Section 832.—Insurance Company Taxable Income

26 CFR 1.832–4.— Gross income.

Insurance companies; premium stabilization reserves. This ruling holds that additions to premium stabilization reserves are return premiums for purposes of determining the amount of premiums earned on insurance contracts during a taxable year.

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ISSUE

Are additions to a premium stabilization reserve return premiums for purposes of determining the amount of premiums earned on insurance contracts during the taxable year under § 832(b)(4)?

FACTS

IC is an insurance company other than a life insurance company, taxable under § 831(a) of the Internal Revenue Code. More than half of *IC*'s business is the issuing of insurance and annuity contracts, including group insurance contracts. Many of *IC*'s group insurance contracts are experience rated and provide for premium stabilization reserves.

IC's premium stabilization reserves are funds that it maintains under its group insurance contracts to stabilize the group policyholders' premiums over a number of years. These reserves are funded by experience rate credits on the group insurance policies. Specifically, rather than rebate amounts already included in gross premiums written to group policyholders based on experience, *IC* retains the amounts in premium stabilization reserves to pay extraordinary claims or to offset future premium increases for those policyholders. Each premium stabilization reserve arrangement is individually negotiated with the affected group policyholder. *IC* is contractually obligated to follow the formula outlined in the insurance contract for applying the premium stabilization reserve against future increases in premiums; the operation of the premium stabilization reserves is not subject to *IC*'s experience or discretion. The premium stabilization reserves are refundable to the group policyholders in the event the related group insurance contracts are cancelled. Thus, the premium stabilization reserves are not part of *IC*'s surplus.

LAW AND ANALYSIS

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(a) provides that, for this purpose, the term "taxable income" means the gross income as defined in § 832(b)(1) less the deductions allowed by § 832(c).

Section 832(b)(1) provides that the gross income of an insurance company that is subject to the tax imposed by § 831 includes the combined gross amount earned during the taxable year from investment income and from underwriting income as provided in § 832(b), computed on the basis of the underwriting and investment exhibit of the annual statement approved by the National Association of Insurance Commissioners (NAIC). 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 amount of premiums earned on insurance contracts during the taxable year is computed by subtracting from gross premiums written any return premiums and amounts paid for reinsurance. 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 reduced by 80 percent of the unearned premiums on outstanding business at the end of the taxable year.

Section 1.832–4(a)(6)(i) of the Income Tax Regulations provides that 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.

Section 1.832–4(a)(4)(i) of the regulations provides that gross premiums written are amounts payable for insurance coverage, and that gross premiums written on an insurance contract include all amounts payable for the effective period of an insurance contract. Section 1.832–4(a)(4)(ii) enumerates specific items that must be included in gross premiums written, including amounts subtracted from a premium stabilization reserve to pay for insurance coverage.

The amounts that *IC* adds to its premium stabilization reserves with respect to group insurance contracts are return premiums within the meaning of § 1.832–4(a)(6)(i) of the regulations. The amounts were previously included in *IC*'s gross premiums written. They do not depend on the experience of *IC* or the discretion of *IC*'s management. Pursuant to formulas that are fixed in the group insurance contracts, the amounts are refundable to *IC*'s group policyholders, either to pay extraordinary claims, to offset future premium increases, or (in the event the contract is cancelled) to rebate the amounts previously paid as premiums.

Because the amounts that *IC* adds to its premium stabilization reserves are return premiums within the meaning of § 1.832–4(a)(6)(i) of the regulations, those amounts are subtracted from gross premiums written to compute premiums earned on insurance contracts under § 832(b)(4). When *IC* subtracts amounts from its premium stabilization reserves in the future to pay for insurance coverage on behalf of the same group policyholders, the amount subtracted will increase gross premiums written under § 1.832–4(a)(4)(ii)(B).

HOLDING

Additions to a premium stabilization reserve are return premiums for purposes of determining the amount of premiums earned on insurance contracts during the taxable year under § 832(b)(4).

DRAFTING INFORMATION

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