OFFICE OF
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DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Assistant Chief Counsel (Field Service)
CC:DOM:FS

SUBJECT:

This Field Service Advice responds to your memorandum dated August 24, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

X =

Y =

ISSUE(S):

1. Whether the fresh start provisions set forth in section 1023(e)(3) of the Tax Reform Act of 1986 avoid the triggering of I.R.C. § 481.

CONCLUSION:

1. Congress used the fresh start provisions of section 1023(e)(3) of the Tax Reform Act of 1986 to avoid triggering the I.R.C. § 481 requirements. The fresh start provisions override I.R.C. § 481.

FACTS:

X sold its subsidiary, Y, during 1991. It has advanced various arguments concerning the application of Treas. Reg. § 1.1505-20 [hereinafter referred to as the Loss Disallowance Regulations] to this sale.

The specific issue raised in the instant request for field service advice is whether there is an I.R.C. § 481 adjustment to be considered under the Loss Disallowance Regulations because of the fresh start provisions of section 1023(e)(3) of the Tax Reform Act of 1986.

LAW AND ANALYSIS

Section 1023 of the Tax Reform Act of 1986 added new section 846 to the Internal Revenue Code. I.R.C. § 846 mandates that property and casualty insurers compute their "losses incurred deductions" using a discounted basis rather than an undiscounted basis. The change from undiscounted to discounted methodology eliminates a tax benefit attributable to the time value of money.

In enacting section 846, Congress included two relief provisions - the "transition" rule and the "fresh start" to facilitate a smooth transition to the new rules. The transition rule, set forth in section 1023(e)(2) of the Tax Reform Act of 1986, provided that for purposes of computing the losses incurred deduction for 1987, the year-end 1986 reserves would be discounted. Absent this relief provision, section 846 would have required property and casualty insurers to compare undiscounted 1986 reserves with discounted 1987 reserves for purposes of computing their losses incurred deductions for 1987. Such a comparison would have significantly reduced the losses incurred deduction for the 1987 tax year.

Notwithstanding the relief provided by the transition rule, property and casualty insurers would still have been obligated to include in their 1987 taxable income the excess of the undiscounted year-end 1986 loss reserves over the discounted year-end 1986 loss reserves due to the application of I.R.C. § 481.

I.R.C. § 481 provides for an adjustment to prevent the duplication or omission of income or expense that may otherwise occur solely as a result of a change in method of accounting. Pursell v. Commissioner, 38 T.C. 263, 271 (1962), aff'd, 315 F.2d 629 (3d Cir. 1963). Compliance with the requirement that property and casualty insurers change the basis for computing their losses incurred deductions from an undiscounted to a discounted methodology constituted a change in accounting method. Thus, but for the "fresh start" provision of section 1023(e)(3) of the Tax Reform Act of 1986, section 481 would have required property and casualty insurers to recognize as income the difference between (1) the undiscounted amount of loss reserves, as of year-end 1986, included in the computation of the losses incurred deduction for 1986 and (2) the discounted amount of such loss reserves.

Section 1023(e)(3) of the Tax Reform Act of 1986 provides:

> (3) Fresh Start.--
>
> (A) In General.–Except as otherwise provided in this paragraph, any difference between–
>
> (I) the amount determined to be the unpaid losses and expenses unpaid for the year preceding the 1st taxable year of an insurance company beginning after December 31, 1986, determined without regard to paragraph (2) [i.e., without discounting], and
>
> (Ii) such amount determined with regard to paragraph (2) [i.e., with discounting],
>
> shall not be taken into account for purposes of the Internal Revenue Code of 1986.

Although the amount of the Fresh Start adjustment was specifically excluded from the taxpayer's income, according to the Joint Committee Minutes for the 1986 Act, p. 618, such adjustment was to be taken into account in full for purposes of calculating any adjustment to the taxpayer's earnings and profit.

Congress recognized that there was a potential for abuse created by the fresh start provision. That is, insurers could manipulate the fresh start provision by inflating their reserves. To prevent such abuse, Congress enacted section 1023(e)(3)(B) to exclude any increases in loss reserves due to "reserve strengthening."

The Tax Court examined the treasury regulations that defined reserve strengthening and invalidated Treas. Reg. § 1.846-3(c) to the extent that it defined all additions to a property and casualty insurer's loss reserves as reserve strengthening. The Third Circuit and the Supreme Court reversed the Tax Court's determination and held that the treasury regulation was valid. Western National Mutual Insurance Company v. Commissioner, 102 T.C. 338 (1994), aff'd, 65 F.3d 90 (8th Cir. 1995); Atlantic Mutual Insurance Company v. Commissioner, T.C. Memo. 1996-75, rev'd, 111 F.3d 1056 (3d Cir. 1997); aff'd, 523 U.S. 382 (1998).

In their analyses in Atlantic Mutual Insurance Company, the Tax Court and the Third Circuit discussed the application of the fresh start provisions to I.R.C. § 481. The Supreme Court also mentioned the interplay.

The Tax Court recognized that the fresh start provision was a relief provision. It engaged in an extensive analysis of the interplay between the fresh start provision and I.R.C. § 481. The Tax Court held that "To avoid triggering section 481 adjustments, Congress provided P&C [property and casualty] insurers with a 'fresh start' pursuant to section 1023(e)(3) of TRA '86. ... In essence, the fresh start provision overrode section 481 by excluding from taxable income the difference between the amount of the year-end 1986 undiscounted loss reserves and the discounted amount of such reserves. In its report, the Committee of Conference (conference committee) described the effect of the fresh start provision as 'forgiveness of income.' H. Conf. Rept. 99-841 (Vol. II), at II-367 (1986), 1986-3 C.B. (Vol. 4) 1, 367." Atlantic Mutual, 71 T.C.M. (CCH) 2154, 2156 (1996).

The Third Circuit's analysis of the fresh start provision and section 481 is very similar to that of the Tax Court. The Third Circuit held that "To avoid the application of section 481, Congress allowed P & C [property and casualty] insurers a one-time 'forgiveness' of income under the 'fresh start' provision of section 1023(e)(3) of TRA 1986. ... In substance, the fresh start rule overrides section 481 by excluding from taxable income the difference between the amount of the year-end 1986 undiscounted loss reserves and the discounted amount of such reserves." Atlantic Mutual, 111 F.3d 1058.

The Supreme Court also refers to the fresh start provision as avoiding the consequence [recognizing as income the difference between undiscounted and discounted year-end 1986 loss reserves] required by section 481(a). Atlantic Mutual, 523 U.S. at 385.

Based upon the above court opinions, an argument should be advanced that the fresh start provisions set forth in section 1023(e)(3) of the Tax Reform Act of 1986 overrode section 481. That is, that section 1023(e)(3) of the Tax Reform Act of 1986 provides relief by allowing a change of accounting method required solely by that subtitle to be treated as not being a change in the method of accounting.

Such an argument can be bolstered by looking at the fresh start provisions provided to insurance companies by Congress when it enacted I.R.C. § 808(c)(1) and amended I.R.C. § 832(b)(5)(A). I.R.C. § 808(c)(1) was enacted by Congress in 1984. It provides that the policyholder dividends deduction is limited to the policyholder dividends paid or accrued during the taxable year, as limited in the case of mutual life insurance companies by I.R.C. § 809. Under a transitional rule in the Deficit Reduction Act of 1984, Pub. L. 98-369, the change to the paid or accrued method was to be treated as not being a change in the method of accounting.

Section 216(b) of the Deficit Reduction Act of 1984 provided the transitional rule for insurance companies that had to change their method of accounting for policyholder dividends as a result of the paid or accrued requirement. Section 216(b) provides:

> (b) Fresh Start.--
>
> (1) In general.–Except as provided in paragraph (2), in the case of any insurance company, any change in the method of accounting (and any change in the method of computing reserves) between such company's first taxable year beginning after December 31, 1983, and the preceding taxable year which is required solely by the amendments made by this subtitle shall be treated as not being a change in the method of accounting (or change in the method of computing reserves) for purposes of the Internal Revenue Code of 1954.

The conference report for the fresh start provisions set forth at section 216(b) demonstrates that its purpose was the same as that for the fresh start provisions set forth at section 1023(e)(3) of the Tax Reform Act of 1986. H. Conf. Rep. 98-861 at 1056 (1984), 1984-3 C.B. (Vol. 2) at 310 states "Under the fresh start transitional rule, this change from a reserve to an accrual method is not to be treated as a change in the method of accounting. Thus, no income or loss is to be recognized with respect to amounts in existing policyholder dividend reserves." See National Life Insurance Company and Subsidiaries v. Commissioner, 103 T.C. 35 (1994), aff'd, 103 F.3d 5 (2d Cir. 1996).

While section 1023(e)(3) of the Tax Reform Act of 1986 does not have language that specifically mandates that the change in the basis for computing losses incurred deductions from an undiscounted to a discounted methodology should not be treated as a change in the method of accounting for purposes of I.R.C. § 481 [as did section 216(b) of the Deficit Reduction Act of 1984], the courts have recognized that this is its effect.

Congress provided a fresh start provision for insurance companies who were forced to change from the cash method to the accrual method for salvage recoveries by the amendment to I.R.C. § 832(b)(5)(A). Congress specifically recognized that the amendment had to be treated as a change in method of accounting. However, Congress allowed such insurance companies to only take a percent of the adjustment into account to provide them with a partial fresh start. [Companies that were already following an accrual approach received a different benefit called the special deduction.]

I.R.C. § 832(a) defines insurance company taxable income. For designated [property and casualty] insurance companies, taxable income means gross income, as defined in I.R.C. § 832(b)(1), less deductions allowed, as defined in I.R.C.

§ 832(c). Among the deductions allowed is the I.R.C. § 832(c)(4) deduction for losses incurred. I.R.C. § 832(b)(5) mandates how the losses incurred had to be computed. Salvage recoveries are a major component in computing the losses incurred per I.R.C. § 832(b)(5)(A).

Prior to the 1990 Act, most property and casualty insurance companies accounted for salvage on a cash basis, i.e., took salvage into income only when recoveries were made. Section 11305 of the 1990 Act amended I.R.C. § 832(b)(5)(A) to require property and casualty insurance companies to account for salvage on an accrual basis, i.e., take future salvage recoveries into account on an estimated basis in computing losses incurred.

The Committee Report noted that both the House and Senate versions of the bill provided the insurance companies who were forced to change their method of accounting from cash to accrual for salvage recoveries with a total or partial fresh start. The Committee Report observed that the House bill provided a total fresh start - a permanent forgiveness of income in the amount of the adjustment that would otherwise be includible in gross income. The Senate bill provided only a partial fresh start - a forgiveness of income equal to 23 percent of the amount of the adjustment with the remaining amount spread over four years. The bill as enacted forgave 87 percent of the adjustment that would otherwise be included in income with the remaining 13 percent spread over a period not to exceed four years. H.R. Rep. No. 101-964, 101st Cong., 2d Sess. 1071 (1990).

As previously stated, section 11305 of the 1990 Act amended I.R.C. § 832(b)(5)(A) to require that the accrual method be used for salvage recoveries. Section 11305(c)(2) provides:

> AMENDMENTS TREATED AS CHANGE IN METHOD OF ACCOUNTING.--
>
> (A) IN GENERAL.–In the case of any taxpayer who is required by reason of the amendments made by this section to change his method of computing losses incurred–
> (i) such change shall be treated as a change in method of accounting,
> (ii) such change shall be treated as initiated by the taxpayer, and
> (iii) such change shall be treated as having been made with the consent of the Secretary.

> (B) ADJUSTMENTS.–In applying section 481 of the Internal Revenue Code of 1986 with respect to the change referred to in subparagraph (A)--
>
> (i) only 13 percent of the net amount of adjustments (otherwise required by section 481 to be taken into account by the taxpayer) shall be taken into account, and
>
> (ii) the portion of such net adjustments ... shall be taken into account over a period not to exceed four years ...

Thus, in providing fresh start provisions for insurance companies, Congress has uniformly reduced or eliminated the impact of I.R.C. § 481. In section 216(b) of the Deficit Reduction Act of 1984, Congress specifically provided that the change should not be treated as a change in the method of accounting. In section 11305(c) of the 1990 Act, Congress gave partial relief from the impact of I.R.C. § 481. In enacting section 1023(e)(3) of the Tax Reform Act of 1986, Congress' intent in rendering I.R.C. § 481 inapplicable to the change was apparent, as the courts have recognized.

<u>CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:</u>

[redacted]

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