INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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CASE-MIS No.: TAM-134113-05/CC:FIP:B4

Taxpayer's Name:
Taxpayer's Address:

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

LEGEND:

Taxpayer
Agreement
XXX
YYY
AAA
Plan

ISSUES

1. Whether Taxpayer may apply the safe harbor method for premium acquisition expenses provided in Rev. Proc. 2002-46, 2002-2 C.B. 105, to deduct the liability shown on its annual statement with respect to a deferred compensation plan for independent contractor insurance agents prior to the taxable year for which this compensation is deductible under § 404(d) of the Internal Revenue Code?

2. If the conclusion with respect to Issue 1 is adverse to Taxpayer, whether this conclusion is to be applied without retroactive effect pursuant to § 7805(b)?

CONCLUSIONS

1. Taxpayer cannot use the safe harbor method of accounting for premium acquisition expenses provided in Rev. Proc. 2002-46 to deduct the liability shown on its annual statement with respect to a deferred compensation plan for independent contractor insurance agents. Sections 404(a)(5) and 404(d) specifically preclude Taxpayer from deducting the contributions or compensation allocable to this plan prior to the taxable year in which such compensation is includible in the gross income of the agents participating in the plan. These deduction limitations apply regardless of whether the contributions or compensations would otherwise be deductible under any other Code provisions.

2. Taxpayer's request under §7805(b) to have the conclusion with respect to Issue 1 applied without retroactive effect is denied.

FACTS

Taxpayer is taxable under Part II of subchapter L as a non-life insurance company and is the parent corporation of an affiliated group of corporations that file a consolidated Federal income tax return. Taxpayer and certain affiliated insurance companies (collectively referred to as "Taxpayer") sell property and casualty insurance through independent contractor agents located throughout the United States. Each agent enters into a written agreement with Taxpayer styled Agreement. The Agreement serves to govern all aspects of the business relationship between the parties and has been enforced by the courts. The Agreement requires the agent to act as Taxpayer's exclusive agent in the sale and servicing of insurance business. The Agreement also provides that the agent will be treated as an independent contractor for all purposes, including the responsibility for paying all federal, state, and local income and self-employment taxes. Under the Agreement, the agents are entitled to receive regular commissions based on the amount of premiums that they generate on both new and recurring insurance business.

The Agreement also contains a deferred compensation arrangement called the Plan. Under the Plan, Taxpayer agrees to pay participating agents additional amounts on their retirement or termination depending on the agent's past business performance and whether certain other requirements are met. All payments under the Plan are based on the agent's regular commissions for certain prior periods, which in turn reflect the amount of premiums that the agent generated in such periods with respect to both recurring and new business. Taxpayer's contractual liability to pay these additional amounts is dependent upon there being a "qualified cancellation" of the Agreement. A "qualified cancellation" is generally any cancellation of the Agreement unless the agent has induced or attempted to induce, either directly or indirectly, policyholders to lapse, cancel, or replace any of their policies with Taxpayer.

The Plan basically has two separate components. The first payment component is styled as the agent's XXX. The amount of an agent's XXX is based on the level of the agent's regular commissions for the year, to the extent that such regular commissions exceed certain dollar thresholds set forth in the Plan. If the agent generates an amount of regular commissions in excess of the Plan's minimum dollar threshold, the agent earns an XXX equal to a percentage of the excess, up to the next threshold. Taxpayer accumulates the XXX credited each year in a memorandum account that Taxpayer maintains for each agent. On the agent's retirement or termination, Taxpayer will pay out the agent's accumulated XXX in not less than 3 nor more than 10 annual installments, provided there has been a qualified cancellation of the Agreement and the agent has satisfied certain minimum age requirements. If the Agreement terminates as a result of the agent's death or permanent disability, Taxpayer will also pay out the agent's XXX either to the agent or to a designated beneficiary provided that the agent has completed at least five years of service.

The second payment component under the Plan is styled as the agent's YYY. This payment component entitles the agent to receive an amount equal to the last 12 full calendar months renewal commissions upon a qualified cancellation of the Agreement. As the liability with respect to YYY is not determinable prior to the agent's retirement or termination, Taxpayer accrues a liability with respect to YYY only with respect to agents who have already retired or otherwise terminated their relationship with Taxpayer.

The Plan contains various payment provisions that may affect the amount of XXX and YYY payments to which an agent will ultimately be entitled. For example, if an agent retires before age 60, the agent receives less than 100% of the XXX using a sliding scale based on age. In addition, certain actions taken by the agent can cause Taxpayer's liability to make XXX and YYY payments to the agent to be extinguished completely. In that regard, if the actions of an agent involve soliciting Taxpayer's policyholders within a certain distance of the agent's prior business location, or inducing any of those policyholders to cancel or lapse any of their insurance policies with Taxpayer, Taxpayer's liability to make additional XXX or YYY payments to the agent ceases.

Taxpayer filed Form 3115, Application for Change in Accounting Method, with its consolidated federal income tax return for the taxable year ended December 31, , requesting an automatic change to treat the net increase in the liability shown on its annual statement with respect to the Plan as premium acquisition expenses incurred for the tax year under the safe harbor method provided by Rev. Proc. 2002-46. Taxpayer's application indicated that, as of the beginning of the taxable year, the liability shown on Taxpayer's annual statement with respect to the Plan was AAA. Taxpayer treated this amount as the negative § 481(a) adjustment resulting from the change in accounting method, which was taken into account as a reduction of Taxpayer's taxable income for the taxable year.

On the Form 3115, Taxpayer stated that it was adopting the safe harbor method of accounting because the Plan meets the definition of a premium acquisition expense under Rev. Proc. 2002-46:

> Amounts relating to Taxpayer's … Plan meet the definition of a premium acquisition expense as stated above. The amounts under the Plan are additional compensation to the agent for the production of premiums similar to a commission. The only difference is that payment to the agent is deferred. Thus, these amounts are primarily related to the production of premiums. In addition, the amounts for both the XXX and YYY components of the Plan are determined by formulas that are based on commissions. Since commissions are determined as a percentage of the premium, the amounts under the Plan vary directly with the amount of gross premiums on the underlying contracts.

Taxpayer also stated on the Form 3115 that, although it had previously limited its deductions with respect to the Plan to the amounts actually paid out to agents pursuant to § 404(d), the safe harbor method set forth in Rev. Proc. 2002-46 allows insurance companies to deduct the premium acquisition expenses shown on the annual statement, regardless of whether another Code provision would preclude the deduction:

> Under the safe harbor method, [Taxpayer's] accrual in the annual statement for amounts under the Plan would fall within [the unpaid premium acquisition expenses shown on the annual statement referred to in section 5.02 (B) of Rev. Proc. 2002-46]. Therefore, the change in the annual statement accrual is deductible as a component of premium acquisition expenses for the tax year. The safe harbor method applies to premium acquisition expense accruals shown on the annual statement even though they may not meet the all events test or are otherwise subject to other IRC sections governing the timing of deductions.

Pursuant to section 9 of Rev. Proc. 2002-9, 2002-1 C.B. 327, the Field reviewed the Form 3115 filed by Taxpayer to determine if the change in method of accounting was made in accordance with the applicable provisions of Rev. Proc. 2002-46. As a result of this review, the Field has requested National Office technical advice to determine whether Taxpayer is entitled to use the safe harbor method provided in Rev. Proc. 2002-46 to deduct the liabilities related to the Plan prior to the taxable year for which this deferred compensation would deductible under §§ 404(a)(5) and 404(d).

The Field has challenged Taxpayer's application of the safe harbor method of accounting provided by Rev. Proc. 2002-46 to accelerate the deduction of the liabilities relating to the Plan for two reasons. First, the Field contends that Taxpayer's agent deferred compensation liabilities are not premium acquisition expenses as defined in Rev. Proc. 2002-46 because the deferred benefits that agents receive under the Plan are based on factors other than the agents' past regular commissions, and thus do not directly vary with the acquisition of gross premiums written on new and renewal insurance contracts. Even if the liabilities relating to the Plan fit the definition of premium acquisition expenses under Rev. Proc. 2002-46, the Field argues that Taxpayer cannot apply the Revenue Procedure's safe harbor method because the deduction limitations of §§ 404(a)(5) and 404(d) specifically govern when this deferred compensation must be taken into account.

Taxpayer contends that because the liabilities shown on its annual statement with respect to the Plan meet the definition of premium acquisition expenses under Rev. Proc. 2002-46, it is entitled to treat those liabilities as part of its deductible premium acquisition expenses notwithstanding the deduction limitations of § 404. Taxpayer further contends that, by issuing Rev. Proc. 2002-46, the Service invited insurance companies to rely on annual statement accounting when determining their deductible premium acquisition expenses. Since Taxpayer contends that it complied with, and in good faith relied upon Rev. Proc. 2002-46's automatic change procedure, Taxpayer requests that in the event of adverse advice, its use of the safe harbor method be discontinued on a prospective basis, pursuant to the Commissioner's authority under section §7805(b).

For purposes of addressing this technical advice, the Field and Taxpayer agree that, in the absence of Rev. Proc. 2002-46, Taxpayer's liability with respect to the Plan constitutes deferred compensation subject to the deduction limitations of §§ 404(a)(5) and 404(d).

Issue 1

LAW

Section 831(a) imposes a tax for each taxable year on the taxable income of every insurance company other than a life insurance company.

Section 832 provides that the taxable income of an insurance company subject to the tax imposed by § 831 is the gross income as defined in § 832(b) less the deductions allowed by § 832(c).

Section 832(b) provides that the gross income of an insurance company subject to tax under § 831(a) includes the combined gross amount earned for the taxable year from investment income and underwriting income, as provided in § 832(b), computed on the basis of the annual statement approved by the National Association of Insurance Commissioners. Under § 832(b)(3), underwriting income consists of the premiums earned on insurance contracts during the taxable year, less losses incurred and expenses incurred.

Section 832(b)(4) provides that the computation of premiums earned on insurance contracts during the taxable year is made by taking the gross premiums written on insurance contracts during the taxable year, reduced by return premiums and premiums paid for reinsurance. Subject to certain exceptions not relevant here, the amount so obtained is increased by 80 percent of the unearned premiums on outstanding business at the end of the preceding taxable year, and is reduced by 80 percent of the unearned premiums on outstanding business at the end of the current taxable year.

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 year. For this purpose, expenses incurred do not include any unpaid loss adjustment expenses shown on the annual statement, which are to be treated as part of the insurance company's unpaid losses. 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 business expenses incurred, as provided under § 162," taxes, as provided under § 164, and other deductions, as provided in part VI of subchapter B (§ 161 and following, relating to itemized deductions for individuals and corporations), and subchapter D (§ 401 and following, relating to pension, profit sharing, stock bonus plans, etc.). See §§ 832(c)(1), 832(c)(4), and 832(c)(10).

Section 461(h) provides that for purposes of determining of whether an amount has been incurred with respect to any item during any taxable year, the all events test shall not be treated as met any earlier than the taxable year in which economic performance occurs with respect to that liability. When the liability of a taxpayer arises out of that taxpayer's receipt of services provided by another person, generally economic performance with respect to that liability occurs as the services are performed. Section 461(h)(2)(i). The rules set forth in § 461(h) do not apply to any item for which the Code specifically provides for a deduction for a reserve for estimated expenses. Section 461(h)(5).

Section 1.461-1(a)(2)(i) provides, in general, that under an accrual method of accounting, a liability is incurred, and generally is taken into account for Federal income tax purposes, in the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability.

Section 1.461-1(a)(2)(iii)(D) provides, in part, that except as provided in any Internal Revenue regulation, revenue procedure, or revenue ruling, the economic performance requirement of § 461(h) and the regulations thereunder is satisfied to the extent that any amount is otherwise deductible under § 404 (employer contributions to a plan of deferred compensation).

Section 1.461-1(a)(2)(iii)(A) provides, in part, that if any provision of the Code requires a liability to be taken into account in a taxable year later than the taxable year provided in § 1.461-2(a)(2)(i), the liability is taken into account as prescribed by that Code provision.

Section 404(a) provides that if compensation is paid or accrued on account of any employee under a plan deferring the receipt of compensation, the compensation is not deductible under chapter 1 of subtitle A (§§ 1 through 1400L), but if the compensation would otherwise be deductible, it is deductible under § 404, subject to the limitations imposed by § 404 as to the amounts deductible in any year.

Section 404(a)(5) provides the general rule that compensation paid under a nonqualified plan (contributions to which are deductible under §§ 404(a)(1), (2), or 3)) of deferred compensation is deductible in the taxable year in which an amount attributable to the contribution is includible in the gross income of employees participating in the plan.

Section 404(b) provides that if there is no plan, but there is a method or arrangement that has the effect of a plan deferring the receipt of compensation, §404(a) shall apply as if there were a plan.

Section 404(d) extends the application of §404(a) to benefits or compensation paid to nonemployees by providing that if a plan would be covered by § 404(a) (as modified by § 404(b)) but for the fact that no employer-employee relationship exists, the contributions or compensation (if otherwise deductible under chapter 1 of subtitle A) shall be deductible for the taxable year in which an amount attributable to the compensation is includible in the gross income of the persons participating in the plan.

Section 1.404(b)-1T, Q&A-1, provides, in part, that §§ 404(a) and (d) govern the deduction of compensation paid or incurred with respect to plans, or methods, or arrangements, however denominated, that defer the receipt of any amount of compensation or benefit, including fees and other payments. Under §§ 404(a) and (b), if otherwise deductible, a contribution paid or incurred with respect to a nonqualified plan, or method or arrangement, is deductible in the taxable year of the employer in which or with which ends the taxable year of the employee in which the amount attributable to the contribution is includible in the gross income of the employee (without regard to any applicable exclusions under chapter 1, Subtitle A).

Section 1.404(d)-1T provides, in part, that in the case of deferred benefits or compensation for service providers with respect to which there is no employer-employee relationship, §§ 404(a) and (b) and the regulations thereunder apply as if the person providing the services were the employee and the persons to whom the services are provided were the employer.

Section 1.404(b)-1T, Q&A-2(a), provides that a plan, or method or arrangement, defers the receipt of compensation or benefits to the extent an employee receives compensation or benefits thereunder more than a brief period of time after the end of the employer's taxable year in which the services creating the right to such compensation or benefits are performed. The determination whether a plan, or method or arrangement, defers the receipt of compensation or benefits is made separately with respect to each employee and each amount of compensation or benefit.

Section 1.404(b)-1T, Q&A-2(b)(1), provides that a plan, or method or arrangement, is presumed to be one that defers the receipt of compensation for more than a brief period of time after the end of an employer's taxable year to the extent that compensation is received after the 15th day of the third month after the end of the employer's taxable year in which the services are rendered (the 2-1/2 month period).

Under § 1.404(b)-1T, Q&A-2(b)(2), the taxpayer may rebut this presumption only by demonstrating that it was impracticable to avoid the deferral of the receipt by an employee of the amount of compensation or benefits beyond the applicable 2-1/2 month period and that, as of the end of the employer's taxable year, such impracticability was unforeseeable.

Rev. Proc. 2002-46 provides certain insurance companies subject to tax under § 831 with a safe harbor method of accounting for premium acquisition expenses, and a procedure to obtain automatic consent to change to the safe harbor method. Section 5.02 of Rev. Proc. 2002-46 describes this safe harbor method as follows:

(i) Except as provided in section 5.02(ii) or this revenue procedure, an insurance company is permitted to treat as premium acquisition expenses incurred for the tax year an amount equal to the sum of—

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

(B) the difference between the unpaid premium acquisition expenses shown on the insurance company's annual statement for the tax year and the unpaid premium expenses shown on the company's annual statement for the preceding tax year; and

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

Section 5.02(ii) of Rev. Proc. 2002-46 provides a limitation on the current deductibility of certain pro forma expenses as follows:

(ii) For purposes of calculating the premium acquisition expenses incurred for the taxable yearn under section 5.02(i) of the 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 3.01 of Rev. Proc. 2002-46 defines premium acquisition expenses that are subject to the safe harbor method:

> A premium acquisition expense is an expense that is primarily related to production of gross premiums written on an insurance contract and directly varies with the amount of gross premiums 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 company is treated as a premium acquisition expense to the extent that this expenses allowance reflects the reinsurer's reimbursements 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 for the associated contracts.

ANALYSIS

The issue in this technical advice request is twofold: whether the liability for the Plan shown on the Taxpayer's annual statement meets Rev. Proc. 2002-46's definition of premium acquisition expenses; and if so, whether Taxpayer may use the revenue procedure's safe harbor to deduct such liability without regard to the deduction limitations for deferred compensation under § 404(d).

The definition of premium acquisition expenses set forth in Rev. Proc. 2002-46 was intended to restrict the expenses eligible to be accounted for under the safe harbor method to those expense categories for which there was a direct nexus between the expenses incurred by the insurance company and the amounts included by the company in gross premium written with respect to new and renewal insurance policies when determining premiums earned under § 832(b)(4). Accordingly, Rev. Proc. 2002-46 refers to agent's commissions, premium taxes, and premium-based assessments as examples of premium acquisition expenses, because these expenses are directly linked to the insurance company's direct written premiums.

Arguably, the liabilities relating to Taxpayer's Plan do not bear a direct nexus to the amounts taken into account by Taxpayer as gross premiums written on new and renewal insurance contracts because the deferred benefits that an agent receives under the Plan may vary depending on the overall level of the agent's business performance, the agent's age and years of service, and other factors specified in the Plan. Moreover, unlike the items cited as examples of premium acquisition expenses in Rev. Proc. 2002-46, which under annual statement accounting conventions must be charged off against an insurance company's underwriting income for the year in the related gross premiums written are recorded, Taxpayer accounts for the Plan liabilities through a reserve provision based on the actuarial present value of the estimated future payments under the plan. This method of measuring the liability implicitly treats the deferred compensation as being funded by a combination of Taxpayer's current income and future investment earnings.

Despite these differences, the definition of premium acquisition expenses set forth in Rev. Proc. 2002-46 does not specifically provide that such expenses must be based exclusively on the amount of gross premiums written on the underlying insurance policies. In addition, even in the case of the expense categories cited by Rev. Proc. 2002-46 as examples of premium acquisition expenses, the amount of the insurance company's liability for the expense may be affected by factors other than the gross premiums written recorded on the insurance company's annual statement. In light of the manner in which Rev. Proc. 2002-46 defines premium acquisition expenses, and because we believe that the more fundamental issue is whether the Revenue Procedure's safe harbor method overrides the deduction limitations of § 404(a)(5) and § 404(d), we conclude that solely for purposes of this technical advice request, Taxpayer's deferred compensation liabilities should be treated as meeting the definition of premium acquisition expenses under Rev. Proc. 2002-46.

In the Tax Reform Act of 1986, Congress amended the provisions of § 832(b)(4) to provide that, in computing premiums earned, an insurance company was allowed to deduct only 80 percent of the net increase of unearned premiums during the taxable year. The legislative committee reports indicate that Congress adopted the 20 percent reduction of unearned premiums as a means of correcting the mismeasurement of income that resulted from the deferral of unearned premiums and the current deduction of premium acquisition expenses, including premium acquisition expenses attributable to unearned premiums.

Prior to the 1986 Act, an insurance company was allowed to exclude the full amount of unearned premiums on outstanding business at the end of the taxable year when determining premium earned under § 832(b)(4). At the same time, an insurance company was allowed to deduct the related expenses in generating new and renewal insurance policies in the year incurred as provided by §§ 832(b)(6) and 832(c), notwithstanding that such expenses might include amounts attributable to the unearned premiums. Rather than adopt a rule requiring the deferral of an insurance company's deductions for premium acquisition expenses attributable to unearned premiums, which would have involved difficult measurement issues, Congress chose instead to address the mismatching of income and deductions by providing that only 80 percent of the net increase in unearned premiums during the taxable year was excluded from the insurance company's premiums earned. The legislative committee reports of the 1986 Act indicate that the 20 percent reduction of unearned premiums was intended to represent the allocable portion of the company's expenses incurred in generating the unearned premiums, and thus was equivalent to denying current deductibility for a portion of the insurance company's premium acquisition expenses.

The 1986 Act legislative committee reports suggest that, in adopting the 20 percent reduction of unearned premiums, Congress operated under the assumption that this adjustment was necessary to correct for the current deductibility of premium acquisition expenses allowed by §§ 832(b)(6) and 832(c). In Western Casualty and Surety Company v. Commissioner, 571 F.2d 514 (10th Cir. 1978) and The Home Group v. Commissioner, 875 F.2d 377 (1989), the courts ruled that an insurance company was not permitted to deduct unpaid commissions relating to deferred premium installments as incurred expenses under § 832(b)(6) and § 832(c)(1), even though the unpaid commissions were shown as incurred expenses on the company's annual statement. In those cases, the courts interpreted the reference to ordinary and necessary expenses in § 832(c)(1) as meaning that, to be deductible, such expenses must be paid or incurred within the meaning of § 162. (The years involved predated the enactment of §404(d).) The courts also upheld the disallowance of the companies' accrual of unpaid commissions based on the Commissioner's authority under § 446(b) to disregard a taxpayer's ordinary method of accounting to the extent that such method did not clearly reflect income. The courts found that allowing the taxpayers to deduct the unpaid commissions based on annual statement accounting conventions would not clearly reflect income because such commissions were taken into account as a current deduction, whereas the deferred premium installments were allocable to the insurance company's unearned premium reserve, and thus were includible in taxable income only when the insurance company provided the future coverage funded by those installments. The holdings in Western Casualty and Home Group applied to taxable years prior to the effective date of the 1986 Act's amendments to § 832(b)(4).

On January 7, 2000, the Service and Treasury issued final regulations under § 1.832-4(a)(3) through (11), relating to the determination of underwriting income by non-life insurance companies. The regulations address the manner in which non-life insurance companies determine gross premiums written and the amount of unearned premiums which are subject to the 20 percent reduction provided by § 832(b)(4)(B). The rules set forth in § 1.832-4 apply regardless of the method that the insurance company uses to record written premiums and unearned premiums on its annual statement filed for State regulatory reporting purposes. In some situations, the regulations may require an insurance company to take into account the gross premiums written for an insurance contract earlier in the calculation of premiums earned under § 832(b)(4) than the year for which those premiums are recorded on the company's annual statement. In these situations, the regulations may cause the insurance company to accelerate the amount of premiums earned under § 832(b)(4) due to the effect of the 20 percent reduction of unearned premiums.

Rev. Proc. 2002-46 provides that, under the safe harbor method of accounting for premium acquisition expenses, an insurance company is permitted to treat as premium acquisition expenses incurred for the taxable year the yearly net increase in unpaid premium acquisition expenses shown on the company's annual statement as well as the yearly net increase in certain pro forma premium acquisition expenses. These expenses are deductible under § 832(b)(6) and § 832(c), even if they would not otherwise be treated as incurred under the general accrual accounting rules. (Cf. Western Casualty and Home Group.) Rev. Proc. 2002-46 indicates that the Service allowed insurance companies to use this safe harbor method for premium acquisition expenses consistent with the intent underlying the 20 percent reduction of unearned premiums required by § 832(b)(4)(B), i.e., that such reduction "was intended to correct the mismatching that results from the deferral of unearned premium income and the current deduction of premium acquisition expenses."

There is nothing in Rev. Proc. 2002-46's description of the safe harbor method that suggests this method would override the deduction limitations of §§ 404(a)(5) and 404(d). Rev. Proc. 2002-46 makes no mention of the deduction limitations of § 404. Nor does the plain language used in the Revenue Procedure to describe the safe harbor method – i.e., that an insurance company may use the safe harbor method to determine "the premium acquisition expenses incurred for the taxable year" - imply that if an insurance company were to treat a liability for deferred compensation as a premium acquisition expense, the company could use this method to deduct such deferred compensation without regard to the deduction limitations of § 404 that preclude a taxpayer from deducting deferred compensation expenses that it has incurred until such compensation is includible in the income of the plan participant.

When Rev. Proc. 2002-46 is placed alongside the provisions of §§ 404(a)(5) and 404(d), it is evident that the deduction limitations of § 404 must be satisfied independently of the Revenue Procedure's safe harbor for purposes of determining the year of deduction of Taxpayer's agents deferred compensation liabilities. Sections 404(a)(5) and 404(d) specifically provide that if an employer's contributions or compensation with respect to a nonqualified plan of deferred compensation would otherwise be deductible, such contributions or compensation shall not be deductible under the employer's regular method of accounting, but shall be deductible under § 404(a)(5) for the taxable year in which amounts with respect to such contributions or compensation are includible in the gross income of the persons participating in the plan.

Taxpayer argues that the liabilities shown on its annual statement with respect to the Plan are deductible because the concept underlying the revenue procedure's safe harbor method is that, in order to match the income generated by the 20 percent reduction of unearned premiums with an insurance company's deductions for premium-related expenses, the company should be permitted to deduct all premium acquisition expenses for the taxable year in which related premiums are recognized in determining premiums earned under § 832(b)(4). Taxpayer contends that the Service provided this special treatment of premium acquisition expenses pursuant to the Commissioner's authority under § 446(b), recognizing that without this premium/expense matching, the 20 percent reduction of unearned premiums under § 832(b)(4)(B) would not operate to compensate for the current deduction of the insurance company's premium acquisition expenses.

Even if Taxpayer's characterization of the Service's purpose and legal basis for issuing Rev. Proc. 2002-46 is correct, we do not think such purpose and legal basis evidence an intent to override § 404. Sections 404(a)(5) and 404(d) provide specific limitations on the deduction of employer's contributions or compensation under a deferred compensation plan, allowing the deduction only as set forth in those provisions. The concept underlying §§ 404(a)(5), and 404(d) is that, in order to ensure that employers do not have a tax incentive to adopt deferred compensation plans over qualified pension plans, the employer's deduction of the contributions or compensation attributable to such deferred compensation plans is allowed no earlier than the amounts are includible in the gross income of the persons participating in such plan or arrangement. Accordingly, the rules for nonqualified deferred compensation operate on a "matching rule" that ensures that the employer is ordinarily not allowed a deduction with respect to contributions or compensation under the plan until such contributions or compensation are taxed to the employee. The "matching rule" applies specifically for the purposes of § 404, and is fundamentally different than the income and expense matching concepts of § 446(b).

Taxpayer's other principal argument is that the safe harbor method of accounting provided by Rev. Proc. 2002-46 should be construed as overriding other deduction limitations in the Code, including § 404, because this result is necessary to sustain the validity of the regulations under § 1.832-4. Taxpayer contends that the Service issued Rev. Proc. 2002-46 in order to avoid a protracted controversy with the insurance industry over the validity of the regulations under § 1.832-4. In a number of situations, the regulations require an insurance company to include amounts in gross written premiums for purposes of determining the company's premiums earned under § 832(b)(4) prior to the year in which those premiums are reported on the company's annual statement, or to the year in which those premiums would be taken into account under general accrual accounting rules. According to Taxpayer, in order to sustain the validity of these rules, the Service recognized that it was necessary to permit an insurance company to accelerate the deduction of all related premium acquisition expenses, including unpaid agents commissions, regardless of whether the commissions are shown on the annual statement. Taxpayer argues that Rev. Proc.

2002-46's allowance of a deduction for unpaid agents commissions necessarily implicates § 404 since, in many instances, such commissions will not be paid to the agent within the 2 ½ month period after the end of the taxable year in which the agent's services with respect to the sale of the insurance policy were performed. Thus, if the safe harbor method were interpreted as precluding the deduction of premium acquisition expenses that are subject to § 404, Taxpayer argues that this would render the relief provided to insurance companies with respect to their unpaid agents commissions a dead letter.

We will not address Taxpayer's arguments regarding the possible impact that applying the deduction limitations under §§ 404(a)(5), and 404(d) to an insurance company's premium acquisition expenses could have on the validity of the regulations under § 1.832-4 because these arguments are frankly irrelevant to the facts of this technical advice request. There is nothing in the stated facts that suggests that Taxpayer was required under § 1.832-4 to accelerate the reporting of gross premiums written with respect to its property and casualty insurance business.

Taxpayer's final argument is that the limitation specified in section 5.02(ii) of Rev. Proc. 2002-46 with respect to the current deductibility of pro forma premium acquisition expenses shows that the Service did not intend that the treatment of premium acquisition expenses provided for in Rev. Proc. 2002-46 would be overridden by other limitations in the Code, such as § 404. To prove this point, Taxpayer posits a situation in which an insurance company has pro forma premium acquisition expenses in excess of the limitation specified in section 5.02(ii), a portion of which would also be limited by § 404. If the insurance company reduces its pro forma premium acquisition expenses by the limitation in section 5.02(ii), and then makes a further reduction to the extent the remaining pro forma expenses are attributable to deferred compensation subject to § 404, the limitation in section 5.02(ii) produces an inequitable result because it crowds out pro forma expenses that would have been otherwise deductible if the limitation in § 404 were to be applied first. We do not find this argument persuasive. At most, this argument shows that Rev. Proc. 2002-46's rules regarding the treatment of pro forma premium acquisition expenses did not clearly provide that the section 5.02(ii) limitation should be applied after the § 404 limitation. The argument does not demonstrate that the safe harbor method of accounting provided by Rev. Proc. 2002-46 overrides the deduction limitations of §§ 404(a)(5) and 404(d).

Issue 2

LAW

Section 601.201(l)(1) of the statement of Procedural Regulations provides in part that a ruling, except to the extent incorporated in a closing agreement, may be revoked or modified at any time in the wise administration of the taxing statutes. If a ruling is revoked or modified, the revocation or modification applies to all open years under the statutes, unless the Commissioner or his delegate exercises the discretionary authority under § 7805(b) to limit the retroactive effect of the revocation or modification.

Section 601.201(l)(5) provides in part that except in rare or unusual circumstances, the revocation or modification of a ruling will not be applied retroactively with respect to the taxpayer to whom the ruling originally was issued or to a taxpayer whose tax liability directly was involved in such ruling if (i) there has been no misstatement or omission of material facts, (ii) the facts subsequently developed are not materially different from the facts on which the ruling was based, (iii) there has been no change in the applicable law, (iv) the ruling originally was issued with respect to a prospective or proposed transaction, and (v) the taxpayer directly involved in the ruling acted in good faith in reliance upon the ruling and the retroactive revocation would be to his detriment.

Section 7805(b)(8) provides that the Secretary may prescribe the extent, if any, to which any ruling (including any judicial decision or ay administrative determination other than by regulation) relating to the internal revenue laws shall be applied without retroactive effect.

Section 15 of Rev. Proc. 2005-2, 2005-1 I.R.B. 86,112 sets forth a defined set of circumstances in which the Service may apply a technical advice memorandum (TAM) that retroactively revokes an earlier TAM or ruling that involves a particular taxpayer.

Section 16 of Rev. Proc. 2005-2, 2005-1 I.R.B. 86, 13 provides that under § 7805(b) an Associate Chief Counsel, as the Commissioner's delegate, may prescribe the extent, if any, to which a TAM will be applied without retroactive effect.

It is the position of the Service that it does not revoke a revenue procedure through the issuance of a technical advice memorandum. See CC-2003-014 (May 8, 2003).

ANALYSIS

Taxpayer has requested that if the Service sustains the Field's position, that the technical advice would be applied without retroactive effect pursuant to § 7805(b). Taxpayer also suggests that if the Service believes that its application of the safe harbor method was inappropriate the Service should modify Rev. Proc. 2002-46 to carve out the long-term compensation from the definition of premium acquisition expenses. Such modification should also apply on a prospective basis.

Taxpayer contends that the Service invited non-life insurance company taxpayers to use Rev. Proc. 2002-46 to deduct all premium acquisition expenses in the year in which the related gross written premiums are included under § 832(b)(4). Taxpayer represents it relied upon this definition of premium acquisition expenses in changing its method of accounting. Taxpayer also contends that if the Service sustains the field's position that the safe harbor method does not override § 404, it will be to the Taxpayer's detriment because other non-life companies that filed under the revenue procedure treated unpaid agents commissions as premium acquisition expenses incurred for the taxable year, without regard to the deduction limitations for deferred compensation under § 404.

The Procedural and Administrative Regulations section 601.201(l)(5) and Rev. Proc. 2005-2 apply to a particular taxpayer. Taxpayer may have met the standards of section 601.201(l)(5) in interpreting the definition of premium acquisition expenses under Rev. Proc. 2002-46. However, Taxpayer does not meet the standards of section 601.201(I)(5) for the change in method of accounting because the safe harbor method of accounting described in Rev. Proc. 2002-46 does not override §§ 404(a)(5) and 404(d). Accordingly, Taxpayer's request for relief under § 7805(b) is denied.

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..