

26 CFR 601.204: Changes in accounting periods and methods of accounting.

(Also Part I, § 832; 1.832-4; 1.832-5.)

Rev. Proc. 2002-46

SECTION 1. PURPOSE

This revenue procedure provides certain insurance companies subject to tax under § 831 of the Internal Revenue Code with a safe harbor method of accounting for premium acquisition expenses. This revenue procedure also provides a procedure for insurance companies to obtain automatic consent of the Commissioner to change to this safe harbor method.

SECTION 2. BACKGROUND

.01 Section 832(b)(1) provides that the gross income of an insurance company subject to tax under § 831 includes the company's "underwriting income."

.02 Section 832(b)(3) defines "underwriting income" as "premiums earned on insurance contracts during the taxable year, less losses incurred and expenses incurred."

.03 Section 832(b)(4) provides that to compute premiums earned, an insurance company reduces the amount of gross premiums written on insurance contracts during the taxable year by return premiums and premiums paid for reinsurance. Subject to the exceptions in §§ 832(b)(7), (b)(8), and 833, this amount is increased by 80 percent of the unearned premiums on outstanding insurance contracts at the end of the preceding

taxable year, and is decreased by 80 percent of the unearned premiums on outstanding insurance contracts at the end of the current year. This 20 percent reduction in the amount of an insurance company's deduction for increases in unearned premiums is intended to represent the allocable portion of the company's expenses incurred in generating the unearned premiums. S. Rep. No. 313, 99th Cong. 2d Sess. 496 (1986), 1986-3 (Vol. 3) C.B. 496; H. Rep. No. 426, 99th Cong. 1st Sess. 669 (1985), 1986-3 (Vol. 2) C.B. 669.

.04 Sections 1.832-4(a)(3) through (11) of the Income Tax Regulations, effective for taxable years beginning after December 31, 1999, prescribe specific rules regarding the manner in which an insurance company determines gross premiums written, return premiums, and unearned premiums for purposes of the calculation of premiums earned under § 832(b)(4). These rules apply regardless of the accounting practices used by the insurance company to record gross premiums written and unearned premiums on its annual statement filed for state regulatory reporting purposes. Section 1.832-4(a)(4) defines "gross premiums written" as "all amounts payable for the effective period of the insurance contract." Section 1.832-4(a)(5)(i) generally requires the insurance company to report gross premiums written "for the earlier of the taxable year that includes the effective date of the insurance contract or the year in which the company receives all or a portion of the gross premium for the insurance contract." In some situations, this rule may result in gross premiums written being taken into account in the calculation of premiums earned under § 832(b)(4) for a taxable year earlier than the year in which those written premiums are reported on the company's annual statement.

.05 Section 1.832-4(a)(5) provides special methods of reporting gross premiums written for certain categories of insurance contracts with installment premiums, including contracts for which an advance premium installment is received prior to the effective date of the underlying contract, cancellable accident and health insurance contracts, and certain multi-year insurance contracts with premiums payable at guaranteed rates. To use one of these special methods of reporting gross premiums written, the insurance company must satisfy an annual pro rata expense limitation with regard to the amount of premium acquisition expenses deducted for the underlying contract. Section 1.832-4(a)(5)(vii). This annual pro rata expense limitation ensures that the company does not deduct the premium acquisition expenses for the insurance contract more rapidly than the company includes the gross premiums written for the associated contract in the calculation of premiums earned under § 832(b)(4).

.06 Section 832(b)(6) provides that “expenses incurred” means all expenses shown on the insurance company’s annual statement. Expenses incurred generally are calculated as the sum of the expenses paid during the taxable year, plus the increase in unpaid expenses during the taxable year. To be included in expenses incurred, an expense listed on the annual statement also must be an allowable deduction under § 832(c). Section 832(c) lists various categories of allowable deductions, including “all ordinary and necessary expenses incurred, as provided in §162 (relating to trade or business expenses).” See § 832(c)(1).

.07 The 20 percent reduction in the deduction for increases in unearned premiums under § 832(b)(4) was intended to correct the mismatching that results from

the deferral of unearned premium income and the current deduction of premium acquisition expenses. S. Rep. No. 313, at 496 (1986); H. Rep. No. 426, at 668-69 (1985). Consistent with this intent, the Internal Revenue Service will allow insurance companies within the scope of this revenue procedure to account for premium acquisition expenses using the safe harbor method described in section 5.02 of this revenue procedure.

SECTION 3. DEFINITIONS

The following definitions apply solely for purposes of this revenue procedure.

.01 Premium acquisition expenses. A premium acquisition expense is an expense that is primarily related to the production of gross premiums written on an insurance contract and directly varies with the amount of gross premiums written on the underlying contract. For example, agent and broker commissions, premium taxes, and premium-based assessments generally qualify as premium acquisition expenses because these expenses vary with and are primarily related to the acquisition of gross premiums written on new and renewal insurance contracts. An annual expense allowance payable by a reinsurer to assume all or a portion of the risk on insurance contracts of another insurance company is treated as a premium acquisition expense to the extent that this expense allowance reflects the reinsurer's reimbursement of the premium acquisition expenses incurred by the direct writing company. However, expenditures with respect to salaried personnel and general administrative costs typically will not qualify as premium acquisition expenses. Although a portion of these costs may be associated with activities relating to the issuance of insurance contracts,

these expenditures do not vary directly based on the amount of gross premiums written for the associated contracts.

.02 Pro forma premium acquisition expenses. A pro forma premium acquisition expense is any unpaid premium acquisition expense that is not shown on the insurance company's annual statement for the year in which the insurance company includes the gross premiums written to which that expense relates in the calculation of premiums earned under § 832(b)(4).

.03 Pro forma unearned premium reserve. The pro forma unearned premium reserve is the portion of an insurance company's year-end unearned premiums (other than amounts to which special rules in §§ 832(b)(7)(A) and 832(b)(8) apply) attributable to gross premiums written that are not shown on the company's annual statement, but which the company is required to report in the calculation of premiums earned under § 832(b)(4) for the taxable year in accordance with the provisions of § 1.832-4.

.04 Unearned premium reserve offset amount. (i) Except as otherwise provided in paragraph 3.04(ii), an insurance company determines the unearned premium offset amount for a taxable year by multiplying—

(A) The amount, if any, by which the company's pro forma unearned premium reserve at the end of the taxable year exceeds its pro forma unearned premium reserve at the end of the preceding taxable year, by

(B) .20.

(ii) In the case of a financial guaranty insurer to which the special rules in § 832(b)(7)(B) apply, the unearned premium reserve offset amount is determined by

multiplying the amount, if any, by which the company's pro forma unearned premium reserve for financial guaranty contracts at the end of the taxable year exceeds its pro forma unearned premium reserve for financial guaranty contracts at the end of the preceding taxable year by .10.

SECTION 4. SCOPE

.01 Except as otherwise provided in section 4.02 of this revenue procedure, this revenue procedure applies to any insurance company that is subject to tax under § 831(a) and determines its premiums earned for insurance contracts during the taxable year under § 832(b)(4) in accordance with the provisions of § 1.832-4.

.02 This revenue procedure does not apply to an existing Blue Cross or Blue Shield organization or any other organization to which § 833 applies.

SECTION 5. SAFE HARBOR METHOD

.01 Taxpayers within the scope of this revenue procedure are permitted to account for premium acquisition expenses incurred for taxable years beginning after December 31, 1999 using the safe harbor method described in section 5.02 of this revenue procedure.

.02 Description of Safe Harbor Method. (i) Except as provided in section 5.02(ii) of this revenue procedure, an insurance company is permitted to treat as premium acquisition expenses incurred for the taxable year an amount equal to the sum of—

(A) The amount of premium acquisition expenses paid during the taxable year;

(B) The difference between the unpaid premium acquisition expenses shown on the company's annual statement for the taxable year and the unpaid premium

acquisition expenses shown on the company's annual statement for the preceding taxable year; and

(C) The difference between the amount of the insurance company's pro forma premium acquisition expenses at the end of the taxable year and the company's pro forma premium acquisition expenses at the end of the preceding taxable year.

(ii) Limitation on current deductibility of certain pro forma expenses. For purposes of calculating the premium acquisition expenses incurred for the taxable year under section 5.02(i) of this revenue procedure, the amount taken into account as a net increase in pro forma premium acquisition expenses during the year under section 5.02(i)(C) cannot exceed the insurance company's unearned premium reserve offset amount for that year. If the amount taken into account as a net increase in pro forma premium acquisition expenses during the year under section 5.02(i)(C) is reduced as a result of this limitation, the reduction amount is carried forward and increases the company's pro forma premium acquisition expenses at the end of the succeeding taxable year.

SECTION 6. APPLICATION OF SAFE HARBOR METHOD TO CERTAIN CONTRACTS WITH INSTALLMENT PREMIUMS

An insurance company using one of the special methods of reporting gross premiums written in § 1.832-4(a)(5) for a category of insurance contracts with installment premiums may apply the safe harbor method to determine the amount of premium acquisition expenses treated as incurred for the taxable year with regard to those contracts. The company's premium acquisition expenses treated as incurred for the taxable year with regard to those contracts, however, cannot exceed the annual pro

rata expense limitation of § 1.832-4(a)(5)(vii). If the insurance company is required to reduce the amount of premium acquisition expenses that would otherwise be treated as incurred for a taxable year in order to meet the annual pro rata expense limitation of § 1.832-4(a)(5)(vii), the reduction amount is carried forward and is taken into account in determining the company's premium acquisition expenses incurred with regard to those contracts for the succeeding taxable year.

SECTION 7. CHANGE IN METHOD OF ACCOUNTING

.01 In general. A change to the safe harbor method provided in section 5.02 of this revenue procedure is a change in method of accounting to which the provisions of §§ 446 and 481 and the regulations thereunder apply. Thus, in order to change to the safe harbor method, an insurance company must complete Form 3115, Application for Change In Method of Accounting, and otherwise comply with the procedures in this section 7.

.02 Automatic change. A taxpayer that wants to change its method of accounting for premium acquisition expenses to the safe harbor method provided by section 5.02 of this revenue procedure must follow the automatic change in method of accounting provisions of Rev. Proc. 2002-9, 2002-3 I.R.B. 327 (or its successor), as modified by Rev. Proc. 2002-19, 2002-13 I.R.B. 696, with the following modifications:

- (1) The scope limitations in section 4.02 of Rev. Proc. 2002-9 do not apply.
- (2) To assist the Service in processing changes in method of accounting under this section of the revenue procedure, and to ensure proper handling, section 6.02(4)(a) of Rev. Proc. 2002-9 is modified to require that a Form 3115 filed under this revenue procedure include the statement: "Automatic Change Filed Under Rev. Proc.

2002-46.” This statement should be legibly printed or typed on the appropriate line of any Form 3115 filed under this revenue procedure.

.03 Automatic change for the first taxable year beginning after December 31, 1999. A taxpayer that wants to change to the safe harbor method for its first taxable year beginning after December 31, 1999 is not subject to the filing requirements in section 6.02(3)(a) or the effective date provision in section 13.01 of Rev. Proc 2002-9, provided that the taxpayer complies with the following filing requirements. The taxpayer must complete and file a Form 3115 in duplicate. The original must be filed with the taxpayer’s amended federal income tax return for its first taxable year beginning after December 31, 1999. A copy of the Form 3115 must be filed with the national office (see Rev. Proc. 2002-9 for the address) no later than when the taxpayer’s amended return is filed. The amended return must be filed no later than January 21, 2003. A taxpayer that wants to change to the safe harbor method for a taxable year earlier than its first taxable year ending on or after December 31, 2001 must take into account the § 481(a) adjustment required as a result of the change over a four-year adjustment period. See sections 4.01 and 4.04(1) of Rev. Proc. 2002-19.

.04 Pending applications with national office. If a taxpayer filed an application or ruling request with the national office to make a change in method of accounting for premium acquisition expenses for a taxable year beginning before January 1, 2002, and the application or ruling request is pending with the national office on June 20, 2002 the taxpayer may make the method change under this revenue procedure. However, the national office will process the application or ruling request in accordance with the authority under which it was filed, unless prior to September 20, 2002 the taxpayer

notifies the national office that it wants to make the method change under this revenue procedure. If the taxpayer timely notifies the national office that it wants to make the method change under this revenue procedure, the application or ruling request will be considered closed and any user fee that was submitted with the application or ruling request will be returned to the taxpayer.

SECTION 8. EXAMPLE

The following example illustrates the manner in which an insurance company applies the safe harbor method to determine the amount of premium acquisition expenses treated as incurred for the taxable year.

Example.

(i) IC is an insurance company taxable as described in section 4 of this revenue procedure that files its returns on a calendar year basis. IC writes automobile insurance policies which provide insurance coverage for a one-year period beginning on January 1st and ending on December 31st. The premiums for the policies are payable on a monthly installment basis. For annual statement reporting purposes, IC reports gross premiums written for these insurance policies based on the calendar year in which the related coverage commences. For purposes of calculating its premiums earned under § 832(b)(4), IC is required by § 1.832-4(a)(5)(i) to report gross premiums written for the policies for the earlier of the taxable year that includes the effective date of the related policies or the year in which all or a portion of the premiums for the policies are received. However, pursuant to § 1.832-4(a)(5)(iii), IC has adopted the method of reporting advance premium installments in gross premiums written for the taxable year of receipt.

(ii) As of December 31, 2002, IC has collected \$250 of advance premium installments during the year with respect to insurance policies with effective dates in 2003. IC determines that the premium acquisition expenses attributable to these advance premium installments are \$62.50 and that the total amount of premium acquisition expenses expected to be incurred over the effective period of the related insurance policies is \$750. On its 2002 annual statement, IC reports total amount of premium acquisition expenses of \$1,250, consisting of \$1,000 of paid expenses plus a \$250 increase in unpaid expenses. The expenses shown on IC's 2002 annual statement did not include the \$62.50 of premium acquisition expenses attributable to \$250 of advance premium installments that IC collected in 2002 with respect to policies with effective dates in 2003, but did include \$50 of premium acquisition expenses attributable to \$200 of advance premium installments that IC collected in 2001 with

respect to policies with effective dates in 2002. Pursuant to § 1.832-4(a)(5)(iii), IC had already included those \$200 of advance premium installments in gross premiums written and unearned premiums when calculating the amount of premiums earned under § 832(b)(4) for the 2001 taxable year.

(iii) For the taxable year ending December 31, 2002, IC changes to the safe harbor method of deducting premium acquisition expenses described in section 5.02 of this revenue procedure. To determine the deductible premium acquisition expenses for the 2002 taxable year, IC adds the amount of premium acquisition expenses paid during the taxable year (\$1,000) to the increase in unpaid expenses as shown on the 2002 annual statement (\$250). The increase in pro forma premium acquisition expenses for the taxable year equals \$12.50 ($\$62.50 - \$50.00 = \12.50). For the 2002 taxable year, IC's unearned premium reserve offset amount equals \$10 ($(\$250 \times .20 = \$50) - (\$200 \times .20 = \$40)$). Accordingly, IC's deductible premium acquisition expenses for the 2002 taxable year equal \$1,260 ($\$1,000 + 250 + 10$). The \$2.50 of pro forma premium acquisition expenses which cannot be deducted in 2002 as a result of the limitation in section 5.02(ii) is added to IC's pro forma premium acquisition expenses at the end of the 2003 taxable year.

(iv) To determine the amount of premium acquisition expenses deductible under the safe harbor method, IC also must apply the annual pro rata expense limitation of § 1.832-4(a)(5)(vii) with respect to those insurance policies for which IC collected advance premium installments during 2002. For this purpose, IC compares the ratio of the amount of expenses allowable under the safe harbor method over the total premium acquisition expenses for the related insurance policies ($(\$62.50 - 2.50 = \$60)/\$750 = .08$) with the ratio of the advance premium installments over the total gross premiums written for the related insurance policies ($\$250/\$2,000 = .125$). As .08 is less than .125, the amount of premium acquisition expenses determined under the safe harbor method satisfies the annual pro rata expense limitation of § 1.832-4(a)(5)(vii).

(v) On its 2002 federal income tax return, IC follows the general automatic change procedures of Rev. Proc. 2002-9, as modified by this revenue procedure, to change to the safe harbor method. This change in method of accounting results in a negative § 481(a) adjustment of \$50, the pro forma acquisition expenses attributable to the \$200 of advance premium installments received by IC for the 2001 taxable year. Pursuant to section 5.04 of Rev. Proc. 2002-9, as modified by Rev. Proc. 2002-19, IC takes the \$50 negative § 481(a) adjustment into account in one-year in computing its taxable income for the taxable year ending December 31, 2002.

SECTION 9. EFFECTIVE DATE

This revenue procedure is effective for changes in method of deducting premium acquisition expenses for the taxable years ending after December 31, 1999.

SECTION 10. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 2002-9 is modified and amplified to include this automatic method change in section 5 of the APPENDIX.

DRAFTING INFORMATION

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