SOCIETY OF ACTUARIES

Article from:

Taxing Times

February 2009 – Volume 5 – Issue No. 1

T³: *TAXING TIMES* Tidbits

Premium Deficiency Reserves Designated as Tier III Issue

by Peter H. Winslow

On Sept. 12, 2008, the Internal Revenue Service (IRS) designated the deductibility of premium deficiency reserves as its first Tier III issue specifically related to the insurance industry. According to the IRS, Tier III issues present high compliance risks within an industry. They are not mandatory for IRS audit examination, but, when raised, trigger some degree of coordination between IRS auditors and IRS industry specialists.[1] Although the IRS notice states that the issue applies to all types of insurance companies, it is really directed to property/casualty and health insurance companies.[2] SSAP 53, paragraph 15 provides as follows for premium deficiency reserves:

> When the anticipated losses, loss adjustment expenses, commissions and other acquisitions costs, and maintenance costs exceed the recorded unearned premium reserve, and any future installment premiums on existing policies, a premium deficiency reserve shall be recognized by recording an additional liability for the deficiency, with a corresponding charge to operations.

Paragraph 16 further requires disclosure of premium deficiency reserves on the annual statement.

It is surprising that premium deficiency reserves established under the National Association of Insurance Commissioners' Statement of Statutory Accounting Principles (SSAP) 53 should be the first Tier III issue because, like their life insurance counterpart, their tax treatment is pretty clear. The regulations provide that unearned premiums do not include additional liabilities established on the annual statement to cover premium deficiencies.[3] Moreover, premium deficiency reserves generally cannot be deducted as another type of insurance reserve. In general, an insurance company is required to use an accrual method of accounting for its deductions for commissions and other policy acquisition costs and for policy maintenance costs.[4] Losses and loss adjustment expenses are deductible on a reserve basis under I.R.C. § 832(b)(5) and § 846(f)(2), but only as a fair and reasonable estimate of the amount relating to claims that already have been incurred.[5] Premium deficiency reserves are not held for incurred claims. Rev. Proc. 2002-46[6] allows an insurance company to elect to use a reserve method of accounting for certain premium acquisition expenses. For this purpose, a premium acquisition expense is defined as "an expense that is primarily related to the production of gross premiums written on an insurance contract and directly varies with the amount of gross premiums written on the underlying contract." It is possible that a portion of premium deficiency reserves may be deductible as premium acquisition expenses. But, if this special rule does not apply, it appears that there is very little controversy over the likely resolution of the IRS' first Tier III issue.

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End Notes

1. *See* S. Mitchell, *IRS Issues Exam Guidelines to Promote Consistency, TAXING TIMES*, VOL. 3, ISSUE 3 (Sept. 2007).
2. Formulaic deficiency reserves that arise for life insurance companies when the present value of future gross premiums exceeds the present value of future net premiums are expressly excluded from life insurance reserves and total reserves by the Code and regulations. I.R.C. §§ 807(d)(3)(C), 816(h); Treas. Reg. § 1.801-4(e)(4). *See also North American Reassurance Co. v. Commissioner*, 29 B.T.A. 683 (1934).
3. Treas. Reg. § 1.832-4(a)(8)(i).
4. *Western Casualty & Surety Co. v. Commissioner*, 571 F.2d 514 (10th Cir. 1978); but see, *Ohmer Register Co. v. Commissioner*, 131 F.2d 682 (6th Cir. 1942).
5. Treas. Reg. § 1.832-4(b); see, e.g., *State of Maryland Deposit Ins. Fund Corp. v. Commissioner*, 88 T.C. 1050 (1987).
6. 2002-2 C.B. 105.

Final Regulations Issued on Information Reporting Rules for Employer-Owned Life Insurance Contracts

by Lynlee C. Baker

The Treasury Department (Treasury) and the Internal Revenue Service (IRS) have removed temporary regulations (T.D. 9364) and issued final regulations (T.D. 9431) that require taxpayers to fulfill reporting requirements under section 6039I, relating to employer-owned life insurance contracts, by filing Form 8925, Report of Employer-Owned Life Insurance Contracts. Section 6039I generally requires applicable policyholders to file a return each year showing its total number of employees, the number of employees insured with employer-owned life insurance contracts, and the total amount of insurance in force at the end of the year under these contracts, as well as other related information. Section 6039I was enacted with section 101(j) as part of the Pension Protection Act of 2006.[1] Section 101(j) generally requires businesses to treat proceeds from company-owned life insurance contracts as income, excluding as a death benefit only the premiums and other amounts it paid for the contracts, except where certain requirements are satisfied. The temporary regulations, issued late last year, merely delegated authority to the IRS to prescribe the details of the information reporting requirements for employer-owned life insurance contracts under section 6039I.[2] In connection with the temporary regulations, the IRS issued Form 8925, Report of Employer-Owned Life Insurance Contracts, to which the final regulations now refer.

Employers holding life insurance contracts should use Form 8925 to report the number of employees covered by employer-owned life insurance contracts issued after Aug. 17, 2006, and the total amount of employer-owned life insurance in force on those employees at the end of the tax year. Policyholders also must indicate whether a valid consent has been received from each covered employee, and the number of covered employees for which a valid consent has not been received for purposes of Form 8925. An insurance contract is an employer-owned life insurance contract if it (i) is owned by a person who is engaged in a trade or business that employs the insured and is the direct or indirect beneficiary of the contract, and (ii) covers the life of the owner's employee(s) on the date the life insurance contract is issued. Special rules apply in the context of master contracts. Form 8925 should be attached to the policyholder's income tax return for each tax year ending after Nov. 13, 2007, during which the policyholder has employer-owned life insurance contract(s) in force.

End Notes

1. Pub.L. No. 109-280 (2006).
2. For more detailed discussions of section 101(j) and section 6039I, *see* J. Adney and B. Keene, *New "Best Practices" Rules for Corporate-Owned Life Insurance, TAXING TIMES*, February 2007, and J. Adney and M. Garcia, *Section 101(j) and 1035-The IRS Issues Rulings Addressing Employer Owned Life Insurance, TAXING TIMES*, September 2007. *See also* L. Baker, *New Temporary and Proposed Regulations Issued on Information Reporting Rules for Employer Owned Life Insurance Contracts, TAXING TIMES*, February 2008.

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