INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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Taxpayer's Name:
Taxpayer's Address:
Taxpayer's Identification No
Year(s) Involved:
Date of Conference:

LEGEND:

Taxpayer:

Foreign Insurer:

Insurer A:

Insurer B:

Country A:

Number 1:

Year A:

Year B:

Year C:

Year D:

Amount A:

Amount B:

Amount C:

Amount D:

Amount E:

Amount F:

Amount G:

Amount H:

Amount I:

Date A:

Date B:

Date C:

Fund A:

Fund B:

ISSUES:

1. Whether provisional indemnification receivables (PIR) for incurred but not reported loss reserves are includable in the calculation of subpart F insurance income of a Foreign Insurer and its earnings and profits.

2. If the PIR are includable in the calculation of the Foreign Insurer's subpart F income and its earnings and profits, whether the changes to the Foreign Insurer's taxable

income and earnings and profits are included in Taxpayer's income on a pro-rata basis under sections 951 and 953 of the Internal Revenue Code.

CONCLUSIONS:

1. The PIR for incurred but not reported loss reserves are includable in the calculation of subpart F insurance income of the Foreign Insurer and its earnings and profits.

2. Because the PIR are includable in the calculation of the Foreign Insurer's subpart F income and its earnings and profits, the changes to the Foreign Insurer's taxable income and earnings and profits are included in Taxpayer's income on a pro-rata basis under sections 951 and 953 of the Internal Revenue Code.

FACTS:

Taxpayer is a United States shareholder of Foreign Insurer and has policies reinsured by Foreign Insurer covering auto liability, auto physical damage, and general liability and worker's compensation. Foreign Insurer has over Number 1 shareholders that appear to be unrelated. Foreign Insurer is located in Country A and is a controlled foreign corporation. Foreign Insurer prepares its financial statements as required by Country A. It does not prepare the National Association of Insurance Commissioners (NAIC) annual statement. Foreign Insurer assumes reinsurance from an unrelated insurance company ("ceding insurer") based in the United States. Foreign Insurer computes its income on an accrual basis for both book and tax purposes.

Up until the underwriting years of Year A and Year B, Foreign Insurer endeavored to write insurance on a direct basis for indemnification of losses sustained within the insured's applicable deductible for coverage pertaining to workers' compensation, employers liability, automobile physical damage, independent owner/operator physical damage, commercial automobile and commercial liability risks. Thereafter for Year C and Year D, under the business plan, Insurer A issues the initial policy and cedes a certain layer of coverage to Foreign Insurer. As part of the arrangement, specific excess reinsurance is provided by Insurer B. Premiums are experience –rated based on evaluation of the individual insured underwriting data. Insured with adverse claims experience in the layer reinsured by the Foreign Insurer are levied additional premiums based on a predetermined formula. These additional premiums, which are ceded to the Foreign Insurer, could total a maximum amount of approximately 50% of the original premiums. As additional security, the fronting carrier holds letters of credit secured on the assets of the shareholder/insureds for a value of at least 66% of potential additional premiums. Each participant will pay Amount A to Foreign Insurer in a cash contribution for stock.

The obligations of the shareholder/insured are covered by the shareholder agreement. Under the shareholder agreement, the intent of the formula to be used in calculating a shareholder/insured's premium is that each shareholder/insured pays a premium to fund losses which are distributed among the entire shareholder base. Each shareholder/insured's previous five-year claims history is collected and the data is trended and developed by Foreign Insurer's actuarial firm. The actuarial firm then produces what they believe a shareholder/insured's predictable losses will be, from Amount B to Amount C per occurrence, during the year. This is called the shareholder/insured's Fund A. They also estimate the amount of losses from Amount C to Foreign Insurer's retained limit, of currently Amount D. This is called the shareholder/insured's Fund B. The fixed costs of the program such as excess reinsurance, direct insurance costs and claims services are calculated for each shareholder/insured on a prorated basis against each shareholder/insured's premium. When the contributions of that shareholder/insured to the Fund A, Fund B, and fixed costs are added together, its premium for the year has been calculated. In addition to premium charges, a shareholder/insured can be assessed up to an amount equal to 100% of its Fund A contribution if its expected losses exceed its contribution for that year.

Under the premium calculation loss distribution rules, the maximum additional costs that can be assessed to a shareholder/insured, as additional claims costs, due to an unsatisfactory loss level is an amount no greater that its original Fund A contribution for that year. Any additional losses above this amount will be risk shifted to the other shareholder/insureds. Therefore the maximum cost that a shareholder/insured can pay for the year is: 2(Fund A) + Fund B+ Fixed Costs = Maximum Costs. If an individual shareholder/insured's losses in the Fund B contribution layer exceed the amount that it has paid to the Fund B layer for that year and if it has a surplus within its Fund A contribution layer, then this surplus shall be used to pay for these excess Fund B losses. If a shareholder/insured's Fund B losses exceed its Fund B contribution for that year, but there is no surplus within the Fund A layer, then the Fund A layer cannot be assessed for these additional losses. These excess losses will be risk shifted to the other shareholder/insureds and it is agreed these risk losses will be shared. Only additional losses within the Fund A layer can be further assessed to the shareholder/insured. If there is an assessment for an additional contribution to the Fund A, it will be assessed as 50% in Year 2, 30% in year 3 and 20% in year 4.

If losses in the individual's shareholder/insured's Fund A contribution exceed that contribution plus the additional Fund A Experience Adjustment, then these additional losses shall be assessed against that shareholder/insured's Fund B for that year until exhausted. Surplus from a shareholder/insured's Fund B can be credited to a shareholder/insured's Fund A loss Experience Adjustment but only after the underwriting year is closed by the Foreign Insurer. Should a shareholder/insured's losses within its Fund A exceed its maximum Experience Adjustment, any deficit reallocation of a Fund A Experience Adjustment to other shareholder/insureds shall be risk shared in proportion to the actual percentage of a shareholder/insured's Fund A contribution to the total shareholder/insureds' Fund A contributions. Should a shareholder/insured's losses within its Fund B exceed its initial payment, any deficit reallocation of a Fund B loss shall be risk shared in proportion to the actual percentage of a shareholder/insured's Fund B contribution to the total for shareholder/insureds that have a positive balance in their Fund B accounts. If Fund B losses exceed all Fund B balances (surplus), then the balance required shall be risk shared (allocated) against each shareholder/insured's Fund A in proportion to a shareholder/insured's percentage contribution to the total. In no case shall a shareholder/insured pay more than its maximum 100% Experience Adjustment.

Any profits distributable to shareholders will be determined by the Board of Directors of Foreign Insurer based on each individual shareholder/insured's surplus in its Fund A and/or Fund B. A shareholder/insured may only receive profits if there is a surplus in its Fund A and/or Fund B at the close of the policy year as determined by the Board of Directors of Foreign Insured through the application of the Experience Rated/Premium Loss Formula.

The operating documents of Foreign Insurer set forth the mechanism by which the risk of loss is shared among the shareholder/insureds. The premiums of a shareholder/insured are first applied to their own losses and then to the losses of other shareholder/insureds. A schedule shows the allocation of the paid losses and actuarially determined loss reserves for the Year A and Year B underwriting years as of Date B. Taxpayer is included in this schedule. Taxpayer's expected losses as of Date B are less than its initial premiums. However due to the expected losses of other shareholder/insureds based on paid losses and actuarial determined losses reserves, it is anticipated that additional premium assessments will be made against Taxpayer.

Foreign Insurer computes the amount of expected additional premiums receivables from shareholder/insureds based upon it's actuarially determined increased in unpaid loss reserves, "Claims Indemnification Receivable" (CIR) for case reserves and "Provisional Indemnification Receivable" (PIR) for incurred but not reported losses.

The financial statements of Foreign Insurer for Year C and Year D include in income the increase in the receivables for both CIR and PIR which offsets the corresponding increase in unpaid losses.

On its federal income tax return for Year C and Year D, Taxpayer excluded the increase in receivables for PIR in computing its deemed dividend income from Foreign Insurer under subpart F. However, the increase in the actuarial estimated reserves for incurred but not reported losses was deducted by Taxpayer for federal income tax on the same basis as book income.

Foreign Insurer had the following PIR:

Date A	Date B	Date C
Amount E	Amount F	Amount G

The increase in PIR is computed as follows:

PIR	Year C	Year D
Beginning of year	Amount E	Amount F
End of year	Amount F	Amount G
Increase	Amount H	Amount I

LAW AND ANALYSIS:

Neither the Internal Revenue Code nor the Income Tax Regulations define the terms "insurance" or "insurance contract". The United States Supreme Court of the United States has explained that in order for an arrangement to constitute insurance for federal income tax purposes, both risk shifting and risk distribution must be present. Helvering v. LeGierse, 312 U.S. 531 (1941). The risk transfer must be the risk of economic loss. See, e.g., Allied Fidelity Corp. v. Commissioner, 572 F. 2d 1190 (7th Cir. 1978), cert. denied. The risk must contemplate the fortuitous occurrence of a stated contingency, Commissioner v. Treganowan, 183 F. 2d 288, (2d Cir. 1950), and must not be merely an investment or business risk. Le Gierse, 312 U.S. at 542, Rev. Rul. 89-96, 1989-2 C. B. 114; Rev. Rul. 2007-47, 2007-2 C.B. 127. The arrangement between Foreign Insurer and the shareholder/insured is insurance because of its risk shifting and risk distribution; and it is not merely an investment or business risk.

The subpart F regime applies to foreign corporations that qualify as CFCs. Section 957 defines a CFC as a foreign corporation with regard to which more than 50% of the total combined voting power of all classes of stock entitled to vote or the total value of the stock of the corporation is owned by United States (U.S.) shareholders. A U.S. shareholder, in turn, is defined under section 951 as a U.S. person who owns 10% or more of the total combined voting power of all classes of stock entitled to vote of the foreign corporation.

Section 957(b) provides the following special rule for insurance. For purposes only of taking into account income described in section 953(a) (relating to insurance income), the term CFC includes not only a foreign corporation as defined in subsection (a) but also one of which more than 25% of the total combined voting power of all classes of stock (or more than 25% of the total value of the stock) is owned (within the meaning of section 958(a)), or is considered as owned by applying the rules of ownership of section 958(b), by U.S. shareholders on any day during the taxable year of such corporation, if the gross amount of premiums or other consideration in respect of the reinsurance or the issuing of insurance or annuity contracts described in section 953(a)(1) exceeds 75% of the gross amount of premiums or other consideration in respect of all risks.

Section 953(c) modifies section 957 for certain insurance companies. Under section 953(c)(1)(a) the term U.S. shareholder means with respect to any foreign corporation, a U.S. person (as defined in section 957(c)) who owns (within the meaning of section 958(a)) any stock of the foreign corporation. Under section 953(c)(1)(b) the term controlled foreign corporation has the meaning given to such term by section 957(a) determined by substituting 25% or more for more than 50%. Under section 953(c)(1)(C) the reference to pro rata share in section 951(a)(1)(A)(i) shall be determined under section 953(c)(5). As a CFC, its U.S. shareholders must include in gross income their pro rata shares of the corporation's subpart F income, as defined in section 952, and the amounts determined under 956, which are based on the U.S. property held by the CFC.

Section 951(a)(1)(A)(i) requires a U.S. shareholder of a CFC to include in gross income such shareholder's pro rata share of the CFC's subpart F income for the year. Section 952(a) defines subpart F income to include, among other things, insurance income as defined in section 953, and foreign base income, as defined in section 954. In effect, section 951 provides for the inclusion in the taxable income of a U.S. shareholder its share of current earnings and profits of a foreign insurance company as "deemed dividends."

Section 953(a)(1) defines insurance income to mean income which (A) is attributable to the issuing (or reinsuring) of an insurance or annuity contract, and (B) would be taxed under subchapter L (sections 801 through 848) if such income were the income of a domestic insurance company. Amounts includable as deemed dividends are computed on the same basis as a domestic insurance company's taxable income.

Insurance companies subject to tax under section 831 are required to determine taxable income under section 832. Section 832(a) provides that the term "taxable income" means the gross income as defined in section 832(b)(1) less the deductions allowed by section 832(c).

Section 832(b)(1) generally defines the gross income of an insurance company by reference to a company's underwriting income or loss, as well as gains and other income items, determined of the basis of the underwriting and investment exhibit of the National Association of Insurance Commissioners (NAIC). Section 832(b)(3) defines underwriting income as the premiums earned on insurance contracts during the taxable year less losses incurred and expenses incurred.

Section 832(b)(4) provides that the term premiums earned on insurance contracts during the taxable year means an amount computed as follows: (A) from the amount of gross written premiums written on insurance contracts during the taxable year, deduct return premiums and premiums paid for reinsurance; (B) to the results so obtained, add 80% of the unearned premiums on outstanding business at the end of the preceding taxable year and deduct 80% of the unearned premiums on outstanding business at the of the taxable year.

Section 832(b)(5) defines losses incurred during the taxable year on insurance contracts as follows: (1) from losses paid during the taxable year, deduct salvage and reinsurance recovered during the taxable year; (2) to the result so obtained, add all unpaid losses on life insurance contracts plus all discounted unpaid losses (as defined by section 846) outstanding at the end of the taxable year and deduct all unpaid losses on life insurance contracts plus all discounted unpaid losses outstanding at the end of the preceding taxable year; and (3) to the results so obtained, add estimated salvage and reinsurance recoverable as of the end of the preceding taxable year and deduct estimated salvage and reinsurance recoverable as of the end of the taxable year. The amount of unpaid losses must be fair and reasonable. The amount of estimated salvage recoverable shall be determined on a discounted basis in accordance with procedures established by the Secretary.

Section 1.832-4(a)(8)(i) of the Income Tax Regulations provides that the unearned premium for a contract, other than a contract described in section 816(b)(1)(B), generally is the portion of the gross premium written that is attributable to future insurance coverage during the effective period of the insurance contract. Unearned premiums do not include any additional liability established by the insurance company on its annual statement to cover premium deficiencies.

The NAIC issues Statements of Statutory Accounting Principles (SSAP) that promulgates accounting practices and procedure for the insurance industry. SSAP No. 53 covers the reporting of premiums. Item 3 of SSAP No. 53 defines written premium as the “contractually determined amount charged by the reporting entity to the policyholder for the effective period of the contract based on the expectation of risk, policy benefits, and expenses associated with the coverage provided by the terms of the insurance contract.” Item 9 of SSAP No. 53 details the reporting of earned but unbilled premiums as follows: “reporting entities shall estimate audit premiums, the amount generally referred to as earned but unbilled (EBUB) premiums, and shall record the amount as an adjustment to premium, either through written premium or as an adjustment to earned premium. The estimate for EBUB may be determined using actuarially or statistically supported aggregate calculations using historical company unearned premium data, or per policy calculations.”

Section 446(a) provides that taxable income shall be computed under the method of accounting on the basis on which taxpayer regularly computes his income in keeping his books and records. Section 1.446-1(a) of the Income Tax Regulations provides further that the term “method of accounting” includes not only the overall method of accounting of a taxpayer but also the accounting treatment of any item. Examples of such over-all methods are the cash and receipts disbursement method, accrual method, combinations of the foregoing with various methods provided for the accounting treatment of special items.

Under section 446(b), taxable income is to be computed under the accounting method regularly used by the taxpayer for keeping its books and records unless the method used “does not clearly reflect income.”

Section 451(a) provides that the amount of any item of gross income shall be included in the gross income for the taxable year in which received by a taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period.

Section 461(a) provides that the amount of any deduction shall be taken for the taxable year which is the proper taxable year under the method of accounting used in computing taxable income. Section 1.461-1(a) of the Income Tax Regulations provides for taxpayers using the accrual method that a liability is incurred and generally taken into account for federal income tax purposes in the taxable year in which all events have occurred which established the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability. Section 461(h)(5) exempts reserves for unpaid losses of insurance companies from the economic performance requirements of the all events test.

Taxpayer takes the position that the change in the PIR, which represents potential assessments on shareholder/insureds, on the books of Foreign Insurer, which is a CFC, are reversed for the calculation of taxable earnings and profits for subpart F purposes because of their contingent nature. When the assessments are actually determinable, they are included in the calculation of taxable earnings and profits of Foreign Insurer as claims indemnification. Taxpayer believes that the PIR are not contractually determinable with certainty at the close of the taxable year and therefore should not be includable under SSAP No. 53 as written premiums on a NAIC annual statement. Additionally, the provisional assessments do not meet the definition of an audit premium and, therefore, item 6 of SSAP No. 53 would not be applicable.

We do not agree with Taxpayer’s position. The scheme of taxation in section 832 requires a property and casualty insurance company to determine its gross income, in part, on an earned premium basis. Under this system, a premium is not earned when a policy is written or when the premium is collected. Rather, the premium is earned over the period of coverage.

Under section 832(b)(4), earned premiums are composed, in part, of gross written premiums during the taxable year less return premiums and premiums paid for reinsurance. The amount of written premiums is then converted to an earned basis by means of the reduction allowed with respect to the net increase in unearned premiums during the taxable year. The items taken into account under section 832(b)(4) closely track the items reflected in the calculation of earned premiums on the annual statement underwriting and investment exhibit.

There is no indication that the amounts taken into account in gross written premiums for purposes of section 832(b)(4) are subject to the same standard as a non-insurance company for the accrual of income. For purposes of the annual statement, the term “written premium” refers to the premium for the full term of coverage under an insurance policy, without regard to whether the premium has been collected or billed as of the date of the annual statement. Thus, the determination of gross written premiums in section 832(b)(4) necessarily includes certain amounts that would not otherwise be accruable under general tax accrual principles because the insurance company either has not received the premium or does not have an enforceable right to collect these amounts.

The PIR estimates due to Foreign Insurer from the shareholder/insured based on estimated incurred but not reported losses must be included in Foreign Insurer’s earned premiums under section 832(b)(4) without regard to whether the amounts would meet the all events test for accrual of income by a non-insurance company. Inclusion of these amounts in income is necessary to clearly reflect income as required by section 446(b). To clearly reflect underwriting income, premiums earned and losses incurred must be computed on the same basis. Thus, the deduction for unpaid loss reserves in excess of Fund A must be offset by the increase in PIR.

Under the terms of the Foreign Insurer’s contract with shareholder/insureds, the shareholders are required to pay additional premiums. The PIRs are Foreign Insurer’s expected additional premiums computed based on incurred but not reported losses. Foreign Insurer has included these additional premiums in its financial income, but has excluded them from its computation of subpart F taxable income and earnings and profits. However, Foreign Insurer has included in financial and taxable income the expected premiums (CIR) from shareholder/insureds based upon its actuarially determined reserves for reported losses. There should be no distinction between these receivables and the additional receivables from shareholder/insured on incurred but not reported losses. Thus, Foreign Insurer must also include PIR in taxable subpart F income as it does with its financial income. The PIR is also includable in the calculation of Foreign Insurer’s earnings and profits. The changes to the Foreign Insurers subpart F income and earnings and profits to reflect the PIR are included in Taxpayer’s income on a pro-rata basis under sections 951 and 953.

A copy of this technical advice memorandum is to be given to the taxpayer. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

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