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May 01, 2001

Internal Revenue Service
National Office Technical Advice Memorandum

Taxpayer:

Taxpayer's Address:

Taxpayer's Identification Number:

Years Involved:

Date of Conference:

LEGEND:

X =

Year 1 =

Year 2 =

Year 3 =

Year 4 =

Year 5 =

Year 6 =

Year 7 =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

CONCLUSIONS:

1. For purposes of determining premiums earned under section 832(b)(4) of the Internal Revenue Code for retrospectively rated insurance policies, X may not use the accrual method of accounting for reporting retrospective debits (retro debits) and retrospective credits (retro credits) relating to the expired portion of unexpired insurance policies.

2. X is required to include retro debits in gross premiums written for purposes of determining premiums earned under section 832(b)(4) of the Code and X must include retro credits in unearned premiums pursuant to section 1.832-4(a)(3)(ii)[1] of the Income Tax Regulations.

FACTS:

X is a property and casualty insurance company, taxed under the provisions of Part II of Subchapter L of the Internal Revenue Code. X offers retrospectively rated insurance policies. Generally, retro debits represent premiums due from policyholders on retrospectively rated insurance policies when at the end of the policy year, the actual premium calculated based on a formula which takes into account the amount of losses and loss expenses incurred, exceeds the contract's initial premium. Retro credits represent amounts owed to policyholders when the contract's initial premium exceeds the actual premium.

Prior to Year 6, X used the reserve method for determining when to report retrospective adjustments on unexpired policies for both annual statement and federal income tax purposes. X began to use the accrual method of accounting for retrospective adjustments on unexpired policies, for tax purposes, after this method was proposed by the Service in audit adjustments to retrospective credits for Year 2. During Year 2, X only had retro credits. X's annual statements do not indicate that there were any retro debits in the Year 3 tax years. X, however, contends that there were retro debits. A technical advice memorandum covering Year 3 was issued on Date 2. The technical advice memorandum was the basis for Revenue Ruling 67-225, 1967-2 C.B. 238.

The accrual method of accounting for the retrospective adjustments was again raised for Year 4. The issue for Year 2 was settled by the Appeals Office on Date 3. X agreed to a disallowance of the portion of its liability (retro credits) for retrospectively rated policies attributable to policies which had not expired as of Date 1. X continued to use the reserve

[1] All references to the regulations under section 832(b) of the Code are to the regulations in existence during the tax years in question.

method for Year 5. During these years X had a retro credit balance. The examining agent again disallowed a portion of the retro credits to place X on the accrual method of accounting. X agreed with these audit adjustments without protesting the issue to Appeals. These audits were completed Date 4.

During the Year 6 audit, the examining agent did not propose any audit adjustments to the retro credits. This audit was completed Date 5.

The issue of whether an insurance company could deduct a retro credit reserve as part of the unearned premium reserve was litigated in Bituminous Casualty Corp. v. Comm'r. 57 T.C. 58 (1971), acq. in result 1973-2 C.B. 1. In that case, the Tax Court held that Bituminous correctly included reserves for retro credits in the unearned premium reserve. In addition, the court held that the reserves were reasonable estimates of the portions of premiums otherwise earned at the end of each taxable year which would be required to be returned to policyholders. The Service acquiesced in result only to the decision and issued Revenue Ruling 73-302, 1973-2 C.B. 220 which revoked Rev. Rul. 67-225. At the time of the Year 6 audit, Rev. Rul. 73-302 had been issued. X represents that for the tax years beginning in Year 6 and for all subsequent years, all income tax returns were prepared on the accrual method as first required in the Year 2 audit. Further, the issues of whether X could use the accrual method of accounting for retro debits and credits and whether X could net the retro debits and retro credits in the unearned premium reserve, were not raised until Year 7 was examined.

Congress enacted, in the Tax Reform Act of 1986, sections 832(b)(4)(B) and (C) which disallowed a deduction for 20% of the annual change in the unearned premium reserve for years after 1986.

Based on this change in law, the examining agent proposed a change to X's method of accounting for retrospective adjustments, for Year 7. During these audit years, X's retrospective adjustments were net retro debits. The examining agent could not determine the actual amounts of retro credits that were a part of the net retro debit balance. For tax purposes, X employed the accrual method of reporting retrospective adjustments relating to the expired portion of unexpired polices. Under this method, for example, if a contract had a policy year of 7/1/87-6/30/88 with a contract premium of $1,000.00, X would report half of the premium ($500.00) in unearned premium reserve for the 12/31/87 tax year end. On 12/31/87, if X estimated that there was a retrospective debit of $100.00, X would not report the estimated debit in either the gross premiums written or in the unearned premium reserve on the basis that the all events test under section 451 of the Code had not been met. The examining agent proposed taking the unaccrued retrospective adjustments into account on a reserve method, the same method as X used for the Annual Statement. The examining agent made an adjustment taking the estimated unaccrued retro debits into account in gross premiums written.

In calculating the unearned premium reserve, X included both retro debits and retro credits on expired policies. Thus, if in the tax year ended 12/31/88, X calculated that there was a

$200.00 retro debit earned on the 7/1/87-6/30/88 contract year, X would report $200.00 relating to the expired policies in the unearned premium reserve. The examining agent removed from the unearned premium reserve the retro debits and reported the retro debits in gross premiums written. The examining agent represents that X has taken the net retro debits or credits into account as part of the unearned premium reserve for both annual statement and income tax purposes.

LAW & ANALYSIS:

Issue 1

Section 832(b)(1) provides, in part, that the gross income of an insurance company subject to tax under section 831 includes its investment and underwriting income, computed on the basis of the annual statement approved by the National Association of Insurance Commissioners plus gains from the sale or other disposition of property and other items constituting gross income under the general rules of inclusion applicable to all taxpayers.

Section 832(b)(3) defines underwriting income as the premiums earned on insurance contracts during the taxable year, less losses incurred and expenses incurred. Prior to the amendment to section 832(b)(4), a premium was not considered to be earned until the risk relating to the premium had expired. Thus, it was only as amounts left the unearned premiums reserve that they became an item of gross income, Federal Union Insurance Company v. Comm'r., 5 T.C. 374, 377 (1945), acq., 1946-1 C.B. 2. In 1986, Congress expanded the definition of "premiums earned" to include 20% of the unearned premiums.

Section 832(b)(4) defines premiums earned on insurance contracts during the taxable year as the gross premiums written on insurance contracts reduced by return premiums and premiums paid for reinsurance. This amount is increased by 80 percent of the unearned premiums on outstanding business at the end of the preceding taxable year and is decreased by 80 percent of the unearned premiums on outstanding business at the end of the current taxable year.

Section 1.832-4(a)(2) of the Income Tax Regulations provides, in part, that the underwriting and investment exhibit of the annual statement is presumed to reflect the true net income of the insurance company, and insofar as it is not inconsistent with the provisions of the Code will be recognized and used as a basis for that purpose. This regulation also recognizes, however, that all items of the underwriting and investment exhibit do not reflect the company's true net income under the Code.

Section 1.832-4(a)(3)(ii) provides in computing "premiums earned on insurance contracts during the taxable year" the amount of unearned premiums includes, in part, the liability for return premiums under a rate credit or retrospective rating plan based on experience.

Under the provisions of section 832(b), a property and casualty insurance company

determines its underwriting income on a reserve method which includes estimates for such items as losses incurred and premiums earned. Thus, under this method, the insurance company generally records the gross premiums written for an insurance policy (net of return premiums and premiums paid for reinsurance) for the taxable year in which the policy is issued. The insurance company will also establish an unearned premium liability to reflect the portion of the gross premiums written which relates to the unexpired portion of the insurance coverage. The insurance company receives a deduction for the increase in the unearned premium liability which serves to defer the portion of the insurance company's premiums still in force which are attributable to coverage in a future taxable year.

The Annual Statement was devised for the purpose of regulatory reporting. The focus of the Annual Statement is the solvency of the company. The purpose of the provisions under Part II of Subchapter L of the Code is to determine taxable income of a company. Although Congress enacted provisions relying, in part, on the Annual Statement because of the unique business which takes income in first and then incurs the related claims and expenses, the statute does not provide that income is computed as it is on the Annual Statement. Section 832(b)(3) indicates that, in part, the income of a property and casualty insurance company is computed on the basis of the NAIC Annual Statement. The section does not, however, indicate that the income is taken from the NAIC annual statement nor does it state that income is computed as on the same methods approved by NAIC Annual Statement. The statute also does not mandate the use of the Annual Statement. The court in Commissioner v. General Reinsurance Corp. 190 F 2d 148, 151 (2d Cir. 151) highlighted a provision of the property and casualty insurance provisions which did not specifically follow the Annual Statement. For Annual Statement purposes, the taxpayer was not permitted to adjust its loss and unearned premium reserves to take into account the effect of reinsurance with unauthorized companies. The court determined that the statute provided that reinsurance was to be taken into account without any distinction between authorized or unauthorized reinsurance.

X contends that section 803 provides for the inclusion in life insurance gross income of the gross amount of premiums, and under section 807 this includes an adjustment for changes in the unearned premium reserve. Further, X contends that section 811 and the legislative history of section 811 make clear that life insurance companies must use the accrual method of accounting. Thus X argues, based on the fact that life companies have a similar methodology of recognizing gross income with an adjustment for an unearned premium reserve, it follows that property and casualty insurance companies may also use the accrual method. However, section 811 specifically states that all computations entering into the determination of taxes imposed by this part shall be made 1) under an accrual method of accounting or 2) to the extent permitted under regulations prescribed by the Secretary, under a combination of an accrual method of accounting with any other method permitted by this chapter (other than the cash receipts or disbursements method).

Neither section 832(b)(3) nor section 832(b)(4) of the statute use the term "accrual" or refer to the "accrual method of accounting." Nor are there other provisions under Part II of Subchapter L that refer to the exclusive use of the accrual method of accounting. When

Congress intended the use of the accrual method the statute provided so. In particular, section 832(c) provides that expenses incurred are deductible if they meet the ordinary and necessary provisions of section 162. The reference to section 162 in turn incorporates the use of the accrual method of accounting.

The concept addressed in section 832(b)(4) is how to measure at the end of the annual accounting period, the premium income from a contract providing coverage for a specific period of time (annual accounting period). Therefore, at the end of the accounting period, premium income would include estimated retro debits. As originally enacted in the 1921 Act, section 832(b)(4) (formerly section 246(a)(5)) calculated premiums earned on insurance contracts during the taxable year as follows:

> "From the amount of gross premiums written on insurance contracts during the taxable year, deduct return premiums and premiums paid for reinsurance. To the result so obtained add unearned premiums on outstanding business at the end of the preceding table year and deduct unearned premiums on outstanding business at the end of the taxable year."

Thus, "gross premiums written" as drafted in section 832(b)(4) was not written suggesting that gross premiums written was determined on a limited basis such "as paid", "as stated on the Annual Statement", "as billed" or "as accrued." This is consistent with the 1920 Annual Statement which defined gross premiums broadly as "the aggregate of all the premiums written in the policies or renewals issued during the year." The definition in the 1920 Annual Statement was broad enough to cover retro debits even though they were not in existence at the time.

Starting with the all-encompassing gross premiums written concept, the determination of premiums earned does not result in an accrual method or necessarily one of the methods allowed for Annual Statement purposes. The method as prescribed does however result in an insurance company taking estimates into account. The court in Bituminous acknowledges that, "the annual statement method of accounting relies extensively on the use of estimated amounts which would be improper under general tax accounting. Thus, for example, instead of taking into income all of the premiums received or accrued, casualty insurance companies take into account only the portion of those premiums which are estimated to be 'earned'." 57 T.C. 58, 77.

Premiums that are written on a contract are recognized as gross premiums written. The premiums related to coverage that has not been provided are set aside in an "unearned premium reserve". Historically, the unearned premiums reserve has represented the amount required to be set aside out of premiums to compensate some reinsurer if, in the event of insolvency, it is necessary for the reinsurer to fulfill the original insurer's obligations to policyholders for periods subsequent to the date of reinsurance. Bituminous Casualty at 81.

X contends that the inherent conservatism of the insurance regulators requires a deferral

of recognition of anticipated future income or assets until the actual receipt of such amounts is certain and therefore many states interpret these rules as not permitting estimates of premiums to be included in gross premiums written. However, it should be noted that:1) in the 1980s, the NAIC manual and instructions were silent as to treatment of earned but unbilled premiums as gross premiums written and 2) in 1986 the IASA's "Property-Liability Insurance Accounting", 112 (1986) provided that "the earned but unbooked premiums may be recorded as written premium, or as a reduction of the unearned premium reserves, or as an offset to loss reserves, or not recorded at all." Further, the 1994 NAIC Manual, "Premiums" section 14-2 (1994) provides that with respect to earned but not billed premiums a company has an option and may recognize as an asset accrued earned but unbilled premiums.

Section 446 provides that if the method of accounting used by a taxpayer does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income.

X contends that it has consistently followed the accrual method of accounting for income tax purposes since it was placed on that method by the examining agents forYear 1. Further, this method has never been challenged by an examining agent for 25 years. X argues that the Tax Court in Bituminous Casualty did not suggest that the accrual method of accounting did not clearly reflect income nor did it state that the method was impermissible. In addition, the Service 1) did not state that the accrual method was no longer permissible or prescribe a particular method of accounting in Rev. Rul. 73-302; and 2) did not revoke the prior technical advice memorandum.

In Rev. Rul. 67-225, the Service took the position that an estimated retrospective rate credit with respect to the expired portion of a casualty insurance policy which does not terminate on or before the end of the taxable year does not qualify as an unearned premium within the meaning of section 1.832-4(a)(3)(ii) defining "unearned premiums" to include "a liability for return premiums under a rate credit retrospective rating plan based on experience". The Service took the position that the term "liability" as used in section 1.832-4(a)(3)(ii) was limited to accrued liabilities which satisfied the "all-events test."

The court in Bituminous Casualty rejected the Service's position in Rev. Rul. 67-225 that under section 1.832-4(a)(3)(ii) the liability for an estimated retro credit with respect to the expired portion of a casualty insurance policy that did not terminate on or before the end of the taxable year did not qualify to be deducted as part of unearned premiums. With respect to the taxpayer's reserve for retro credits, the court reasoned that section 1.832-4(a)(3)(ii) was directly on point and "could hardly be more explicit." 57 T.C. 82. The retro credit reserves were therefore expressly allowable under the regulations as a "liability for return premiums." The court, in analyzing the method of accounting for non-life insurance companies stated that "casualty insurance companies take into account only the portion of those premiums which are estimated to be earned." The court continued: "major deductions from income are 'losses' and 'loss adjustment expenses,' which are again estimated amounts. The deduction of these losses

and loss adjustment expense items is fundamentally at odds with the ‘all events’ test: The items include amounts for liabilities which are not established, but on the contrary, vigorously contested; they include, in the case of the loss adjustment items, expenses which will not only be paid in the future, both which are attributable to events which will not even occur until the future...” 57 T.C 77. Thus, it is clear that the earned method under section 832(b)(4) is consistent with the method employed in determining the related unpaid losses and unpaid loss adjustment expenses. Insurance companies may estimate these expenses for events that have occurred even though the liability is not fixed and determinable.

Contrary to X’s argument, the court made it very clear that Rev. Rul. 67-225, requiring the accrual method, was not only erroneous but invalid. The court stated that the revenue ruling was 1) inconsistent with the plain language of the regulations; 2) seeking to apply an “all events test” to insurance liabilities in a manner inconsistent with the intent of Congress, the Treasury regulations, and established industry practice; 3) wrong in its interpretation of the regulations; and 4) contrary to the “legislative history”of the regulations. 57 T.C. 82 n.2

X relies on The Travelers Insurance Co. v. U.S., 35 Fed. Cl. 138 (1996), Gerling International Insurance Co., 98 T.C. 640 (1992), and Utah Medical Insurance Association v. Comm’r, T.C. Memo 1998- 458 (1998) to support the proposition that the law precludes the Service from changing a taxpayer’s method of accounting simply because it prefers one method over another. In our opinion, these cases are all factually distinguishable from X. Gerling is distinguishable from X because it is a burden of proof case addressing the responsibility of the company to provide gross amounts for premiums, losses and expenses and a timing issue as to which year Gerling should report information shown on its reinsurance statements. Utah Medical is distinguishable because it addressed the reasonableness standard imposed on losses incurred.

The court in Travelers stated that section 446(b) has a 2-prong test. First, the Service has an obligation to prove that the X’s method of accounting does not accurately reflect income and second, that the Service’s method of accounting does clearly reflect income. Thus, the Service may not change a taxpayer from one permissible method to another permissible method of accounting.

Section 446(a) provides that taxable income is computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.

Section 1.446-1(a)(2) provides, in part, that it is recognized that no uniform method of accounting can be prescribed for all taxpayers. Each taxpayer shall adopt such forms and systems as are, in his judgement, best suited to his needs. However, no method of accounting is acceptable unless, in the opinion of the Commissioner, it clearly reflects income.

Section 446(b) provides that if no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable

income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income.

The issue in Travelers was whether the Service abused its discretion under section 446 in determining that Travelers' profit and loss method for translating its profits and losses from foreign operations into United States dollars did not clearly reflect income. Travelers employed a method that was similar to the profit and loss method. Travelers calculated its taxable gain and income by computing the net amounts in foreign currency and then translating them into U.S. dollars according to the year-end exchange rate. Relying on section 446(b), the Service recomputed Travelers' income by converting each line-item amount attributable to foreign operations into U.S. dollars, combining that amount with U.S. dollar amounts from Travelers' other operations and then reporting the total in U.S. dollars. Also, the Service translated certain assets using historic exchange rates and other reportable items using the current, end-of-year exchange rate. At the time, neither the Code nor regulations prescribed a method of accounting. However, the Service permitted in Rev. Rul. 75-107, 1975-1 C.B. 32, the "profit and loss" method and in Rev. Rul. 75-106, 1975-1 C.B. 32 , the "net worth" method. The "profit and loss" method provided that the foreign income was calculated by translating the collective results of branch operations. The court determined that Traveler's method was essentially that described in Rev. Rul. 75-107.

The situation in Traveler's is distinguishable from X's. First, as the court ruled in Bituminous, the statute is clear with respect to the calculation of earned premiums. The methods of accounting at issue with X involve two distinct methods: accrual and reserve. The court in Bituminous rejected the accrual method of accounting. The court's decision provided that the reserve method clearly reflects income under section 1.446-1(a)(2). The Service affirmed that the accrual method is an incorrect method of accounting and that the reserve method is the proper method by revoking Rev. Rul. 67-225 with the issuance of Rev. Rul. 73-302. The issue in Travelers' was the interpretation of one method - the "profit and loss" method. The court was asked to place Travelers' on the Service's interpretation of the "profit and loss" method. The court indicated that Travelers' method was "the crux of the profit and loss method described in Revenue Ruling 75-107." 35 Fed. Cl. 138, 142.

The Service may change a taxpayer from an impermissible method to a permissible method of accounting. The Commissioner has broad discretion to determine whether in his opinion a taxpayer's accounting method clearly reflects income. American Automobile Association 367 US 687 (1961) and Thor Power Tool Co. v. Comm'r, 439 US 522, 532 99 S. Ct. 773 (1979) .

We agree with the agent that X must employ the reserve method of accounting as prescribed in section 832(b)(4) to determine earned premiums. The accrual method is not a permissible method of accounting with respect to the recognition of premiums earned.

Issue 2

The examining agent's position is that, for purposes of determining premiums earned under section 832(b)(4), retro debits should be recognized as gross premiums written because they represent premiums to be collected for coverage already provided. Further, by netting the retro debits and credits in the unearned premium reserve, X is able to defer the recognition of 20% of amounts which are in substance earned. When debits are placed in the unearned premium reserve, they reduce the unearned premium reserve balance. Thus, the 20% addition to the gross premiums written is reduced. The retro debits would therefore not be recognized until they are paid and placed in gross premiums written.

X contends that since Year 1, it has consistently taken net retro adjustment into account as part of the unearned premium reserve. Because this issue was not raised until the Year 7 audit, X contends that the Service has accepted the netting of debits and credits in the unearned premium reserve. X believes that the Tax Court in Bituminous Casualty also accepts the netting of debits and credits. Further, X contends, if retro debits are excluded from the unearned premium reserve, the 20% addition to gross premiums written is maximized.

Prior to 1987, the treatment of retro debits as either reductions or negative offsets to unearned premiums, or as adjustment to written premiums had no impact on a property and casualty insurance company's taxable income. However, section 832(b)(4)(B), as enacted by the 1986 Act, requires a property and casualty insurance company to compute premiums earned by taking into account 80%, rather than 100%, of the change in "unearned premiums' during the year. Accordingly, the placement of the retro debits and credits in gross written premiums or unearned premium reserve change had a significant impact on the computation of a property and casualty insurance company's taxable income.

In the Tax Reform Act of 1986, ("1986 Act"), Congress amended the provisions of section 832(b)(4) to reduce a property and casualty insurance company's deduction for net increases in unearned premiums by 20 percent. Accordingly, for a taxable year beginning after 1986, only 80% of the net increase in unearned premiums during the taxable year is deductible in computing premiums earned under section 832(b)(4). And conversely, a net decrease in unearned premiums results in an increase in premiums earned under section 832(b)(4). The 1986 Act included a transition rule whereby 20% of an insurance company's unearned premiums at the close of 1986, which would otherwise not be taken into account in determining premiums earned for taxable years after 1986, would be included in premiums earned ratably over a 6-year period, beginning in 1987. The 20% reduction applied to the unearned premiums is known as the "20% haircut."

The legislative history indicates that Congress enacted the 20% haircut in order to address a mismatching of income and expenses, and a consequent mismeasurement of income, that occurred under the prior law pattern of taxing property an casualty insurance companies. Prior to the 1986 Act, property and casualty insurance companies were generally allowed to deduct agents' commissions and other premium acquisition expenses in the year incurred, and also to exclude the full amount of increase of unearned premiums. Congress believed that allowing both

a deferral of unearned premiums and a current deduction for the corresponding premium acquisition expenses resulted in a significant mismatching of income and expenses for Federal income tax purposes.

To correct this mismatching, the 1986 Act amended the provisions of 832(b)(4) to reduce the deduction for increases in unearned premiums by 20%. Although these amendments operate to accelerate the rate in which the unearned premiums are included in taxable income, Congress viewed this approach as equivalent to denying current deductibility for a portion of an insurance company's premium acquisition expenses. See 2 H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-354 (1986), 1986-3 C.B. (Vol.4) 354-55; S. Rep. No. 313, 99th Cong., 2d Sess. 486-98 (1986), 1986-3 C.B. (Vol.3) at 495-98; H.R. Rep. No. 426, 99th Cong., 1st Sess. 496 (1985), 1996-3 C.B. (Vol. 2) 668-70.

Congress intended to apply the 20% haircut to all amounts (other than life insurance reserves and title insurance reserves) that were considered unearned premium reserves for tax purposes as of 1986. The House report underlying the amendments to section 832(b)(4) states that "[a]ll items which are included in unearned premiums under section 832(b) of present law are subject to this reduction of the deduction ." H.R. Rep. No. 426, 1986-3 C.B. (Vol. 2) at 669. In describing the House bill, the Conference Report reiterates that "[a]ll items which are included in this reduction in the deduction" and describes the Senate amendment as "the same as the House bill, except that the life insurance reserves which are included in unearned premiums reserves under section 832(b)(4) are not subject to this reduction." 2 H.R. Conf. Rep. No. 841, 1986-3 C.B. (Vol.4) at 354-355. The Report's description of the Conference agreement states that the agreement "follows the Senate amendment" but "provides special treatment of title insurance unearned premium reserves." Id.

Although with the change in law in 1986, the placement of retro credits and retro debits had an impact on the computation of premium income, the definition of unearned premiums, retrospective credits and retrospective debits has not changed. Premiums are generally earned for annual statement purposes through the passage of time (the premium is earned over the term of the policy). An unearned premium for annual statement purposes represents the amount of written premium relating to the unexpired potion of all the policies on the insurer's books which should be excluded from the income statement. Thus, the purpose of the unearned premium reserve is to set aside amounts to met future obligations on behalf of the insurer. Unearned premiums are generally viewed as having the following characteristics: 1) are attributable to the unexpired part of policies in force; 2) must be returned to policyholders upon cancellation of the policy; and 3) provide funds if the policies are reinsured. KPMG Peat Marwick, Federal Taxation of Insurance Companies, sec. 40.01 at 4017 (1991).

Neither the Code nor the Income Tax Regulations under section 832 define the term "unearned premiums." The term "unearned premiums" historically has meant that portion of premiums that had to be returned to the policyholder on the cancellation of the policy and that was also in direct proportion to the unexpired term of the policy. Buckeye Union Casualty Co.

v. Commissioner, 448 F.2d 230 (6th Cir. 1971), aff'g 54 T.C. 13, 20 n.5 (1970). Rev. Rul. 61-167, 1961-2 C.B. 130, defines the term "unearned premiums" generally to mean that portion of the premiums which the insurance company has not yet had time to earn or, more precisely, that portion of the premiums paid by the policyholder which must be returned to him on cancellation of the policy and which is in direct proportion to the unexpired term which the policy has to run.

Section 1.832-4(a)(3)(ii) provides that in computing "premiums earned" the amount of unearned premiums includes the liability for return premiums under a rate credit or retrospective rating plan based on experience, such as the "War Department Insurance Rating Plan," and which return premiums are therefore not earned premiums." Retro debits are not unearned premiums because they represent amounts earned for coverage already provided. Retro debits are earned premiums because the related risk period for which the premium is owed has expired. Massachusetts Protective Assn. v. U.S., 114 F.2d 304, 312 (1st Cir. 1940), 1941-1 C.B. 383. These debits are not amounts set aside for future obligations. Retro debits represent amounts earned by the insurer and owed by the insured (a receivable to the insurer) for insurance coverage already provided.

Similarly, the NAIC Manual, "Unearned Premiums", section 12-1 (1980) provides that "at the expiration of an insurance contract or policy, the entire premium has been earned. At any point prior to expiration, the company is required to establish a pro rata portion of the premium as a liability to cover the remaining policy term. The company's total unearned premium reserve represents the unearned premium liability for all policies in force." Thus, retro debits represent amounts that are earned not unearned. Companies, however, have netted retro debits and retro credits in the unearned premium reserve for annual statement purposes. Although X contends that the Annual Statement (section 12-2 of the NAIC Manual) provides a company the leeway in its methodology to determine the unearned premium reserve, X also acknowledges that the regulators are concerned about the undisclosed retro debits. Accordingly, line 33, labeled "Accrued Retrospective Premiums Based on Experience" was added to the 1988 Annual Statement. Line 33 as described in section 8-2 of the 1992 Instructions, is the positive amount, the total of accrued retrospective debit adjustment based on experience included as negative amounts in Column 4.

We conclude that retro debits are not includible in unearned premiums under section 832(b)(4)(B). X's retro debits represent estimates of additional premiums expected to be collected from policyholders with respect to coverage that has already been provided under the policy term. Retro debits are premiums that have already been earned during the period of coverage to which they relate and not amounts held to meet X's future obligations.

The treatment of retro debits as reductions to unearned premiums under section 832(b)(4)((B) is contrary to the rationale of the 20 percent haircut. The rationale of the 20 percent haircut is to accelerate earned premiums to compensate for the distortion created by the expensing of premium acquisition costs on the annual statement. Rather than defer a portion of a nonlife insurance company's premium acquisition expenses, which would have involved difficult

measurement issue, Congress chose to accelerate the rate at which unearned premiums flow into taxable income. If retro debits are treated as reductions to unearned premiums, this would reduce the amount of unearned premiums subject to the 20 percent haircut and defer the recognition of gross premiums written as earned premiums until the retro debits are paid and recognized in gross premiums written . We do not believe that Congress intended this result.

X contends that the decision in Bituminous Casualty acknowledges that retro debits and retro credits are netted in the unearned premium reserve. The taxpayer in Bituminous Casualty, computed, and included in its unearned premium reserve:

> ...a reserve for retrospective rate credits [which] consisted of its estimate... of that portion of its earned premium... attributable to retro policies that would thereafter be refundable to policyholders, net after deductible additional premiums collectible under the formulas in such policies. (57 T.C. at 61)

Although the court acknowledged the netting of retro credits and debits in arriving at the taxpayer's reserve, the court's holding was merely directed at the application of section 1.832-4(a)(3)(ii). The netting of retro debits and retro credits was not an issue before the court, and would not have made any difference under the provisions of section 832(b)(4) then in effect. Thus, this office does not believe that Bituminous Casualty is controlling authority for purposes of the issue of whether retro debits and retro credits are netted in the unearned premium reserve.

X also contends that if retro debits are included in gross premiums written, X must be allowed an offsetting deduction or there is a mismatching of income and expense. We disagree. X must refer to sections 832(b)(4), 832(b)(6), and 832(c). Each of these provisions provide the method for determining and time for recognizing the income and related expense. Both sections 832(b)(4) and 832(b)(6) use the Annual Statement as a basis but provide for certain adjustments which take into account estimated amounts. Section 832(c) identifies which deductions are allowed and establishes the time for the deduction by its reference to section 162. These provisions illustrate, as explained in section 1.832-(4)(a)(2), that the intended purpose is to arrive at the true net income under the Code.

Accordingly, this office agrees with the agent's position that: 1) gross retro credits are included in unearned premiums under section 832(b)(4), and therefore deductible as part of X's net increase in unearned premiums during the taxable year; and 2) gross retro debits are included in gross written premiums under section 832(b)(4).

CAVEAT:

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