

comments directly to the IRS internet site at [http://www.irs.ustreas.gov/prod/tax\\_regs/comments.html](http://www.irs.ustreas.gov/prod/tax_regs/comments.html). The public hearing will be held in the Auditorium, Internal Revenue Service Building, 1111 Constitution Avenue NW, Washington, DC.

**FOR FURTHER INFORMATION CONTACT:**

Concerning the regulations, Gary Geisler, (202) 622-3970; concerning submissions and the hearing, Evangelista Lee, (202) 622-7190 (not toll-free numbers).

**SUPPLEMENTARY INFORMATION:**

**Background**

A nonlife insurance company's underwriting income equals its premiums earned on insurance contracts during the taxable year less its losses incurred and its expenses incurred. For taxable years beginning on or after January 1, 1993, a company's premiums earned on insurance contracts during the taxable year is an amount equal to the gross premiums written on insurance contracts during the taxable year, less return premiums and premiums paid for reinsurance, plus 80 percent of unearned premiums at the end of the prior taxable year, less 80 percent of unearned premiums at the end of the current taxable year.

The gross premiums written for an insurance or reinsurance contract is the total amount charged by the insurance company for the insurance coverage provided under the contract, including amounts charged covering the company's expenses and overhead. Written premiums are generally recorded for the full term of coverage for the year in which the contract is issued. Upon recording a written premium, the company establishes an unearned premium liability to reflect the portion of the written premium which relates to the unexpired portion of the insurance coverage.

The term "unearned premium" historically referred to the portion of the gross premiums written that would have to be returned to the policyholder upon cancellation of the policy and that was in direct proportion to the unexpired term of the policy. See, e.g., *Buckeye Union Casualty Co. v. Commissioner*, 448 F.2d 228, 230 (6th Cir. 1971), *aff'g* 54 T.C. 13, 20 n.5 (1970). Cases and rulings expanded this definition to include premiums paid for a future benefit, the cost of which was fixed when the policy was issued. See, e.g., *Massachusetts Protective Ass'n v. United States*, 114 F.2d 304 (1st Cir. 1940); *C.P.A. Co. v. Commissioner*, 7 T.C. 912 (1946) (nonlife company), *acq.* 1947-1 C.B. 1; Rev. Rul. 55-705, 1955-

2 C.B. 280. *But cf. Bituminous Casualty Corp. v. Commissioner*, 57 T.C. 58 (1971), *acq. in result* 1973-2 C.B. 1 (stating in dictum that "unearned premiums" had a substantially broader definition than the one developed in the cases and rulings cited above).

Prior to 1987, the increase in unearned premiums during the taxable year was deducted from gross premiums written in the computation of premiums earned. For example, if a company on September 1st issued a one-year fire insurance policy with a premium of \$1,200, the company on that date would record a gross written premium of \$1,200 and establish a \$1,200 unearned premium reserve. On December 31st, the company would have earned one-third of the premium, \$400, but would have an \$800 unearned premium reserve liability for the remaining eight months of coverage to be provided in periods after the close of the taxable year. The subtraction of the full amount of unearned premiums from the gross written premium "generally reflect[ed]" the accounting conventions (often referred to as "statutory accounting principles") used to prepare the annual statement for state insurance regulatory purposes. 2 H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-354 (1986), 1986-3 C.B. (Vol. 4) 354; S. Rep. No. 313, 99th Cong., 2d Sess. 495 (1986), 1986-3 C.B. (Vol. 3) 495; H.R. Rep. No. 426, 99th Cong., 1st Sess. 668 (1985), 1986-3 C.B. (Vol. 2) 668.

A nonlife company generally deducts expenses incurred in the taxable year in which the expenses are reported on the company's annual statement. These expenses include premium acquisition expenses attributable to unearned premiums.

In 1986, Congress determined that the combination of deferring unearned premiums and currently deducting premium acquisition expenses attributable to unearned premiums under the accounting conventions used to prepare a nonlife insurance company's annual statement resulted in a mismatch of income and expense. Congress decided to require a better measurement of income for Federal income tax purposes. H.R. Rep. No. 426, 1986-3 C.B. (Vol. 2) at 669; S. Rep. No. 313, 1986-3 C.B. (Vol. 3) at 496. Rather than require a nonlife company to capitalize and amortize premium acquisition expenses, Congress reduced by 20 percent the current deduction for unearned premiums. See section 832(b)(4)(B); 2 H.R. Conf. Rep. No. 841, 1986-3 C.B. (Vol. 4) at 354-55; S. Rep. No. 313, 1986-3 C.B. (Vol. 3) at 495-98; H.R. Rep. No. 426, 1986-3 C.B. (Vol. 2) at 668-70. This reduction in unearned

premiums is sometimes referred to as the "20 percent haircut." The acceleration of income as a result of the 20 percent haircut is intended to be roughly equivalent to denying current deductibility for a portion of the premium acquisition expenses.

Congress intended the 20 percent haircut to apply to all amounts (other than life insurance reserves and title insurance reserves) that were considered unearned premiums for Federal income tax purposes as of 1986. The House Report states that "[a]ll items which are included in unearned premiums under section 832(b) of present law are subject to this reduction in the deduction." H.R. Rep. No. 426, 1986-3 C.B. (Vol. 2) at 669. In describing the House bill, the Conference Report reiterates that "[a]ll items which are included in unearned premiums under section 832(b) of present law are subject to this reduction in the deduction" and describes the Senate amendment as "the same as the House bill, except that life insurance reserves which are included in unearned premium reserves under section 832(b)(4) are not subject to this reduction." 2 H.R. Conf. Rep. No. 841, 1986-3 C.B. (Vol. 4) at 354-55. The Report's description of the Conference agreement states that the agreement "follows the Senate amendment" but "provides special treatment of title insurance unearned premium reserves." Id. See sections 832(b) (7) and (8) for the rules applicable to life insurance and title insurance reserves.

Following the imposition of the 20 percent haircut on unearned premiums, the National Association of Insurance Commissioners (NAIC) revised the statutory accounting principles used to prepare a nonlife insurance company's annual statement. In general, these changes permitted a nonlife company to defer recording written premiums and/or to reduce the amount of unearned premiums reported on the company's annual statement. The affected items included advance premiums, additional premiums on retrospectively rated insurance policies, and the reporting of written premiums for workers' compensation policies and certain other casualty policies where the covered risk varies over the policy term.

Prior to 1989, advance premiums were required to be reported in written premiums and unearned premiums on the annual statement for the year in which the advance premiums were received. However, statutory accounting principles now permit advance premiums to be accumulated in a suspense account and reported as a write-in liability on the annual