

Office of Chief Counsel
Internal Revenue Service
memorandum

CC:WR: [REDACTED]: [REDACTED]: TL-N-4747-99
[REDACTED]

MAR 23 2000

date: [REDACTED]
to: Chief, Examination Division, [REDACTED] District
Attn: [REDACTED] and [REDACTED], [REDACTED]

from: District Counsel, [REDACTED] District, [REDACTED]
[REDACTED], Assistant District Counsel
[REDACTED], Attorney

subject: [REDACTED] UPR Issue

DISCLOSURE STATEMENT

This advice constitutes return information subject to I.R.C. § 6103. This advice contains confidential information subject to attorney-client and deliberative process privileges and if prepared in contemplation of litigation, subject to the attorney work product privilege. Accordingly, the Examination or Appeals recipient of this document may provide it only to those persons whose official tax administration duties with respect to this case require such disclosure. In no event may this document be provided to Examination, Appeals, or other persons beyond those specifically indicated in this statement. This advice may not be disclosed to taxpayers or their representatives.

This advice is not binding on Examination or Appeals and is not a final case determination. Such advice is advisory and does not resolve Service position on an issue or provide the basis for closing a case. The determination of the Service in the case is to be made through the exercise of the independent judgment of the office with jurisdiction over the case.

By a memorandum dated August 31, 1999, we provided advice on whether amounts retained by the agents of [REDACTED] [REDACTED] as fees for title services and included in gross premiums for purposes of the unearned premium calculations in accordance with a directive issued by the [REDACTED] Department of Insurance must also be included in gross premiums for Federal income tax purposes. We forwarded a copy of this advice to our National Office for post-review as Non-Docketed Significant Advice.

The National Office agreed with our conclusion that for purposes of calculating [REDACTED]'s Unearned Premium Reserve

(UPR), the premium received by [REDACTED] should be reported gross of the amounts retained by its agents as fees. However, the National Office recommended that we issue the instant supplemental advice to make the following two revisions to our memorandum:

1) First, footnote two of our memorandum dated August 31, 1999, is revised as follows:

For insurance companies other than title insurance companies the unearned premium reserve is defined differently. Section 832(b)(4) of the Code does not define unearned premiums. In Buckeye Union Casualty Co. v. Commissioner, 448 F.2d 228 (6th Cir. 1971), aff'g 54 T.C. 13 (1970), the United States Court of Appeals indicated that "unearned premiums" for purposes of section 832(b)(4) is generally defined to mean that portion of net premiums that the insurance company has not yet had time to earn or, more precisely, that portion of the premiums paid by the policyholder that must be returned to him on cancellation of the policy and that is in direct proportion to the unexpired term that the policy has to run. See also Rev. Rul. 55-693, 1955-2 C.B. 284. The Service has also acknowledged that in determining unearned premiums of a property and casualty insurance company, estimated liability for retrospective rate credits on the expired portion of insurance policies that are still in effect at the close of the taxable year is taken into account. Bituminous Casualty Corp. v. Commissioner, 57 T.C. 58 (1971); Rev. Rul. 73-302, 1973-2 C.B. 220, revoking Rev. Rul. 67-225, 1967-2 C.B. 238. Because title insurance companies earn their premiums in full at the time they are received (i.e., the title is either good when it passes, or it is not), the Service ruled that they can have no unearned premiums. Rev. Rul. 70-245, 1970-1 C.B. 154. Congress has not indicated that it disagrees with that ruling as a technical matter. It has merely provided for recognition of the statutory accounting framework for Federal income tax purposes.

2) Second, the string of citations in the carryover paragraph ending on page 5 of our memorandum, is revised to include at the end, a citation to Rev. Rul. 79-138, 1979-1 C.B. 359.

Should you have any questions concerning the foregoing, please feel free to telephone the undersigned attorney at [REDACTED].

[REDACTED]

Attorney

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:WR: [REDACTED]: [REDACTED]: TL-N-4747-99
[REDACTED]

date: August 31, 1999

to: Chief, Examination Division, [REDACTED] District
Attn: [REDACTED] and [REDACTED], [REDACTED]

from: District Counsel, [REDACTED] District, [REDACTED]
[REDACTED], Assistant District Counsel
[REDACTED], Special Litigation Assistant

subject: [REDACTED] UPR Issue

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ISSUE

Whether the amounts retained by the taxpayer's agents as fees for title services and included in gross premiums for purposes of the unearned premium calculations in accordance with a directive issued by the [REDACTED] Department of Insurance must also be included in gross premiums for Federal income tax purposes.

CONCLUSION

Yes. The amounts included in gross premiums and thus in the unearned premium calculation for statutory accounting purposes may not be excluded for Federal income tax purposes simply because those amounts were retained by the taxpayer's agents as fees for services.

FACTS

[REDACTED] is engaged in the business of providing title insurance. [REDACTED]'s agents generate premiums and then retain a portion as their fee. [REDACTED] records the entire amount of these premiums as income. [REDACTED] also records an expense item for the same amount as the fee retained by the agent who generated and retained part of the premium. In accordance with a directive issued by the [REDACTED] Department of Insurance, [REDACTED] includes the retained amounts in its calculation of its gross premiums. As a consequence, [REDACTED] must set aside greater amounts to fund its Unearned Premium Reserve (UPR) because the UPR is calculated based on gross premiums. These amounts were not considered part of the gross premiums received by [REDACTED] prior to 1994. Beginning in 1994, however, [REDACTED] had to change its treatment of these amounts pursuant to directive issued by [REDACTED] Department of Insurance. The taxpayer's treatment of this item is, therefore, in accordance with statutory accounting for state law purposes.

Premiums on title insurance policies are usually paid in their entirety when the policy is issued. A sample contract provided by the taxpayer indicates that [REDACTED] will not receive any portion of the premium retained by the agent except in cases of error, fraud, or losses in excess of a stated percentage of the premiums.

LAW AND ANALYSIS

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

Section 832(b)(1)(A) of the Code 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 section 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). This is a reference to the amounts reported on the Form 9

filed with the state in accordance with the state's rules and regulations regarding insurance companies.

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

Section 832(b)(4) of the Code 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 amount determined in (A), 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.¹

(C) To the amount so determined, in the case of a taxable year beginning after December 31, 1986, and before January 1, 1993, add an amount equal to 3-1/3 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, the second step is applied using discounted unearned premiums rather than 80% of unearned premiums and the third step is omitted. Section 832(b)(8)(A); see also sections 832(b)(8)(B), (C). The amount of discounted unearned premiums is determined by applying a present value formula to the undiscounted unearned premiums. "Undiscounted unearned premiums" are defined as "the unearned premiums shown in the yearly statement filed by the taxpayer for the year ending with or within such taxable year." Section 832(b)(8)(C)(i). This refers to the statement filed with the state insurance commission, otherwise known as Form 9. See Rev. Rul. 91-22, 1991-1 C.B. 91.²

¹ This 80% rule for the inclusion or exclusion of the change in the unearned premiums is actually a 20% reduction. Under prior law, 100% was taken into account because unearned premiums were not considered current income. See discussion below.

² For insurance companies other than title insurance companies the unearned premium reserve is defined differently. Section 832(b)(4) of the Code does not define unearned premiums. In Buckeye Union Casualty Co. v. Commissioner, 448 F.2d 228 (6th

Federal income tax case law indicates that taxpayers may pay each other by setting their mutual obligations off against each other rather than making actual payments, provided the obligations are bona fide. Hudspeth v. Commissioner, 509 F.2d 1224 (9th Cir. 1975), rev'g in part and aff'g in part, T.C. Memo. 1972-253; Estate of Franklin v. Commissioner, 544 F.2d 1045 (9th Cir. 1976), aff'g, 64 T.C. 752 (1975), and Rosenblatt v. Commissioner, 16 T.C. 100 (1951). The contract between [REDACTED] and its agents provides that the insurer has a right to the premium and the agent has a right to a commission/fee. The insurer is at risk for all defects in the chain of title and would be very imprudent if it did not spend the money necessary to examine the title. The insurer could choose not to pay someone to examine the title and then would actually receive the money retained by the agent. The fact that the insurer does the prudent thing and pays someone to examine the title does not mean that it does not have a right to the money--it merely has a concomitant expense. In addition, the agent receives other premium amounts for [REDACTED] as its agent, and issues insurance policies in [REDACTED]'s name. The agents are agents for Federal income tax purposes, and their receipt of premiums paid is the same as receipt by [REDACTED]. See, e.g., Diescher v. Commissioner, 36 B.T.A. 732, 74-45 (1937), acq. and nonacq. on other issues, 1938-1 C.B. 9, 40, aff'd on other issues, 110 F.2d 90 (3d Cir.), cert. denied, 310 U.S. 650 (1940) (proceeds of sale of license received by corporate agent); Huntington National Bank v. Commissioner, 32 B.T.A. 342, 346-47 (1935), aff'd, 90 F.2d 876 (6th Cir. 1937) (receipt by broker of proceeds of stock sale); Wilson v. Commissioner, 12 B.T.A. 403, 405 (1928), acq., VIII-1 C.B. 49 (receipt of crop proceeds by agent taxable to cash basis farmer); Strauss v. Commissioner, 2 B.T.A. 598 (1935) (receipt by dishonest real estate agent of proceeds of land sale); Cataldo v. Commissioner, T.C. Memo. 1971-219, aff'd 476 F.2d 628 (2d Cir.

Cir. 1971), aff'g 54 T.C. 13 (1970), the United States Court of Appeals indicated that "unearned premiums" for purposes of section 832(b)(4) is generally defined to mean that portion of net premiums that the insurance company has not yet had time to earn or, more precisely, that portion of the premiums paid by the policyholder that must be returned to him on cancellation of the policy and that is in direct proportion to the unexpired term that the policy has to run. See also Rev. Rul. 55-693, 1955-2 C.B. 284. Because title insurance companies earn their premiums in full at the time they are received (i.e., the title is either good when it passes, or it is not), the Service ruled that they can have no unearned premiums. Rev. Rul. 70-245, 1970-1 C.B. 154. Congress has not indicated that it disagrees with that ruling as a technical matter. It has merely provided for recognition of the statutory accounting framework for Federal income tax purposes.

1973); Rev. Rul. 70-567, 1970-2 C.B. 133; and Rev. Rul. 82-177, 1982-2 C.B. 365.

Thus, the fact that a portion of the amount paid by the insured for the insurance (commonly known as a premium and likely considered wholly as such by the insured) is retained by the agent as a setoff does not mean that the agent did not receive it as the agent for the insurance company and that it was not income to the company. Thus, even if the Code did not adopt the statutory accounting results regarding this issue, the taxpayer's treatment of this item would be consistent with Federal income tax law.

In the final analysis, however, there is no conflict here between the statutory accounting principles and the rules of the Code. The rules of the Code specifically adopt the statutory accounting principles for the purpose of calculating the gross income of a title insurance company. Unless the Service can show that [REDACTED] failed to follow proper statutory accounting, there is no issue here.

CONCLUSION

The amounts at issue here are included in gross premiums under state law and this treatment is specifically imported into [REDACTED]'s Federal income tax calculations by section 832(b). The fact that the amounts are retained by the agents as fees does not change this result. We will coordinate this memorandum with the Chief Counsel's national office as we did our prior memorandum dated December 31, 1998, which dealt with this issue also. Our coordination of the prior memorandum confirmed that the opinion expressed in that memorandum and in this one is the position of the Office of Chief Counsel.

[REDACTED]
Special Litigation Assistant