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INTERNAL REVENUE SERVICE  
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR DISTRICT COUNSEL

FROM: DEBORAH A. BUTLER  
ASSISTANT CHIEF COUNSEL (FIELD SERVICE) CC:DOM:FS

SUBJECT: Unearned Premium Reserve

This Field Service Advice responds to your memorandum dated May 6, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

Taxpayer =  
Company A =  
Reinsurer =  
Year 1 =  
\$A =

ISSUES:

- 1) Whether a property and casualty insurer which issues claims-made medical malpractice insurance policies<sup>1</sup> may maintain an unearned premium reserve

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<sup>1</sup> Under a claims-made policy, the insurer only provides coverage for claims filed during the policy year.

attributable to the projected cost of providing tail coverage<sup>2</sup> during the extended reporting period triggered by the insured's death, when the insured is not deceased at the end of the taxable year.

- 2) Whether a property and casualty insurer which issues claims-made medical malpractice insurance policies may maintain an unearned premium reserve attributable to the projected cost of providing tail coverage during the extended reporting period triggered by the insured's disability, when the insured is not disabled at the end of the taxable year.
- 3) Whether a property and casualty insurer which issues claims-made medical malpractice insurance policies may maintain an unearned premium reserve attributable to the projected cost of providing tail coverage during the extended reporting period triggered by the insured's retirement, when the insured is not retired at the end of the taxable year.
- 4) Whether, assuming that all or some of the above-mentioned reserve is properly treated as unearned premium for federal income tax purposes, taxpayer may treat such unearned premium reserves as life insurance reserves pursuant to I.R.C. ' 832(b)(7)(A), thereby avoiding the 20% haircut@ applicable to unearned premium reserves for property and casualty insurance pursuant to ' 832(b)(4).<sup>3</sup>
- 5) Whether, assuming that all or some of the above-mentioned reserve should be treated as an unearned premium reserve, such reserve should be reduced by potential ceded losses.

#### CONCLUSION:

- 1-3) Taxpayer may treat the reserve in question as an unearned premium reserve for tax purposes.
- 4) No portion of the reserve qualifies as a life insurance reserve.
- 5) No portion of the reserve should be reduced for ceded losses.

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<sup>2</sup> ATail coverage@ refers to claims that are covered under a claims-made policy although they are submitted after the policy has terminated.

<sup>3</sup> Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as in effect during the taxable year in issue.

FACTS:

Taxpayer provides medical malpractice coverage to physicians on a claims-made basis. The policies at issue provide coverage for claims submitted during the policy period. The policies also provide free tail coverage for claims filed after the policy terminates, if termination occurs as a result of the insured's death, disability, or retirement. Taxpayer has reinsured the risks attributable to these policies by entering into an excess of loss reinsurance treaty with Reinsurer.<sup>4</sup>

At the end of calendar Year 1, Taxpayer maintained a reserve (the DDR reserve) in the amount of \$A with respect to the tail coverage triggered by the death, disability, or retirement of its insureds. Taxpayer treated the DDR reserve on its annual statement as an unearned premium reserve.<sup>5</sup> Taxpayer's independent actuary, Company A, described the DDR reserve as an estimate of the difference between:

- (i) expected losses associated with the future utilization of this benefit by current [Taxpayer] insureds, and (ii) expected premium covering the benefit to be received in the future from current [Taxpayer] insureds.

Company A computed the DDR reserve in part by estimating the expected cost of medical malpractice claims covered by the future free tail coverage endorsements. Company A also computed the DDR reserve by estimating the number and timing of future free tail coverage endorsements to be issued to Taxpayer's current policyholders on the basis of those policyholders' assumed mortality, disability, and retirement rates.

For tax purposes, Taxpayer treated the DDR reserve as both an unearned premium reserve and as a life insurance reserve. Taxpayer did not reduce the DDR reserve for amounts recoverable from Reinsurer pursuant to the reinsurance treaty.

LAW AND ANALYSIS:


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<sup>4</sup> Under an excess of loss reinsurance policy, the reinsurer agrees to be liable for claims filed with the insurer to the extent that each claim, or an aggregation of claims, exceed a certain amount.

<sup>5</sup> The term annual statement refers to the financial statement form prescribed by the National Association of Insurance Commissioners.

Since Taxpayer is an insurance company other than a life insurance company, it is taxable under ' 831 et seq. Under ' 832(a), the term "taxable income" means gross income as that term is defined in ' 832(b)(1), less the deductions allowed by ' 832(c). Under ' 832(b)(1) Agross income@includes, inter alia, the sum of Athe combined gross amount earned during the taxable year, from investment income and from underwriting income as provided in this subsection....@ ' 832(b)(1)(A). Section 832(b)(3) defines Aunderwriting income@as Athe premiums earned on insurance contracts during the taxable year less losses incurred and expenses incurred.@ Section 832(b)(4) provides that Apremiums earned@means an amount computed, in part, by adding A80 percent of the unearned premiums on outstanding business at the end of the preceding taxable year and deduct[ing] 80 percent of the unearned premiums on outstanding business at the end of the taxable year.@ ' 832(b)(4)(B). Section 832(b)(7)(A) further provides that with respect to any portion of the unearned premium reserve attributable to contracts described in ' 816(b)(1)(B) (i.e., life insurance, annuity, and noncancellable accident and health insurance contracts involving life, accident, or health contingencies), ' 832(b)(4)(B) will apply by substituting A100 percent@for A80 percent.@

Thus, Taxpayer is entitled to deduct 80 percent of the DDR reserve from its gross income to the extent that the DDR reserve qualifies as an unearned premium reserve from contracts other than life insurance, and Taxpayer is entitled to deduct 100 percent of the DDR reserve to the extent that the DDR reserve qualifies as both an unearned premium reserve and a life insurance reserve attributable to contracts described in ' 816(b)(1)(B).

Issues 1-3: Whether Taxpayer may treat any or all of its DDR reserve as an unearned premium reserve for tax purposes.

We first address the question of whether any or all of the DDR reserve constitutes an unearned premium reserve. An unearned premium reserve is an amount set aside by an insurer in recognition that certain premiums are paid in advance and are Aearned@by the insurer as the protection is actually provided. Phoenix Mut. Life Ins. Co. v. Commissioner, 96 T.C. 497, 521 n.29 (1991). As explained by the Tax Court in Bituminous Casualty Corp. v. Commissioner, 57 T.C. 58, 81 (1971), acq. 1973-2 C.B. 1:

The term Aunearned premium@is entirely a term of insurance art and can be understood only by reference to industry practice and history. The Aunearned premium reserve@... grew up historically as a reserve for insolvency reinsurance, i.e., as the amount required to be set aside out of premiums to compensate some reinsurer if, in the event of insolvency, it should be necessary for the reinsurer to undertake fulfillment of the original insurer=s obligations to policyholders for periods subsequent to the date of reinsurance.

Obviously, the ... reserves involved here are the kind of obligation for which a reinsurer would require compensation if it were to take over future obligations to a company's policyholders.

Although the policies at issue are claims-made, the DDR reserve is attributable to coverage for certain claims filed after the policy has been otherwise terminated. A portion of the premiums charged by Taxpayer are, therefore, attributable to coverage for periods which had not elapsed as of the end of the policy year. Accordingly, the premiums received by Taxpayer with respect to these policies were not wholly earned as of the end of the period for which they were paid. See Massachusetts Protective Ass'n, Inc. v. United States, 114 F.2d 304, 310 (1<sup>st</sup> Cir. 1940) (premiums for noncancellable level premium accident and health insurance are not wholly earned because a portion of the premiums are paid for coverage in subsequent years). In this regard, if Taxpayer were to become insolvent, a reinsurer accepting Taxpayer's medical malpractice risks through a portfolio or assumption reinsurance transaction would require compensation for subsequent tail coverage liabilities. For the foregoing reasons, we conclude that the DDR reserve should be treated as an unearned premium reserve for tax purposes.

Issue 4: Whether Taxpayer may treat any or all of its DDR reserve as a life insurance reserve.

We now turn to whether the DDR reserve constitutes a life insurance reserve for purposes of ' 832(b)(7)(A). As mentioned, ' 832(b)(7)(A) only applies to contracts described in ' 816(b)(1)(B).<sup>6</sup> Section 816(b) provides:

(1) In General.-- For purposes of this part, the term life insurance reserves means amounts **B**

(A) which are computed or estimated on the basis of recognized mortality or morbidity tables and assumed rates of interest, and

(B) which are set aside to mature or liquidate, either by payment or reinsurance, future unaccrued claims arising from life insurance, annuity, and noncancellable accident and health insurance contracts ... involving, at the time with respect to which the reserve is computed, life, accident, or health contingencies.

Accordingly, a life insurance reserve is defined by the manner in which it is computed, by the contingency that gives rise to a claim, and by the nature of the contract from which the claim arises. In this case, the DDR reserve does not arise from either life insurance, annuity, or noncancellable accident and health insurance contracts. Rather, the reserves are attributable to medical malpractice liability contracts. Moreover, the DDR reserve, insofar as it is attributable to claims payable upon the retirement or disability of an insured, cannot constitute a life insurance reserve because it is payable upon a contingency other than death. See Aetna Life Ins. Co. v. United States, 16 Cl. Ct. 364, 378 (1989), aff-d. by unpublished opinion, 935 F.2d 280 (Fed. Cir. 1991) (reserve for claims contingent upon disability of insured cannot be a life insurance reserve under predecessor to ' 816). We also note that, although Taxpayer computed the DDR reserve, in part, on the basis of the policyholders' mortality risks, Taxpayer also computed the DDR reserve on the basis of the amount it expected to pay to satisfy anticipated medical malpractice claims. Therefore, we conclude that the DDR reserve does not constitute a life insurance reserve for purposes of ' 832(b)(7)(A). The DDR reserve, thus, is subject to the 20% income inclusion required by ' 832(b)(4)(B).<sup>6</sup>

Issue 5: Whether Taxpayer should reduce the DDR reserve for amounts to be ceded to Reinsurer.

We assume that the reinsurance policies currently in effect do not apply to liabilities that may arise in the future when the tail coverage on currently eligible insureds come into effect. As mentioned in the Revenue Agent's Request for Technical Advice dated \_\_\_\_\_, "These are losses which have not yet occurred on policies which have not yet been issued." Since the reinsurance presently in effect does not apply to the anticipated losses contemplated by the DDR reserve, we see no basis for requiring Taxpayer to reduce the DDR reserve for reinsurance that it has not yet purchased.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

Although in Issue 4 we have concluded that, on the basis of the plain language of

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<sup>6</sup> We note that ' 848, in similar fashion to ' 832(b)(4)(B), imposes a limitation upon "Specified policy acquisition expenses attributable to net premiums on Specified insurance contracts." ' 848(a), (c). The term "Specified insurance contracts" refers to "Any life insurance, annuity, or noncancellable accident and health insurance contract." ' 848(e)(1)(A). Therefore, ' 848 is not applicable to the DDR reserve in this case. Accordingly, were the 20% income inclusion not applicable to the DDR reserve, Taxpayer could avoid each of the statutory mechanisms which Congress fashioned as a proxy for requiring insurance companies to amortize their policy acquisition expenses.

' 816(b)(1)(B) and ' 832(b)(7)(A), the DDR reserve is not a life insurance reserve, the case law cited in your request for advice presents litigation hazards with respect to the portion of the DDR reserve attributable to claims payable on account of the death of an insured. In Aetna Life Ins. Co., supra, an insurer issued cancellable health and accident policies that also provided continued guaranteed life insurance coverage for permanently disabled insureds. The insurer established two reserves: a reserve attributable to life insurance coverage for insureds who were disabled, and a reserve attributable to anticipated life insurance coverage for insureds who were not presently disabled but were expected to become disabled in the future. The reserves were computed on the basis of recognized mortality tables. The court concluded that the reserve attributable to life insurance coverage of presently disabled insureds was a life insurance reserve, but that the reserve attributable to anticipated coverage of insureds who were not yet disabled was not a life insurance reserve. 16 Cl. Ct. at 378. The court reasoned that the reserve for presently disabled insureds were life insurance reserves because coverage was contingent upon the death of the insured, whereas the reserve for insureds who were not yet disabled was a health and accident reserve because coverage was first contingent upon the disability of the insured. Id.

In the present case, Company A used recognized mortality tables in determining the portion of Taxpayer's DDR reserve attributable to claims payable on the account of the death of an insured. Since claims underlying that portion of the DDR reserve are contingent upon the death of the insured, that portion of the DDR reserve resembles the reserve which the court in Aetna considered to be a life insurance reserve. Nevertheless, the reserve addressed in Aetna is distinguishable from that portion of the DDR reserve because claims underlying the DDR reserve are contingent upon both the death of the insured and the filing of a medical malpractice claim. For that reason, Company A determined the DDR reserve by using mortality tables as well as the expected cost of future medical malpractice claims. We also note that in Aetna, the court concluded that the portion of the reserve attributable to claims contingent upon both death and disability were not life insurance reserves. Accordingly, the opinion in Aetna presents a litigation hazard, but does not affect our conclusion.

Please call if you have any further questions.

By:

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