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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: JOEL E. HELKE
Branch Chief CC:DOM:FS:FI&P

SUBJECT: Internal Revenue Service National Office Field Service Advice

This Field Service Advice responds to your memorandum dated . 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:

Taxpayer =

State A =

ISSUE(S):

Whether earned retrospective rate debits may be included in the unearned premium reserve on an estimated basis for the purpose of calculating the inclusion in earned premium income of 20 per cent of the year's increase in the unearned premium reserve or should be reported as increasing earned premiums and gross premiums written for the year of the insurance coverage.

CONCLUSION:

Earned retrospective rate debits should be reported as increasing earned premiums and gross premiums written for the year of the insurance coverage.

FACTS:

This case involves the computation of "premiums earned" as defined by section 832(b)(4). Specifically, the controversy concerns whether the Taxpayer may account for additional premiums owed to it by customers and referred to as "retrospective rate debits" (retro debits) that are attributable to insurance coverage provided for and by: a) including them in each year's unearned premium reserve ("UPR") for purposes of calculating "premiums earned" (Taxpayer's position) or, b) including them in the gross written premiums in each year and directly increase earned premiums (Service's position).

Retro debits arise out of insurance contracts that include a retrospective rating plan for pricing the coverage provided. Under these plans, an initial premium is charged based on an estimate of the insured's expected losses and exposure during the term of the policy. The annual retrospective pricing adjustment is calculated utilizing the insured's actual losses during the policy term according to a formula stipulated in the policy. For purposes of making this calculation, only paid losses and losses reported to the insurance company are utilized. Therefore, the normal pattern of retrospective premium adjustments is for the initial rating adjustment to result in a return of premium to the insured (retro credit) and for subsequent rating adjustments to result in the policyholder paying an additional premium to the insurer (retro debit).

An insurance company calculates its provision for retrospective premium adjustments (that is, estimates of retro debits and retro credits)
for its entire line of retrospectively rated policies. Thus, to the extent that the later retrospective rating adjustments of all policies would result in an excess of additional premiums being collected from policyholders

than being paid out as return premiums, the company would reflect an excess of retro debits i.e., amounts owed to the insurer, over retro credits i.e., amounts owed to the insured. This has been Taxpayer’s experience.

At the end of the calendar year, Taxpayer's actuaries calculated the unpaid losses, including incurred but not reported losses ("IBNR"), and these amounts were deducted as part of the company's "losses incurred." The retro debits that would be due from its insureds was also calculated. These estimated retro debits were reported as a reduction of the UPR for the year of insurance coverage and thereby increased earned premiums for that year. Because retro debits exceeded unearned premiums on policies that were not retrospectively rated, the effect of including the estimated debits in the UPR was to not only eliminate any UPR susceptible to the 20% haircut but also to produce a "negative" UPR.

The Taxpayer's primary lines of insurance coverage are workers compensation, general liability, and auto liability, most of which is retrospectively rated. Taxpayer's method of reporting retro credits and retro debits did not change after 1986; Taxpayer included retro credits and retro debits in its unearned premium reserve prior to and subsequent to 1986. In , Taxpayer experienced an excess of retro debits over its retro credits, thus producing a negative UPR. This was caused by a change in the type of insurance policies that Taxpayer issued.

Under the terms of the retro policies, Taxpayer may only invoice its customers for retro debits by referring to claimed losses reported to the company by the insureds. Therefore, six months after the close of the policy year and annually thereafter, Taxpayer determines the

reported claims thus far arising from the policy year and bills the insured for the additional premiums due (the retro debits). In the year Taxpayer invoices its customers for additional premiums under the retro agreement, it reports the debits as a positive amount in written premiums and correspondingly increased the UPR. It is at least six months after the end of the policy period and tax period ending 12\31 before Taxpayer reports any additional income under the policies even though it has already deducted the 1osses that give rise to this income. Thus, the Service contends that Taxpayer's reporting method mismatches income and expense.

Taxpayer contends that its retro debits are primarily related to its incurred but not reported losses in the workers' compensation business. To the extent that these unpaid losses are required to be discounted for tax purposes, and the aggregate discount factor applied to these losses is .80 or lower, the amounts accrued as premium income and the related unpaid loss deductions are properly matched.

On the annual statements filed with State A for the years in issue, Taxpayer reported retro debits for underwriting statement purposes on Exhibit 11 as a reduction of the UPR (a contra liability), consistent with how it reported debits on its tax returns. When reporting "assets" on page 2 of the annual statement, however, Taxpayer removed the debits from the UPR and identified them separately as an asset. State A accepted Taxpayer' statements as filed. It has been indicated that State A viewed the treatment by Taxpayer of retro debits on its annual statement as permissive and allowed rather than prescribed or mandated. It has also been indicated that State A considered NAIC guidelines for annual statement accounting entries to be totally separate and unrelated to federal income tax requirements.

Finally, other insurance companies did not treat retrospective rate debits and credits in the same manner as this Taxpayer and thus that there was no industry required method or practice of reporting retro debits and retro credits for annual statement reporting purposes.

LAW AND ANALYSIS:

Non-life insurance companies such as Taxpayer determine their underwriting income using an earned premium method. See section 832(b)(3). "Gross premiums written" is the total amount charged by the insurance company for the insurance coverage provided under the contract, including amounts charged that cover the company's expenses and overhead. A non-life company reports its gross premiums written for insurance contracts during the taxable year, with adjustments for return premiums and premiums paid for reinsurance. The company also establishes an unearned premium liability (unearned premium reserve), which is generally based on the portion of the gross premium written attributable to the unexpired policy term at the end of the tax year.

The issue in this case arises from certain changes to the calculation of "earned premiums" under section 832(b)(4) adopted as part of the Tax Reform Act of 1986.

Prior to the 1986 Act, a non-life company's earned premiums were calculated by subtracting 100 percent of the net increase in unearned premiums during the taxable year from its gross premiums written or adding 100 percent of the net decrease in unearned premiums during the taxable year to its gross premiums written. The amounts deducted as increases in unearned premiums included not only the portion of the premium allocable to future insurance claims but also the loading portion allocable to company expenses and profit. Thus, for income purposes, the company was treated as recovering expenses and earning its profit ratably over the policy term.

A different timing rule applies to a non-life insurance company's expenses. Under section 832(b)(6), the company is generally allowed to deduct expenses incurred as shown on its annual statement. Expenses incurred include agents' commissions and expenses attributable to unearned premiums. Under annual statement accounting rules, commissions must be recorded as incurred expenses no later than the year for

which the written premiums are reported. This treatment allowed both a deferral of unearned premiums and a current deduction for the corresponding premium acquisition expenses, which resulted in a significant mismatching of income and expenses. To remedy this mismatching, Congress modified section 832(b)(4) so that for all years after 1986, premiums earned are calculated as described above except that only 80 percent of the year's increase in the UPR may be subtracted from written premiums, thus effectively taxing non-life companies on 20 percent of unearned premiums. This requirement that a non-life company include in income 20 percent of its UPR is referred to as the "20% haircut."

Retro rate credits are included in the UPR in accordance with Treas. reg. § 1.832-4(a)(3)(ii) and the opinion in Bituminous Casualty Insurance Corp. v. Commissioner, 57 T.C. 59 (1971), acq. 1973-2 C.B. 1. Including retro credits in the UPR increases the UPR because retro credits represent premiums owed to the insured (a liability). This affects the gross premiums and decreases earned premiums.

Prior to the enactment of the 20% haircut, including debits in the UPR was a method of recognizing currently the income due to debits because it would decrease the adjustment to gross premiums written attributable to the unearned premium reserve and thereby increase earned premiums. In light of the change in the law, generally allowing debits to be reflected in a UPR in effect decreases the amount of taxable income caused by the 20% haircut.

The Service's position that debits should be reflected as an increase to earned premiums in the year of the insurance coverage is based on the fact that a retro debit represents a asset of the insurer, i.e., an earned premium owed to the insurer by the insured. When a non-life company writes retrospectively rated policies for a policy period, the parties to the insurance contract contemplate that the total actual premium ultimately due for the year may be more than the amount initially paid. Thus, it is appropriate to increase gross premiums written for the year by the amount of the debits. The

debits relate to insurance coverage that has already been provided, the additional premium has already been earned, and it is inappropriate to include debits in the unearned premium reserve. In addition, the losses giving rise to the debits are included in "losses incurred" so that currently including debits in taxable income provides a matching of income and expenses.

The Service also bases its position in part on the fact that non-life companies are on an "earned" basis for calculating both premium income and underwriting losses. It is this accounting method that allows non-life companies to deduct
currently IBNR losses even though such losses have not necessarily been discovered by the customers or reported to the insurance company. As explained in General Dynamics, Inc. v. Commissioner, 481 U.S. 239 (1987), this provides a more accelerated method of recognizing losses than is allowed to non-insurance companies under the all-events test. The "earned" basis of reporting income also allows non-life companies to exclude from taxable income amounts received from customers for insurance coverage that is attributable to a period after the end of the tax year, which is also more favorable than the income recognition rules generally available to accrual basis Taxpayers. See Schlude v. Commissioner, 372 U.S. 128 (1963) .

Neither the Code nor the Treasury Regulations (in their present form) under section 832 define the term "unearned premiums". Premiums are generally earned for annual statement purposes through the passage of time (the premium is earned over the term of the policy). An earned premium represents the pro rata part of the premium applicable to the expired portion of the policy. KPMG Peat Marwick, Federal Taxation of Insurance Companies, section 40.01 at 4017 (1991). The retro debits in this case relate to expired policy periods and therefore qualify as earned premium.

The unearned premium arises because the insurer has collected the whole premium but has yet to provide all of the coverage contemplated by the premium. The unearned premium reserve represents the insurance company's obligation to provide risk protection for the

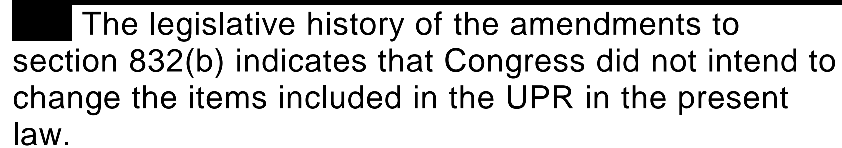
balance of the policy. Galloway, Handbook of Modern Accounting, at 176 (1986). An unearned premium for annual statement purposes represents the amount of written premium relating to the unexpired portion of all the policies on the insurer's books that should be excluded from the income statement. Thus, the purpose of the UPR is to set aside amounts to meet future obligations on behalf of the insurer.

The term "unearned premium" historically has referred to the portion of the gross premiums written that would have to be returned to the policyholder upon the cancellation of that policy and that was set in direct proportion to the unexpired term of the policy. See Buckeye Union Casualty Co. v. Commissioner, 448 F.2d 228, 230 (6th Cir. 1971), aff'g 54 T.C. 13, n.5 (1970). "Unearned premiums" also includes premiums paid for a future benefit, the cost of which was fixed when the policy was issued. Massachusetts Protective Association v. United States, 114 F.2d 304 (1st Cir. 1940). Because the debits do not relate to unexpired policy periods and do not represent amounts that have to be returned to the policyholder upon the cancellation of that policy, it is incorrect to include them in the UPR.

In sum, the Service's position is that the proper way to reflect the impact of retrospective rate debits and credits upon the calculation of earned premiums is to include only retro credits in the UPR and to report retro debits as an increase to gross written premiums that also directly increases earned premiums and not to include debits in the UPR. In this particular case, beginning in 1991, the retro debits not only exceeded any retro credits due to policyholders but also exceeded the unearned premiums held on the business that was not retrospectively rated, Thus, Taxpayer's including the retro debits in the UPR eliminates the UPR and Taxpayer has no "haircut". In fact, the effect of Taxpayer' reporting is to reduce its earned premiums by 20% of the total debits in excess of the UPR. That is, Taxpayer has reported a "negative haircut". In essence, Taxpayer has turned Congress' attempt to increase taxes on the non-life insurance industry by, inter alia, accelerating the reporting of a non-life company's

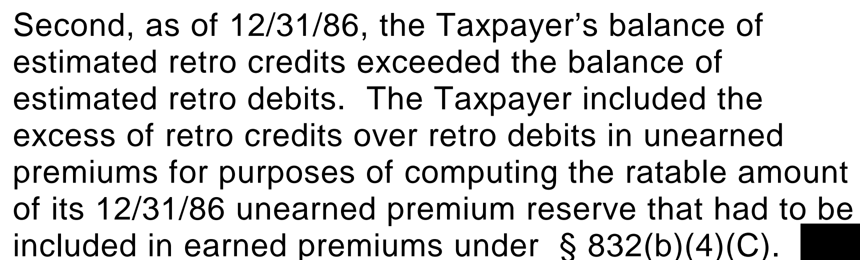
taxable income, into a tax advantage. This is antithetical to congressional intent in enacting the 20% haircut.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:



The legislative history of the amendments to section 832(b) indicates that Congress did not intend to change the items included in the UPR in the present law.

Second, as of 12/31/86, the Taxpayer's balance of estimated retro credits exceeded the balance of estimated retro debits. The Taxpayer included the excess of retro credits over retro debits in unearned premiums for purposes of computing the ratable amount of its 12/31/86 unearned premium reserve that had to be included in earned premiums under § 832(b)(4)(C).



Third, prior to the 1986 Act, the Taxpayer's accounting treatment of retro credits and retro debits – i.e., the accounting treatment of including both of these items as an adjustment in arriving at the amount of unearned premiums, was consistent with the Tax Court's opinion in Bituminous Casualty, supra, and in Rev. Rul.. 73-302, in which the Service announced its acquiescence in the result of this decision. That is, like the Taxpayer in Bituminous Casualty, the Taxpayer computed a "reserve for retro credits" based on the amounts "which would

thereafter be refundable to policyholders as retro rate credits, net after deducting additional premiums collectible under the formulas in such policies." Bituminous Casualty, at 61.

Fourth, the change in the relative proportion of retro debits to retro credits reflected a change in the Taxpayer's business. The Taxpayer simply ceased writing retrospectively rated policies the line of business that had historically generated net retro credits (i.e.,) while it continued to write retrospectively rated policies in the line of business that had produced net retro debits (i.e.,). Thus, the change in the proportion of retro debits to retro credits was not attributable to a change in method of accounting. Instead, the excess of retro debits over retro credits simply reflected the facts of Taxpayer's insurance business, as these facts existed during .

Fifth, the Taxpayer will be able to demonstrate that, both before and after the enactment of the 1986 amendments to § 832(b)(4), its method of accounting for retro debits and retro credits was consistent with NAIC accounting rules, and in fact was consistent with the accounting practices used by the majority of property and casualty companies. Although the NAIC changed the annual statement blank in 1988 to require retro debits and retro credits to be reported separately on the annual statement balance sheet, the Taxpayer will be able to demonstrate that this change was primarily attributable to collect ability concerns of certain insurance regulators, and that the presentation of retro debits and retro credits for purposes of the income statement was not changed.

The Service may be able to show that other insurance companies did not treat retrospective rate debits and credits in the same manner as this Taxpayer, and from this fact argue that there was no "required" method of reporting retro debts and retro credits for annual statement reporting purposes. For example, some insurance companies may have historically accounted for retro debits as part of written premiums rather than

as a reduction to the unearned premium liability on the annual statement.

Furthermore, there may be differences between companies as to when they accrue retro debit adjustments . The fact that . For example, the fact that other insurance
companies reported retro debits in written premiums on the annual statement .

Sixth, the Taxpayer will argue that, applying the 20 percent haircut to its net retro debit balance, when combined with the discounting of unpaid losses under § 846, does not result in a mismatching of expense, and in fact may more clearly reflect the Taxpayer's economic income than the Commissioner's proposed position in this case. That is, retro debits primarily relate to the Taxpayer's incurred but not reported losses in the workers' compensation business.

On
January 2, 1997, the Service issued proposed

regulations under § 1.832-4 with respect to the treatment of certain items for purposes of applying the 20 percent reduction of unearned premiums under § 832(b)(4)(B). See REG-209839-96, 62 Fed. Reg., at 74. One of the notable items in these proposed regulations is that they modify the treatment of retro credits under the existing regulations, so that retro credits are no longer required to be included in the amount of unearned premiums under § 832(b)(4). The proposed regulations also provide that retro debits must be reported in gross premiums written for the taxable year in which these additional premiums can be reasonably estimated based on information used to compute the insurance company's loss reserves. Thus, under the proposed regulations, a insurance company with retro debits in excess of retro credits would take the excess of debits over credits into account as part of net written premiums under § 832(b)(4) (100% of which are included in premiums earned), rather than as a net reduction to unearned premiums (only 80% of which would be included in premiums earned.).

According to the preamble to the proposed regulations, the Service believed that the change in treatment of retro credits was appropriate because retro credits reflect the company's liability for return premiums attributable to expired coverage periods and, therefore, should be accounted for as adjustments to earned premiums rather than as part of unearned premiums. The preamble also states that subtracting retro debits from unearned premiums reduces the acceleration of income under the 20 percent reduction rule under § 832(b)(4)(B) and, in the case of an insurance company with retro debits in excess of other unearned premiums, would allow the company to report a lesser amount of earned premiums for tax purposes than for financial reporting purposes. The preamble states this result is contrary to the Congressional intent to accelerate the recognition of premiums earned to compensate for the current deductibility of agents' commissions and other premium acquisition expenses under annual statement accounting rules.

These regulations are proposed to become effective for reporting premiums earned with respect to insurance

contracts issued or renewed during taxable years beginning after the date of publication of final regulations in the Federal Register. The proposed regulations do not provide a transition rule with respect to items that were not treated in conformity with the new rules in prior periods, or address the question of whether an insurance company may adopt the new rules for computing premiums as a change in method of accounting deemed made with the Commissioner's consent, with an attendant spread of § 481(a) adjustment.

The Government's position in the present litigation would essentially place the Taxpayer in the same position as would have been the case if the Taxpayer had adopted the treatment of retro debits and retro credits in the proposed regulations from inception. However, since the proposed regulations under § 1.832-4 were not even available for the years at issue, the Taxpayer will presumably argue that these regulations should be given no legal weight or that by issuing these proposed regulations the Commissioner was giving Taxpayers notice of a change in the administrative position followed since Bituminous Casualty and Rev. Rul. 73-302. The Taxpayer may cite the issuance of these regulations in support of its argument that, for the years at issue, it was entitled to include both retro credits and retro debits as part of unearned premiums for both annual statement and tax reporting purposes.