

comments electronically via the internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS internet site at http://www.irs.ustreas.gov/prod/tax_regs/comments.html. The public hearing will be held in the Auditorium, Internal Revenue Service Building, 1111 Constitution Avenue NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Gary Geisler, (202) 622-3970; concerning submissions and the hearing, Evangelista Lee, (202) 622-7190 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

A nonlife insurance company's underwriting income equals its premiums earned on insurance contracts during the taxable year less its losses incurred and its expenses incurred. For taxable years beginning on or after January 1, 1993, a company's premiums earned on insurance contracts during the taxable year is an amount equal to the gross premiums written on insurance contracts during the taxable year, less return premiums and premiums paid for reinsurance, plus 80 percent of unearned premiums at the end of the prior taxable year, less 80 percent of unearned premiums at the end of the current taxable year.

The gross premiums written for an insurance or reinsurance contract is the total amount charged by the insurance company for the insurance coverage provided under the contract, including amounts charged covering the company's expenses and overhead. Written premiums are generally recorded for the full term of coverage for the year in which the contract is issued. Upon recording a written premium, the company establishes an unearned premium liability to reflect the portion of the written premium which relates to the unexpired portion of the insurance coverage.

The term "unearned premium" historically referred to the portion of the gross premiums written that would have to be returned to the policyholder upon cancellation of the policy and that was in direct proportion to the unexpired term of the policy. *See, e.g., Buckeye Union Casualty Co. v. Commissioner*, 448 F.2d 228, 230 (6th Cir. 1971), *aff'g* 54 T.C. 13, 20 n.5 (1970). Cases and rulings expanded this definition to include premiums paid for a future benefit, the cost of which was fixed when

**Notice of Proposed Rulemaking
and Notice of Public Hearing**

Determination of Earned Premiums

REG-209839-96

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations relating to the requirement that insurance companies other than life insurance companies reduce by 20 percent their deductions for increases in unearned premiums. This requirement was enacted as part of the Tax Reform Act of 1986. These regulations are necessary in order to provide guidance to nonlife insurance companies that are subject to the 20 percent reduction rule. This document also contains a notice of a public hearing on the proposed regulations.

DATES: Written comments must be received by April 2, 1997. Requests to speak and outlines of oral comments to be discussed at the public hearing scheduled for April 30, 1997 at 10:00 a.m. must be received by April 2, 1997.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (REG-209839-96), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (REG-209839-96), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC. Alternatively, taxpayers may submit

the policy was issued. *See, e.g., Massachusetts Protective Ass'n. v. United States*, 114 F.2d 304 (1st Cir. 1940); *C.P.A. Co. v. Commissioner*, 7 T.C. 912 (1946) (nonlife company), acq. 1947-1 C.B. 1; Rev. Rul. 55-705, 1955-2 C.B. 280. *But cf. Bituminous Casualty Corp. v. Commissioner*, 57 T.C. 58 (1971), acq. in result 1973-2 C.B. 1 (stating in dictum that "unearned premiums" had a substantially broader definition than the one developed in the cases and rulings cited above).

Prior to 1987, the increase in unearned premiums during the taxable year was deducted from gross premiums written in the computation of premiums earned. For example, if a company on September 1st issued a one-year fire insurance policy with a premium of \$1,200, the company on that date would record a gross written premium of \$1,200 and establish a \$1,200 unearned premium reserve. On December 31st, the company would have earned one-third of the premium, \$400, but would have an \$800 unearned premium reserve liability for the remaining eight months of coverage to be provided in periods after the close of the taxable year. The subtraction of the full amount of unearned premiums from the gross written premium "generally reflect[ed]" the accounting conventions (often referred to as "statutory accounting principles") used to prepare the annual statement for state insurance regulatory purposes. 2 H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-354 (1986), 1986-3 C.B. (Vol. 4) 354; S. Rep. No. 313, 99th Cong., 2d Sess. 495 (1986), 1986-3 C.B. (Vol. 3) 495; H.R. Rep. No. 426, 99th Cong., 1st Sess. 668 (1985), 1986-3 C.B. (Vol. 2) 668.

A nonlife company generally deducts expenses incurred in the taxable year in which the expenses are reported on the company's annual statement. These expenses include premium acquisition expenses attributable to unearned premiums.

In 1986, Congress determined that the combination of deferring unearned premiums and currently deducting premium acquisition expenses attributable to unearned premiums under the accounting conventions used to prepare a nonlife insurance company's annual statement resulted in a mismatch of income and expense. Congress decided to require a better measurement of income for Federal income tax purposes. H.R. Rep. No. 426, 1986-3 C.B. (Vol. 2) at 669; S. Rep. No. 313, 1986-3 C.B. (Vol. 3) at

496. Rather than require a nonlife company to capitalize and amortize premium acquisition expenses, Congress reduced by 20 percent the current deduction for unearned premiums. See section 832(b)(4)(B); 2 H.R. Conf. Rep. No. 841, 1986-3 C.B. (Vol. 4) at 354-55; S. Rep. No. 313, 1986-3 C.B. (Vol. 3) at 495-98; H.R. Rep. No. 426, 1986-3 C.B. (Vol. 2) at 668-70. This reduction in unearned premiums is sometimes referred to as the "20 percent haircut." The acceleration of income as a result of the 20 percent haircut is intended to be roughly equivalent to denying current deductibility for a portion of the premium acquisition expenses.

Congress intended the 20 percent haircut to apply to all amounts (other than life insurance reserves and title insurance reserves) that were considered unearned premiums for Federal income tax purposes as of 1986. The House Report states that "[a]ll items which are included in unearned premiums under section 832(b) of present law are subject to this reduction in 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 unearned premiums under section 832(b) of present law are subject to this reduction in the deduction" and describes the Senate amendment as "the same as the House bill, except that life insurance reserves which are included in unearned premium 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 354-55. 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.* See sections 832(b)(7) and (8) for the rules applicable to life insurance and title insurance reserves.

Following the imposition of the 20 percent haircut on unearned premiums, the National Association of Insurance Commissioners (NAIC) revised the statutory accounting principles used to prepare a nonlife insurance company's annual statement. In general, these changes permitted a nonlife company to defer recording written premiums and/or to reduce the amount of unearned premiums reported on the company's annual statement. The affected items included advance premiums, additional premiums on retrospectively rated insurance policies, and the reporting of writ-

ten premiums for workers' compensation policies and certain other casualty policies where the covered risk varies over the policy term.

Prior to 1989, advance premiums were required to be reported in written premiums and unearned premiums on the annual statement for the year in which the advance premiums were received. However, statutory accounting principles now permit advance premiums to be accumulated in a suspense account and reported as a write-in liability on the annual statement. A company electing to use this alternative treatment would not report advance premiums in either written premiums or unearned premiums on the annual statement until the effective date of the underlying coverage.

Statutory accounting principles also required a nonlife insurance company to record an estimated liability for payment of return premiums under retrospectively rated insurance policies (retro credits) as part of the unearned premium liability. Estimates of additional premiums due from insureds under these policies (retro debits) historically were not taken into account except as an offset to the company's estimated liability for payment of retro credits. Thus, retro debits were not permitted to be shown as assets on the annual statement, and generally were not included in written premiums prior to the year in which the company billed the policyholder for these additional premiums. Beginning in 1988, however, the NAIC permitted retro debits to be shown in an insurance company's admitted assets, subject to certain limitations. The NAIC currently has under consideration a proposal that would require retro credits to be recorded as a write-in liability on the annual statement, rather than as part of unearned premiums. This proposal would also permit retro credits and retro debits to be taken into account either as adjustments to written premiums or as adjustments to earned premiums for purposes of determining underwriting income on the annual statement.

A nonlife insurance company ordinarily reports the full amount of premiums provided in a casualty insurance policy (including any deferred premium installments) in written premiums and unearned premiums for the year in which the policy is issued. However, for workers' compensation policies and certain other casualty policies where the covered risk varies over the policy term, some but not all state insurance regulators permit written premiums to be

recorded based on installment billings to the policyholder. If the insurance company issues these policies throughout the year, and the premiums for the policies are billed monthly, the portion of the total written premiums that would be shown as unearned premiums is substantially smaller than would be the case if the written premiums and unearned premiums were determined based on the entire policy term. The NAIC currently has under consideration proposed guidance that would require the full amount of the premiums provided in all casualty insurance policies to be reported in written premiums and unearned premiums on the effective date of the related coverage.

Section 832(b)(1)(A) provides that a nonlife insurance company's income is computed on the basis of the underwriting and investment exhibit of the annual statement approved by the NAIC. Some companies assert that section 832(b)(1)(A) limits application of the 20 percent haircut to the amount of unearned premiums reported on the annual statement. Under this approach, a company that elects for annual statement purposes to report advance premiums as a write-in liability, to offset unearned premiums by retro debits, or to include deferred premiums on policies covering fluctuating risks in written premiums only when billed to the insured, reduces the amount of unearned premiums subject to the 20 percent haircut.

The existing regulations under § 1.832-4(a)(2) state that "[t]he underwriting and investment exhibit[,] . . . insofar as it is not inconsistent with the provisions of the Code will be recognized and used as a basis for [computing the net income of a nonlife insurance company]." However, the regulations recognize that not all items of the exhibit "reflect . . . income as defined in the Code." Where statutory accounting principles permit a company to elect among alternative accounting practices, one or more of which do not clearly reflect income as defined by the Code, the company is required for Federal tax purposes to use a method that clearly reflects income. Section 446(b) and § 1.446-1(a)(2). Furthermore, an accounting practice used on the annual statement, although specifically mandated by statutory accounting principles, is not used for purposes of computing taxable income if that practice is inconsistent with the Code.

Overview of Proposed Regulations

The proposed regulations define gross premiums written, return premiums, and unearned premiums for tax purposes. The proposed regulations also provide rules for determining when gross premiums written, return premiums, and unearned premiums are taken into account for tax purposes. In this manner, the proposed regulations ensure that items such as advance premiums and retrospective premium adjustments are treated consistently for purposes of the 20 percent haircut on unearned premiums.

Explanation of Provisions

The starting point for determining a nonlife insurance company's premiums earned for tax purposes is the "gross premiums written on insurance contracts during the taxable year." Proposed § 1.832-4(a)(4)(i) defines "gross premiums written on insurance contracts" as the total amounts charged by the insurance company for insurance coverage under insurance or reinsurance contracts issued or renewed during the taxable year. Thus, "gross premiums written" includes collected and uncollected premiums.

Proposed § 1.832-4(a)(4)(ii) addresses the treatment of retro debits, which reflect estimates of additional premiums to be received from the insured or the reinsured based on the insurance company's loss experience during expired coverage periods. Thus, retro debits represent additional gross premiums written rather than offsets to the unearned premium liability for unexpired coverage periods. Treating retro debits as offsets to unearned premiums would reduce the acceleration of income under the 20 percent haircut, and would allow some companies with retro debits exceeding their unearned premiums to report a lesser amount of earned premiums for Federal income tax purposes than for annual statement reporting purposes. This result is contrary to the Congressional intent to accelerate the rate at which premiums are earned for tax purposes in order to correct the mismatching of income and expenses on the annual statement. Accordingly, proposed § 1.832-4(a)(4)(ii) requires retro debits to be included in gross premiums written regardless of the manner in which the retro debits are reported on the underwriting exhibit of the annual statement.

Under section 832(b)(4)(A), 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. Proposed § 1.832-4(a)(5)(i) defines return premiums as amounts paid or credited to the policyholder in accordance with the terms of an insurance contract, other than policyholder dividends or claims and benefit payments. Thus, return premiums include amounts paid or credited to the policyholder with respect to endorsements and modifications of the terms of coverage of an insurance contract. Return premiums also include amounts returned or credited to the policyholder on cancellation of an insurance contract, including the unearned portion of any deferred or uncollected premiums previously included by the company in gross premiums written and unearned premiums. Finally, return premiums include amounts contractually required to be returned to the ceding company under a reinsurance contract.

The proposed regulations modify the treatment of retro credits under existing law for purposes of determining earned premiums. Since 1943, § 1.832-4(a)(3)(ii) has provided that the liability for return premiums under a retrospectively rated policy is included in a nonlife company's unearned premiums for tax purposes. Although retro credits were included in unearned premiums in 1986, these amounts are based on an insured's loss experience during expired coverage periods, for which the company has already earned the premium. For this reason, proposed § 1.832-4(a)(5)(ii) provides that a nonlife company's provision for payment of a retro credit generally is included in return premiums that reduce gross premiums written. However, proposed § 1.832-4(a)(6)(iv) gives a company the option to include retro credits in unearned premiums to which the 20 percent haircut applies.

The proposed regulations provide timing rules with respect to when a company reports gross premiums written and unearned premiums for tax purposes. Proposed § 1.832-4(a)(7) requires a company to report gross premiums written with respect to an insurance or reinsurance contract for the earlier of the taxable year which includes the effective date of the contract or the taxable year in which all or a part of the gross premium for the contract is received. Thus, the company must report

gross premiums written with respect to an insurance contract for the year in which it collects an advance premium. By requiring advance premiums to be included in gross premiums written and unearned premiums, regardless of the manner in which the advance premiums are recorded on the annual statement, the proposed regulations ensure that the treatment of a nonlife insurance company's advance premiums conforms with the treatment of advance premiums of a life insurance company under section 807(e)(7).

The NAIC is considering proposed guidance that would require the premium for the entire term of a property and casualty insurance contract to be recorded as written premium on the effective date of the contract. The proposed NAIC guidance rejects the previous NAIC position that permitted written premiums for workers' compensation policies and certain other casualty policies where the covered risk varies over the policy term to be recorded when billed. For this reason, the method of reporting gross premiums written for workers' compensation policies and certain other casualty insurance policies covering fluctuating risks is reserved in the proposed regulations.

Proposed Effective Date

The proposed regulations are proposed to apply to the determination of premiums earned for insurance contracts issued or renewed in taxable years beginning after the date on which final regulations are published in the **Federal Register**.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and 8 copies) that are submitted timely to the IRS. All comments will be available for public inspection and copying.

A public hearing has been scheduled for Wednesday, April 30, 1997 in the Auditorium, Internal Revenue Service Building, 1111 Constitution Avenue NW, Washington, DC. Because of access restrictions, visitors will not be admitted beyond the Internal Revenue Building lobby more than 15 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons that wish to present oral comments at the hearing must submit written comments by April 2, 1997 and submit an outline of the topics to be discussed and the time to be devoted to each topic (a signed original and 8 copies) by April 2, 1997.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of this regulation is Gary Geisler, Office of Assistant Chief Counsel (Financial Institutions and Products). However, other personnel from the IRS and Treasury Department participated in their development.

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Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2 Section 1.832-4 is amended as follows:

1. Paragraph (a)(3) is revised.

2. Paragraphs (a)(4) and (a)(5) are redesignated as (a)(9) and (a)(10).

3. New paragraphs (a)(4) through (a)(8) are added.

The additions and revisions read as follows:

§ 1.832-4 Gross income.

(a) * * *

(3) *Premiums earned.* The determination of premiums earned on insurance contracts during the taxable year begins with the insurance company's gross premiums written on insurance contracts during the taxable year, reduced by return premiums and ceded reinsurance premiums. Subject to the exceptions in sections 832(b)(7), 832(b)(8), and 833(a)(3), this amount is increased by 80 percent of the unearned premiums at the end of the preceding taxable year, and is decreased by 80 percent of the unearned premiums at the end of the taxable year.

(4) *Gross premiums written*—(i) *In general.* An insurance company's "gross premiums written on insurance contracts during the taxable year" are the total amounts charged by the insurance company for insurance coverage under insurance or reinsurance contracts issued or renewed by the company during the taxable year.

(ii) *Debits on retrospectively rated insurance policies.* Gross premiums written include an insurance company's estimate of the gross additional premiums to be received from the insured or the reinsured with respect to the expired portion of a retrospectively rated insurance or reinsurance contract (retro debits). The retro debits are reported for the taxable year in which the amounts can be reasonably estimated based on information used to compute the insurance company's loss reserves. An insurance company adjusts gross premiums written to reflect payments from the insured or the reinsured with respect to retro debits, as well as changes in the estimate of retro debits.

(5) *Return premiums*—(i) *In general.* Return premiums are amounts paid or credited to the policyholder in accordance with the terms of an insurance contract, other than policyholder dividends or claims and benefit payments. For example, return premiums include amounts returned or credited to the policyholder based on modifications of the terms of an insurance contract. Return premiums also include amounts contractually required to be returned to the ceding company pursuant to a reinsurance contract.

(ii) *Credits on retrospectively rated insurance policies.* Except as provided in paragraph (a)(6)(iv) of this section, return premiums include an insurance company's estimate of the gross liability

for return premiums to be paid or credited to the insured or the reinsured with respect to the expired portion of a retrospectively-rated insurance or reinsurance contract (retro credits). The retro credits are included in return premiums for the taxable year in which the insurance company's liability to pay or credit these amounts can be reasonably estimated based on information used to compute the company's loss reserves. An insurance company adjusts return premiums to reflect payments made or amounts credited to the insured or the reinsured with respect to retro credits, as well as changes in the estimate of retro credits.

(iii) *Unpaid premiums on cancelled policies.* If an insurance contract is cancelled, an insurance company includes in return premiums the unearned portion of any deferred or uncollected premiums previously included in gross premiums written and unearned premiums.

(6) *Unearned premiums—(i) In general.* The unearned premium for an insurance or reinsurance contract is the portion of the gross premiums written which is attributable to future insurance coverage to be provided under the contract. An insurance company makes an appropriate adjustment to its unearned premiums for an insurance or reinsurance contract if the contract is reinsured with, or retroceded to, another insurance company.

(ii) *Special rules.* In computing "premiums earned on insurance contracts during the taxable year," the amount of unearned premiums includes—

(A) Life insurance reserves (as defined in section 816(b), but computed in accordance with section 807(d));

(B) In the case of a mutual flood or fire insurance company described in section 832(b)(1)(D) (with respect to contracts described in that section) the amount of unabsorbed premium deposits which the company would be obligated to return to its policyholders at the close of the taxable year if all its policies were terminated at that time;

(C) In the case of an interinsurer or reciprocal underwriter which reports unearned premiums on its annual statement net of premium acquisition expenses, the unearned premiums on the company's annual statement increased by the portion of premium acquisition expenses allocable to those unearned premiums;

(D) In the case of a title insurance company, its discounted unearned premiums (computed in accordance with section 832(b)(8)); and

(E) Amounts treated as unearned premiums pursuant to the optional treatment provided in paragraph (a)(6)(iv) of this section.

(iii) *Method of determining unearned premiums.* If the risk of loss under an insurance or reinsurance contract arises uniformly over the contract period, the unearned premium attributable to the portion of the insurance coverage which has not expired is computed on a pro rata basis. If the risk of loss does not arise uniformly over the contract period, the insurance company may consider the pattern or incidence of the risk in determining the portion of the gross premium written which is attributable to the portion of the insurance coverage which has not yet expired.

(iv) *Option to include retro credits in unearned premiums.* An insurance company may include retro credits in unearned premiums under section 832(b)(4) for its first taxable year beginning after the date on which final regulations are published in the **Federal Register**. Any company exercising this option must apply it consistently to all retro credits with respect to retrospectively rated insurance or reinsurance contracts issued or renewed during the taxable year and all subsequent years.

(7) *Method of reporting gross premiums written—(i) In general.* An insurance company reports gross premiums written with respect to an insurance or reinsurance contract for the earlier of the taxable year which includes the effective date of the contract or the taxable year in which all or a part of the gross premium for the contract is received.

(ii) *Method of reporting gross premiums written on policies covering fluctuating risks.* [Reserved]

(iii) *Examples.* The provisions of this paragraph (a)(7) are illustrated by the following examples:

Example 1. (i) IC is a nonlife insurance company which, pursuant to section 843, files its returns on a calendar year basis. On July 1, 1998, IC issues a fire insurance policy to A, an individual. The policy provides coverage for a one-year term beginning on July 1, 1998 and ending on June 30, 1999. The premium provided in the policy is \$500, which may be paid either in full on the policy effective date or in quarterly installments of \$125. A selects the installment payment option. As of December 31, 1998, the policy issued to A remains in force, and IC has collected a total of \$250 of installment premiums from A. Assume IC has issued no other policies.

(ii) For the taxable year ending December 31, 1998, IC reports the \$500 premium provided in A's policy in gross premiums written under section 832(b)(4)(A). IC also claims a reduction under section 832(b)(4)(B) for 80% of the \$250 of unearned premiums (\$200) associated with the policy at the end of the taxable year.

Example 2. (i) The facts are the same as *Example 1*, except that the term of coverage for the fire insurance policy issued to A begins on January 1, 1999 and ends on December 31, 1999. On December 15, 1998, IC receives \$125 from A and agrees to apply this amount as the first premium installment due on the policy.

(ii) Under paragraph (a)(7)(i) of this section, IC reports gross premiums written for the policy issued to A for the taxable year in which the advance premium is received. Thus, for the taxable year ending December 31, 1998, IC includes \$500 in its gross premiums written under section 832(b)(4)(A). IC also claims a reduction under section 832(b)(4)(B) for 80% of the \$500 of unearned premiums (\$400) associated with the policy at the end of the taxable year.

(8) *Effective date.* Paragraphs (a)(3) through (a)(7) of this section are applicable with respect to the determination of premiums earned for insurance contracts issued or renewed during taxable years beginning after the date on which final regulations are published in the **Federal Register**.

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Michael P. Dolan,
Acting Commissioner of
Internal Revenue.

(Filed by the Office of the Federal Register on December 31, 1996, 8:45 a.m., and published in the issue of the Federal Register for January 2, 1997, 62 F.R. 72)