This memorandum responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Company =
Experience =
Premium Stabilization Reserve =
x% =
Year1 =
Year2 =
$r =
$s =
$t =
$u =
ISSUE

May positive balances in the Company’s Experience Premium Stabilization Reserve (“PSR”) accounts be deducted from gross income under I.R.C. § 832?

CONCLUSION

The positive balances in the PSR are not return premiums and cannot be deducted from gross income under I.R.C. § 832 until they are refundable to customers or creditable to customers’ accounts. Because the Company’s contracts at issue provide that positive PSR balances are not returned to a customer upon termination of the contract, the Company’s liability for the amounts at issue is not fixed.

FACTS

The exam team reports the following pertinent facts:

[The Company] provides retrospectively rated group insurance policies in which the final policy premium is dependent on the policyholder’s actual loss experience during the policy period. The policyholder will pay a deposit or provisional premium that is earned over the policy period. This premium is then adjusted for loss experience. If the policyholder’s loss experience is positive (less claims expected) they will receive a [credit on future premiums]. If the policyholder’s experience is negative, they will receive an additional billing. Refunds or additional billings are either cash payments or a reduction/increase in future premiums.

The items in question are referred to as [PSR] contracts that are not settled upon termination. The policyholder will not owe [the Company] and [the Company] will not owe the policyholder if the contract is not renewed. In [Year1], the taxpayer had an actuarially computed amount owed of $[r] ["positive PSR balance"] and an actuarially computed receivable of $[s] ["negative PSR balance"]. In [Year2], the liability was $[t] and the receivable was $[u].

These retrospective contract arrangements give the policyholders the financial benefit of good experience and hold them accountable for poor experience. When experience is better than what was expected in the rating assumptions, the excess premium is accumulated in the rate stabilization reserve. The [positive PSR] is reflected as a liability to the policyholders in the trial balance and is deducted from income on the tax return. If the experience of the group is worse than anticipated, the group is held accountable and a receivable [negative PSR] is computed. The
[negative PSR] receivable is not booked in the general ledger and is not taken into income on the tax return.

We reviewed a sample contract that the Company provided to the exam team. The taxpayer’s PSR rating formula is only one of many that it uses. Each PSR contract is settled annually and includes a PSR account. Under PSR experience rated arrangements, gains and losses are not returned to or recovered from the group policyholder at termination, but they are considered when calculating renewal rates.

If the group policyholder wishes to renew its contract and has a positive balance, the insured may select either a rate credit or a cash refund in an amount up to x% of the positive PSR balance. The Company’s response to an IDR states that, despite the contract’s allowance for cash refunds, none of the positive PSR balances are paid in cash; they all are amortized in the next contract year. If the policyholder has a negative balance, that negative PSR balance is recouped in the policy renewal rate based on a graded scale defined elsewhere in the contract.

If a PSR policy holder changes to a different type of Company plan, the contract provides that the insured’s PSR balance will be transferred to that new funding arrangement and amortized over an unspecified period of time. The contract also states that if a PSR insured terminates its contract and subsequently re-enrolls in a Company experience-rated group or administrative services contract, the Company may credit or recoup a prorated portion of the insured’s prior PSR balance, which may be amortized over an unspecified period of years. The contract does not specify the terms under which the Company may (or may not) credit or recoup a customer’s prior PSR balance.

The group customer must pay all premiums at least one month in advance. Either the customer or the Company may terminate the contract upon 30 days written notice. The Company also may terminate the contract immediately if premiums are more than 30 days past due.

**LAW AND ANALYSIS**

I.R.C. § 461(a) states that the amount of any deduction allowed by Subtitle A (Income Taxes) shall be taken for the taxable year that is proper under the taxpayer’s method of accounting.

I.R.C. § 461(h)(1) provides that, in determining 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 when economic performance occurs. The all events test is met with respect to any item if all the events have occurred that establish the fact of the liability and the amount of such liability can be determined with reasonable accuracy.

I.R.C. § 461(h) does not apply to any item for which a deduction is allowable under another Code provision that specifically provides for a deduction for a reserve for estimated expenses. I.R.C. § 461(h)(5).

I.R.C. § 831(a) imposes a tax on the taxable income of every insurance company that is not a life insurance company.

I.R.C. § 832(a) provides that the taxable income of an insurance company is gross income, as defined in I.R.C. § 832(b)(1), less deductions allowed by I.R.C. § 832(c). Gross income includes, in relevant part, underwriting income, which in turn includes premiums earned on insurance contracts during the taxable year. I.R.C. § 832(b)(1), (3). 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, plus other adjustments as specified in I.R.C. § 832(b)(4).

Gross premiums written include any additional premiums resulting from increases in risk exposure during the effective period of an insurance contract and amounts subtracted from a premium stabilization reserve to pay for insurance coverage. Treas. Reg. § 1.832-4(a)(4)(ii)(A)-(B). 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, the company reports additional premiums resulting from an increase in risk exposure based on the remainder of the effective period of the insurance contract. Treas. Reg. § 1.832-4(a)(5)(ii).

Treas. Reg. § 1.832-4(a)(6)(i) provides that an insurance company's liability for return premiums includes amounts previously included in the company's gross premiums written that 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. Return premiums include amounts (A) that were previously paid and become refundable due to policy cancellations or decreases in risk exposure during the effective period of an insurance contract or (B) that 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. Treas. Reg. § 1.832-4(a)(6)(ii)(A)-(B). 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 cancelled; it 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. Treas. Reg. § 1.832-4(a)(7).
The Company argues that the amounts in the positive PSR are return premiums within the meaning of Treas. Reg. § 1.832-4(a)(6)(i); they were previously included in the Company’s gross premiums written and they are fixed by the contracts and do not depend on the Company’s experience or the discretion of management. However, the Company’s positive PSR balances are not refundable to the policyholder unless the policy holder renews the contract. The regulations specify that the return premiums must be refundable. Treas. Reg. § 1.832-4(a)(6)(i) (“an insurance company’s liability for return premiums includes amounts . . . that are refundable to a policyholder”). Given the language of the Company contracts that gains and losses are not returned to or recovered from the policyholder at termination but only are considered when calculating renewal rates, the amounts at issue are not “return premiums” as defined in Treas. Reg. § 1.832-4(a)(6)(i).

Rev. Rul. 2005-33, 2005-1 C.B. 1155, is distinguishable. In Rev. Rul. 2005-33, the taxpayer, like the Company, had premium stabilization reserves for group insurance contracts. The question presented was whether additions to the reserve (via experience rate credits) constituted return premiums when determining premiums earned under I.R.C. § 832(b)(4). In the Revenue Ruling, however, the premium stabilization reserves were refundable to the group policyholders if the contracts were cancelled. The Company’s contracts do not contain the same provision; it is entitled to keep amounts in its PSR upon contract cancellation.

Because the additions to the Company’s PSR are not return premiums, the Company cannot subtract its positive PSR amounts from gross premiums under I.R.C. § 832. In addition, the liability for the positive PSR is not fixed under the all events test of I.R.C. § 461(h); a condition precedent (customer renewal) exists to the fixing of the Company’s liability to refund or give credit to its customers. A condition precedent to a liability prevents that liability from meeting both parts of the all events test and, therefore, makes the item non-deductible. United States v. General Dynamics Corp., 481 U.S. 239, 243-44 (1987) (noting that a taxpayer may not “deduct an estimate of an anticipated expense, no matter how statistically certain, if it is based on events that have not occurred by the close of the taxable year.”). Because it is not refundable, the PSR is merely an estimated reserve. See I.R.C. § 461(h)(5). Finally, because the Company’s contracts limit any refunds or rate credits to up to x% of a positive PSR balance, the Company’s liability, even when fixed, does not exceed the amounts actually owed to customers.¹

The positive PSR becomes a return premium under I.R.C. § 832(b)(4) and Treas. Reg. § 1.832-4(a)(6) when the Company is required to refund or credit a customer. According to the Company’s contract, this liability to refund or credit a customer occurs when the customer renews its contract and the renewal premium is due. Until that time,

¹ We assume the actuarially determined positive PSR balance on the Company’s books takes into account the x% limitation, but we suggest exam verify this fact.
the Company’s liability to refund or credit any positive PSR balance is contingent on the
customer’s renewal.

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determined to be necessary, please contact this office for our views.

Please call (313) 628-3133 if you have any further questions.

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