DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

CC:DOM:FS:FI&P March 8, 1999

UILC: 832.05-00

Number: **199925008**
Release Date: 6/25/1999

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: DEBORAH A. BUTLER
ASSISTANT CHIEF COUNSEL (FIELD SERVICE)
CC:DOM:FS

SUBJECT:

This Field Service Advice responds to your memorandum dated December 8, 1998. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

Taxpayer	=
Company A	=
State A	=
State B	=
State C	=
Agreement 1	=
Agreement 2	=
Year 1	=
Year 4	=
Date 1	=
Date 2	=
$A	=
$B	=
$C	=
X%	=

ISSUE:

Whether the ceding company under a retrospectively rated reinsurance treaty may reduce its "premiums earned" under I.R.C § 832(b)(4) by an estimate of additional premiums that it estimates will be due to the reinsurer in acordance with a retrospective rating formula.[1]

CONCLUSION:

Although § 832(b)(4)(A) appears to limit the reduction of "premiums earned" to reinsurance "paid" rather than payable, such an interpretation would improperly place insurers on a cash basis method of accounting in determining underwriting income under § 832(b)(1)(A) and (b)(3). Thus, in the present case, Taxpayer's liability for additional reinsurance premiums payable by Taxpayer to Company A should be taken into account by Taxpayer as a reduction in its premiums earned under § 832(b)(4) for the taxable year in which the liability for payment of these additional premiums is ascertainable based on the loss experience of the reinsured contracts.

FACTS:

Taxpayer provides medical malpractice coverage to physicians, hospitals, and medical facilities in States A, B, and C. It appears that Taxpayer writes these policies on a "claims made" basis.[2]

Taxpayer entered into two excess of loss reinsurance arrangements with Company A.[3] Under Agreement 1, executed on Date 1, Year 1, Taxpayer is responsible for the investigation, settlement, and defense of all claims and losses. Company A may review Taxpayer's records of claims and losses. Agreement 1 further provides that Taxpayer shall pay an annual "flat reinsurance premium" in the amount of $A, with a fixed commission allowance of X%. Thus, although the premium for the reinsurance is $A, Taxpayer is entitled to retain as its commission X% of $A.

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[1] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as in effect during the taxable year in issue.

[2] Under a "claims made" policy, the insurer only provides coverage for claims filed during the policy year.

[3] Under an "excess of loss" reinsurance policy, the reinsurer agrees to be liable for claims filed with the insurer to the extent that each claim, or an aggregation of claims, exceed a certain amount.

This flat reinsurance premium is subject to a retroactive adjustment which may subsequently increase or decrease the annual flat reinsurance premium. Although the policy provision concerning the premium adjustment is unclear, the revenue agent obtained schedules which reflect that the annual flat reinsurance premium, after taking into account the X% reinsurance commission retained by Taxpayer, may be adjusted to a maximum amount of $B and to a minimum amount of $C.

An adjustment to the flat reinsurance premium is calculated yearly. i.e., for each “experience period.” The adjusted reinsurance premium payable for that experience period is calculated at the “statement date,” the first of which is two years after the close of the policy year, and annually thereafter until all claims under the policy are fully discharged. Accordingly, Taxpayer’s flat premium is not adjusted until two years after the close of the policy year. These adjusted premiums are based upon “definitive statements” of policy losses, which Taxpayer provides to Company A. Thus, Company A must pay promptly to Taxpayer its portion of such losses, and two years after the close of the coverage period, Company A furnishes Taxpayer with a statement reflecting the amount of additional reinsurance premium due or refundable under the terms of the retrospective rating provisions.

Agreement 2, which took effect on Date 2, Year 4 is similar to Agreement 1 with some minor differences.

Taxpayer has prepared an actuarial projection of the ultimate premiums due under its retrospective insurance arrangements through Year 4. Taxpayer immediately reduces its premiums earned by the amount of these estimates, thereby decreasing its taxable income. Taxpayer makes these calculations prior to the statement date; therefore, Taxpayer reduces its premiums earned before actually paying additional premium to Company A. The Field argues that Taxpayer is not entitled to reduce its premiums earned for retrospective insurance premiums payable to Company A until the premiums are actually paid. In so doing, the Field cites § 832(b)(4)(A), which allows a deduction for premiums “paid” for reinsurance.

LAW AND ANALYSIS

Since Taxpayer is an insurance company other than a life insurance company, it is taxable under § 831 et seq. Under § 832(a), the term "taxable income" means gross income as that term is defined in § 832(b)(1), less the deductions allowed by § 832(c). Under § 832(b)(1) “gross income” includes, inter alia, the sum of “the combined gross amount earned during the taxable year, from investment income and from underwriting income as provided in this subsection....” Section 832(b)(3) defines “underwriting income” as “the premiums earned on insurance contracts during the taxable year less losses incurred and expenses incurred.” Under

§ 832(b)(4), the term “premiums earned” is defined, in part, as the amount of gross premiums written on insurance contracts during the taxable year, less “return premiums and premiums paid for reinsurance.” § 832(b)(4)(A).

On the basis of a literal interpretation of the phrase “premiums paid for reinsurance” provided in § 832(b)(4)(A), the Field argues that an insurer cannot reduce its premiums earned by the amount of premiums ceded to reinsurers unless the ceded premiums are actually paid during the taxable year. Accordingly, the Field argues that Taxpayer in this case cannot reduce its premiums earned under § 832(b) by amounts that it anticipates that it will pay to Company A in subsequent taxable years. In addition, the Field also contends that because Treas. Reg. § 1.461-4(g)(5) provides that economic performance with respect to an accrual method taxpayer’s liability for insurance premiums occurs as the premiums are paid, insurers ceding premiums to a reinsurer should be subject to the same standard. Thus, the Field attempts to parallel insurers purchasing reinsurance with any accrual method taxpayer purchasing direct insurance.

We first look to Rev. Rul. 77-453, 1977-2 C.B. 236, in which the Service addressed a situation where the taxpayer, a stock casualty insurer, had in force an excess of loss type reinsurance treaty during the taxable year 1973. The taxpayer paid a base premium at the time that the treaty became effective, and was required to pay additional premiums to the reinsurer depending upon the taxpayer’s losses actually reported and incurred. On December 31, 1973, the taxpayer computed that it would owe the reinsurer $500X on June 1, 1974, based upon losses incurred and reported to the taxpayer for the period June 1, 1973 to December 31, 1973. The taxpayer accrued the $500X as a liability for the taxable year 1973, and reduced its gross premiums written by that amount. The Service agreed with the taxpayer’s position, holding that an insurer may reduce gross premiums written for reinsurance premiums not yet paid, as long as the amount of the anticipated reinsurance premiums is “reasonably ascertainable.” Likewise, the Service held that the reinsurer must include in its gross premiums written the amount of the reinsurance premiums which it has a fixed right to receive when the amount is “reasonably ascertainable.”

Thus, the Field’s position that insurers can only reduce gross premiums written by reinsurance premiums actually paid is contrary to the holding of Rev. Rul. 77-453. In this regard, underlying the ruling is GCM 37201, I550-74 (July 26, 1977). Under identical facts to those presented in the ruling, the GCM specifically addressed whether the language “premiums paid for reinsurance” under § 832(b)(4)(A) meant that premiums for reinsurance are deductible by the reinsured only when actually paid to the reinsurer. Rejecting the argument that the phrase “premiums paid for reinsurance” should be interpreted literally, the GCM explains that the phrase gives rise to a definitional problem rather than an accounting problem. In doing so, the GCM indicates that the Code treats liabilities of an insurer for reinsurance premiums as a reduction from gross premiums earned, and not as a business deduction. Thus, the GCM explains that the Code treats insurers covered by reinsurance agreements as agents of the reinsurer with respect to that portion of gross premiums written by the insurer which must be ceded to the reinsurer; once risk has shifted from insurer to reinsurer through an agreement, the insurer cannot “earn” premiums which must be ceded to the reinsurer. Accordingly, the GCM explains that the phrase “premiums paid for reinsurance” has a special meaning for purposes of computing the underwriting income of insurers. The GCM concludes that § 832(b)(4)(A) allows insurers covered by reinsurance to reduce gross premiums written when the risks underlying the reinsurance agreement are transferred to the reinsurer and the amount payable to the reinsurer may be determined with “reasonable accuracy.”

In the present case, placing Taxpayer on a cash basis with respect to reinsurance premiums payable would not clearly reflect the insurer’s income. Under § 832(b)(5)(A)(iii), insurers must reduce “losses incurred” by the change in “reinsurance recoverable” during the taxable year. Therefore, an insurer covered by reinsurance cannot reduce its gross premiums earned by liabilities for losses incurred when the liabilities are those of the reinsurer. Accordingly, the Field’s position would place insurers in a whipsaw: insurers could not deduct premiums payable to reinsurers pursuant to an agreement until the premiums are actually paid, but insurers must reduce their deduction for losses incurred to the extent that the reinsurer is obligated to provide coverage pursuant to the same agreement.

We also conclude that the economic performance rules under § 461 do not apply in this context. Under general tax accrual rules, a liability is incurred in the taxable year in which all events have occurred that establish the fact of liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to that liability. Treas. Reg. § 1.461-1(a)(2)(i). Treas. Reg. §§ 1.461-4(g)(5) and (g)(8), Examples 5-7 provide that economic performance occurs with respect to a liability for insurance premiums when the taxpayer actually pays the premium. Although at first blush an insurer purchasing reinsurance appears similar to a taxpayer purchasing direct insurance, insurers are taxed under a different scheme than other taxpayers. Since Taxpayer in this case is an insurance company, its liability to pay reinsurance premiums to Company A is not an item of expense; rather, it is a component of its “premiums earned,” which in turn is a component of gross income. Accordingly, the “economic performance” rules of § 461 are not applicable to an insurer’s liability to pay reinsurance premiums. In this regard, we note that if property and casualty insurers were required to determine their premium income in accordance with general tax accrual principles, the Code would not require a special definition of the term “premiums earned.” Cf. Modern Home Life Ins. Co. v. Commissioner, 54 T.C. 935, 939 (1970), acq. 1970-2 C.B. xx (explaining that the terms “losses incurred” and “unpaid losses” in § 832(b)(5) includes estimated liabilities which have not otherwise accrued as a deduction because application of accrual accounting rules to property and casualty insurers would render unnecessary the special statutes and regulations applicable to insurance companies). Lastly, we note that in Bituminous Casualty Corp. v. Commissioner, 57 T.C. 58 (1971), acq. Rev. Rul. 73-302, 1973-2 C.B. 220, the Tax Court concluded that an insurer could reduce its premiums earned by the amount it estimated that it would return to policyholders pursuant to a retrospectively rated insurance policy. The court in Bituminous rejected the Service's argument that only those liabilities for retrospective rate credits that satisfied the all events test were properly deductible, explaining that the method of accounting applicable to insurers relies extensively on the use of estimates which would be improper under general tax accrual rules.

We conclude in the present case that the liability for the additional reinsurance premiums payable by Taxpayer to Company A should be taken into account by Taxpayer as a reduction in its premiums earned under § 832(b)(4) for the taxable year in which the liability for payment of these additional premiums is ascertainable based on the loss experience of the reinsured contracts. Since this liability is taken into account on the basis of loss experience, rather than on the basis of the all events test, the economic performance rules do not apply to the liability.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

None.

Please call if you have any further questions.

By: ________________________________

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cc: