26 C.F.R. § 1.832–4, Treas. Reg. § 1.832–4

# § 1.832–4 Gross income.

Currentness

**(a)(1)** Gross income as defined in section 832(b)(1) means the gross amount of income earned during the taxable year from interest, dividends, rents, and premium income, computed on the basis of the underwriting and investment exhibit of the annual statement approved by the National Convention of Insurance Commissioners, as well as the gain derived from the sale or other disposition of property, and all other items constituting gross income under section 61, except that in the case of a mutual fire insurance company described in section 831(a)(3)(A) the amount of single deposit premiums received, but not assessments, shall be excluded from gross income. Section 832(b)(1)(D) provides that in the case of a mutual fire or flood insurance company described in section 831(a)(3)(B), there shall be included in gross income an amount equal to 2 percent of the premiums earned during the taxable year on contracts described in section 831(a)(3)(B) after deduction of premium deposits returned or credited during such taxable year with respect to such contracts. Gross income does not include increase in liabilities during the year on account of reinsurance treaties, remittances from the home office of a foreign insurance company to the United States branch, borrowed money, or gross increase due to adjustments in book value of capital assets.

**(2)** The underwriting and investment exhibit is presumed to reflect the true net income of the company, and insofar as it is not inconsistent with the provisions of the Code will be recognized and used as a basis for that purpose. All items of the exhibit, however, do not reflect an insurance company's income as defined in the Code. By reason of the definition of investment income, miscellaneous items which are intended to reflect surplus but do not properly enter into the computation of income, such as dividends declared to shareholders in their capacity as such, home office remittances and receipts, and special deposits, are ignored. Gain or loss from agency balances and bills receivable not admitted as assets on the underwriting and investment exhibit will be ignored, excepting only such agency balances and bills receivable as have been allowed as deductions for worthless debts or, having been previously so allowed, are recovered during the taxable year.

**(3) Premiums earned.** The determination of premiums earned on insurance contracts during the taxable year begins with the insurance company's gross premiums written on insurance contracts during the taxable year, reduced by return premiums and premiums paid for reinsurance. Subject to the exceptions in sections 832(b)(7), 832(b)(8), and 833(a)(3), this amount is increased by 80 percent of the unearned premiums on insurance contracts at the end of the preceding taxable year, and is decreased by 80 percent of the unearned premiums on insurance contracts at the end of the current taxable year.

**(4) Gross premiums written—(i) In general.** Gross premiums written are amounts payable for insurance coverage. The label placed on a payment in a contract does not determine whether an amount is a gross premium written. Gross premiums written do not include other items of income described in section 832(b)(1)(C) (for example, charges for providing loss adjustment or claims processing services under administrative services or cost-plus arrangements). Gross premiums written on an insurance contract include all amounts payable for the effective period of the insurance contract. To the extent that amounts paid or payable with respect to an arrangement are not gross premiums written, the insurance company may not treat amounts payable to customers under the applicable portion of such arrangements as losses incurred described in section 832(b)(5).

**(ii) Items included.** Gross premiums written include—

(A) Any additional premiums resulting from increases in risk exposure during the effective period of an insurance contract;

(B) Amounts subtracted from a premium stabilization reserve to pay for insurance coverage; and

(C) Consideration in respect of assuming insurance liabilities under insurance contracts not issued by the taxpayer (such as a payment or transfer of property in an assumption reinsurance transaction).

**(5) Method of reporting gross premiums written—(i) In general.** Except as otherwise provided under this paragraph (a)(5), an insurance company reports gross premiums written for the earlier of the taxable year that includes the effective date of the insurance contract or the year in which the company receives all or a portion of the gross premium for the insurance contract. The effective date of the insurance contract is the date on which the insurance coverage provided by the contract commences. The effective period of an insurance contract is the period over which one or more rates for insurance coverage are guaranteed in the contract. If a new rate for insurance coverage is guaranteed after the effective date of an insurance contract, the making of such a guarantee generally is treated as the issuance of a new insurance contract with an effective period equal to the duration of the new guaranteed rate for insurance coverage.

**(ii) Special rule for additional premiums resulting from an increase in risk exposure.** An insurance company reports additional premiums that result from an increase in risk exposure during the effective period of an insurance contract in gross premiums written for the taxable year in which the change in risk exposure occurs. Unless the increase in risk exposure is of temporary duration (for example, an increase in risk exposure under a workers' compensation policy due to seasonal variations in the policyholder's payroll), the company reports additional premiums resulting from an increase in risk exposure based on the remainder of the effective period of the insurance contract.

**(iii) Exception for certain advance premiums.** If an insurance company receives a portion of the gross premium for an insurance contract prior to the first day of the taxable year that includes the effective date of the contract, the company may report the advance premium (rather than the full amount of the gross premium for the contract) in gross premiums written for the taxable year in which the advance premium is received. An insurance company may adopt this method of reporting advance premiums only if the company's deduction for premium acquisition expenses for the taxable year in which the company receives the advance premium does not exceed the limitation of paragraph (a)(5)(vii) of this section. A company that reports an advance premium in gross premiums written under this paragraph (a)(5)(iii) takes into account the remainder of the gross premium written and premium acquisition expenses for the contract in the taxable year that includes the effective date of the contract. A company that adopts this method of reporting advance premiums must use the method for all contracts with advance premiums.

  

**(iv) Exception for certain cancellable accident and health insurance contracts with installment premiums.** If an insurance company issues or proportionally reinsures a cancellable accident and health insurance contract (other than a contract with an effective period that exceeds 12 months) for which the gross premium is payable in installments over the effective period of the contract, the company may report the installment premiums (rather than the total gross premium for the contract) in gross premiums written for the earlier of the taxable year in which the installment premiums are due under the terms of the contract or the year in which the installment premiums are received. An insurance company may adopt this method of reporting installment premiums for a cancellable accident and health insurance contract only if the company's deduction for premium acquisition expenses for the first taxable year in which an installment premium is due or received under the contract does not exceed the limitation of paragraph (a)(5)(vii) of this section. A company that adopts this method of reporting installment premiums for a cancellable accident and health contract must use the method for all of its cancellable accident and health insurance contracts with installment premiums.

**(v) Exception for certain multi-year insurance contracts.** If an insurance company issues or proportionally reinsures an insurance contract, other than a contract described in paragraph (a)(5)(vi) of this section, with an effective period that exceeds 12 months, for which the gross premium is payable in installments over the effective period of the contract, the company may treat the insurance coverage provided under the multi-year contract as a series of separate insurance contracts. The first contract in the series is treated as having been written for an effective period of twelve months. Each subsequent contract in the series is treated as having been written for an effective period equal to the lesser of 12 months or the remainder of the period for which the rates for insurance coverage are guaranteed in the multi-year insurance contract. An insurance company may adopt this method of reporting premiums on a multi-year contract only if the company's deduction for premium acquisition expenses for each year of the multi-year contract does not exceed the limitation of paragraph (a)(5)(vii) of this section. A company that adopts this method of reporting premiums for a multi-year contract must use the method for all multi-year contracts with installment premiums.

**(vi) Exception for insurance contracts described in section 832(b)(7).** If an insurance company issues or reinsures the risks related to a contract described in section 832(b)(7), the company may report gross premiums written for the contract in the manner required by sections 803 and 811(a) for life insurance companies. An insurance company may adopt this method of reporting premiums on contracts described in section 832(b)(7) only if the company also determines the deduction for premium acquisition costs for the contract in accordance with section 811(a), as adjusted by the amount required to be taken into account under section 848 in connection with the net premiums of the contract. A company that adopts this method of reporting premiums for a contract described in section 832(b)(7) must use the method for all of its contracts described in that section.

**(vii) Limitation on deduction of premium acquisition expenses.** An insurance company's deduction for premium acquisition expenses (for example, commissions, state premium taxes, overhead reimbursements to agents or brokers, and other similar amounts) related to an insurance contract is within the limitation of this paragraph (a)(5)(vii) if—

(A) The ratio obtained by dividing the sum of the company's deduction for premium acquisition expenses related to the insurance contract for the taxable year and previous taxable years by the total premium acquisition expenses attributable to the insurance contract; does not exceed

(B) The ratio obtained by dividing the sum of the amounts included in gross premiums written with regard to the insurance contract for the taxable year and previous taxable years by the total gross premium written for the insurance contract.

  

**(viii) Change in method of reporting gross premiums.** An insurance company that adopts a method of accounting for gross premiums written and premium acquisition expenses described in paragraph (a)(5)(iii), (iv), (v), or (vi) of this section must continue to use the method to report gross premiums written and premium acquisition expenses unless the company obtains the consent of the Commissioner to change to a different method under section 446(e) and § 1.446–1(e).

**(6) Return premiums—(i) In general.** An insurance company's liability for return premiums includes amounts previously included in an insurance company's gross premiums written, which are refundable to a policyholder or ceding company, provided that the amounts are fixed by the insurance contract and do not depend on the experience of the insurance company or the discretion of its management.

**(ii) Items included.** Return premiums include amounts—

(A) Which were previously paid and become refundable due to policy cancellations or decreases in risk exposure during the effective period of an insurance contract;

(B) Which reflect the unearned portion of unpaid premiums for an insurance contract that is canceled or for which there is a decrease in risk exposure during its effective period; or

(C) Which are either previously paid and refundable or which reflect the unearned portion of unpaid premiums for an insurance contract, arising from the redetermination of a premium due to correction of posting or other similar errors.

**(7) Method of reporting return premiums.** An insurance company reports the liability for a return premium resulting from the cancellation of an insurance contract for the taxable year in which the contract is canceled. An insurance company reports the liability for a return premium attributable to a reduction in risk exposure under an insurance contract for the taxable year in which the reduction in risk exposure occurs.

**(8) Unearned premiums—(i) In general.** The unearned premium for a contract, other than a contract described in section 816(b)(1)(B), generally is the portion of the gross premium written that is attributable to future insurance coverage during the effective period of the insurance contract. However, unearned premiums held by an insurance company with regard to the net value of risks reinsured with other solvent companies (whether or not authorized to conduct business under state law) are subtracted from the company's unearned premiums. Unearned premiums also do not include any additional liability established by the insurance company on its annual statement to cover premium deficiencies. Unearned premiums do not include an insurance company's estimate of its liability for amounts to be paid or credited to a customer with regard to the expired portion of a retrospectively rated contract (retro credits). An insurance company's estimate of additional amounts payable by its customers with regard to the expired portion of a retrospectively rated contract (retro debits) cannot be subtracted from unearned premiums.

**(ii) Special rules for unearned premiums.** For purposes of computing "premiums earned on insurance contracts during the taxable year" under section 832(b)(4), the amount of unearned premiums includes—

(A) Life insurance reserves (as defined in section 816(b), but computed in accordance with section 807(d) and sections 811(c) and (d));

  

(B) In the case of a mutual flood or fire insurance company described in section 832(b)(1)(D) (with respect to contracts described in that section), the amount of unabsorbed premium deposits that the company would be obligated to return to its policyholders at the close of the taxable year if all its insurance contracts were terminated at that time;

(C) In the case of an interinsurer or reciprocal underwriter that reports unearned premiums on its annual statement net of premium acquisition expenses, the unearned premiums on the company's annual statement increased by the portion of premium acquisition expenses allocable to those unearned premiums; and

(D) In the case of a title insurance company, its discounted unearned premiums (computed in accordance with section 832(b)(8)).

**(9) Method of determining unearned premiums.** If the risk of loss under an insurance contract does not vary significantly over the effective period of the contract, the unearned premium attributable to the unexpired portion of the effective period of the contract is determined on a pro rata basis. If the risk of loss varies significantly over the effective period of the contract, the insurance company may consider the pattern and incidence of the risk in determining the portion of the gross premium that is attributable to the unexpired portion of the effective period of the contract. An insurance company that uses a method of computing unearned premiums other than the pro rata method must maintain sufficient information to demonstrate that its method of computing unearned premiums accurately reflects the pattern and incidence of the risk for the insurance contract.

**(10) Examples.** The provisions of paragraphs (a)(4) through (a)(9) of this section are illustrated by the following examples:

**Example 1.** (i) IC is a non-life insurance company which, pursuant to section 843, files its returns on a calendar year basis. IC writes a casualty insurance contract that provides insurance coverage for a one-year period beginning on July 1, 2000 and ending on June 30, 2001. IC charges a $500 premium for the insurance contract, which may be paid either in full by the effective date of the contract or in quarterly installments over the contract's one year term. The policyholder selects the installment payment option. As of December 31, 2000, IC collected $250 of installment premiums for the contract.

(ii) The effective period of the insurance contract begins on July 1, 2000 and ends on June 30, 2001. For the taxable year ending December 31, 2000, IC includes the $500 gross premium, based on the effective period of the contract, in gross premiums written under section 832(b)(4)(A). IC's unearned premium with respect to the contract was $250 as of December 31, 2000. Pursuant to section 832(b)(4)(B), to determine its premiums earned, IC deducts $200 ($250 x .8) for the insurance contract at the end of the taxable year.

**Example 2.** (i) The facts are the same as Example 1, except that the insurance contract has a stated term of 5 years. On each contract anniversary date, IC may adjust the rate charged for the insurance coverage for the succeeding 12 month period. The amount of the adjustment in the charge for insurance coverage is not substantially limited under the insurance contract.

(ii) Under paragraph (a)(5)(i) of this section, IC is required to report gross premiums written for the insurance contract based on the effective period for the contract. The effective period of the insurance contract is the period for which a rate for insurance coverage is guaranteed in the contract. Although the insurance contract issued by IC has a stated term of 5 years, a rate for insurance coverage is guaranteed only for a period of 12 months beginning with the contract's effective date and each anniversary date thereafter. Thus, for the taxable year ending December 31, 2000, IC includes the $500 gross premium for the 12 month period beginning with the contract's effective date in gross premiums written. IC's unearned premium with respect to the contract was $250 as of December 31, 2000. Pursuant to section 832(b)(4)(B), to determine its premiums earned, IC deducts $200 ($250 x .8) for the insurance contract at the end of the taxable year.

**Example 3.** (i) The facts are the same as Example 1, except that coverage under the insurance contract begins on January 1, 2001 and ends on December 31, 2001. On December 15, 2000, IC collects the first $125 premium installment on the insurance contract. For the taxable year ended December 31, 2000, IC deducts $20 of premium acquisition expenses related to the insurance contract. IC's total premium acquisition expenses, based on the insurance contract's $500 gross premium, are $80.

(ii) Under paragraph (a)(5)(iii) of this section, IC may elect to report only the $125 advance premium (rather than the contract's $500 gross premium) in gross premiums written for the taxable year ended December 31, 2000, provided that IC's deduction for the premium acquisition expenses related to the insurance contract does not exceed the limitation in paragraph (a)(5)(vii). IC's deduction for premium acquisition expenses is within this limitation only if the ratio of the insurance contract's premium acquisition expenses deducted for the taxable year and any previous taxable year to the insurance contract's total premium acquisition expenses does not exceed the ratio of the amounts included in gross premiums written for the taxable year and any previous taxable year for the contract to the total gross premium written for the contract.

(iii) For the taxable year ended December 31, 2000, IC deducts $20 of premium acquisition expenses related to the insurance contract. This deduction represents 25% of the total premium acquisition expenses for the insurance contract ($20/$80 = 25%). This ratio does not exceed the ratio of the $125 advance premium to the insurance contract's $500 gross premium ($125/$500 = 25%). Therefore, under paragraph (a)(5)(iii) of this section, IC may elect to report only the $125 advance premium (rather than the $500 gross premium) in gross premiums written for the taxable year ending December 31, 2000. IC reports the balance of the gross premium for the insurance contract ($375) and deducts the remaining premium acquisition expenses ($60) for the insurance contract in the taxable year ending December 31, 2001.

**Example 4.** (i) The facts are the same as Example 3, except that for the taxable year ending December 31, 2000, IC deducts $60 of premium acquisition expenses related to the insurance contract.

(ii) For the taxable year ended December 31, 2000, IC deducted 75% of total premium acquisition expenses for the insurance contract ($60/$80 = 75%). This ratio exceeds the ratio of the $125 advance premium to the $500 gross premium ($125/$500 = 25%). Because IC's deduction for premium acquisition expenses allocable to the contract exceeds the limitation in paragraph (a)(5)(vii) of this section, paragraph (a)(5)(i) of this section requires IC to report the $500 gross premium in gross premiums written for the taxable year ending December 31, 2000. IC's unearned premium with respect to the contract was $500 as of December 31, 2000. Pursuant to section 832(b)(4)(B), to determine its premiums earned, IC deducts $400 ($500 x .8) for the insurance contract at the end of the taxable year.

**Example 5.** (i) IC is a non-life insurance company which, pursuant to section 843, files its returns on a calendar year basis. On August 1, 2000, IC issues a one-year cancellable accident and health insurance policy to X, a corporation with 80 covered employees. The gross premium written for the insurance contract is $320,000. Premiums are payable in monthly installments. As of December 31, 2000, IC has collected $150,000 of installment premiums from X. For the taxable year ended December 31, 2000, IC has paid or incurred $21,000 of premium acquisition expenses related to the insurance contract. IC's total premium acquisition expenses for the insurance contract, based on the $320,000 gross premium, are $48,000.

(ii) Under paragraph (a)(5)(iv) of this section, IC may elect to report only the $150,000 of installment premiums (rather than the $320,000 estimated gross premium) in gross premiums written for the taxable year ended December 31, 2000, provided that its deduction for premium acquisition expenses allocable to the insurance contract does not exceed the limitation in paragraph (a)(5)(vii). For the taxable year ended December 31, 2000, IC deducts $21,000 of premium acquisition expenses related to the insurance contract, or 43.75% of total premium acquisition expenses for the insurance contract ($21,000/$48,000 = 43.75%). This ratio does not exceed the ratio of installment premiums to the gross premium for the contract ($150,000/$320,000 = 46.9%). Therefore, under paragraph (a)(5)(iv) of this section, IC may elect to report only $150,000 of installment premiums for the insurance contract (rather than $320,000 of gross premium) in gross premiums written for the taxable year ending December 31, 2000.

**Example 6.** (i) IC is a non-life insurance company which, pursuant to section 843, files its returns on a calendar year basis. On July 1, 2000, IC issues a one-year workers' compensation policy to X, an employer. The gross premium for the policy is determined by applying a monthly rate of $25 to each of X's employees. This rate is guaranteed for a period of 12 months, beginning with the effective date of the contract. On July 1, 2000, X has 1,050 employees. Based on the assumption that X's payroll would remain constant during the effective period of the contract, IC determines an estimated gross premium for the contract of $315,000 (1,050 x $25 x 12 = $315,000). The estimated gross premium is payable by X in equal monthly installments. At the end of each calendar quarter, the premiums payable under the contract are adjusted based on an audit of X's actual payroll during the preceding three months of coverage.

(ii) Due to an expansion of X's business in 2000, the actual number of employees covered under the contract during each month of the period between July 1, 2000 and December 31, 2000 is 1,050 (July), 1,050 (August), 1,050 (September), 1,200 (October), 1,200 (November), and 1,200 (December). The increase in the number of employees during the year is not attributable to a temporary or seasonal variation in X's business activities and is expected to continue for the remainder of the effective period of the contract.

(iii) Under paragraph (a)(5)(i) of this section, IC is required to report gross premiums written for the insurance contract based on the effective period of the contract. The effective period of X's contract is based on the 12 month period for which IC has guaranteed rates for insurance coverage. Under paragraph (a)(5)(ii), IC must also report the additional premiums resulting from the change in risk exposure under the contract for the taxable year in which the change in such exposure occurs. Unless the change in risk exposure is of temporary duration, the additional gross premiums are included in gross premiums written for the remainder of the effective period of the contract. Thus, for the taxable year ending December 31, 2000, IC reports gross premiums written of $348,750 with respect to the workers' compensation contract issued to X, consisting of the sum of the initial gross premium for the contract ($315,000) plus the additional gross premium attributable to the 150 employees added to X's payroll who will be covered during the last nine months of the contract's effective period (150 x $25 (monthly premium) x 9 = $33,750). IC's unearned premium with respect to the contract was $180,000 as of December 31, 2000, which consists of the sum of the remaining portion of the original gross premium ($315,000 x 6/12 = $157,500), plus the additional premiums resulting from the change in risk exposure ($33,750 x 6/9 = $22,500) that are allocable to the remaining six months of the contract's effective period. Pursuant to section 832(b)(4)(B), to determine its premiums earned, IC deducts $144,000 ($180,000 x .8) for the insurance contract at the end of the taxable year.

**Example 7.** (i) The facts are the same as Example 6, except that the increase in the number of X's employees for the period ending December 31, 2000 is attributable to a seasonal variation in X's business activity.

(ii) Under paragraph (a)(5)(ii) of this section, for the taxable year ending December 31, 2000, IC reports gross premiums written of $326,500, consisting of the sum of the initial gross premium for the contract ($315,000) plus the additional premium attributable to the temporary increase in risk exposure during the taxable year (150 x $25 x 3 = $11,250). The unearned premium that is allocable to the remaining six months of the effective period of the contract is $157,500. Pursuant to section 832(b)(4)(B), to determine its premiums earned, IC deducts $126,000 ($157,500 x .8) for the insurance contract at the end of the taxable year.

**Example 8.** (i) IC, a non-life insurance company, issues a noncancellable accident and health insurance contract (other than a qualified long-term care insurance contract, as defined in section 7702B(b)) to A, an individual, on July 1, 2000. The contract has an entry-age annual premium of $2,400, which is payable by A in equal monthly installments of $200 on the first day of each month of coverage. IC incurs agents' commissions, premium taxes, and other premium acquisition expenses equal to 10% of the gross premiums received for the contract. As of December 31, 2000, IC has collected $1,200 of installment premiums for the contract.

 

(ii) A noncancellable accident and health insurance contract is a contract described in section 832(b)(7). Thus, under paragraph (a)(5)(vi) of this section, IC may report gross premiums written in the manner required for life insurance companies under sections 803 and 811. Accordingly, for the taxable year ending December 31, 2000, IC may report gross premiums written of $1,200, based on the premiums actually received on the contract. Pursuant to section (a)(5)(vi) of this section, IC deducts a total of $28 of premium acquisition costs for the contract, based on the difference between the acquisition costs actually paid or incurred under section 811(a) ($1,200 x .10 = $120) and the amount required to be taken into account under section 848 in connection with the net premiums for the contract ($1,200 x .077 = $92).

(iii) Under paragraph (a)(8)(ii)(A) of this section, IC includes the amount of life insurance reserves (as defined in section 816(b), but computed in accordance with section 807(d) and sections 811(c) and (d)) in unearned premiums under section 832(b)(4)(B). Section 807(d)(3)(A)(iii) requires IC to use a two-year preliminary term method to compute the amount of life insurance reserves for a noncancellable accident and health insurance contract (other than a qualified long-term care contract). Under this tax reserve method, no portion of the $1,200 gross premium received by IC for A's contract is allocable to future insurance coverage. Accordingly, for the taxable year ending December 31, 2000, no life insurance reserves are included in IC's unearned premiums under section 832(b)(4)(B) with respect to the contract.

**Example 9.** (i) IC, a non-life insurance company, issues an insurance contract with a twelve month effective period for $1,200 on December 1, 2000. Immediately thereafter, IC reinsures 90% of its liability under the insurance contract for $900 with IC–2, an unrelated and solvent insurance company. On December 31, 2000, IC–2 has an $825 unearned premium with respect to the reinsurance contract it issued to IC. In computing its earned premiums, pursuant to section 832(b)(4)(B), IC–2 deducts $660 of unearned premiums ($825 x .8) with respect to the reinsurance contract.

(ii) Under paragraph (a)(8)(i) of this section, unearned premiums held by an insurance company with regard to the net value of the risks reinsured in other solvent companies are deducted from the ceding company's unearned premiums taken into account for purposes of section 832(b)(4)(B). If IC had not reinsured 90% of its risks, IC's unearned premium for the insurance contract would have been $1,100 ($1,200 x 11/12) and IC would have deducted $880 ($1,100 x .8) of unearned premiums with respect to such contract. However, because IC reinsured 90% of its risks under the contract with IC–2, as of December 31, 2000, the net value of the risks retained by IC for the remaining 11 months of the effective period of the contract is $110 ($1,100 − $990). For the taxable year ending December 31, 2000, IC includes the $1,200 gross premium in its gross premiums written and deducts the $900 reinsurance premium paid to IC–2 under section 832(b)(4)(A). Pursuant to section 832(b)(4)(B), to determine its premiums earned, IC deducts $88 ($110 x .8) for the insurance contract at the end of the taxable year.

**(11) Change in method of accounting—(i) In general.** A change in the method of determining premiums earned to comply with the provisions of paragraphs (a)(3) through (a)(10) of this section is a change in method of accounting for which the consent of the Commissioner is required under section 446(e) and § 1.446–1(e).

**(ii) Application.** For the first taxable year beginning after December 31, 1999, a taxpayer is granted consent of the Commissioner to change its method of accounting for determining premiums earned to comply with the provisions of paragraphs (a)(3) through (a)(10) of this section. A taxpayer changing its method of accounting in accordance with this section must follow the automatic change in accounting provisions of Rev. Proc. 99–49, 1999–52 I.R.B. 725 (see § 601.601(d)(2) of this chapter), except that—

(A) The scope limitations in section 4.02 of Rev. Proc. 99–49 shall not apply;

(B) The timely duplicate filing requirement in section 6.02(2) of Rev. Proc. 99–49 shall not apply; and

  

(C) If the method of accounting for determining premiums earned is an issue under consideration within the meaning of section 3.09 of Rev. Proc. 99–49 as of January 5, 2000, then section 7.01 of Rev. Proc. 99–49 shall not apply.

**(12) Effective date.** Paragraphs (a)(3) through (a)(11) of this section are applicable with respect to the determination of premiums earned for taxable years beginning after December 31, 1999.

**(13)** In computing the amount of unabsorbed premium deposits which a mutual fire or flood insurance company described in section 831(a)(3)(B) would be obligated to return to its policyholders at the close of its taxable year, the company must use its own schedule of unabsorbed premium deposit returns then in effect. A copy of the applicable schedule must be filed with the company's income tax return for each taxable year for which a computation based upon such schedule is made. In addition, a taxpayer making such a computation must provide the following information for each taxable year for which the computation is made:

**(i)** The amount of gross premiums received during the taxable year, and the amount of premiums paid for reinsurance during the taxable year, on the policies described in section 831(a)(3)(B) and on other policies;

**(ii)** The amount of insurance written during the taxable year under the policies described in section 831(a)(3)(B) and under other policies, and the amount of such insurance written which was reinsured during the taxable year. The information required under this subdivision shall only be submitted upon the specific request of the district director for a statement setting forth such information, and, if required, such statement shall be filed in the manner provided by this subparagraph or in such other manner as is satisfactory to the district director;

**(iii)** The amount of premiums earned during the taxable year on the policies described in section 831(a)(3)(B) and on other policies and the computations by which such amounts were determined, including sufficient information to support the taxpayer's determination of the amount of unearned premiums on premium deposit plan and other policies at the beginning and end of the taxable year, and the amount of unabsorbed premium deposits at the beginning and end of the taxable year on policies described in section 831(a)(3)(B).

The information required by this subparagraph shall be set forth in a statement attached to the taxpayer's income tax return for the taxable year for which such information is being provided. Such statement shall include the name and address of the taxpayer, and shall be filed not later than the date prescribed by law (including extensions thereof) for filing the income tax return for the taxable year.

**(14)** In computing "losses incurred" the determination of unpaid losses at the close of each year must represent actual unpaid losses as nearly as it is possible to ascertain them.

**(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."

**(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 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.

**(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.

**(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.

**Credits**

[T.D. 6681, 28 FR 11129, Oct. 17, 1963; T.D. 8171, 53 FR 118, Jan. 5, 1988; T.D. 8266, 54 FR 38970, Sept. 22, 1989; T.D. 8293, 55 FR 9425, March 14, 1990; T.D. 8390, 57 FR 3132, Jan. 28, 1992; T.D. 8390, 57 FR 6353, Feb. 24, 1992; T.D. 8857, 65 FR 706, Jan. 6, 2000]

SOURCE: T.D. 6500, 25 FR 11402, Nov. 26, 1960; 25 FR 14021, Dec. 21, 1960, unless otherwise noted.

AUTHORITY: Sections 1.267A–1 through 1.267A–7 also issued under 26 U.S.C. 267A(e).; Section 1.1502–59A also issued under 26 U.S.C. 1502.

Relevant Notes of Decisions (15)

View all 43

Notes of Decisions listed below contain your search terms.

**Construction and application**

  

Fact that amount of unpaid loss reserves set forth in insurer's annual statement was selected by professional management and not tax-motivated, certified as reasonable by a qualified actuary, within a range of reasonable actuarial estimates, and accepted by a state regulator did not establish that amount was fair and reasonable, within meaning of treasury regulation permitting deduction of fair and reasonable estimates of such reserves in computation of income tax. 26 U.S.C.A. § 832(b)(5), (c)(4); 26 C.F.R. § 1.832–4(b). Minnesota Lawyers Mut. Ins. Co. & Subsidiaries v. C.I.R., 2002, 285 F.3d 1086. Internal Revenue 3978

Mutual insurance company's determination and reporting of unpaid losses and loss expenses to state insurance commission does not limit IRS's obligation to enforce regulations and to examine and adjust, as necessary, amounts claimed for federal income tax purposes. 26 U.S.C.A. § 832(b, c); 26 C.F.R. § 1.832-4(a)(5), (b). Mn. Lawyers Mutual Ins. Co. v. C.I.R., 2000, 2000 WL 889739, Unreported, affirmed 285 F.3d 1086. Internal Revenue 3978

**Computation of losses**

Fair and reasonable estimates of mutual insurance company's unpaid losses were determined using point estimate selected by company's qualified actuary, since it was best available estimates. 26 U.S.C.A. § 832(b, c); 26 C.F.R. § 1.832-4(a)(5), (b). Mn. Lawyers Mutual Ins. Co. v. C.I.R., 2000, 2000 WL 889739, Unreported, affirmed 285 F.3d 1086. Internal Revenue 3978

Adverse development addition to case reserves for unpaid loss reserves, as estimated by taxpayer's claim department, was not necessary or reasonable, since there was no concrete evidence or analysis showing that claim department's estimates of unpaid losses were low or failed to reflect potential adverse development, department did not use consistent actuarial methods or standard actuarial loss development techniques in estimating loss reserves, and state certification of reasonability of unpaid losses was not controlling for tax purposes; for each year at issue taxpayer's recent historical experience had proved its case reserves were generous. 26 U.S.C.A. § 832(b, c); 26 C.F.R. § 1.832-4(a)(5), (b). Mn. Lawyers Mutual Ins. Co. v. C.I.R., 2000, 2000 WL 889739, Unreported, affirmed 285 F.3d 1086. Internal Revenue 3978

Although annual statement methodology is normally controlling on insurance company for unpaid losses at close of taxable year, for tax purposes, when annual statement methodology is predicated upon use of estimates, those estimates must be the best possible. 26 U.S.C.A. § 832(b, c); 26 C.F.R. § 1.832-4(a)(5), (b). Mn. Lawyers Mutual Ins. Co. v. C.I.R., 2000, 2000 WL 889739, Unreported, affirmed 285 F.3d 1086. Internal Revenue 3978

**Estimated salvage recoverable**

Savings relating to coordination of benefits (COB) between health insurer and other insurance companies, including savings related to Medicare, did not constitute "estimated salvage recoverable," for purposes of special loss deduction, where insurer used "pursue and pay" approach to amounts for which companies were primarily responsible, and for which they did pay; insurer had no expectation of payment for amounts paid by primary plans, and accordingly, no corresponding salvage right. 26 U.S.C.A. § 832(b)(5)(A); 26 C.F.R. § 1.832–4; Omnibus Budget Reconciliation Act of 1990, § 11305(a), 26 U.S.C.A. § 832. Blue Cross and Blue Shield of Texas, Inc. v. C.I.R., 2003, 328 F.3d 770. Internal Revenue 3977

"Estimated salvage recoverable," for purposes of special deduction under transition rules for enacted change in accounting method for insurers, must consist of amounts insurers expect to recover from amounts that they will pay or have paid, based on insurer's experience and facts of case. 26 U.S.C.A. § 832(b)(5)(A); 26 C.F.R. § 1.832–4; Omnibus Budget Reconciliation Act of 1990, § 11305(a), 26 U.S.C.A. § 832. Blue Cross and Blue Shield of Texas, Inc. v. C.I.R., 2003, 328 F.3d 770. Internal Revenue 3977

Health insurer's letter filed with Texas Department of Insurance did not satisfy requirements for safe harbor for special deduction of portion of "estimated salvage recoverable," under transition rules for enacted change in accounting method for insurers; language in letter to regulator was too broad to adequately inform regulator of extent that insurer's incurred losses were reduced by estimated salvage recoverable. 26 U.S.C.A. § 832(b)(5)(A); 26 C.F.R. § 1.832–4(f)(2); Omnibus Budget Reconciliation Act of 1990, § 11305(c), 26 U.S.C.A. § 832. Blue Cross and Blue Shield of Texas, Inc. v. C.I.R., 2003, 328 F.3d 770. Internal Revenue 3977

Issue of whether "absence of fraud" or "bona fide" should be appropriate standard for determining applicability of safe harbor for special deduction of portion of "estimated salvage recoverable," under transition rules for enacted change in accounting method for insurers, was legal issue, and not factual issue. 26 U.S.C.A. § 832(b)(5)(A); 26 C.F.R. § 1.832–4(f)(2); Omnibus Budget Reconciliation Act of 1990, § 11305(a), 26 U.S.C.A. § 832. Blue Cross and Blue Shield of Texas, Inc. v. C.I.R., 2003, 328 F.3d 770. Internal Revenue 3977

Health insurer could not, pursuant to safe harbor for special deduction of portion of "estimated salvage recoverable," take deduction for savings relating to coordination of benefits (COB) between insurer and other insurance companies, on sole basis that insurer believed in good faith and without fraud that such items were "estimated salvage recoverable," when they were in fact not; safe harbor provision allowed insurer to qualify for benefit despite technical errors in amount claimed, not item claimed. 26 U.S.C.A. § 832(b)(5)(A); 26 C.F.R. § 1.832–4(f)(2); Omnibus Budget Reconciliation Act of 1990, § 11305(a), 26 U.S.C.A. § 832. Blue Cross and Blue Shield of Texas, Inc. v. C.I.R., 2003, 328 F.3d 770. Internal Revenue 3977

"Savings" relating to coordination of benefits (COB) between health insurer and Medicare did not constitute "estimated salvage recoverable" for purposes of special loss deduction; portion of claims covered by Medicare gave rise to no right of recovery or salvage in favor of insurer, since Medicare-related benefits were excluded from coverage under insurer's plans. 26 U.S.C.A. § 832(b)(5)(A); 26 C.F.R. § 1.832-4(c); Omnibus Budget Reconciliation Act of 1990, § 11305(c), 104 Stat. 1388–451. Blue Cross & Blue Shield of Texas, Inc. v. C.I.R., 2000, 115 T.C. 148, Unreported, affirmed 328 F.3d 770. Internal Revenue 3399

Health insurer's letter filed with Texas Department of Insurance did not satisfy requirements for safe harbor for special deduction of portion of "estimated salvage recoverable"; letter to regulators did not disclose losses incurred in each of its lines of business, and did not use the term estimated salvage recoverable. 26 U.S.C.A. § 832(b)(5)(A); 26 C.F.R. § 1.832-4(c); Omnibus Budget Reconciliation Act of 1990, § 11305(c), 104 Stat. 1388–451. Blue Cross & Blue Shield of Texas, Inc. v. C.I.R., 2000, 115 T.C. 148, Unreported, affirmed 328 F.3d 770. Internal Revenue 3399

**Review**

The determination of a fair and reasonable estimate of an insurance company taxpayer's unpaid losses is essentially a valuation issue and a question of fact; thus, the scope of the appellate court's inquiry is limited to deciding whether the Tax Court's determination on the issue was clearly erroneous. 26 U.S.C.A. § 832(b)(5), (c)(4); 26 C.F.R. § 1.832–4(b). Minnesota Lawyers Mut. Ins. Co. & Subsidiaries v. C.I.R., 2002, 285 F.3d 1086. Internal Revenue 4707

Fairness and reasonableness of an insurance company taxpayer's estimate of its unpaid loss reserves, for purpose of income tax deduction, is a factual issue to be determined on a case-by-case basis, and no one factor should be considered conclusive. 26 U.S.C.A. § 832(b)(5), (c)(4); 26 C.F.R. § 1.832–4(b). Minnesota Lawyers Mut. Ins. Co. & Subsidiaries v. C.I.R., 2002, 285 F.3d 1086. Internal Revenue 3978

Tax court's determination that insurance company taxpayer's unpaid loss reserve estimate was not fair and reasonable was not clearly erroneous, in view of taxpayer's failure to adequately explain basis of "adverse loss development" (ALD) portion of its unpaid loss estimates, which comprised a significant portion of taxpayer's total unpaid loss estimates. 26 U.S.C.A. § 832(b)(5), (c)(4); 26 C.F.R. § 1.832–4(b). Minnesota Lawyers Mut. Ins. Co. & Subsidiaries v. C.I.R., 2002, 285 F.3d 1086. Internal Revenue 3978; Internal Revenue 4743.1

Current through February 3, 2022; 87 FR 6077

  

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