INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

May 03, 2012

Third Party Communication: None
Date of Communication: Not Applicable

Number: **201235011**
Release Date: 8/31/2012
Index (UIL) No.: 832.00-00, 832.05-00
CASE-MIS No.: TAM-101205-12

Taxpayer's Name:

Taxpayer's Address:

Taxpayer's Identification No
Year(s) Involved:
Date of Conference:

LEGEND:

Taxpayer:

Insco:

Agents:

Reinsurer:

ISSUE:

Whether an insurance company may maintain an unearned premium reserve (UPR) for amounts attributable to contracts for which 100% of the insurance risk has been reinsured.

CONCLUSION:

An insurance company may not maintain a UPR for amounts attributable to contracts for which 100% of the insurance risk has been reinsured.

FACTS:

Insco is a subsidiary of one of Taxpayer's subsidiaries. Insco is the issuer of certain nonlife insurance contracts. Insco does not sell its contracts directly to policyholders. Instead, Insco allows Agents to sell its contracts.

There is no set amount that a policyholder must pay for one of Insco's contracts. Prospective policyholders must negotiate the price of each contract (Purchase Premium) with Agents. Agents then pay Insco a set amount (Agent Cost) for each contract sold and retain the portion of the Purchase Premium that exceeds the Agent Cost (Agent Commission).

Policyholders may cancel their contract before the contract period expires. Agreements between Agents and Insco generally specify that in the event that a policyholder cancels a contract, Insco will refund to the policyholder the portion of the Purchase Premium that has not yet been earned. The Agents are then liable to indemnify Insco for the portion of refunded premium that is allocable to the Agent Commission.

Insco reinsures some of the contracts it issues with Reinsurer. Under the reinsurance agreement, Reinsurer is liable for 100% of claims under the reinsured contracts. The reinsurance premium Insco pays to reinsurer is roughly equal to the Agent Cost, minus a small amount retained as a ceding commission. If a policyholder cancels a contract, Reinsurer will refund to Insco the corresponding portion of the reinsurance premium that has not yet been earned.

For federal income tax purposes, Insco includes the full amount of the Purchase Premium paid by policyholders in its gross written premiums (GWP) and unearned premium reserve (UPR). Insco deducts the Agent Commission as a premium acquisition expense. Insco also reduces its GWP by the reinsurance premium paid to Reinsurer and reduces its UPR for the amount of the reinsurance premium paid to Reinsurer.

LAW AND ANALYSIS:

Section 831 imposes a tax for each taxable year on the taxable income of a nonlife insurance company. Section 831(c) states that the term "insurance company" has the meaning given to such term by section 816(a).

Section 832(a) states that the taxable income of an insurance company, subject to the tax imposed by section 831 (a nonlife insurance company), is its gross income as defined in section 832(b)(1) less the deductions allowed by section 832(c).

Section 832(b)(1)(A) provides that a non-life insurance company's gross income includes its underwriting income.

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

Section 832(b)(4)defines premiums earned as the amount of gross premiums written on insurance contracts during the taxable year, plus 80% of the UPR from the previous year, minus return premiums and premiums paid for reinsurance, and 80% of the UPR for the taxable year.

Section 1.832-(4)(a)(8)(i) states, in part, that:

> The unearned premium for a contract, other than a contract described in section 816(b)(1)(B), generally is the portion of the gross premium written that is attributable to future insurance coverage during the effective period of the insurance contract. However, unearned premiums held by an insurance company with regard to the net value of risks reinsured with other solvent companies (whether or not authorized to conduct business under state law) are subtracted from the company's unearned premiums.

Example 9 of section 1.832-4(a)(10) illustrates the reduction of unearned premiums by the net value of the risks reinsured:

> (i) IC, a non-life insurance company, issues an insurance contract with a twelve month effective period for $ 1,200 on December 1, 2000. Immediately thereafter, IC reinsures 90% *of its liability under the insurance contract* for $ 900 with IC-2, an unrelated and solvent insurance company. On December 31, 2000, IC-2 has an $ 825 unearned premium with respect to the reinsurance contract it issued to IC. In computing its earned premiums, pursuant to section 832(b)(4)(B), IC-2 deducts $ 660 of unearned premiums ($ 825x.8) with respect to the reinsurance contract.

(ii) Under paragraph (a)(8)(i) of this section, unearned premiums held by an insurance company with regard to the net value of the risks reinsured in other solvent companies are deducted from the ceding company's unearned premiums taken into account for purposes of section 832(b)(4)(B). If IC had not reinsured *90% of its risks*, IC's unearned premium for the insurance contract would have been $ 1,100 ($ 1,200x11/12) and IC would have deducted $ 880 ($ 1,100x.8) of unearned premiums with respect to such contract. However, *because IC reinsured 90% of its risks under the contract* with IC-2, as of December 31, 2000, the net value of the risks retained by IC for the remaining 11 months of the effective period of the contract is $ 110 ($ 1,100-$ 990). For the taxable year ending December 31, 2000, IC includes the $ 1,200 gross premium in its gross premiums written and deducts the $ 900 reinsurance premium paid to IC-2 under section 832(b)(4)(A). Pursuant to section 832(b)(4)(B), to determine its premiums earned, IC deducts $ 88 ($ 110x.8) for the insurance contract at the end of the taxable year. [Emphasis added]

Section 832(c)(1) provides that expenses incurred include ordinary and necessary business expenses under section 162. Premium acquisition expenses, such as agent commissions, are considered ordinary and necessary business expenses for purposes of section 832(c)(1). See House Conference Report No. 99-841, 99th Cong., 2d Sess., at 354, Tax Reform Act of 1986, PL 99-514 (The House Conference Report).

An insurance company may not maintain a UPR for amounts attributable to contracts for which 100% of the risk has been reinsured. Example 9 clearly states that the UPR is reduced by the percentage of the risk reinsured. In Insco's case, 100% of the risk has been reinsured and the unearned premium should be reduced by 100%.

Insco contends that the "risks under the contract" and the "liability under the insurance contract" in Example 9 refer not only to the risk of claims under contracts policyholders insured with Insco, but also Insco's risk of having to refund premiums if a policyholder cancels its contract. Insco's assertion cannot be correct because it is contradictory with the plain language of the example. The risk of having to refund premiums because of a cancelled sale is a business risk and is not insurable or reinsurable. See Helvering v. Le Gierse, 312 U.S. 531, 542 (1941); Rev. Rul. 89-96, 1989-2 C.B. 114. Additionally, the risk of having to refund any premium to a policyholder is not a risk that was insured under the original contract and, thus, cannot be reinsured.

To interpret the "risk" and "liability" in Example 9 as referring to the risk of refunding unearned premium would be contrary to the legislative history of section 832(b)(4)(B). Section 832(b)(4)(B) was added to the Code in the Tax Reform Act of 1986, PL 99-514. The House Conference Report at 354-355, explains that the subsection was added to prevent insurance companies from receiving a double deduction for premium acquisition expenses. A portion of gross written premiums is attributable to premium acquisition expenses. Accordingly, a portion of the unearned premium reserve, which reduces an insurance company's taxable income, is attributable to premium acquisition expenses. Because premium acquisition expenses are deducted as ordinary and necessary expenses under section 832(c)(1), including premium acquisition expenses in the UPR would create a double deduction.

In order to prevent this double deduction, Congress reduced the amount of the UPR deducted for tax purposes by 20%. The House Conference Report at 355, states that a 20% haircut would be easier to administer than requiring the computation of the portion of premium acquisition expenses in the UPR. It also states that the 20% haircut should be sufficient to prevent an excessive amount attributable to premium acquisition expenses from being included in the UPR.

Accordingly, even though the gross UPR includes premium acquisition expenses, the deductible portion of the UPR is not intended to include amounts attributable to premium acquisition expenses. Commissions are premium acquisition expenses. As a result, the value of the risks reinsured described in section 1.832-4(a)(8)(i) cannot refer to the risk of having to refund the Dealer Commissions.

Insco argues that Example 9 is inconsistent with Insco's facts, the result of applying the example to Insco's facts is unreasonable, and that we are, thus, not bound by the example. See Tenn. Baptist Children's Homes v. U.S., 790 F. Supp.2d 534 (6th Cir. 1986). Insco claims that in Example 9, the portion of the risks reinsured includes premium acquisition expenses, but that in Insco's case, premium acquisition expenses are accounted for separately from the insurance risk. There is nothing in Example 9 to indicate that it is inconsistent with the facts in the case at hand. Additionally, the risks reinsured in Example 9 cannot include the risk of refunding the unearned premiums because that risk is not an insurance risk that can be reinsured. See Helvering v. Le Gierse, at 542; Rev. Rul. 89-96, 1989-2 C.B. 114. The result of applying Example 9 to Insco's facts is not unreasonable.

Insco also argues that it should not be required to include the portion of the premiums attributable to Agent Commissions in income because those premiums have not yet been earned under the economic performance rules of section 461(h). Insco is incorrect. Under section 461(h)(5), reserves such as UPR are not subject to the economic performance rules.

Additionally, Insco suggests that the Reinsurer could set up an UPR equivalent to the remaining amount of Insco's UPR. This suggestion is at odds with Example 9, which explains how a reinsurer determines its UPR.

Insco also cites Rev. Rul. 55-693 , Rev. Rul. 61-167 , United States v. Consumer Life Ins. Co., 430 U.S. 725 (1977) , Rev. Rul. 67-43 , Maher v. Commissioner, 469 F.2d 225, (8th Cir. 1972), section 1.338-11, and section 1.817-4(d) as supporting its assertion that the amount by which the UPR is reduced is equal to the amount of the reinsurance premium paid. However, Rev. Rul. 55-693 , Rev. Rul. 61-167 , Consumer Life Ins. Co., Rev. Rul. 67-43 , Maher, and 1.817-4(d), were issued before section 1.832-4(a)(8) was promulgated and do not directly support Insco's arguments.

Section 1.338-11 also does not directly support Insco's arguments. Section 1.338-11 applies to corporate acquisitions. There is no commission or premium acquisition expense involved.

Accordingly, the risks referred to in section 1.832-4(a)(8)(i) include only insurance risks. Insco has ceded 100% of its risks under the contracts Subsidiary reinsures. Insco must, therefore, reduce its UPR attributable to ceded contracts by 100%.

CAVEAT(S):

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