INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM
October 22, 2002

Number: **200330009**
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Index (UIL) No.:832.05-00, 7805.01-01
CASE MIS No.:

Taxpayer's Name:

Taxpayer's Address:

Taxpayer's Identification No:
Years Involved:
Date of Conference:

LEGEND:

Taxpayer =

A =
Date a =
Date b =

ISSUE:

Whether Taxpayer's request for relief under § 7805(b)(8) of the Internal Revenue Code should be granted and the determinations made in TAM (Date b) be applied without retroactive effect.

CONCLUSION:

1) With respect to issue 1, requested relief under § 7805(b)(8) is granted.

2) With respect to issue 2, requested relief under § 7805(b)(8) is denied.

FACTS:

Taxpayer, a property and casualty insurance company, is taxed under the provisions of Part II of Subchapter L of the Internal Revenue Code. Taxpayer issues retrospectively rated insurance policies. These policies provide for retrospective premium adjustments generally referred to as “retro debits” and “retro credits.” A retro debit represents an additional premium amount due from a policyholder if the actual premium, calculated based on a retrospective rating formula which takes into account the amount of losses and loss expenses incurred, exceeds the amount previously collected from the policyholder. A retro credit represents a premium refund owed to a policyholder where the amount collected from the policyholder exceeds the actual policy premium determined under the retrospective rating formula.

On Date a, the Service issued a technical advice memorandum (1967 TAM), to A addressing the recognition of retro credits from retrospectively rated insurance policies in the computation of income. The years at issue were 1959-1961. With regard to retro credits on one-year policies, the 1967 TAM concluded:

> . . . as to a one-year policy which does not terminate on or before the end of the taxable year, the estimated potential retrospective rate credit or refund on the expired portion is not an unearned premium. Where the policy does terminate on or before the end of the taxable year, and it is determined that a retrospective credit or refund is due on the entire policy, such liability shall be taken into account in computing earned premium.

Regarding retro debits on 1-year policies, the 1967 TAM concluded:

> . . . if at the termination of the policy it is determined that additional premium is due and payable under the retrospective rating plan, such premium income should be accrued.

As to multi-year policies, the 1967 TAM stated:

> . . . if the retrospective premium is computed and settled at the close of each policy year, then there is a fixed liability to refund or a fixed right to receive premiums and such liability and right should be taken into account as if the policy were a one-year policy. If on the other hand, the determination must await the expiration of the entire contract, which might be the case if experience factors are cumulative, then the entire liability and right are contingent and are not taken into account

The 1967 TAM thus required Taxpayer to account for retrospective premium adjustments for one-year policies in the taxable year in which the policy expired. Retrospective adjustments for unexpired multi-year policies could be taken into account only if the adjustment was determined based on loss experience for a policy year ending on or before the end of the taxable year. See also Rev. Rul. 67-225, 1967-2 C.B. 238, revoked by Rev. Rul. 73-302, 1973-2 C.B. 20. Additionally, the 1967 TAM neither required nor endorsed the netting of retro credits and retro debits in the unearned premium reserve. Rather, the 1967 TAM indicated that liabilities for accrued retro credits were taken into account in computing earned premium and that accrued retro debits were included in premium income.

In 2001, the Service issued TAM with regard to tax years 1987-1990 of Taxpayer. TAM addressed two issues relating to retrospective premium adjustments:

1. Whether retro debits or retro credits related to the expired portion of a policy which had not terminated by the end of a taxable year were required to be taken into account in computing taxable income for the taxable year.

2. Whether retro debits were included in gross premiums written or reduced unearned premiums.

In contrast to the 1967 TAM, TAM concluded that Taxpayer was required to take into account retro debits and retro credits related to the expired portions of policies which had not terminated by the end of the taxable year. In addition, TAM concluded that retro debits were included in gross premiums written and retro credits were included in unearned premiums.

In view of the 1967 TAM, Taxpayer requested that the determinations made in TAM be applied without retroactive effect.

LAW & ANALYSIS:

Section 7805(b) provides that the Secretary may prescribe the extent, if any, to which any ruling (including any judicial decision or any administrative determination other than by regulations) relating to the internal revenue laws shall be applied without retroactive effect.

Section 18.06 of Rev. Proc. 2002-2, 2002-1 I.R.B. 81 provides that generally a technical advice memorandum is not applied retroactively to the taxpayer for whom the technical advice memorandum was originally issued if-

(1) there has been no misstatement or omission of material facts;

(2) the facts at the time of the transaction are not materially different from the facts on which the technical advice memorandum was based;

(3) there has been no change in the applicable law;

(4) in the case of a letter ruling, it was originally issued on a prospective or proposed transaction; and

(5) the taxpayer directly involved in the technical advice memorandum acted in good faith in ruling on the technical advice memorandum, and the retroactive revocation would be to the taxpayer's detriment.

With respect to the first issue, Taxpayer meets the requirements of §18.06 of Rev. Proc. 2002-2.

Subsequent to the 1967 TAM, the Service issued Rev. Rul. 67-225, 1965-2 C.B. 238. The issue in Rev. Rul. 67-225 was "whether a casualty insurance company may include, as part of its unearned premiums, a contingent liability for retrospective rate credits or refunds on policies that have not expired as of the close of the taxable year." Like the 1967 TAM, Rev. Rul. 67-225 concluded that–

> . . . if the taxpayer's one year policy does not terminate on or before the end of the taxable year, the estimated contingent retrospective rate credit or refund on the expired portion of the policy is not an unearned premium and may not be taken into account. Where the policy terminates on or before the end of the taxable year and the total experience factors which are taken into account in determining the ultimate credit or refund due and payable on the entire policy are known or reasonably ascertainable, the liability for the credit or refund becomes fixed and shall be taken into account by taxpayer in computing earned premiums.
>
> As to taxpayer's multiple year policies, if the retrospective premium is computed only on the basis of the experience factors at the close of each policy year and without regard to the subsequent experience factors, then there is a fixed liability to refund at the close of each policy and such liability shall be taken into account at that time in computing earned premiums as if the policy were an expired one-year policy. If, on the other hand, the experience factors are cumulative and the ultimate determination of the retrospective premium must await the expiration of the entire contract, any potential credit or refund is a contingent liability and shall not be taken into account prior to the expiration of the entire contract.

In Bituminous Casualty Corp.v. Commissioner, 57 T.C. 58 (1971), acq. in result 1973-2 C.B. 1, the Tax Court rejected Rev. Rul. 67-225 and allowed the insurance

company to include in unearned premiums the estimated liability for retro credits on the expired portions of policies that had not terminated by the close of the taxable year.

After the decision in Bituminous Casualty, the Service issued Rev. Rul. 73-302, 1973-2 C.B. 20, which revoked Rev. Rul. 67-225. In Rev. Rul. 73-302 , the Service agreed that retro credits with regard to the expired portions of policies that had not terminated by the close of the taxable are permitted to be taken into account in determining an insurance company's unearned premiums for the taxable year. Rev. Rul. 73-302 thus notified taxpayers that the Service would no longer require insurance companies to account for retro credits using the accrual method of accounting. However, Rev. Rul. 73-302 did not notify taxpayers that the accrual method was not an acceptable method of accounting for retro debits. Accordingly, Rev. Rul. 73-302 did not clearly revoke the 1967 TAM. To the extent that TAM inferred that Rev. Rul. 73-302 revoked the 1967 TAM, TAM is modified to eliminate that inference. The 1967 TAM is hereby revoked.

With regard to the second issue, the Taxpayer does not meet the requirements of § 18.06(3) and §18.06(5) of Rev. Proc. 2002-2.

Taxpayer interprets the1967 TAM as imposing the netting of retro debits and credits in the unearned premium reserve because agents did not reclassify the retro debits during audit. Taxpayer claims that as a result, Taxpayer relied on the 1967 TAM to its detriment. However, the above quoted portions of the 1967 TAM demonstrate that it neither required nor endorsed the netting of retro credits and retro debits in the unearned premium reserve. Rather, the 1967 TAM indicated that liabilities for retro credits were taken into account in computing earned premiums and that retro debits were included in premium income. Thus, Taxpayer cannot claim that it relied on the 1967 TAM to its detriment.

Taxpayer also argues that case law and IRS rulings have continued to provide for netting of retro debits with retro credits as part of the unearned premium reserve. Taxpayer cites to Rev. Rul. 73-302. However, the netting of retro debits with retro credits in the unearned premium reserve was not an issue in Rev. Rul. 73-302. Thus, Taxpayer cannot claim that it relied on Rev. Rul. 73-302 to its detriment.

Taxpayer claims that during audits conducted prior to 1987, agents did not remove retro debits from Taxpayer's unearned premium reserve. Prior to the Tax

Reform Act of 1986, the netting of retro debits and retro credits in the unearned premium reserve did not have any impact on taxable income. The entire amount of a retro debit was taxed regardless of whether the retro debit was netted against a retro

credit in the unearned premium reserve or was reported in gross premiums written. In 1986, Congress amended the provisions of § 832(b)(4) to reduce the amount of unearned premium reserve taken into account for tax purposes by 20 percent. For taxable years beginning after 1986, only 80 percent (rather than 100 percent) of unearned premiums are taken into account in determining an insurance company's premiums earned. Thus, post-1986, the netting of retro debits with retro credits in the unearned premium reserve would have a significant impact on the computation of a property and casualty insurance company's taxable income.

It is well established that the Service is not bound to allow a taxpayer to continue to use its method notwithstanding its consistent use. Western Casualty & Surety Co.v. Commissioner, 65 T.C. 897, at 911-912 (1976), aff'd, 571 F.2d 514 (10th Cir. 1978), Coors v. Commissioner, 60 T.C. 368, 395 (1973) aff'd, 59 F2d 1280 (10th Cir. 1975), cert. denied, 423 U.S. 1087 (1976) (argument that a method has been long utilized and tacitly approved can be answered that consistency does not make it right; failure to clearly reflect income cannot be justified on grounds of tenure).

CAVEAT

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