April 30, 2018

BIR RULING NO. 748-18

Section 43 of the NIRC, as amended; BIR Ruling No. 005-06

Insurance Commission
1071 United Nations Avenue
Manila

Attention: *Ferdinand George A. Florendo*
Deputy Insurance Commissioner
Financial Examination Group

Gentlemen :

This refers to your letters dated March 15, 2016 and May 8, 2017, informing this Office of the change in the basis of valuation by life insurance companies of their life insurance reserves, from Net Premium Valuation (NPV) to Gross Premium Valuation (GPV), in accordance with Sections 216 and 423 of Republic Act (RA) No. 10607, otherwise known as, "The Amended Insurance Code" (New Insurance Code). You are of the position that the aforesaid change in the basis of valuation involves change in accounting policy which requires consent of the Commissioner of Internal Revenue pursuant to Section 168 of Revenue Regulations (RR) No. 02-40.

Background:

In 15 August 2013, President Benigno S. C. Aquino III signed into law RA No. 10607 in order to revise Presidential Decree (PD) No. 612 dated 18 December 1974, and to bring insurance industry up to date and at par with regional and global standards. The New Insurance Code brought significant changes, which include the change in the valuation of the life insurance companies' and mutual benefit association's policy liabilities/reserves, which under Sections 216 and 423, "shall be made, according to the standard adopted by the company, as prescribed by the Commissioner in accordance with internationally accepted actuarial standards. . ."

On 28 December 2016, the Insurance Commission (IC) issued Circular Letter No. 2016-66 in order to provide guidance on the implementation of the New Insurance Code. This Circular was implemented on 01 January 2017.

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In particular, this Circular has changed the basis of valuation of life insurance reserves from NPV to GPV. Though the NPV approach is not an incorrect approach in calculating reserves, a majority of countries are currently using, or shifting towards, the GPV approach because it is a market-consistent approach and represents the best estimate of the insurance company's liabilities. Changing the requirement of the valuation approach, allowed the Philippines to align itself with global standards.

Under the NPV, insurance companies were only required to value their life insurance reserves according to a standard mortality table with interest capped at six percent (6%). Reserves are essentially funds owed to policyholders. If the amount owed to other people rises, then income of an insurance company becomes smaller. In accounting, the increase in reserves would show up as an expense in the income statement for the year.

On the other hand, the GPV method prescribed in Circular Letter No. 2016-66, considers other assumptions such as morbidity, lapse and/or persistency, expenses, non-guaranteed benefits and margin for adverse deviation (MfAD). Because of these additions to reserves, expenses to the company are generally seen to increase. Moreover, the new methodology allows an insurance company to use discount rates prevailing at market. The use of actual market rates as prescribed by the Insurance Code, instead of the six percent (6%) interest rate cap under the old NPV method will cause significant changes in the liability given that prevailing interest rates in the market are much lower than the six percent (6%) companies apply.

Also, the movement of the liability will be more unpredictable considering that the discount rate to be applied is no longer fixed. Since it is no longer fixed, it will follow the volatile movement in the market, resulting to the recognition of increase or decrease of the reserves brought by changes in discount rates.

Below are two (2) tables showing a comparison in the valuation of insurance reserves of life insurance companies under NPV and GPV scenarios had the latter valuation methodology been effected in CY 2015 and CY 2016:

Life Insurance Policy Reserves (CY 2015; in PHP)					
Item No.	**Company Name**	**Total NPV Reserves (Old)**	**Total GPV Reserves (New)**	**Difference**	**% Increase/ (Decrease)**
1	Allianz PNB Life Insurance, Inc.	_____	_____	_____	_____%
2	AsianLife and General Assurance Corporation	_____	_____	_____	_____%
3	BDO Life Assurance Company, Inc.	_____	_____	_____	_____%
4	Caritas Life Insurance Corporation	_____	_____	_____	_____%
5	Cooperative Insurance System of the Philippines	_____	_____	_____	_____%
6	Country Bankers Life Insurance Corporation	_____	_____	_____	_____%
7	First Life Financial Company, Inc.	_____	_____	_____	_____%
8	Fortune Life Insurance Company, Inc.	_____	_____	_____	_____%
9	FWD Life Insurance Corporation	_____	_____	_____	_____%

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10	Insular Life Assurance Company, Ltd., The	_____	_____	_____	_____%
11	Manila Bankers Life Insurance Corporation	_____	_____	_____	_____%
12	Manufacturers Life Insurance Company (Phils.), Inc., The	_____	_____	_____	_____%
13	Manulife Chinabank Life Assurance Corporation	_____	_____	_____	_____%
14	Paramount Life & General Insurance Corporation	_____	_____	_____	_____%
15	Philippine AXA Life Insurance Corporation	_____	_____	_____	_____%
16	Philippine Life Financial Assurance Corporation	_____	_____	_____	_____%
17	Philippines International Life Insurance Company, Inc.	_____	_____	_____	_____%
18	Pioneer Life, Inc.	_____	_____	_____	_____%
19	Pru Life Insurance Corporation of U.K.	_____	_____	_____	_____%
20	Sun Life Grepa Financial, Inc.	_____	_____	_____	_____%
21	Sun Life of Canada (Philippines), Inc.	_____	_____	_____	_____%
22	United Coconut Planters Life Assurance Corporation	_____	_____	_____	_____%
23	United Life Assurance Corporation	_____	_____	_____	_____%
TOTAL		_____	_____	_____	**_____%**

Life Insurance Policy Reserves (CY 2016; in PHP)					
Item No.	**Company Name**	**Total NPV Reserves (Old)**	**Total GPV Reserves (New)**	**Difference**	**% Increase/ (Decrease)**
1	Allianz PNB Life Insurance, Inc.	_____	_____	_____	_____%
2	AsianLife and General Assurance Corporation	_____	_____	_____	_____%
3	BDO Life Assurance Company, Inc.	_____	_____	_____	_____%
4	BPI-Philam Life Assurance Corporation	_____	_____	_____	_____%
5	Cooperative Insurance System of the Philippines	_____	_____	_____	_____%
6	Country Bankers Life Insurance Corporation	_____	_____	_____	_____%
7	East West Ageas Life Insurance Corporation	_____	_____	_____	_____%
8	First Life Financial Company, Inc.	_____	_____	_____	_____%
9	FWD Life Insurance Corporation	_____	_____	_____	_____%
10	Generali Life Assurance Philippines, Inc.	_____	_____	_____	_____%
11	Insular Life Assurance Company, Ltd., The	_____	_____	_____	_____%
12	Manila Bankers Life Insurance Corporation	_____	_____	_____	_____%
13	Manufacturers Life Insurance Company (Phils.), Inc., The	_____	_____	_____	_____%
14	Manulife Chinabank Life Assurance Corporation	_____	_____	_____	_____%
15	Paramount Life & General Insurance Corporation	_____	_____	_____	_____%
16	Philam Equitable Life Assurance Company, Inc.	_____	_____	_____	_____%
17	Philippine American Life and General Insurance Company	_____	_____	_____	_____%
18	Philippine AXA Life Insurance Corporation	_____	_____	_____	_____%
19	Philippine Life Financial Assurance Corporation	_____	_____	_____	_____%
20	Philippines International Life Insurance Company, Inc.	_____	_____	_____	_____%
21	Pioneer Life, Inc.	_____	_____	_____	_____%
22	Pru Life Insurance Corporation of U.K.	_____	_____	_____	_____%
23	Sun Life Grepa Financial, Inc.	_____	_____	_____	_____%
24	Sun Life of Canada (Philippines), Inc.	_____	_____	_____	_____%

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TOTAL	_____	_____	_____	____%

As shown above, the transition adjustment from NPV to GPV will generally increase the amount of reserves (liabilities) to be estimated by the companies as a result of the inclusion of factors such as morbidity, lapse and/or persistency, expenses, non-guaranteed benefits, MfAD and volatility in the discount rates, which are no longer capped at 6%.

In reply, please be informed that the change of accounting method from one system to another is specifically allowed under the provision of Section 43 of the National Internal Revenue Code, in relation to Section 167 of Revenue Regulations No. 2-40, the pertinent portion of which provides as follows:

> *"SEC. 43. General Rule. — The taxable income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner clearly reflects the income. . ."*

Section 167 of Revenue Regulations No. 2-40 provides:

> *". . . It is recognized that no uniform method of accounting can be prescribed for all taxpayers and the law contemplates that each taxpayer shall adopt such forms and systems of accounting as are in his judgment best suited for his purpose. . . . Any approved standard method of accounting which reflects taxpayer's income may be adopted. . ."*

Likewise, Section 168 of the same Regulations prescribes that:

> *"Section 168. Changes in accounting methods. — The true income, computed under the law, shall in all cases be entered in the return. If for any reason the basis of reporting income subject to tax is changed, the taxpayer shall attach to his return a separate statement setting forth for the taxable year and for the preceding year the classes of items differently treated under the two systems, specifying in particular all amounts duplicated or entirely omitted as the result of such change.*
>
> ***A taxpayer who changes the method of accounting** employed in keeping his book **shall**, before computing his income upon such new method for purposes of taxation, **secure the consent of the Commissioner of Internal Revenue**. For the purposes of this section, a change in the method of accounting employed in keeping books means any change in the accounting treatment of items of income or deductions, such as a change from cash receipts and disbursements method to the accrual method, or vice versa; a change involving the basis of valuation employed in the computation of inventories (see Sections 144 to 151 of these regulations); a*

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change from the cash or accrual method to the long-term contract method, or vice versa; a change in the long term contract method from the percentage of completion basis to the completed contract basis, or vice versa (see section 44 of these regulations) or a change involving the adoption of, or a change in the use of, any other specialized basis of computing net income such as the crop basis. Application for permission to change the method of accounting employed and the basis upon which the return is made shall be filed within 90 days after the beginning of the taxable year to be covered by the returns. The application shall be accompanied by a statement specifying all amounts which would be duplicated or entirely omitted as a result of the proposed change. Permission to change the method of accounting will not be granted unless the taxpayer and the Commissioner of Internal Revenue agree to the terms and conditions under which the change will be effected." (emphasis supplied)

The changes introduced by the Circular on the basis of valuation of life insurance reserves is in effect a change in the method itself since the newly prescribed valuation methodology shall be the basis of deductible expense *(for additions required by law to reserve funds)* and taxable income *(for released reserves)* for income tax purposes effective January 1, 2017. Thus, the change in reserving methodology from NPV to GPV is a change in accounting policy.

It should be noted that the change in method of accounting is in line with the passage of RA 10607 and the change in the valuation of the life insurance companies' and mutual benefit association's policy liabilities/reserves is prescribed and authorized by the Insurance Commissioner in accordance with internationally accepted actuarial standards.

In BIR Ruling 005-06 dated March 8, 2006, this Office ruled, that:

*"x x x **the Tax Code itself prescribes no hard and fast rule that would guide taxpayers in allocating expenses** where the business involves distinct activities like that of Wyeth, i.e., the operation of its existing two spray dryers (which is subject to regular taxation) and the proposed third dryer (which is subject to ITH). It is recognized that no uniform method of accounting can be prescribed for all taxpayers, and the law contemplates that each taxpayer shall adopt such forms and systems as are in his judgment best suited to his purpose (Section 167, Revenue Regulations No. 2).*

***Allocation of costs is essentially an accounting issue**, and given that the law does not expressly provide rules that will govern situations like that of Wyeth, the method of allocation adopted, should, at best, be one that is reasonable and justifiable, and is consistently used. Hence, a method of accounting which reflects the consistent application of generally accepted principles in a particular trade or business in accordance with accepted practices in that trade or business ordinarily is regarded as accurately reflecting income (Mertens, Law of Federal Income Taxation, Volume 2, Chapter 12B.01). Moreover, it has been held that the allocation of expenses attributable to exempt and non-exempt income is to be based on all the facts and circumstances (CCH, Standard Federal Tax Reporter, citing*

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Rev. Reg. 63-27, 1963-1 CB 57).

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***Moreover, the use of the said cost allocation method is authorized by the BOI**. It is noted that the BOI, a co-equal body, is mandated by law to grant fiscal and non-fiscal incentives to pursue the objectives of and implement the investments programs under the Omnibus Investments Code, and the BIR takes cognizance of such mandate (BIR Ruling No. 064-00 dated November 27, 2000)."*

In view of the foregoing, the permission to change the method of accounting *vis-à-vis* change in reserving methodology from NPV to GPV of insurance companies pursuant to CL No. 2016-66 in accordance with RA 10607 is hereby granted.

Relative thereto, the transition adjustments (*i.e.*, the cumulative prior year impact of the change in reserving methodology from NPV to GPV) [1] as of December 31, 2016 shall be treated as non-deductible expense/non-taxable other income.

Henceforth and pursuant to Section 37 of the NIRC, the net additions/released reserve under the GPV method prescribed under IC Circular Letter No. 2016-66 shall be reported as Profit/Loss items (*i.e.*, morbidity, lapse and/or persistency, expenses, non-guaranteed benefits and MfAD) and shall be treated as deductible expenses/taxable other income.

However, the increase or decrease in reserves resulting from changes in discount rates shall be reported as Other Comprehensive Income/Loss items in accordance with the IC financial reporting framework for Reserve Accounts consistent with the Philippine Financial Reporting Standards (PFRS) for Insurance Contracts. Considering that the change in discount rate is not a result of the insurance company's transactions, this shall be treated as non-deductible expenses/non-taxable other income for tax purposes.

This ruling is being issued on the basis of the foregoing facts as represented. However, if upon investigation, it will be disclosed that the facts are different, then this ruling shall be considered null and void.

Very truly yours,

(SGD.) CAESAR R. DULAY
Commissioner of Internal Revenue

Footnotes

1. With January 1, 2017 as the basis of Transition Adjustment consistent with the guidelines under "Item No. 5 — Transition Accounting" of Insurance Commission Circular Letter No. 2016-65 dated December 28, 2016.

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