Office of Chief Counsel
Internal Revenue Service

memorandum

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CWMaurer

date: AUG 02 2001

to: Associate Area Counsel(LMSB), Manhattan, NY
Attention: Cheryl McInroy

from: Associate Area Counsel(LMSB), Boston, MA

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subject: Taxpayer: [redacted]
Unearned Premium Reserves of Title Insurers

This refers to an EMail February 2, 2001, from Cheryl McInroy of your office to Charles Maurer of this office and subsequent conversations regarding the treatment of unearned premium reserves of title insurers. This memorandum should not be cited as precedent.

ISSUES:

1. Is a title insurer required to use the same method of accounting for determining undiscounted unearned premiums for annual statement purposes and for federal income tax purposes?

2. If a title insurer uses the same method for determining undiscounted unearned premiums for annual statement purposes and for federal income tax purposes, and then changes the method used for annual statement purposes, would the use of the new method for federal income tax purposes be considered a change in method of accounting?

CONCLUSIONS:

1. A title insurer is required to use the same method of accounting for determining undiscounted unearned premiums for annual statement purposes and for federal income tax purposes.

2. If a title insurer changes the method used for determining undiscounted unearned premiums for annual statement purposes, the use of the new method for federal income tax purposes would be considered a change in method of accounting

FACTS

[redacted] is a subsidiary of the taxpayer, [redacted]. [redacted] is a domiciliary of [redacted].

The adjustments in dispute are based on the difference between the reserves shown on [redacted]'s tax returns, and the reserves shown on its Annual Statements.

Year	Undiscounted Reserve per Tax Return	Undiscounted Reserve per Annual Statement	Difference
[redacted]	[redacted]	[redacted]	[redacted]

The deductions claimed are based on the discounted reserves. The discounted reserves shown on the tax return were as follows:

Year	Beginning of Year	End of Year	Deduction Claimed
[redacted]	[redacted]	[redacted]	[redacted]

The examining agent has determined that the corrected discounted reserves are as follows, with corresponding adjustments from the discounted amounts shown on the tax returns:

	Corrected Reserve				
	Beginning of Year	End of Year	Deduction Allowed	Deduction Claimed	Disallowance
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]

[redacted] maintains a statutory premium reserve (SPR) as required by state law.

[redacted] categorizes state reserving requirements under four methods: [redacted], [redacted], [redacted], and [redacted]. Prior to [redacted], [redacted] computed the SPR shown in its Annual Statement based upon one of these four methods for each state. Where a state required the computation of SPR, [redacted] used one of these specific methods for Annual Statement purposes. Where a state did not have a requirement for a specific method for computation of SPR, the [redacted] method was used to ensure that [redacted] at least met the [redacted] SPR requirement. The

aggregate of these computations was then included in [redacted]'s Annual Statements. The same computations were used for tax purposes.

For years after [redacted], [redacted] changed its computation methods for Annual Statement purposes. [redacted] first computed its SPR based on each individual state's statutory requirement, reflecting no SPR for those states that did not have an SPR requirement. Note that before [redacted], if the state did not have a requirement for a specific method, the [redacted] method was used. Second, [redacted] computed its SPR requirement based on the [redacted] method, on all its business. This is different from the method used before [redacted], where the local methods for [redacted], [redacted], and [redacted] were used for some states, and the [redacted] method was the default method for the states that had no requirement for SPR. For years after [redacted], [redacted] made an alternative computation using the [redacted] method for all states. [redacted] then compared the two computations. Since the [redacted] method produced the greater SPR when compared to each individual state's SPR in the aggregate, [redacted] used the SPR computed under the [redacted] method in its Annual Statements.

However, the [redacted] method produced lesser amounts of undiscounted SPR, and thus more earned premium, than the method used prior to [redacted]. Accordingly, for income tax purposes [redacted] continued to use the method for computation of SPR that it had used for pre-[redacted] years.

It does not appear that the change in [redacted]'s computation method for Annual Statement purposes was required by any change in state law. Rather, it appears that the method [redacted] used before [redacted], and the method it used for years after [redacted], were both acceptable methods under state law.

DISCUSSION

In 1986, Congress amended section 832 regarding the two principal reserves maintained by property and casualty insurance companies: unearned premiums, and unpaid losses. In addition to these amendments, Congress also made changes in the treatment of title insurance reserves, which had been a long-standing subject of dispute.

In 1924, the Service took the position that title insurers were not entitled to claim a reserve for unearned premiums. During the 1930's and 1940's, state laws were enacted specifically requiring "unearned premium" reserves for title insurers, and the Service allowed such reserves in those states.

In 1983, the Service returned to its original position, contending that title insurers could not claim reserves for unearned premiums, since such reserves were redundant of unpaid loss reserves that included losses incurred but not reported. In 1984, based on a representation that a substantial majority of title insurers do not include losses incurred but not reported in their unpaid loss reserves, the Service announced it was reconsidering its position.

The Tax Reform Act of 1986 amended the general treatment of unearned premiums and of unpaid losses, while enacting specific provisions that resolved the dispute in the treatment of title insurance reserves. Section 832(b)(4) deals generally with "premiums earned." The 1986 amendments provide in effect that only 80 percent of any change in the unearned premium reserve will be taken into account for tax purposes. Section 832(b)(5) deals generally with "losses incurred." The 1986 amendments provide that changes in the reserve for unpaid losses shall be discounted.

The specific provisions applicable to title insurance reserves are placed in section 832(b)(8), under the heading "Special rules for applying paragraph (4) to title insurance premiums." Section 832(b)(8)(A) provides that, in computing premiums earned, rather than using 80 percent of the unearned premiums, as required generally by section 832(b)(4), title insurance companies should instead use the "discounted unearned premiums." Section 832(b)(8)(C)(i) states that "The term 'undiscounted unearned premiums' means the unearned premiums shown in the yearly statement filed by the taxpayer for the year ending with or within such taxable year." In other words, title insurance premium reserves are treated as unearned premiums, subject to section 832(b)(4), but rather than being reduced by 20 percent as is the case with unearned premiums generally, title insurance premium reserves are subject to discounting similar to unpaid loss reserves.

In the present case, for tax purposes the taxpayer has continued to use the method of computing unearned premiums which it used on its annual statement prior to [redacted]. However, in preparing its annual statement, the taxpayer now uses a different method of computing unearned premiums. It does not appear that the taxpayer was compelled by state law to change the method it uses for annual statement purposes. Rather, it appears that both the method it is currently using for annual statement purposes, and the method it formerly used for annual statement purposes and continues to use for federal income tax purposes, are acceptable methods under state law.

As indicated above, section 832(b)(8)(C)(i) provides that in computing a title insurance company's premiums earned, "The term 'undiscounted unearned premiums' means the unearned premiums shown in the yearly statement filed by the taxpayer for the year ending with or within such taxable year." (Emphasis added.) Accordingly, with respect to this income item of title insurers, the Code has incorporated not just the format of the annual statement, but the actual number shown in the annual statement.

Since the Code incorporates the actual number for undiscounted unearned premiums shown in the annual statement, the method which a title insurer uses for computing that number must also be used for federal income tax purposes. If the taxpayer changes the method it uses for annual statement purposes, the use of that method for federal income tax purposes would be considered a change in method of accounting.

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By: /s/ CWM
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