

Office of Chief Counsel
Internal Revenue Service
memorandum

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to: Chief, Examination Division, Southern California District
Elaine Lew and Michael Birecree

from: District Counsel, Southern California District, Laguna Niguel
Jeff Hatfield, Assistant District Counsel,
Frank N. Panza, Attorney

subject: [REDACTED] (Taxpayer) - I.R.C. § 832

DISCLOSURE STATEMENT

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QUESTION PRESENTED

Whether Taxpayer is entitled to defer escrow fees and other amounts it has received if they are included in unearned title insurance premiums on Form 9, Schedule 2B (Annual Statement for Title Insurance)?

CONCLUSION

To the extent that they are included in "Total charges for policies of title insurance" as required by CA Insurance Code § 12412, 4½% of Taxpayer's Escrow and Settlement Charges (which totaled \$[REDACTED]) and Other Title Fees and Service Charges (which totaled \$[REDACTED]) are to be included in Taxpayer's undiscounted unearned premiums described in Internal Revenue Code § 832(b)(8)(C)(i) (except when otherwise noted, all statutory references in this memorandum are made to the Internal Revenue Code of 1986, as amended).

FACTS

Taxpayer is engaged in the business of issuing title insurance policies. In addition to generating approximately \$[REDACTED] in Net Premiums Written, it recorded in Other Income as set forth on Schedule T of its Form 9 (the Annual Statement for Title Insurance) filed respecting [REDACTED] Escrow and Settlement Charges totaling \$[REDACTED] and, Other Title Fees and Service Charges totaling \$[REDACTED]. Its Other Title Fees and Service Charges included items described as Underwriting Fee Income, Reconveyance Fees, TSG Search Fees and Other Income. (This memorandum will refer to those Escrow and Settlement Charges and Other Title Fees and Service Charges as "the relevant amounts.")

Sections 12382.2(c)(1) and (2) of the CA Insurance Code provide, *inter alia*, that out of "Total charges for policies of title insurance", a title insurer shall add to its unearned premium reserve an amount equal to 4½% of the sum of its "Direct Written Premiums" and "Other Income", as set forth on Schedule T of its Annual Statement. Section 12380(a) of the CA Insurance Code provides, in part, that the term "Total charges for policies of title insurance" includes the total of fees and charges as shown on policies, as required by § 12412. At least some portion, and possibly all, of the relevant amounts were included in its "Total Charges for policies of title insurance" as defined in § 12380(a) of the CA Insurance Code.

LAW AND ANALYSIS

In the case of an insurance company subject to the tax imposed by § 831, § 832(a) provides that the term, "taxable income", means gross income as defined in § 832(b)(1), less the deductions allowed by § 832(c).

Section 832(b)(1)(A) defines the term "gross income" to include 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).

Section 832(b)(3) provides that the term "underwriting income" means the premiums earned on insurance contracts during the taxable year, less losses and expenses incurred.

Section 832(b)(4) provides that "premiums earned on insurance contracts during the taxable year" is the amount computed as follows:

(A) From the amount of gross premiums written on insurance contracts during the taxable year, deduct return premiums and premiums paid for reinsurance.

(B) To the result so obtained, add 80 percent of the unearned premiums on outstanding business at the end of the preceding taxable year and deduct 80 percent of the unearned premiums on outstanding business at the end of the taxable year.

(C) To the result so obtained, in the case of a taxable year beginning after December 31, 1986, and before January 1, 1993, add an amount equal to 3½ percent of unearned premiums on outstanding business at the end of the most recent taxable year beginning before January 1, 1987.

For premiums attributable to title insurance, step (B) is applied using discounted unearned premiums rather than 80 percent of unearned premiums, and step (C) is omitted. See §§ 832(b)(8)(A)-(C). For such premiums, the amount of undiscounted unearned premiums is determined by applying a present value formula to "undiscounted unearned premiums." The term, "undiscounted unearned premiums", is defined as the "unearned premiums shown in the yearly statement filed by the taxpayer for the year ending with or within such taxable year." See § 832(b)(8)(C)(i). Rev. Rul. 91-22, 1991-1 C.B. 91 indicates that "discounted unearned premiums" are determined by discounting the amounts added during the tax year to a "state statutory title insurance unearned premium reserve at the interest rate generally applicable to property and casualty unpaid loss reserves."

The Service is concerned that the inclusion of amounts other than premiums in the amounts taken into account in calculating a taxpayer's unearned premium reserve will result in the unwarranted deferral of income tax on a portion of the taxpayer's income.

For a substantial period of time prior to the enactment of the Tax Reform Act of 1986, the proper tax treatment of title insurance unearned premium reserves was unclear. See, Rev. Rul. 83-174, 1983-2 C.B. 108, as modified by Rev. Rul. 84-107,

1984-2 C.B. 122. Rev. Rul. 83-174 holds that amounts set aside by a title insurance company in a state required reserve do not constitute "unearned premiums" under § 832(b)(4) as in effect for tax years beginning prior to January 1, 1987. That ruling indicates that in the case of a title insurance policy, the risk insured against¹ is mature on issuance of the policy. Because the amounts a title insurer reflects as unpaid losses are sufficient to protect the interests of policyholders and to provide for reinsurance, it concludes that amounts added to a state required title insurance unearned premium reserve are, in effect, set aside for solvency purposes.

Rev. Rul. 83-174 revoked two previous revenue rulings in which the Service had recognized that state required title insurance reserves qualified as unearned premium reserves for federal income tax purposes so long as the reserves met certain standards. See Rev. Rul. 59-251, 1959-2 C.B. 167, and Rev. Rul. 71-598, 1971-2 C.B. 261.

Rev. Rul. 84-107, 1984-2 C.B. 122 announced that the Service was reconsidering the holding of Rev. Rul. 83-174 in the case of certain title insurance companies that did not include estimates of incurred but not reported losses in the computation of losses incurred under then § 832(b)(5). Those title insurance companies that had deducted both net additions to a state required unearned premium reserve together with incurred but not reported losses were required to change their method of accounting for the first tax year beginning on or after November 28, 1983. In those cases, however, Rev. Rul. 84-107 permitted taxpayers either to (i) comply with the holding of Rev. Rul. 83-174, or (ii) adopt the prevailing industry practice of deducting additions to a state required unearned premium reserve as unearned premiums under then § 832(b)(4), and case reserves as losses incurred under then § 832(b)(5).

In 1991, the Service released Rev. Rul. 91-22, 1991-1 C.B. 91. That ruling was intended to eliminate any uncertainty respecting the status of title insurance unearned premium reserves during 1985 and 1986 caused by the varying effective dates of Rev. Ruls. 83-174, as modified by Rev. Rul. 84-107, and §§ 832(b)(4) and (8) enacted in the Tax Reform Act of 1986. Rev. Rul. 91-22 also addresses whether the holdings of Rev. Ruls. 83-174 and 84-107 continue to apply after the effective date of § 832(b)(8). Rev. Rul. 91-22 holds specifically that "discounted unearned premiums" described in § 832(b)(8) "are determined by discounting the amounts added during the tax year to a state statutory title insurance unearned premium reserve" at the interest rate generally applicable to property and casualty unpaid loss reserves. That ruling goes on to provide that in view of the enactment of § 832(b)(8) by the Tax Reform Act of 1986, the

¹ The risk insured against is the unmarketability of real estate due to a title defect or encumbrance.

holdings of Rev. Ruls. 83-174 and 84-107 are obsolete with respect to taxable years of a title insurance company beginning after December 31, 1986.

Although Rev. Rul. 83-174 is obsolete, its statement that a title insurer's risks are mature at the time it enters into a title insurance contract remains true. Thus, as an economic matter, unlike the premiums received on other property and casualty insurance policies, the premiums received on a title insurance policy can not be considered to be "earned" ratably or otherwise over a limited and defined period during which an insured risk is outstanding.

In many cases a title insurer's statutory unearned premium reserve is not a function of the premium paid on the relevant title insurance policy. See: 215 Illinois Compiled Statutes, § 155/11 providing that a title insurance company's statutory unearned premium reserve should initially be equal to 12½ cents for each \$1000 of net retained liability under each title insurance policy on a single risk written on Illinois property after January 1, 1990; § 38.2-4610.1 D.2 of the Code of Virginia providing that a title insurer's statutory unearned premium reserve should initially be equal to \$1.50 for each policy of insurance covering a single risk written after June 30, 1986, plus a sum equal to 12½ cents of each \$1000 of net retained liability under each such policy; and, Connecticut General Statutes § 38a-408(d)(2) providing that a title insurer's statutory unearned premium reserve should initially be equal to 15 cents for each \$1000 of net retained liability on a single risk written on properties located in that state written after October 1, 1990.

Even in those cases where a title insurer's unearned premium reserve is calculated by reference to its income or receipts, there is a significant variation among the amounts different states require to be included in the relevant reserve. See: New Jersey Statutes §§ 17:18-13 (a) and (b) providing that a title insurer's statutory unearned premium reserve should initially be equal to 3% of its total gross premiums and fees during its first ten years of doing business, and 2% of the total of those gross premiums and fees thereafter; Ohio Revised Code, § 3953.11(B) and 40 Pennsylvania Statutes § 152, each of which provide that a title insurer's statutory unearned premium reserve should initially be equal to 10% of the title insurance premium received during the preceding calendar year for the issuance of policies, not to exceed the aggregate amount of \$250 thousand; and, Texas Insurance Code, Art. 9.16 providing that a title insurer writing \$250 million or more in direct premiums is initially to set up a statutory unearned premium reserve equal to 6½% of the total of its direct premiums, escrow and settlement service fees, other title fees and service charges, and premiums for reinsurance assumed less premiums for reinsurance ceded.² New York combines the

² The rate applicable to a Texas title insurer writing less than \$250 million in direct premiums is 3½ percent.

reinsurance assumed less premiums for reinsurance ceded.² New York combines the approaches of New Jersey, Ohio and Texas by providing that beginning January 1, 1986, the amount of a title insurer's unearned premium reserve shall be equal to (i) \$1.50 for each policy issued, plus 1/80th of 1% of the face amount of insurance effected thereby, and, (ii) 3% of the gross fees and premiums a title insurer receives for guaranteed certificates of title, guaranteed searches and guaranteed abstracts of title not included in (i).

In view of:

(a) the disparity in the rules in the various states regarding the amounts of unearned premium reserves a title insurer is required to maintain;

(b) the facts that a title insurer's unearned premium reserve is not necessarily related to the premiums it receives and that a title insurance premium, unlike other property and casualty insurance premiums can not be said to be earned ratably or otherwise over the period a risk is outstanding; and,

(c) Congress' specific reference in § 832(b)(8)(C)(i) to the relevant title insurer's unearned premiums shown in its statutory annual statement,

we conclude that the extent that they are included in "Total charges for policies of title insurance" as required by CA Insurance Code § 12412, 4½% of Taxpayer's Escrow and Settlement Charges (which totaled \$██████████) and Other Title Fees and Service Charges (which totaled \$██████████) are to be included in Taxpayer's undiscounted unearned premiums described in § 832(b)(8)(C)(i).


Frank N. Panza
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² The rate applicable to a Texas title insurer writing less than \$250 million in direct premiums is 3½ percent.