



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR ASSOCIATE AREA COUNSEL

SPECIAL LITIGATION

ASSISTANT
CC:LM:NR:DEN

FROM: Donald J. Drees, Jr.

SUBJECT: Calculation of premiums earned

This Chief Counsel Advice responds to your memorandum dated July 12, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Taxpayer =

Company Y =

State Z =

Date 1 =

Date 2 =

Date 3 =

Year 1 =

I =

m =

n =

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o =p =q =r = _____s = _____t =u = _____v =w =x =y =z =ISSUES

What is Taxpayer's proper tax accounting treatment of the payments to and from the "experience account" established by the reinsurance contract entered into between Taxpayer and Company Y?

CONCLUSIONS

Taxpayer must recognize refunds that are payable based on the loss experience of the reinsurance treaties as an adjustment in computing premiums earned under § 832(b)(4) of the Internal Revenue Code for the taxable year in which the losses, or lack thereof, that give rise to these refunds are ascertainable. The portion of the initial reinsurance premium that is paid to the reinsurer regardless of the loss experience of the reinsurance treaty is a reduction of gross premiums written under § 832(b)(4)(A) for the taxable year in which this reinsurance premium is issued. We recommend that the Service effect a change in Taxpayer's method of accounting for its payments to and from the experience account in a manner consistent with the above.

FACTS

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Taxpayer is a mutual insurance company organized and operating in State Z. Taxpayer provides medical malpractice insurance to doctors, hospitals, medical group practices, and other health care providers. Its policies are offered on a claims-made basis. The policies offer extended tail coverage to individual policyholders at death, retirement, or disability at no additional premium. The policies have limits of l dollars per occurrence and m dollars and n dollars aggregates for doctors and hospitals, respectively.

Taxpayer reinsures a portion of its business through four “layers” of reinsurance contracts. The first layer cedes 80 percent of the first o dollars in excess of p dollars of loss. The second layer cedes 100 percent of the first q dollars of loss in excess of the first layer. The third layer cedes 100 percent of the first r dollars of loss in excess of the first two layers.

Taxpayer’s fourth layer of reinsurance is the transaction that is at issue in this field service advice. This layer of reinsurance is an aggregate excess of loss contract between Taxpayer and Company Y, an unrelated, domestic insurance company.¹ The contract became effective Date 1 and has been extended each year through Year 1, the year under examination. Throughout the contract years, the contract has been amended four times, but these amendments have not significantly affected the substance of the arrangement.

For the purposes of this field service advice, the most important provisions of the contract are as follows:

- The contract provides for a notional “experience account” that is increased annually by a specified amount. Prior to Date 2, this amount was s percent of the reinsurance premium, net of the ceding commission.² After Date 3, this amount was u percent of the reinsurance premium.
- The experience account is reduced by the amount of losses paid to Taxpayer by reinsurer.
- The balance of this experience account is credited annually with an interest rate equal to the one-year Treasury Bill yield.
- Upon cancellation of the contract, the reinsurer must pay the balance of the experience account to the Taxpayer. The contract may be cancelled by the

¹ Hereinafter, all references to the “contract” will refer to the reinsurance contract between Taxpayer and Company Y.

² The contract provides for a ceding commission of t percent, depending on the contract year.

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Taxpayer or the reinsurer upon 90 days notice or upon the failure to pay premiums due.

- Taxpayer has the option to partially commute the experience account at any time.
- The reinsurer's obligation to pay Taxpayer's losses in excess of the retention and of all other layers of reinsurance is subject to a specific limit. In Year 1, this limit was y dollars annually with an aggregate limit of the greater of (1) w dollars; (2) 200 percent of reinsurance premiums, net of ceding commissions; or (3) the experience account balance.³

Thus, the contract provides a mechanism whereby a substantial portion of the reinsurance premium to Company Y may be refunded to Taxpayer. The amount of the refund, if any, depends on the loss experience of the reinsured contracts. The refund may be collected, in whole or in part, by Taxpayer through partial or complete commutation.

Under Taxpayer's current method of accounting, payments made by Taxpayer to the experience account are considered premiums paid for reinsurance and are used to decrease Taxpayer's taxable income by reducing premiums earned under § 832(b)(4)(A). Taxpayer will treat any payments received from the experience account as income in the year of receipt. Taxpayer does not include the interest added to the experience account as income until such time as it is remitted to Taxpayer in the form of payment from the experience account. Taxpayer uses an accrual method of accounting.

LAW AND ANALYSIS

The tax base of an insurance company subject to the tax imposed by § 831 includes the company's underwriting income. § 832(b)(1). A component of underwriting income is "the premiums earned on insurance contracts during the taxable year." § 832(b)(3). Section 832(b)(4) provides that "the premiums earned on insurance contracts during the taxable year" are composed, in part, of the gross premiums written on insurance contracts during the taxable year, less return premiums and premiums paid for reinsurance.

In Rev. Rul. 77-453, 1977-2 C.B. 236, the Internal Revenue Service held that an accrual method stock casualty company that enters into an excess loss type reinsurance treaty should reduce gross premiums written in the taxable year in which the treaty becomes effective plus the additional premiums accrued based on the loss experience on the reinsured policies during the taxable year. The reinsurer is required to include in its gross premiums written under § 832(b)(4)(A)

³ In Year 1, the experience account balance was approximately x dollars.

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the amount of the additional reinsurance premium that it has a fixed right to receive under the reinsurance treaty when such amount is reasonably ascertainable based on the loss experience of the insured contracts. Rev. Rul. 77-453.

Although Rev. Rul. 77-453 addressed a situation in which the loss experience of the reinsurance treaty resulted in a liability on the part of the ceding company for payment of additional premiums to the reinsurer, the ruling's holding that reinsurance premium adjustments that are dependent on loss experience are accruable when the amount of such losses are reasonably ascertainable also applies to experience-based refunds payable to the ceding company. See also National Association of Insurance Commissioners, Accounting Practices and Procedures Manual for Property/Casualty Insurance Companies, 22-9 (1997) ("If the reinsurance treaty incorporates an obligation on the part of the assuming company to refund to the ceding company any portion of the consideration received by the assuming company based upon loss experience under the treaty, . . . such refund shall be recognized by the ceding company during the accounting period in which the loss event(s) giving rise to the obligation to make such refund occur(s)").

Taxpayer's current method of accounting for payments to and from the experience account is incorrect. The portion of the initial reinsurance premium that is paid by Taxpayer to the reinsurer regardless of the loss experience of the reinsurance treaty (y percent of the reinsurance premium, net of ceding commission, before Date 2 and z percent of the reinsurance premium after Date 3) must be recognized by Taxpayer as a reduction of gross premiums written under § 832(b)(4)(A) for the taxable year in which this reinsurance premium is issued. Refunds from the experience account that are payable to Taxpayer based on the loss experience of the reinsurance treaties (including any refund amount available because of interest accrued on the experience account) must be recognized by Taxpayer as an adjustment in computing premiums earned under § 832(b)(4) for the taxable year in which the losses, or lack thereof, that give rise to those refunds are ascertainable.

We recommend that the Service effect a change in Taxpayer's method of accounting for its payments to and from the experience account in a manner consistent with the above analysis. This change in Taxpayer's method of accounting requires an adjustment in the year of change to correct any duplications or omissions caused by the accounting method change. § 481(a); Rev. Proc. 97-27, 1997-1 C.B. 680. Because the method change will be involuntary, Taxpayer must include the entire § 481(a) adjustment in income in the year of change, which is Taxpayer's earliest taxable year under examination. Rev. Proc. 97-27.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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Associate Area Counsel's request for Chief Counsel Advice concerning this matter involved the potential application of § 845(b) to the reinsurance contract entered into between Taxpayer and Company Y. However, it is our position that the above described change in Taxpayer's method of accounting along with the corresponding § 481(a) adjustment is the proper treatment of the transaction at issue. Thus, at this time we decline to address the potential application of § 845(b) to the issue presented by this case.

[REDACTED]

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Please call if you have any further questions.

Sincerely yours,
DONALD J. DREES, JR.
Senior Technician Reviewer, Branch 4
Office of Associate Chief Counsel
(Financial Institutions & Products)