Section 832.—Insurance Company Taxable Income

26 CFR 1.832–4: Gross Income.

T.D. 8857

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 1

Determination of Underwriting Income

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the determination of underwriting income by insurance companies other than life insurance companies. In computing underwriting income, non-life insurance companies are required to 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 provide guidance to non-life insurance companies for purposes of determining the amount of unearned premiums that are subject to the 20 percent reduction rule.

DATES: The regulations are effective January 5, 2000**.**

FOR FURTHER INFORMATION CONTACT: Gary Geisler, (202) 622-3970 (not a toll-free number)

SUPPLEMENTARY INFORMATION:

Background

On January 2, 1997, the IRS published in the **Federal Register** a notice of proposed rulemaking (REG–209839–96, 1997–1 C.B. 780 [62 F.R. 72]) proposing amendments to the Income Tax Regulations (26 CFR part 1) under section 832(b) of the Internal Revenue Code. The IRS received a number of written comments on the proposed regulations. On April 30, 1997, the IRS held a public hearing on the proposed regulations. After consideration of all written and oral comments regarding the proposed regulations, those regulations are adopted as revised by this Treasury decision.

Explanation of Revisions and Summary of Comments

Underwriting income

A non-life insurance company's underwriting income equals its premiums earned on insurance contracts during the taxable year less its losses incurred on insurance contracts and its expenses incurred.[1] *See* section 832(b)(3). To compute premiums earned, the company starts with the gross premiums written on insurance contracts during the taxable year, subtracts return premiums and premiums paid for reinsurance, and makes an adjustment to reflect the change in its unearned premiums over the course of the taxable year. *See* section 832(b)(4). This computation results in premiums being recognized in underwriting income over the term of the insurance contract, rather than in the taxable year in which the premiums are billed or received from the policyholder.

Prior to 1987, 100 percent of the change in unearned premiums during the taxable year was taken into account as an increase or decrease to written premiums in computing premiums earned. This treatment "generally reflect[ed]" the accounting conventions (often referred to as "statutory accounting principles") used to prepare a non-life insurance company's annual statement for state insurance regulatory purposes. *See* 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. Because unearned premiums are computed on the basis of the gross premiums for an insurance contract, the amount of unearned premiums reflects not only the portion of the gross premium allocable to future insurance claims but also the portion allocable to the insurance company's expenses and profit on the insurance contract.

In 1986, Congress determined that deferring unearned premium income and currently deducting premium acquisition expenses attributable to unearned premiums resulted in a mismatch of an insurance company's net income and expense. Congress decided to require a better measurement of net income for Federal income tax purposes. *See* 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 defer the deduction for premium acquisition expenses attributable to unearned premiums, Congress reduced by 20 percent the adjustment for unearned premiums. For taxable years beginning on or after January 1, 1993, a non-life insurance company's premiums earned is an amount equal to: (1) its gross premiums written, less both return premiums and premiums paid for reinsurance; plus (2) 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. Section 832(b)(4). The acceleration of income that is typically generated by the 20 percent reduction of unearned premiums is intended to be roughly equivalent to denying current deductibility for the portion of the insurance company's premium acquisition expenses allocable to the unearned premiums. *See* 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.

Role of the annual statement

The proposed regulations provide definitions of the items used to determine premiums earned under section 832(b)(4) and timing rules for taking these items into account for Federal income tax purposes. The treatment provided in the proposed regulations would apply regardless of the classification or method of reporting the items used on an insurance company's annual statement.

Several comments questioned whether there is legal authority to require an insurance company to use a method to cal-

[1]For this purpose, expenses incurred generally refers to the expenses reported on the company's annual statement approved by the National Association of Insurance Commissioners (NAIC) and filed for state insurance regulatory purposes, less expenses incurred which are not allowed as deductions under section 832(c). *See* section 832(b)(6). Expenses incurred generally include premium acquisition expenses attributable to unearned premiums on insurance contracts.

culate premiums earned for Federal income tax purposes that differs from the method that the company is permitted to use to calculate premiums earned on its annual statement. As noted in the preamble to the proposed regulations, the existing regulations under §1.832–4(a)(2) state that the annual statement ". . . 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 non-life insurance company. Also, if statutory accounting principles permit alternative practices, one or more of which do not clearly reflect income as defined by the Code, the company is required for Federal income tax purposes to use a method that clearly reflects income. Section 446(b) and §1.446–1(a)(2).

Gross premiums written

The proposed regulations generally define gross premiums written as the total amounts payable for insurance coverage under insurance or reinsurance contracts issued or renewed during the taxable year. The proposed regulations, however, do not address situations where the amounts charged for insurance coverage may change due to increases or decreases in coverage limits, additions or deletions in property or risks covered, changes in location or status of insureds, or other similar factors.

The final regulations define an insurance company's "gross premiums written" on insurance contracts (which includes premiums attributable to reinsurance contracts) as amounts payable for insurance coverage for the effective periods of the contracts. The label placed on a payment in a contract does not determine whether an amount is a gross premiums written. The effective period of a contract is the period over which one or more rates for insurance coverage are guaranteed in the contract. If a new rate for insurance coverage is guaranteed after the effective date of an insurance contract, the making of the guarantee generally is treated as the issuance of a new insurance contract with an effective period equal to the duration of the new guaranteed rate for insurance coverage.

Under the final regulations, gross premiums written include: (1) additional premiums resulting from increases in risk exposure during the effective period of an insurance contract; (2) amounts subtracted from a premium stabilization reserve that are used to pay premiums; and (3) consideration for assuming insurance liabilities under contracts not issued by the insurance company (that is, a payment or transfer of property in an assumption reinsurance transaction). Gross premiums written, however, do not include other items of gross income described in section 832(b)(1)(C). To the extent that amounts paid or payable to an insurance company with respect to an arrangement are not gross premiums written, the insurance company may not treat amounts payable to customers with respect to the applicable portion of such arrangements as losses incurred described in section 832(b)(5).

Method of reporting gross premiums written

The proposed regulations provide that a non-life insurance company reports the full amount of gross premiums written for an insurance contract for the earlier of the taxable year which includes the effective date of the contract or the year in which all or a portion of the premium for the contract is received. A variety of comments were received with respect to the application of this timing rule to insurance contracts with installment premiums. In response to comments, the final regulations provide a number of exceptions from the general rule with respect to when an insurance company reports gross premiums written.

Advance premiums

Under the proposed regulations, a non-life insurance company that receives a portion of the premium for an insurance contract prior to the effective date of the contract includes the full amount of the premium in gross premiums written for the taxable year during which the portion of the premium was received.

Several comments addressed the treatment of advance premiums in the proposed regulations. One comment endorsed the proposed treatment of advance premiums, noting that it is proper under statutory accounting principles to record the full amount of gross premiums written and expenses incurred with respect to a casualty insurance policy for the year in which an advance premium is received.[2] Other comments argued that since the policyholder may demand a refund of an advance premium prior to the policy's effective date, the company should be permitted to treat an advance premium as a nontaxable deposit until such time as coverage begins under the contract. Alternatively, these comments urged that the company be permitted to report only the advance premium (rather than the entire gross premium for the contract) in gross premiums written for the taxable year of receipt, and to report the remainder of the gross premium for the taxable year that includes the contract's effective date. These comments also indicated that companies generally do not deduct the full amount of premium acquisition expenses for the contract in the taxable year in which they receive advance premiums.

In response to comments, the final regulations permit an insurance company that receives part of the gross premium for an insurance contract prior to the effective date of the contract to report only the advance premium (rather than the full amount of the gross premium written for the contract) in gross premiums written for the taxable year of receipt. The remainder of the gross premium for the insurance contract is included in gross premiums written for the taxable year which includes the effective date of the contract. This method of reporting gross premiums written is available only if the company's deduction for premium acquisition expenses attributable to the contract does not exceed a limitation specified in the regulations, which is intended to ensure that a company does not deduct premium acquisition expenses attributable to an insurance contract more rapidly than the company includes premiums for the insurance contract in its gross premiums written. Companies that adopt this method of reporting gross pre-

[2]Prior to 1989, advance premiums were required to be reported in written premiums and unearned premiums on a non-life insurance company's annual statement. However, statutory accounting principles were later modified to 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 its annual statement until the effective date of the underlying coverage.

miums written must use this method for all insurance contracts with advance premiums.

Accident and health insurance contracts

The proposed regulations have no special rules for determining gross premiums written with respect to accident and health insurance contracts. Several comments indicated that the longstanding practice of insurance companies that issue accident and health insurance contracts with installment premiums is to include amounts in gross premiums written for the taxable year in which the installment premiums become due under the contracts. These comments also stated that companies generally do not deduct premium acquisition expenses allocable to installment premiums not yet due or received with respect to accident and health insurance contracts.

In response to comments, the final regulations permit a non- life insurance company that either issues or proportionally reinsures cancellable accident and health insurance contracts with installment premiums to report the installment premiums in gross premiums written for the earlier of the taxable year in which the installment premiums become due under the terms of the contract or the taxable year in which the installment premiums are received. This method of reporting gross premiums written for cancellable accident and health insurance contracts with installment premiums is available only if the company's deduction for premium acquisition expenses attributable to those contracts does not exceed the matching limitation specified in the regulations. Companies that adopt this method of reporting gross premiums written must use it for all cancellable accident and health insurance contracts with installment premiums.

Multi-year contracts with installment premiums

The final regulations also provide an exception with respect to the reporting of gross premiums written for a multi-year insurance contract for which the gross premium is payable in installments over the effective period of the contract. Under the final regulations, a company may treat this type of multi-year insurance contract as a series of separate insurance contracts. The first insurance contract in the series will be treated as having an effective period of 12 months. Subsequent insurance contracts in the series will be treated as having an effective period equal to the lesser of 12 months or the remainder of the period for which the rates for insurance coverage are guaranteed in the multi-year insurance contract.

This method of reporting gross premium written for a multi-year insurance contract with installment premiums is available only if the company's deduction for premium acquisition expenses attributable to the contract does not exceed the matching limitation specified in the regulations. Companies that adopt this method of reporting gross premiums written for a multi-year insurance contract must use it for all multi-year contracts with installment premiums.

Contracts that give rise to life insurance reserves

Some insurance companies that are taxable under Part II of Subchapter L issue or reinsure risks relating to guaranteed renewable accident and health insurance contracts or other contracts that give rise to "life insurance reserves" (as defined in section 816(b)). For these companies, section 832(b)(4) provides that unearned premiums includes the amount of the company's life insurance reserves, as determined under section 807. However, under section 832(b)(7), the unearned premiums for contracts giving rise to life insurance reserves are not reduced by 20 percent. Instead, an amount of otherwise deductible expenses equal to a percentage of the net premiums for the contracts must be capitalized and amortized as specified policy acquisition expenses under section 848.[3] For purposes of determining the amount of specified policy acquisition expenses under section 848, a non-life insurance company computes net premiums for the contracts in accordance with section 811(a). *See* section 848(d)(2). Thus, with respect to contracts described in section 832(b)(7), a non-life insurance company does not take into account unpaid premiums attributable to insurance coverage not yet provided (such as deferred and uncollected premium installments) in determining the amount of specified policy acquisition expenses required to be amortized under section 848. The proposed regulations do not provide special rules for determining gross premiums written with respect to contracts described in section 832(b)(7). Under the final regulations, a non-life insurance company that issues or reinsures the risks related to a contract described in section 832(b)(7) may report gross premiums written for the contract in the manner required for life insurance companies under sections 803 and 811. This method of reporting gross premiums written for contracts described in section 832(b)(7) is available only if the company also determines its deduction for premium acquisition expenses for the contracts in accordance with section 811(a), as adjusted by the amount required to be amortized under section 848 based on the net premiums of the contracts. Thus, the final regulations ensure that the rules for determining premium income and amortizing premium acquisition expenses for contracts described in section 832(b)(7) operate consistently, whether the issuing company is a non-life insurance company or a life insurance company.

Fluctuating risk contracts

The method of reporting gross premiums written for certain insurance contracts covering fluctuating risks is reserved in the proposed regulations. Some comments requested that the final regulations not address the method of reporting gross premiums written for insurance contracts covering fluctuating risks, noting that the method of recording gross written premiums for these policies for annual statement reporting purposes was being considered by the NAIC as part of its project to codify statutory accounting principles. Subsequently, the NAIC issued guidance permitting an insurance company for annual statement purposes to report written premiums on workers' compensation policies (but not on other casualty contracts involving "fluctuating risks," such as commercial automobile liability and product liability policies) either on the effective date of the insurance contract or based on installment billings to the policyholder. By contrast, with re-

[3]Under section 848(e)(5), a contract that reinsures a contract subject to section 848 is treated in the same manner as the reinsured contract.

spect to other types of casualty insurance policies, the NAIC reaffirmed the general rule that gross premiums with respect to these policies must be recorded on the annual statement on the effective date of the insurance contract.

The final regulations do not permit a non-life insurance company to report gross premiums written for a fluctuating risk contract based on installment billings to the policyholder. Rather, the final regulations require a company generally to report the gross premiums written for the contract for the earlier of the taxable year which includes the effective date of the contract or the year in which all or a portion of the premium for the contract is received, with special rules for advance premiums, cancellable accident and health contracts, multi-year insurance contracts, and contracts described in section 832(b)(7). The company reports any additional premiums resulting from an increase in risk exposure in gross premiums written for the taxable year in which the change in risk exposure occurs. Unless the increase in risk exposure is of temporary duration, the company determines the additional premium resulting from a change in risk exposure based on the remainder of the effective period of the contract.

Return premiums

The proposed regulations define return premiums as amounts (other than policyholder dividends or claims and benefit payments) paid or credited to the policyholder in accordance with the terms of an insurance contract. Under the final regulations, return premiums are amounts previously included in an insurance company's gross premiums written, which are refundable to the policyholder (or the ceding company with respect of a reinsurance agreement) if the amounts are fixed by the insurance contract and do not depend on the experience of the insurance company or the discretion of its management. This rule incorporates a specific definition of policyholder dividends.

The final regulations list a number of items which are included in return premiums, to the extent they have previously been included in gross premiums written. These items include: (1) amounts that are refundable due to policy cancellations or decreases in risk exposure during the effective period of an insurance contract; (2) the unearned portion of unpaid premiums for an insurance contract that is canceled or for which there is a decrease in risk exposure during its effective period; and (3) amounts that are either refundable or that reflect the unearned portion of unpaid premiums for an insurance contract, arising from the redetermination of the premium due to correction of posting or other similar errors.

In addition, the final regulation provides timing rules for the deduction of return premiums. If a contract is canceled, the return premium arising from that cancellation is deducted in the taxable year in which the contract is canceled. If there is a reduction in risk exposure under an insurance contract that gives rise to a return premium, such return premium is deductible in the taxable year in which the reduction in risk exposure occurs.

Retrospectively rated insurance contracts

The proposed regulations provide that gross written premiums include an insurance company's estimate of additional premiums (retro debits) to be received with regard to the expired portion of a retrospectively rated insurance or reinsurance contract. The proposed regulations also provide that return premiums include an insurance company's estimate of amounts to be refunded to policyholders (retro credits) with regard to the expired portion of a retrospectively rated insurance or reinsurance contract. The proposed regulations, therefore, would modify the treatment of retro credits under §1.832–4(a)(3)(ii) of the existing regulations, which treat retro credits as unearned premiums. At the option of the taxpayer, however, the proposed regulations permit a company to continue to include gross retro credits (but not gross retro debits) in the amount of unearned premiums subject to the 20 percent reduction under section 832(b)(4)(B).

A variety of comments were received with respect to the treatment of retro debits and retro credits in the proposed regulations. Most comments approved of the proposed rule to modify the treatment of retro credits in §1.832–4(a)(3)(ii) and, instead, to permit retro credits to be accounted for as part of return premiums. Some comments contended, however, that the method of netting retro debits and retro credits as an adjustment to unearned premiums was required under NAIC accounting rules, prior case law, and the Service's published rulings interpreting §1.832–4(a)(3)(ii). These comments argued that the enactment of the 20 percent reduction rule in 1986 did not authorize the Service to change the items included in unearned premiums, including the historical treatment of retro debits and retro credits as part of unearned premiums. Other comments contended that retro debits (but not retro credits) should be discounted using the applicable discount factors for unpaid losses under section 846. These comments argued that there is a direct correlation between amounts reported by an insurance company as retro debits and the company's related liabilities for unpaid losses and unpaid loss adjustment expenses. Therefore, the comments urged that, to achieve proper matching of these items, a non-life insurance company should be permitted either to report retro debits as a subtraction from unearned premiums or to discount the retro debits using the applicable discount factors under section 846 for the related line of business.

The treatment of retro debits and retro credits in the proposed regulations was premised on the assumptions that retrospectively rated arrangements could qualify as insurance contracts for tax purposes, and that all amounts payable under such arrangements could be considered to have been paid for insurance coverage. The final regulations provide that gross premiums are amounts paid for insurance coverage. Similarly, unearned premiums and return premiums only include amounts included in gross written premiums. The final regulations also provide that retro credits are not included in unearned premiums, and retro debits cannot be subtracted from unearned premiums. The final regulations do not permit amounts includable in gross premiums written to be discounted, regardless of when such amounts are paid to the insurance company.

The final regulations do not provide any inference as to whether some or all of a retrospective arrangement can qualify as an insurance contract, or as to whether or the extent to which amounts paid or payable to an insurance company with respect to a retrospective arrangement are for insurance coverage.

Premium stabilization reserves

Several comments asked for clarification of the treatment of premium stabilization reserves.[4] As noted below, the final regulations provide that retro credits are not unearned premiums for Federal income tax purposes. Thus, retro credits added to premium stabilization reserves are not unearned premiums for Federal income tax purposes. The final regulations also provide that amounts withdrawn from a premium stabilization reserve to pay premiums are included in gross premiums written for the taxable year in which these amounts are withdrawn from the stabilization reserve for that purpose.

Unearned premiums

The proposed regulations define unearned premiums as the portion of the gross premiums written that is attributable to future insurance coverage to be provided under an insurance or reinsurance contract. The final regulations generally retain the rules relating to unearned premiums. Consistent with the existing regulations under §1.801–4(a), the final regulations provide that an insurance company must exclude from unearned premiums amounts attributable to the net value of risks reinsured with, or retroceded to, another insurance company. The final regulations also provide that unearned premiums do not include a liability established by an insurance company on its annual statement to cover premium deficiencies.

The proposed regulations provide that an insurance company may consider the incidence or pattern of the insured risks in determining the portion of the gross premium written that is attributable to the unexpired portion of the insurance coverage. The final regulations clarify that, if the risk of loss under an insurance contract does not vary significantly over the effective period of the contract, the unearned premium attributable to the unexpired portion of the effective period of the contract is determined on a pro rata basis. However, if the risk of loss under an insurance contract varies significantly over the effective period of the contract, the insurance company may consider the pattern and incidence of the risk in determining the portion of gross premium which are attributable to the unexpired portion of the effective period of the contract, provided that the company maintains sufficient information to demonstrate that its method of computing unearned premiums accurately reflects the pattern and incidence of the risk for the insurance contract.

Effective date and transition rules

Under the proposed regulations, the new rules apply to the determination of premiums earned for insurance contracts issued or renewed during taxable years beginning after January 6, 2000. Several comments requested that the regulations permit an insurance company to adopt the new rules for determining premiums earned as a change in method of accounting deemed made with the Commissioners' consent, with audit protection for prior years. These comments also urged that the insurance company be given the option of either implementing the change in method of accounting on a cut-off basis or spreading the section 481(a) adjustments resulting from the change over a number of years consistent with the Commissioner's general administrative procedures when a taxpayer files a request to change a method of accounting under section 446(e).

In response to these comments, the final regulations permit taxpayers to change their method of accounting for determining premiums earned to comply with the final regulations under the automatic change in method of accounting provisions of Rev. Proc. 99–49, 1999–52 I.R.B. 725, subject to certain limitations. A taxpayer makes the automatic change in method of accounting on its Federal income tax return for the first taxable year beginning after December 31, 1999. The scope limitations in section 4.02 of Rev. Proc. 99–49 do not apply to a taxpayer's automatic change in method of accounting pursuant to this regulation. The timely duplicate filing requirement in section 6.02 of Rev. Proc. 99–49 also does not apply to this change. If the taxpayer's method of computing earned premiums was an issue under consideration (within the meaning of section 3.09 of Rev. Proc. 99–49) on January 5, 2000, however, then the audit protection rule in section 7.01 of Rev. Proc. 99–49 does not apply to the taxpayer's change in method of accounting.

Special Analyses

It has been determined that this Treasury Decision 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 these regulations do not impose on small entities a collection of information requirement, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

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

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is 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 paragraphs (a)(13) and (a)(14).

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[4]In Rev. Rul. 97–5, 1997–1 C.B. 136, the Service revoked Rev. Rul. 70–480, 1970–2 C.B. 142, which had held that amounts held by a non-life insurance company in a premium stabilization reserve funded by retro credits are not unearned premiums under section 832(b)(4). Rev. Rul. 97–5 reasoned that the assumption in Rev. Rul. 70–480 that stabilization reserves are part of the insurance company's surplus was erroneous.

3. New paragraphs (a)(4) through (a)(12) 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 premiums paid for reinsurance. 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 on insurance contracts at the end of the preceding taxable year, and is decreased by 80 percent of the unearned premiums on insurance contracts at the end of the current taxable year.

(4) *Gross premiums written*—(i) *In general.* Gross premiums written are amounts payable for insurance coverage. The label placed on a payment in a contract does not determine whether an amount is a gross premium written. Gross premiums written do not include other items of income described in section 832(b)(1)(C) (for example, charges for providing loss adjustment or claims processing services under administrative services or cost-plus arrangements). Gross premiums written on an insurance contract include all amounts payable for the effective period of the insurance contract. To the extent that amounts paid or payable with respect to an arrangement are not gross premiums written, the insurance company may not treat amounts payable to customers under the applicable portion of such arrangements as losses incurred described in section 832(b)(5).

(ii) *Items included.* Gross premiums written include—

(A) Any additional premiums resulting from increases in risk exposure during the effective` period of an insurance contract;

(B) Amounts subtracted from a premium stabilization reserve to pay for insurance coverage; and

(C) Consideration in respect of assuming insurance liabilities under insurance contracts not issued by the taxpayer (such as a payment or transfer of property in an assumption reinsurance transaction).

(5) *Method of reporting gross premiums written*—(i) *In general.* Except as otherwise provided under this paragraph (a)(5), an insurance company reports gross premiums written for the earlier of the taxable year that includes the effective date of the insurance contract or the year in which the company receives all or a portion of the gross premium for the insurance contract. The effective date of the insurance contract is the date on which the insurance coverage provided by the contract commences. The effective period of an insurance contract is the period over which one or more rates for insurance coverage are guaranteed in the contract. If a new rate for insurance coverage is guaranteed after the effective date of an insurance contract, the making of such a guarantee generally is treated as the issuance of a new insurance contract with an effective period equal to the duration of the new guaranteed rate for insurance coverage.

(ii) *Special rule for additional premiums resulting from an increase in risk exposure.* An insurance company reports additional premiums that result from an increase in risk exposure during the effective period of an insurance contract in gross premiums written for the taxable year in which the change in risk exposure occurs. Unless the increase in risk exposure is of temporary duration (for example, an increase in risk exposure under a workers' compensation policy due to seasonal variations in the policyholder's payroll), the company reports additional premiums resulting from an increase in risk exposure based on the remainder of the effective period of the insurance contract.

(iii) *Exception for certain advance premiums.* If an insurance company receives a portion of the gross premium for an insurance contract prior to the first day of the taxable year that includes the effective date of the contract, the company may report the advance premium (rather than the full amount of the gross premium for the contract) in gross premiums written for the taxable year in which the advance premium is received. An insurance company may adopt this method of reporting advance premiums only if the company's deduction for premium acquisition expenses for the taxable year in which the company receives the advance premium does not exceed the limitation of paragraph (a)(5)(vii) of this section. A company that reports an advance premium in gross premiums written under this paragraph (a)(5)(iii) takes into account the remainder of the gross premium written and premium acquisition expenses for the contract in the taxable year that includes the effective date of the contract. A company that adopts this method of reporting advance premiums must use the method for all contracts with advance premiums.

(iv) *Exception for certain cancellable accident and health insurance contracts with installment premiums.* If an insurance company issues or proportionally reinsures a cancellable accident and health insurance contract (other than a contract with an effective period that exceeds 12 months) for which the gross premium is payable in installments over the effective period of the contract, the company may report the installment premiums (rather than the total gross premium for the contract) in gross premiums written for the earlier of the taxable year in which the installment premiums are due under the terms of the contract or the year in which the installment premiums are received. An insurance company may adopt this method of reporting installment premiums for a cancellable accident and health insurance contract only if the company's deduction for premium acquisition expenses for the first taxable year in which an installment premium is due or received under the contract does not exceed the limitation of paragraph (a)(5)(vii) of this section. A company that adopts this method of reporting installment premiums for a cancellable accident and health contract must use the method for all of its cancellable accident and health insurance contracts with installment premiums.

(v) *Exception for certain multi-year insurance contracts.* If an insurance company issues or proportionally reinsures an insurance contract, other than a contract described in paragraph (a)(5)(vi) of this section, with an effective period that exceeds 12 months, for which the gross premium is payable in installments over the effective period of the contract, the company may treat the insurance coverage provided under the multi-year contract as a series of separate insurance contracts.

The first contract in the series is treated as having been written for an effective period of twelve months. Each subsequent contract in the series is treated as having been written for an effective period equal to the lesser of 12 months or the remainder of the period for which the rates for insurance coverage are guaranteed in the multi-year insurance contract. An insurance company may adopt this method of reporting premiums on a multi-year contract only if the company's deduction for premium acquisition expenses for each year of the multi-year contract does not exceed the limitation of paragraph (a)(5)(vii) of this section. A company that adopts this method of reporting premiums for a multi-year contract must use the method for all multi-year contracts with installment premiums.

(vi) *Exception for insurance contracts described in section 832(b)(7)*. If an insurance company issues or reinsures the risks related to a contract described in section 832(b)(7), the company may report gross premiums written for the contract in the manner required by sections 803 and 811(a) for life insurance companies. An insurance company may adopt this method of reporting premiums on contracts described in section 832(b)(7) only if the company also determines the deduction for premium acquisition costs for the contract in accordance with section 811(a), as adjusted by the amount required to be taken into account under section 848 in connection with the net premiums of the contract. A company that adopts this method of reporting premiums for a contract described in section 832(b)(7) must use the method for all of its contracts described in that section.

(vii) *Limitation on deduction of premium acquisition expenses*. An insurance company's deduction for premium acquisition expenses (for example, commissions, state premium taxes, overhead reimbursements to agents or brokers, and other similar amounts) related to an insurance contract is within the limitation of this paragraph (a)(5)(vii) if–

(A) The ratio obtained by dividing the sum of the company's deduction for premium acquisition expenses related to the insurance contract for the taxable year and previous taxable years by the total premium acquisition expenses attributable to the insurance contract; does not exceed

(B) The ratio obtained by dividing the sum of the amounts included in gross premiums written with regard to the insurance contract for the taxable year and previous taxable years by the total gross premium written for the insurance contract.

(viii) *Change in method of reporting gross premiums.* An insurance company that adopts a method of accounting for gross premiums written and premium acquisition expenses described in paragraph (a)(5)(iii), (iv), (v), or (vi) of this section must continue to use the method to report gross premiums written and premium acquisition expenses unless the company obtains the consent of the Commissioner to change to a different method under section 446(e) and §1.446–1(e).

(6) *Return premiums*—(i) *In general*. An insurance company's liability for return premiums includes amounts previously included in an insurance company's gross premiums written, which are refundable to a policyholder or ceding company, provided that the amounts are fixed by the insurance contract and do not depend on the experience of the insurance company or the discretion of its management.

(ii) *Items included*. Return premiums include amounts–

(A) Which were previously paid and become refundable due to policy cancellations or decreases in risk exposure during the effective period of an insurance contract;

(B) Which reflect the unearned portion of unpaid premiums for an insurance contract that is canceled or for which there is a decrease in risk exposure during its effective period; or

(C) Which are either previously paid and refundable or which reflect the unearned portion of unpaid premiums for an insurance contract, arising from the redetermination of a premium due to correction of posting or other similar errors.

(7) *Method of reporting return premiums*. An insurance company reports the liability for a return premium resulting from the cancellation of an insurance contract for the taxable year in which the contract is canceled. An insurance company reports the liability for a return premium attributable to a reduction in risk exposure under an insurance contract for the taxable year in which the reduction in risk exposure occurs.

(8) *Unearned premiums*—(i) *In general*. 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. Unearned premiums also do not include any additional liability established by the insurance company on its annual statement to cover premium deficiencies. Unearned premiums do not include an insurance company's estimate of its liability for amounts to be paid or credited to a customer with regard to the expired portion of a retrospectively rated contract (retro credits). An insurance company's estimate of additional amounts payable by its customers with regard to the expired portion of a retrospectively rated contract (retro debits) cannot be subtracted from unearned premiums.

(ii) *Special rules for unearned premiums*. For purposes of computing "premiums earned on insurance contracts during the taxable year" under section 832(b)(4), the amount of unearned premiums includes—

(A) Life insurance reserves (as defined in section 816(b), but computed in accordance with section 807(d) and sections 811(c) and (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 that the company would be obligated to return to its policyholders at the close of the taxable year if all its insurance contracts were terminated at that time;

(C) In the case of an interinsurer or reciprocal underwriter that 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; and

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

(9) *Method of determining unearned premiums*. If the risk of loss under an insurance contract does not vary significantly over the effective period of the contract, the unearned premium attributable to the unexpired portion of the effective period of the contract is determined on a pro rata basis. If the risk of loss varies significantly over the effective period of the contract, the insurance company may consider the pattern and incidence of the risk in determining the portion of the gross premium that is attributable to the unexpired portion of the effective period of the contract. An insurance company that uses a method of computing unearned premiums other than the pro rata method must maintain sufficient information to demonstrate that its method of computing unearned premiums accurately reflects the pattern and incidence of the risk for the insurance contract.

(10) *Examples*. The provisions of paragraphs (a)(4) through (a)(9) of this section are illustrated by the following examples:

Example 1. (i) IC is a non-life insurance company which, pursuant to section 843, files its returns on a calendar year basis. IC writes a casualty insurance contract that provides insurance coverage for a one-year period beginning on July 1, 2000 and ending on June 30, 2001. IC charges a $500 premium for the insurance contract, which may be paid either in full by the effective date of the contract or in quarterly installments over the contract's one year term. The policyholder selects the installment payment option. As of December 31, 2000, IC collected $250 of installment premiums for the contract.

(ii) The effective period of the insurance contract begins on July 1, 2000 and ends on June 30, 2001. For the taxable year ending December 31, 2000, IC includes the $500 gross premium, based on the effective period of the contract, in gross premiums written under section 832(b)(4)(A). IC's unearned premium with respect to the contract was $250 as of December 31, 2000. Pursuant to section 832(b)(4)(B), to determine its premiums earned, IC deducts $200 ($250 x .8) for the insurance contract at the end of the taxable year.

Example 2. (i) The facts are the same as *Example 1*, except that the insurance contract has a stated term of 5 years. On each contract anniversary date, IC may adjust the rate charged for the insurance coverage for the succeeding 12 month period. The amount of the adjustment in the charge for insurance coverage is not substantially limited under the insurance contract.

(ii) Under paragraph (a)(5)(i) of this section, IC is required to report gross premiums written for the insurance contract based on the effective period for the contract. The effective period of the insurance contract is the period for which a rate for insurance coverage is guaranteed in the contract. Although the insurance contract issued by IC has a stated term of 5 years, a rate for insurance coverage is guaranteed only for a period of 12 months beginning with the contract's effective date and each anniversary date thereafter. Thus, for the taxable year ending December 31, 2000, IC includes the $500 gross premium for the 12 month period beginning with the contract's effective date in gross premiums written. IC's unearned premium with respect to the contract was $250 as of December 31, 2000. Pursuant to section 832(b)(4)(B), to determine its premiums earned, IC deducts $200 ($250 x .8) for the insurance contract at the end of the taxable year.

Example 3. (i) The facts are the same as *Example 1*, except that coverage under the insurance contract begins on January 1, 2001 and ends on December 31, 2001. On December 15, 2000, IC collects the first $125 premium installment on the insurance contract. For the taxable year ended December 31, 2000, IC deducts $20 of premium acquisition expenses related to the insurance contract. IC's total premium acquisition expenses, based on the insurance contract's $500 gross premium, are $80.

(ii) Under paragraph (a)(5)(iii) of this section, IC may elect to report only the $125 advance premium (rather than the contract's $500 gross premium) in gross premiums written for the taxable year ended December 31, 2000, provided that IC's deduction for the premium acquisition expenses related to the insurance contract does not exceed the limitation in paragraph (a)(5)(vii). IC's deduction for premium acquisition expenses is within this limitation only if the ratio of the insurance contract's premium acquisition expenses deducted for the taxable year and any previous taxable year to the insurance contract's total premium acquisition expenses does not exceed the ratio of the amounts included in gross premiums written for the taxable year and any previous taxable year for the contract to the total gross premium written for the contract.

(iii) For the taxable year ended December 31, 2000, IC deducts $20 of premium acquisition expenses related to the insurance contract. This deduction represents 25% of the total premium acquisition expenses for the insurance contract ($20/$80 = 25%). This ratio does not exceed the ratio of the $125 advance premium to the insurance contract's $500 gross premium ($125/$500 = 25%). Therefore, under paragraph (a)(5)(iii) of this section, IC may elect to report only the $125 advance premium (rather than the $500 gross premium) in gross premiums written for the taxable year ending December 31, 2000. IC reports the balance of the gross premium for the insurance contract ($375) and deducts the remaining premium acquisition expenses ($60) for the insurance contract in the taxable year ending December 31, 2001.

Example 4. (i) The facts are the same as *Example 3*, except that for the taxable year ending December 31, 2000, IC deducts $60 of premium acquisition expenses related to the insurance contract.

(ii) For the taxable year ended December 31, 2000, IC deducted 75% of total premium acquisition expenses for the insurance contract ($60/$80 = 75%). This ratio exceeds the ratio of the $125 advance premium to the $500 gross premium ($125/$500 = 25%). Because IC's deduction for premium acquisition expenses allocable to the contract exceeds the limitation in paragraph (a)(5)(vii) of this section, paragraph (a)(5)(i) of this section requires IC to report the $500 gross premium in gross premiums written for the taxable year ending December 31, 2000. IC's unearned premium with respect to the contract was $500 as of December 31, 2000. Pursuant to section 832(b)(4)(B), to determine its premiums earned, IC deducts $400 ($500 x .8) for the insurance contract at the end of the taxable year.

Example 5. (i) IC is a non-life insurance company which, pursuant to section 843, files its returns on a calendar year basis. On August 1, 2000, IC issues a one-year cancellable accident and health insurance policy to X, a corporation with 80 covered employees. The gross premium written for the insurance contract is $320,000. Premiums are payable in monthly installments. As of December 31, 2000, IC has collected $150,000 of installment premiums from X. For the taxable year ended December 31, 2000, IC has paid or incurred $21,000 of premium acquisition expenses related to the insurance contract. IC's total premium acquisition expenses for the insurance contract, based on the $320,000 gross premium, are $48,000.

(ii) Under paragraph (a)(5)(iv) of this section, IC may elect to report only the $150,000 of installment premiums (rather than the $320,000 estimated gross premium) in gross premiums written for the taxable year ended December 31, 2000, provided that its deduction for premium acquisition expenses allocable to the insurance contract does not exceed the limitation in paragraph (a)(5)(vii). For the taxable year ended December 31, 2000, IC deducts $21,000 of premium acquisition expenses related to the insurance contract, or 43.75% of total premium acquisition expenses for the insurance contract ($21,000/$48,000 = 43.75%). This ratio does not exceed the ratio of installment premiums to the gross premium for the contract ($150,000/$320,000 = 46.9%). Therefore, under paragraph (a)(5)(iv) of this section, IC may elect to report only $150,000 of installment premiums for the insurance contract (rather than $320,000 of gross premium) in gross premiums written for the taxable year ending December 31, 2000.

Example 6. (i) IC is a non-life insurance company which, pursuant to section 843, files its returns on a calendar year basis. On July 1, 2000, IC issues a one-year workers' compensation policy to X, an employer. The gross premium for the policy is determined by applying a monthly rate of $25 to each of X's employees. This rate is guaranteed for a period of 12 months, beginning with the effective date of the contract. On July 1, 2000, X has 1,050 employees. Based on the assumption that X's payroll would remain constant during the effective period of the contract, IC determines an estimated gross premium for the contract of $315,000 (1,050 x $25 x 12 = $315,000). The estimated gross premium is payable by X in equal monthly installments. At the end of each calendar quarter, the premiums payable under the contract are adjusted based on an audit of X's actual payroll during the preceding three months of coverage.

(ii) Due to an expansion of X's business in 2000, the actual number of employees covered under the contract during each month of the period between

July 1, 2000 and December 31, 2000 is 1,050 (July), 1,050 (August), 1,050 (September), 1,200 (October), 1,200 (November), and 1,200 (December). The increase in the number of employees during the year is not attributable to a temporary or seasonal variation in X's business activities and is expected to continue for the remainder of the effective period of the contract.

(iii) Under paragraph(a)(5)(i) of this section, IC is required to report gross premiums written for the insurance contract based the effective period of the contract. The effective period of X's contract is based on the 12 month period for which IC has guaranteed rates for insurance coverage. Under paragraph (a)(5)(ii), IC must also report the additional premiums resulting from the change in risk exposure under the contract for the taxable year in which the change in such exposure occurs. Unless the change in risk exposure is of temporary duration, the additional gross premiums are included in gross premiums written for the remainder of the effective period of the contract. Thus, for the taxable year ending December 31, 2000, IC reports gross premiums written of $348,750 with respect to the workers' compensation contract issued to X, consisting of the sum of the initial gross premium for the contract ($315,000) plus the additional gross premium attributable to the 150 employees added to X's payroll who will be covered during the last nine months of the contract's effective period (150 x $25 (monthly premium) x 9 = $33,750). IC's unearned premium with respect to the contract was $180,000 as of December 31, 2000, which consists of the sum of the remaining portion of the original gross premium ($315,000 x 6/12 = $157,500), plus the additional premiums resulting from the change in risk exposure ($33,750 x 6/9 = $22,500) that are allocable to the remaining six months of the contract's effective period. Pursuant to section 832(b)(4)(B), to determine its premiums earned, IC deducts $144,000 ($180,000 x .8) for the insurance contract at the end of the taxable year.

Example 7. (i) The facts are the same as *Example 6*, except that the increase in the number of X's employees for the period ending December 31, 2000 is attributable to a seasonal variation in X's business activity.

(ii) Under paragraph (a)(5)(ii) of this section, for the taxable year ending December 31, 2000, IC reports gross premiums written of $326,500, consisting of the sum of the initial gross premium for the contract ($315,000) plus the additional premium attributable to the temporary increase in risk exposure during the taxable year (150 x $25 x 3 = $11,250). The unearned premium that is allocable to the remaining six months of the effective period of the contract is $157,500. Pursuant to section 832(b)(4)(B), to determine its premiums earned, IC deducts $126,000 ($157,500 x .8) for the insurance contract at the end of the taxable year.

Example 8. (i) IC, a non-life insurance company, issues a noncancellable accident and health insurance contract (other than a qualified long-term care insurance contract, as defined in section 7702B(b)) to A, an individual, on July 1, 2000. The contract has an entry-age annual premium of $2,400, which is payable by A in equal monthly installments of $200 on the first day of each month of coverage. IC incurs agents' commissions, premium taxes, and other premium acquisition expenses equal to 10% of the gross premiums received for the contract. As of December 31, 2000, IC has collected $1,200 of installment premiums for the contract.

(ii) A noncancellable accident and health insurance contract is a contract described in section 832(b)(7). Thus, under paragraph (a)(5)(vi) of this section, IC may report gross premiums written in the manner required for life insurance companies under sections 803 and 811. Accordingly, for the taxable year ending December 31, 2000, IC may report gross premiums written of $1,200, based on the premiums actually received on the contract. Pursuant to section (a)(5)(vi) of this section, IC deducts a total of $28 of premium acquisition costs for the contract, based on the difference between the acquisition costs actually paid or incurred under section 811(a) ($1,200 x .10 = $120) and the amount required to taken into account under section 848 in connection with the net premiums for the contract ($1,200 x .077 = $92).

(iii) Under paragraph (a)(8)(ii)(A) of this section, IC includes the amount of life insurance reserves (as defined in section 816(b), but computed in accordance with section 807(d) and sections 811(c) and (d)) in unearned premiums under section 832(b)(4)(B). Section 807(d)(3)(A)(iii) requires IC to use a two-year preliminary term method to compute the amount of life insurance reserves for a noncancellable accident and health insurance contract (other than a qualified long-term care contract). Under this tax reserve method, no portion of the $1,200 gross premium received by IC for A's contract is allocable to future insurance coverage. Accordingly, for the taxable year ending December 31, 2000, no life insurance reserves are included in IC's unearned premiums under section 832(b)(4)(B) with respect to the contract.

Example 9. (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 ($825 x .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 ($1,200 x 11/12) and IC would have deducted $880 ($1,100 x .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 ($110 x .8) for the insurance contract at the end of the taxable year.

(11) *Change in method of accounting*—(i) *In general*. A change in the method of determining premiums earned to comply with the provisions of paragraphs (a)(3) through (a)(10) of this section is a change in method of accounting for which the consent of the Commissioner is required under section 446(e) and §1.446–1(e).

(ii) *Application*. For the first taxable year beginning after December 31, 1999, a taxpayer is granted consent of the Commissioner to change its method of determining premiums earned to comply with the provisions of paragraphs (a)(3) through (a)(10) of this section. A taxpayer changing its method of accounting in accordance with this section must follow the automatic change in accounting provisions of Rev. Proc. 99–49, 1999–52 I.R.B. 725 (see §601.601(d)(2) of this chapter), except that–

(A) The scope limitations in section 4.02 of Rev.

Proc. 99–49 shall not apply;

(B) The timely duplicate filing requirement in section 6.02(2) of Rev. Proc. 99–49 shall not apply; and

(C) If the method of accounting for determining premiums earned is an issue under consideration within the meaning of section 3.09 of Rev. Proc. 99–49 as of January 5, 2000, then section 7.01 of Rev. Proc. 99–49 shall not apply.

(12) *Effective date*. Paragraphs (a)(3) through (a)(11) of this section are applicable with respect to the determination of premiums earned for taxable years beginning after December 31, 1999.

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Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

Approved December 23, 1999.

Jonathan Talisman,
Acting Assistant Secretary of the Treasury.

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