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Corrected by Tax Treatment of Salvage and Reinsurance, IRS TD, February 24, 1992

1992-7 I.R.B. 13 (IRS TD), T.D. 8390, 57 FR 3130, 57 FR 3130-01, 1992-1 C.B. 242, 1992 WL 10934
**1 RULES and REGULATIONS

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 1 and 602

(T.D. 8390)
RIN 1545-AP37

Tax Treatment of Salvage and Reinsurance

Tuesday, January 28, 1992

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final regulations.

SUMMARY: This document provides final regulations relating to the treatment of salvage and reinsurance in computing the deduction for losses incurred of insurance companies other than life insurance companies. Changes to the applicable law were made by the Revenue Reconciliation Act of 1990. The regulations are necessary to provide these insurance companies with guidance needed to comply with these changes.

EFFECTIVE DATE: The regulations apply to taxable years beginning after December 31, 1989.

FOR FURTHER INFORMATION CONTACT:Katherine A. Hossofsky (202) 566-4336 (not a toll-free call) or Michael J. Douglass (202) 566-3603 (not a toll-free call).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this final regulation has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1980 (44 U.S.C. 3504(h)) under control number 1545-1227. The estimated average burden per respondent is 2 hours.

These estimates are an approximation of the average time expected to be necessary for a collection of information. They are based on such information as is available to the Internal Revenue Service. Individual respondents may require greater or less time depending on their particular circumstances.

Comments regarding the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, T:FP, Washington, DC 20224, and to the Office of Management and Budget, Attention: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

Background

This document sets forth final income tax regulations relating to the treatment of salvage and reinsurance under section 832(b)(5)(A) of the Internal Revenue Code. Section 832(b)(5)(A) was amended by section 11305 of the Revenue Reconciliation Act of 1990, 104 Stat. 1388 ("the 1990 Act"). Proposed regulations under section 832(b)(5)(A) were published in the Federal Register on March 15, 1991 (56 FR 11127) (FI-104-90). Written comments were received from the public. No public hearing was held because there were no requests for a hearing. After consideration of all the written comments received, the proposed regulations under section 832(b)(5)(A) are adopted as modified by this Treasury decision.

Guidance regarding certain implementation issues under section 832(b)(5)(A) also is provided in Rev. Proc. 91-48, 1991-34 I.R.B. 12.

Explanation of Provisions

In General

Section 832(b)(3) of the Code defines the "underwriting income" of an insurance company subject to tax under section 831 as premiums earned less losses incurred and expenses incurred. Under section 832(b)(5)(A), "losses incurred" are computed by taking into account paid losses, unpaid losses, and salvage and reinsurance. For taxable years beginning before January 1, 1990, salvage and reinsurance recoverable was taken into account as a reduction to paid losses. For those taxable years, the regulations required salvage recoverable to be taken into account only to the extent that the salvage recoverable could be treated as an asset for state statutory accounting purposes.

**2 For taxable years beginning after December 31, 1989, the 1990 Act amended section 832(b)(5)(A) to require *3131 all estimated salvage recoverable (including that which cannot be treated as an asset for state statutory accounting purposes) to be taken into account in computing the deduction for losses incurred. Under section 832(b)(5)(A), paid losses are to be reduced by salvage and reinsurance recovered during the taxable year. This amount is adjusted to reflect changes in discounted unpaid losses on nonlife insurance contracts and in unpaid losses on life insurance contracts. An adjustment is then made to reflect any changes in discounted estimated salvage recoverable and in reinsurance recoverable.

The amendments to the regulations conform the regulations to the new treatment of estimated salvage recoverable required by the 1990 Act. The regulations clarify that estimated salvage recoverable includes estimates of salvage recoverable that may not be treated as assets for state statutory accounting purposes. See H.R. Conf. Rep. No. 964, 101st Cong., 2d Sess. 1071 (1990). The regulations also make clear that the term "salvage recoverable" includes anticipated recoveries on account of subrogation claims arising with respect to paid or unpaid losses.

Under section 846(b)(1), the starting point for determining discounted unpaid losses for Federal income tax purposes is the amount of unpaid losses reported to state regulatory authorities on the annual statement. This conformity of tax and annual statement amounts discourages companies from overstating unpaid losses for Federal tax purposes because the claiming of excess unpaid losses may have adverse consequences for state regulatory purposes.

Commentators noted that certain companies had taken estimated salvage recoverable into account in determining the unpaid losses on their annual statements. For these companies, the requirement in the proposed regulations that estimated salvage recoverable be taken into account separately in computing losses incurred may result in a double counting of salvage. In response to these comments, the final regulations permit a limited exception to the conformity requirement if there is adequate disclosure to state regulatory authorities to assure that the purposes of conformity are achieved. Under the final regulations, a company that has taken estimated salvage recoverable into account in determining the amount of unpaid losses reported on the annual statement may increase its unpaid losses for tax purposes by the amount of estimated salvage recoverable taken into account in determining those unpaid losses provided this amount is disclosed to the state regulatory authorities.

The final regulations provide rules for making the disclosure. Under the final regulations, a company is allowed, for any taxable year, to adjust the amount of unpaid losses shown on its annual statement by estimated salvage recoverable only if the company either (i) discloses on its annual statement, by line of business and accident year, the extent to which estimated salvage recoverable was taken into account in determining the amount of unpaid losses shown on the annual statement, or (ii) files a statement with the state regulatory authority of each state to which the company is required to submit an annual statement. The statement must disclose, by line of business and accident year, the extent to which estimated salvage recoverable was taken into account in computing the unpaid losses shown on the annual statement. Rules also are provided concerning the form of the statement and the time it must be filed.

Transitional Rules

****3** By requiring insurance companies to take estimated salvage recoverable into account in computing losses incurred, the 1990 Act changed the method by which companies compute losses incurred. Section 11305(c)(2)(A) of the 1990 Act treats this change as a change in method of accounting. Section 11305(c)(2)(B) of the 1990 Act provides that an insurance company must take into account only 13 percent of the section 481 adjustment that would otherwise have been required as a result of the change in method of accounting.

Section 11305(c)(4) of the 1990 Act provides a rule for overestimates of the section 481 adjustment. Under this rule, an insurance company subject to tax under section 831 is required to include in gross income 87 percent of any amount (adjusted for discounting) by which the section 481 adjustment is overestimated. The rule is applied by comparing the amount of the section 481 adjustment (determined without regard to section 11305(c)(2) of the 1990 Act and any discounting) to the sum of the actual salvage recoveries and the remaining undiscounted estimated salvage recoverable that are attributable to losses incurred in accident years beginning before 1990. For any taxable year beginning after December 31, 1989, any excess of the section 481 adjustment over this sum is an overestimate for purposes of section 11305(c)(4) of the 1990 Act. To determine the amount to be included in income, it is necessary to discount this excess and multiply the resulting amount by 87 percent.

In the case of an insurance company subject to tax under section 831, section 11305(c)(3) of the 1990 Act allows the insurance company to deduct 87 percent of the discounted amount of estimated salvage recoverable that the company took into account under its method of accounting for the last taxable year beginning before January 1, 1990 (“special deduction”). In response to comments requesting clarification of the proposed regulations, the final regulations make clear that a company that claims the special deduction may not also claim the benefit of section 11305(c)(2)(B) of the 1990 Act.

The proposed regulations provide that an insurance company claiming the special deduction must be able to establish to the satisfaction of the district director that it took estimated salvage recoverable into account for the last taxable year before January 1, 1990. Under the proposed regulations, a company may not satisfy this requirement merely by stating that estimated salvage recoverable is reflected in the company's loss reserves, but may satisfy this requirement by disclosing to the relevant state regulatory authority the extent to which the company took into account estimated salvage recoverable in computing paid or unpaid losses (whichever is applicable) on its 1989 annual statement.

In response to comments concerning the scope of this disclosure provision, the final regulations clarify the circumstances under which disclosure to state regulatory authorities will satisfy this requirement. The final regulations provide that the amount of a special deduction will be deemed to have been established to the satisfaction of the district director if (i) by September 16, 1991, the company filed with its state regulatory authority a statement disclosing the extent to which losses incurred for each line of business shown on the 1989 annual statement were reduced by estimated salvage recoverable, and (ii) the company agreed, on a statement attached to its return for its first taxable year beginning after December 31, 1989, to apply the special rule for overestimates to the amount of estimated salvage recoverable for which it has taken the special deduction. If the company is a member of a consolidated group, each property and casualty insurance company that is a member of the consolidated group must join in the agreement to apply the special rule for overestimates.

**4 *3132 The special deduction was designed to create parity between those taxpayers that took estimated salvage recoverable into account for the last taxable year beginning before January 1, 1990, and those taxpayers that did not take estimated salvage recoverable into account. If the inclusion of estimated salvage recoverable did not increase a company's taxable income, no special deduction is needed. Accordingly, the final regulations provide that an insurance company that claimed a "fresh start" benefit with respect to estimated salvage recoverable under section 1023(e) of the Tax Reform Act of 1986 may not claim the special deduction under section 11305(c)(3) of the 1990 Act to the extent the company has previously claimed the benefit of a fresh start.

Special Analyses

It has been determined that these rules are not major rules as defined in Executive Order 12291. Therefore, a Regulatory Impact Analysis is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, a final Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, a copy of the rules was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Drafting Information

The principal authors of these proposed regulations are Katherine A. Hossofsky and Michael J. Douglass of the Office of the Assistant Chief Counsel (Financial Institutions and Products), Internal Revenue Service. However, other personnel from the Internal Revenue Service and Treasury Department participated in their development.

List of Subjects

26 CFR 1.831-1 Through 1.832-7T

Income taxes, Insurance companies.

26 CFR Part 602

Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

For the reasons set out in the preamble, 26 CFR parts 1 and 602 are amended as follows:

PART 1—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953

Paragraph 1. The authority for part 1 is amended by removing the citation for § 1.832-4T and by adding the following citation:

Authority: Sec. 7805, 68A Stat. 917; 26 U.S.C. 7805 * * * Section 1.832-4 also issued under 26 U.S.C. 832(b)(5)(A).

§ 1.832-4T (Redesignated as § 1.832-4)

Par. 2. Section 1.832-4T is redesignated as § 1.832-4.

Par. 3. Newly redesignated § 1.832-4 is amended as follows:

1. The section heading is revised.

2. The last sentence of paragraph (a)(5) is removed.

3. Paragraphs (b) through (e) are revised.

4. Paragraphs (f) and (g) are added.

5. The revised and added provisions read as follows:

§ 1.832-4 Gross income.

* * * * *

(b) Losses incurred. Every insurance company to which this section applies must be prepared to establish to the satisfaction of the district director that the part of the deduction for "losses incurred" which represents unpaid losses at the close of the taxable year comprises only actual unpaid losses. See section 846 for rules relating to the determination of discounted unpaid losses. These losses must be stated in amounts which, based upon the facts in each case and the company's experience with similar cases, represent a fair and reasonable estimate of the amount the company will be required to pay. Amounts included in, or added to, the estimates of unpaid losses which, in the opinion of the district director, are in excess of a fair and reasonable estimate will be disallowed as a deduction. The district director may require any insurance company to submit such detailed information with respect to its actual experience as is deemed necessary to establish the reasonableness of the deduction for "losses incurred."

**5 (c) Losses incurred are reduced by salvage. Under section 832(b)(5)(A), losses incurred are computed by taking into account losses paid reduced by salvage and reinsurance recovered, the change in discounted unpaid losses, and the change in estimated salvage and reinsurance recoverable. For purposes of section 832(b)(5)(A)(iii), estimated salvage recoverable includes all anticipated recoveries on account of salvage, whether or not the salvage is treated, or may be treated, as an asset for state statutory accounting purposes. Estimates of salvage recoverable must be based on the facts of each case and the company's experience with similar cases. Except as otherwise provided in guidance published by the Commissioner in the Internal Revenue Bulletin, estimated salvage recoverable must be discounted either—

(1) By using the applicable discount factors published by the Commissioner for estimated salvage recoverable; or

(2) By using the loss payment pattern for a line of business as the salvage recovery pattern for that line of business and by using the applicable interest rate for calculating unpaid losses under section 846(c). For purposes of section 832(b)(5)(A) and the regulations thereunder, the term "salvage recoverable" includes anticipated recoveries on account of subrogation claims arising with respect to paid or unpaid losses.

(d) Increase in unpaid losses shown on annual statement in certain circumstances—(1) In general. An insurance company that takes estimated salvage recoverable into account in determining the amount of its unpaid losses shown on its annual statement is allowed to increase its unpaid losses by the amount of estimated salvage recoverable taken into account if the company complies with the disclosure requirement of paragraph (d)(2) of this section. This adjustment shall not be used in determining under section 846(d) the loss payment pattern for a line of business.

(2) Disclosure requirement. (i) In general. A company described in paragraph (d)(1) of this section is allowed to increase the unpaid losses shown on its annual statement only if the company either—

(a) Discloses on its annual statement, by line of business and accident year, the extent to which estimated salvage recoverable is taken into account in computing the unpaid losses shown on the annual statement filed by the company for the calendar year ending with or within the taxable year of the company; or

(B) Files a statement on or before the due date of its Federal income tax return (determined without regard to extensions) with the appropriate state regulatory authority of each state to which the company is required to submit an annual statement. The statement must be contained in a separate document captioned "DISCLOSURE CONCERNING LOSS RESERVES" and must disclose, by line of business and accident year, the extent to which estimated salvage recoverable is taken ***3133** into account in computing the unpaid losses shown on the annual statement filed by the company for the calendar year ending with or within the taxable year of the company.

****6** (ii) Transitional rule. For a taxable year ending before December 31, 1991, a taxpayer is deemed to satisfy the disclosure requirement of paragraph (d)(2)(i)(B) of this section if the taxpayer files the statement described in paragraph (d)(2)(i)(B) of this section before March 17, 1992.

(3) Failure to disclose in a subsequent year. If a company that claims the increase permitted by paragraph (d)(1) of this section fails in a subsequent taxable year to make the disclosure described in paragraph (d)(2) of this section, the company cannot claim an increase under paragraph (d)(1) of this section in any subsequent taxable year without the consent of the Commissioner.

(e) Treatment of estimated salvage recoverable—(1) In general. An insurance company is required to take estimated salvage recoverable (including that which cannot be treated as an asset for state statutory accounting purposes) into account in computing the deduction for losses incurred. Except as provided in paragraph (e)(2)(iii) of this section, an insurance company must apply this method of accounting to estimated salvage recoverable for all lines of business and for all accident years.

(2) Change in method of accounting—(i) If an insurance company did not take estimated salvage recoverable into account as required by paragraph (c) of this section for its last taxable year beginning before January 1, 1990, taking estimated salvage recoverable into account as required by paragraph (c) of this section is a change in method of accounting.

(ii) If a company does not claim the deduction under section 11305(c)(3) of the 1990 Act, the company must take into account 13 percent of the adjustment that would otherwise be required under section 481 for pre-1990 accident years as a result of the change in accounting method. This paragraph (e)(2)(ii) applies only to an insurance company subject to tax under section 831.

(iii) If a company claims the deduction under section 11305(c)(3) of the 1990 Act and paragraph (f) of this section, the company must implement the change in method of accounting for estimated salvage recoverable for post-1989 taxable years pursuant to a "cut-off" method.

(3) Rule for overestimates. An insurance company is required under section 11305(c)(4) of the 1990 Act to include in gross income 87 percent of any amount (adjusted for discounting) by which the section 481 adjustment is overestimated. The rule is applied by comparing the amount of the section 481 adjustment (determined without regard to paragraph (e)(2)(ii) of this section and any discounting) to the sum of the actual salvage recoveries and remaining undiscounted estimated salvage recoverable that are attributable to losses incurred in accident years beginning before 1990. For any taxable year beginning after December 31, 1989, any excess of the section 481 adjustment over this sum (reduced by amounts treated as overestimates in prior taxable years pursuant to this paragraph (e)(3)) is an overestimate. To determine the amount to be included in income, it is necessary to discount this excess and multiply the resulting amount by 87 percent.

****7** (f) Special deduction—(1) In general. Under section 11305(c)(3) of the 1990 Act, an insurance company may deduct an amount equal to 87 percent of the discounted amount of estimated salvage recoverable that the company took into account in determining the deduction for losses incurred under section 832(b)(5) in the last taxable year beginning before January 1, 1990. A company that claims the special deduction must establish to the satisfaction of the district director that the deduction

represents only the discounted amount of estimated salvage recoverable that was actually taken into account by the company in computing losses incurred for that taxable year.

(2) Safe harbor. The requirements of paragraph (f)(1) of this section are deemed satisfied and the amount that the company reports as bona fide estimated salvage recoverable is not subject to adjustment by the district director, if—

(i) The company files with the insurance regulatory authority of the company's state of domicile, on or before September 16, 1991, a statement disclosing the extent to which losses incurred for each line of business reported on its 1989 annual statement were reduced by estimated salvage recoverable,

(ii) The company attaches a statement to its Federal income tax return filed for the first taxable year beginning after December 31, 1989, agreeing to apply the special rule for overestimates under section 11305(c)(4) of the 1990 Act to the amount of estimated salvage recoverable for which it has taken the special deduction, and

(iii) In the case of a company that is a member of a consolidated group, each insurance company subject to tax under section 831 that is included in the consolidated group complies with paragraph (f)(2)(ii) of this section with respect to its special deduction, if any.

(3) Limitations on special deduction—(i) The special deduction under section 11305(c)(3) of the 1990 Act is available only to an insurance company subject to tax under section 831.

(ii) An insurance company that claimed the benefit of the "fresh start" with respect to estimated salvage recoverable under section 1023(e) of the Tax Reform Act of 1986 may not claim the special deduction allowed by section 11305(c)(3) of the 1990 Act to the extent of the estimated salvage recoverable for which a fresh start benefit was previously claimed.

(iii) A company that claims the special deduction is precluded from also claiming the section 481 adjustment provided in paragraph (e)(2)(ii) of this section for pre-1990 accident years.

(g) Effective date. Paragraphs (b) through (f) of this section are effective for taxable years beginning after December 31, 1989.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPER REDUCTION ACT

§ 602.101 (Amended)

Par. 4. The table of OMB Control Numbers in § 602.101 is amended by revising the entry for § 1.832-4 as follows:

"§ 1.832-4 . . . . 1545-1227".

December 24, 1991.

Michael J. Murphy,

Acting Commissioner of Internal Revenue.

**8 Approved: December 24, 1991.

Kenneth W. Gideon,

Assistant Secretary of the Treasury.

(FR Doc. 92-1942 Filed 1-27-92; 8:45 am)

26 CFR 602.101 1.832-7T 1.832-4T 1.832-4 1.831-1

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