. Proc. 2015-14, 2015-5 I.R.B. 450, Section 25.03.

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