OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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MEMORANDUM FOR Thomas R. Roley
Director, Office of Corporate & Individual Income Tax
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Attn: Tony Seidel

FROM: Donald J. Drees, Jr. Donald J. Drees Jr.
Senior Technician Reviewer,
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SUBJECT: [redacted]

[redacted]

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As the facts state in the TAM, Taxpayer represents that the annual estimated premium is undeterminable at the inception date of the policy and rarely, if at all, has a relationship of the actual amount of premiums ultimately collected from the policyholder. The premiums vary with the production of the insured. Taxpayer represents that this is common in the insurance industry for those insurers who underwrite the contractors and other industries which have variable, unpredictable, payrolls or production patterns. Further, it is represented that the inclusion of annual estimated premium on Taxpayer's policies is required by the National Council on Compensation Insurance (NCCI) rules.

An annual estimated premium is prepared and included on the face of the policy issued by Taxpayer. Taxpayer does not require the annual estimated premium to be paid by the policyholder at the time the policy is issued. At the time the policy is issued (contract is written but prior to the effective date of the policy), Taxpayer does require the payment of a premium "deposit". The stated purpose of the "deposit" is to secure performance by the policyholder of its obligation under the policy.

The premium "deposit" is determined by Taxpayer in accordance with NCCI guidance. NCCI operates as the statistical rating agent for the majority of the states in which Taxpayer operates. The "deposit" is not required by the applicable state insurance regulators.

The policy requires a "deposit" and that the carrier shall establish the amount of the "deposit". The amount of the deposit is based on the insured's credit history, the coverage risk and the policyholder's past payment performance with Taxpayer, and the method of payment of the insured. The majority of policyholders pay the "deposit". The "deposit" ranges from 1% to 15% of the estimated annual premium or it may be a flat dollar amount. In some instances the "deposit" that is paid is the same amount as the estimated annual premium. As required by the NCCI, the policyholder has 3 days after the inception date of the policy to cancel and receive a refund of the entire "deposit". No restrictions are placed on the use of the "deposit" funds held by Taxpayer and the funds are not segregated in separate accounts. The funds may be used by Taxpayer for investment and/or business activities. There is no specific requirement in the policy place on Taxpayer to return the deposit. Taxpayer represents, however, that its policy is that agents explain the nature of the "deposit" to all policyholders, that the "deposit" is refundable or may be applied to the renewal policy.

Monthly premium payments are required from the policyholder after the end of each monthly reporting period of the annual policy period. The policyholder calculates and submits the payment based on actual production and /or payroll figures which are directly related to the prior month. This information as well as the monthly payment are submitted by the insured to the insurance agent. The agent then submits the information to Taxpayer. If during the policy period the insured does not make a monthly payment, Taxpayer may cancel the policy and utilize the premium "deposit" towards the missed monthly payment.

A final audit is conducted by Taxpayer at the end of the annual policy period. Taxpayer is required to perform the final audit within 90 days of the end of the annual policy period. Taxpayer represents that the audit is generally completed within 30-45 days. If a policy is canceled during the policy year, Taxpayer performs the audit at that time. Taxpayer represents that the "deposit" is always refunded at a final audit on canceled policies when the policyholder fulfills the obligations under the policy. If the policyholder fails to fulfill the contractual obligations of the policy- payment of monthly premiums- the "deposit" may be utilized by the company to offset the balance due. In the event that the "deposit" is greater than any balance due, then the remaining "deposit" is refunded to the policyholder. The policyholder also has the option to apply the refundable balance to the succeeding year's policy "deposit".

For purposes of determining taxable income for companies taxable under section 831 of the Code, section 832(b)(1) defines the term gross income. Gross income includes the combined gross amount earned during the taxable year, from investment income and from underwriting income computed on the basis of the underwriting and investment exhibit of the National Association of Insurance Commissioners (NAIC) and all other items constituting gross income under Subchapter B (Computation of Income) and premium deposits. See also section 1.832-4(a) of the Income Tax Regulations.

We continue to maintain that the so called "deposit' is an insurance premium. It is paid for insurance coverage. Taxpayer considers the coverage risk in establishing the amount of the "deposit". Virtually all policyholders (99%) pay a deposit. The "deposit" pays for coverage for at least the first month of the policy and possible the entire policy if future payments are not made and the policy is canceled. The policy provides that the deposit is paid at the time the policy is written. Policyholders are billed monthly in arrears for coverage that has already been provided. The policyholder receives a refund only because the contract is terminated and a determination has been made that all premiums have been paid. If, however, the final premium exceeds those paid by the policyholder, additional premium is due to Taxpayer.

Accordingly, when the policy is written and the "deposit" is paid, Taxpayer will recognize as gross premiums written both the estimated annual premium and the "deposit" paid. Taxpayer will also set aside a major portion of the annual premium and "deposit" as the unearned premium because it has not been earned. Taxpayer will take into account in computing gross income the 80% change in the unearned premiums for the taxable year. When and if the policy is canceled or the policy is terminated and the audit complete and if the premium is returned, then that premium amount will reduce the gross written premium. A return premium can include refunds or credits due to policy cancellations, errors in premium billings, changes in coverage or rates and repayment of a portion of the premium based on an insured's actual loss experience (retrospective rate credit). KPMG Federal Taxation of Insurance Companies at 4024 (1984).

The treatment of Taxpayer who charges a "deposit" to cover insurance provided and also bills in arrears, and a taxpayer who bills the first of the month are consistent. Both have charged a premium for insurance coverage to be provided. Taxpayer, however, has received a payment of additional premium for insurance coverage to be provided for a minimum of 1 month and which is not required by contract to be returned to the policyholder. In your example, for instance, two insurance companies (X and Y) each issue a policy for the period 10/1/98-9/30/99. Company X requires a premium payment of $1,000 on 10/1/98 at the inception of the policy and on the first day of the succeeding month of coverage. Thus, the contract price for the period 10/1/98-9/30/99 is $12,000. This is the gross written premium. Company Y requires a "deposit" premium of $1,000 on 10/1/98 at the inception of the policy and then requires a premium payment one month in arrears for the insurance coverage provided. The "deposit" is in addition to the estimated annual insurance premium of $12,000. The gross written premium in this instance is $13,000. The gross written premium is not identical for both companies because $1,000 "deposit" charged by Company Y is a premium payment for coverage that is provided by Company Y in the first month of the policy. Accordingly, the tax liabilities will not be the same for both Company X and Company Y.