

INTERNAL REVENUE SERVICE

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Taxpayer =

State Y =

Parent =

Date-a =

Date-b =

This refers to the letter submitted on Date-a, which requests a ruling regarding the treatment under §§ 1.832-4(a)(4) through (8) of the Income Tax Regulations of premium stabilization reserves which Taxpayer maintains in conjunction with certain group accident and health insurance contracts. The information submitted with Taxpayer's ruling request is summarized below.

Facts

Taxpayer is a nonlife insurance company incorporated under the laws of State Y and is taxable under § 831(a) of the Internal Revenue Code. Taxpayer is a wholly owned subsidiary of Parent and joins with Parent in filing a consolidated Federal income tax return on a calendar year basis.

Taxpayer's primary and predominant business involves the underwriting of group accident and health insurance contracts. Many of Taxpayer's contracts are experience rated and provide for premium stabilization reserves. In general, a premium stabilization reserve is a fund maintained by an insurance company in connection with a group insurance program which seeks to stabilize the group policyholder's premiums over a number of years. Typically, the premium stabilization reserve is funded by experience rate credits on the group insurance policy which, instead of being rebated to the group policyholder, are retained by the insurance company in an account to pay extraordinary claims or to offset future rate increases for the insured group. The premium stabilization is not part of the insurance company's capital and surplus, and only is refundable to the group policyholder in the event of cancellation of the related group insurance contract.

Taxpayer has submitted specimen copies of several premium stabilization reserve arrangements that it maintains in connection with group accident and health insurance contracts. In general, each premium stabilization reserve arrangement is individually negotiated with the

group policyholder. Depending on the particular arrangement, the agreement providing for the premium stabilization reserve may specify more or less contractual detail with respect to how the experience rating on the group accident and health insurance contract will be done. In addition, the arrangements may specify different formulas or mechanisms by which Taxpayer will apply interest credits to the premium stabilization reserves during the period in which these funds are held on behalf of the insured group.

One of the most common types of premium stabilization reserve arrangements offered by Taxpayer involves the issuance of an experience rated group accident and health insurance contract to an employer together with a rider providing for the establishment of a "Special Experience Account." Under the basic group accident and health insurance contract, the employer is charged a stated premium rate based on the number of active employees and their qualified dependents, the type of coverage selected (e.g., individual, dependent spouse, dependent child, or dependent family member), and the type of health care plan (e.g., HMO, PPO, or managed indemnity plan). The group contract is experience rated, so that at the end of each rating period Taxpayer is required to determine a rating adjustment for the contract by comparing the sum of the premiums and investment income earned with respect to the insured group to the sum of the group's claims and expenses incurred plus a factor covering Taxpayer's risk charges and profit. If the rating adjustment for the experience period results in an experience credit (i.e., the sum of the premiums and the investment income earned with respect to the group exceeds the sum of the group's claims and expenses incurred plus Taxpayer's risk and profit charges), Taxpayer adds the amount of the experience credit to the Special Experience Account maintained on behalf of the employer. Conversely, if the rating adjustment results in an experience debit (i.e., the sum of claims and expenses incurred with respect to the group plus Taxpayer's risk and profit charges are greater than the sum of the premiums and investment income earned with respect to the group), Taxpayer subtracts the amount of the experience debit from the Special Experience Account. If the experience debit exceeds the balance of the Special Experience Account, the employer is not charged an additional premium; however, the deficit in the Special Experience Account is carried over and offsets any future additions to the account as the result of experience rate credits.

Taxpayer is required to credit interest to the average balance of an employer's Special Experience Account, based on an annual interest rate which is reset at the beginning of each experience period. The employer may request a withdrawal from the Special Experience Account at any time for the payment of premiums or to cover extraordinary claims under the group contract, thus stabilizing the employer's premiums over time. If the employer terminates or fails to renew the group accident and health insurance contract, Taxpayer is required to pay the balance in the Special Experience Account together with a pro rata interest adjustment to the employer within a specified period after the date of termination.

For comparison purposes, Taxpayer also has submitted specimen copies of certain funding agreements that Taxpayer uses in connection with administrative services agreements or modified minimum premium agreements with uninsured health care plans (both generally referred to as "administrative services only" or "ASO" contracts). Under these arrangements, Taxpayer manages the funds supporting an employer's health benefit plan and provides claims

processing and other administration services for the plan. The deposit funds are treated as belonging to the employer and Taxpayer manages the funds subject to an agreement to pay interest thereon. Taxpayer charges the employer a fee for processing health care claims and other administrative expenses, which is included in gross income; however, a risk charge for overall coverage of plan benefits is not involved and Taxpayer is not liable for any claims or benefits in excess of the amount of funds on deposit.

On its annual statement filed for State regulatory reporting purposes, Taxpayer treats premium stabilization reserves in the same manner as experience rate credits that have been actually paid or credited to the group policyholders. Accordingly, Taxpayer records additions to or increases in the premium stabilization reserves as part of the liability for “Experience Rate Credits” on the premium reserve exhibit of the annual statement, which reduces the amount of premiums earned as shown on the underwriting exhibit. With respect to those group policies for which a rating has not been made at year-end, Taxpayer includes an estimated liability for additions to or increases in the premium stabilization reserve for those policies based on its loss experience to date.

On Date-b, Taxpayer received permission from the Commissioner of the Internal Revenue Service to include amounts held with respect to premium stabilization reserves (including estimates of the increase in the liability for such reserves based on loss experience through year-end) in the computation of unearned premiums.¹ Accordingly, the premium stabilization reserves have been included in the amount of unearned premiums subject to the 20 percent reduction required by § 832(b)(4)(B). By contrast, Taxpayer does not report funds that it receives from employers under ASO contracts in either gross premiums written under § 832(b)(4)(A) or unearned premiums under § 832(b)(4)(B), and does not deduct the amounts withdrawn from such funds to pay health care claims under the employer’s health benefit plan as losses incurred under § 832(b)(5). Rather, Taxpayer only reports the fees that it receives for providing claims processing and administrative services for the employer’s health benefit plan in gross income under § 832(b)(1)(C).

On January 7, 2000, the Internal Revenue Service issued final regulations under

¹ In Rev. Rul. 70-480, 1970-2 C.B. 142, the Service had held that amounts held by a non-life insurance company in a premium stabilization reserve funded with credits on experience rated group accident and health insurance contracts are not taken into account in determining the company’s unearned premiums. Rev. Rul. 70-480 concluded that stabilization reserves are not unearned premiums because the credits retained by the insurance company come into being after the relevant risk period had expired and thus constitute part of the company’s surplus, which is available to pay policyholder dividends. Rev. Rul. 97-5, 1997-1 C.B.136 revoked Rev. Rul. 70-480. Rev. Rul. 97-5 notes that Rev. Rul. 70-480’s conclusion that the premium stabilization reserves are part of the insurance company’s surplus is erroneous because the company had at all times a legal obligation to return the stabilization reserves to its policyholders to the extent that the stabilization reserves were not used to purchase future coverage.

§ 1.832-4, relating to the determination of underwriting income by nonlife insurance companies. The final regulations are intended to clarify what amounts are included in gross premiums written and unearned premiums for purposes of the 20 percent reduction of such unearned premiums provided by § 832(b)(4)(B). The final regulations provide guidance with respect to the items included in gross premiums written, return premiums, and unearned premiums. The final regulations also provide rules relating to the method (or timing) for taking these items into account for federal income tax purposes. These definitions and timing rules apply regardless of the classification of the related items on an insurance company's annual statement. The final regulations are effective for the taxable years of a nonlife insurance company beginning after December 31, 1999.

In light of the final regulations, Taxpayer has requested a ruling that additions or increases in premium stabilization reserves maintained in conjunction with a group accident and health insurance policy are deductible as "return premiums" within the meaning of § 1.832-4(a)(6) in the taxable year of the increase, and that subtractions or decreases in premium stabilization reserves which are applied to offset the amount of premiums otherwise required under the group accident and health insurance policy are included in "gross premiums written" within the meaning of § 1.832-4(a)(4) in the taxable year of the subtraction.

Law and Analysis

Section 832(b)(1) provides that the gross income of an insurance company that is subject to the tax imposed by § 831 includes its investment income or loss, its underwriting income or loss, gains from the sale of property, and other items constituting gross income under the rules of inclusion applicable to other taxpayers. Under § 832(b)(3), underwriting income consists of the premiums earned on insurance contracts during the taxable year, less losses incurred and expenses incurred.

Section 832(b)(4) provides that the amount of premiums earned on insurance contracts during the taxable year is computed by starting with the gross premiums written on insurance contracts during the taxable year and then subtracting from this amount return premiums and premiums paid for reinsurance. This amount is increased by 80 percent of the balance of unearned premiums on outstanding business at the end of the preceding taxable year, and then reduced by 80 percent of the increase in unearned premiums on outstanding business at the end of the taxable year. The 20 percent reduction of the deduction for net increases in unearned premiums under this computation is intended to reflect the premium acquisition expenses associated with the unearned premiums.

The starting-point for determining a non-life insurance company's premiums earned on insurance contracts during the taxable year under § 832(b)(4) is the amount of gross premium written on insurance contracts during the taxable year. Section 1.832-4(a)(4)(i) provides that "[g]ross premiums are amounts payable for insurance coverage," and that "gross premiums written on an insurance contract include all amounts payable for the effective period of an insurance contract."

Section 1.832-4(a)(4)(ii) lists certain items which must be included in gross premiums written. Section 1.832-4(a)(4)(ii)(B) provides specifically that gross premiums written includes amounts subtracted from a premium stabilization reserve to pay for insurance coverage.

Section 1.832-4(a)(5) provides guidance with respect to the method (or timing) for reporting gross premiums written. In general, an insurance company reports gross premiums written for the earlier of the taxable year that includes the effective date of the contract or the year in which the company receives all or a portion of the gross premium for the contract. For purposes of the foregoing general rule, the effective date of the insurance contract is the date on which coverage commences, and the effective period of an insurance contract is the period over which one or more rates for insurance coverage is guaranteed in the contract. See § 1.832-4(a)(5)(i).

Section 1.832-4(a)(6)(i) provides that return premiums are amounts previously include in an insurance company's gross premiums written, which are refundable to the policyholder (or the ceding company with respect of a reinsurance agreement) if 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.

Section 1.832-4(a)(7) discusses the timing for reporting of certain types of return premiums. More specifically, § 1.832-4(a)(7) provides that the liability for return premiums resulting from the cancellation of the contract is reported in the year of cancellation, and the liability for return premiums attributable to a reduction in risk exposure is taken into account in the taxable year in which the reduction of risk exposure occurs.

Section 1.832-4(a)(8) defines unearned premiums as the portion of the gross premiums written which is attributable to future insurance coverage during the effective period of the insurance contract. Section 1.832-4(a)(8) also provides specifically that unearned premiums are determined without regard to retrospective premium adjustments. Thus, unearned premiums do not include an insurance company's estimate of amounts to be refunded or credited to the customer with regard to the expired portion of a retrospectively rate insurance contract (retro credits). Likewise, 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.

The definition of unearned premiums in § 1.832-4(a)(8) represents a reversal of a provision of the prior regulations (prior § 1.832-4(a)(3)(ii)), that had provided for the inclusion of a "liability for return premiums under a rate credit or retrospective rating plan based on experience" in the computation of unearned premiums. Therefore, it is clear under the final regulations that additions to or increases in premium stabilization reserves that are attributable to experience rate credits are no longer included in the amounts taken into account as unearned premiums under § 832(b)(4)(B).

Unlike § 1.832-4(a)(4)(ii), which provides specifically for the treatment of subtractions from premium stabilization reserves to pay for insurance coverage as an item included in gross premiums written, the final regulations do not specifically list additions to or increases in premium stabilization reserves attributable to experience rate credits as an item included in

return premiums. Rather, § 1.832-4(a)(6)(i) provides a general definition of return premiums, stating that an insurance company's liability for return premiums includes amounts previously included in gross premiums written, which are refundable to a policyholder or a ceding company (excluding amounts which are treated as policyholder dividends under § 832(c)(11)). Thus, the issue is whether the premium stabilization that Taxpayer maintains in connection with its group accident and health insurance policies represent a "liability for return premiums" as generally defined under § 1.832-4(a)(6)(i).

Taxpayer issues group accident and health insurance contracts which are experience rated and for which it maintains premium stabilization reserves. The amounts added to the premium stabilization reserve represent the excess, if any, of the premiums and investment income earned with respect to the insured group over the group's claims and benefits paid plus a provision for Taxpayer's administrative costs and risk charges intended to assess the group policyholder for an appropriate share of Taxpayer's anticipated losses on policies if claims and expenses exceed the premiums collected. Therefore, additions to the premium stabilization reserve are attributable to amounts that Taxpayer has previously included in gross premiums written under 832(b)(4)(A), together with an adjustment reflecting a portion of Taxpayer's earned investment income which is allocable to premiums collected from the insured group. Although a group accident and health insurance contract may not specify in exact detail the manner in which rating adjustments will be done, the amounts added to the premium stabilization reserve are based on Taxpayer's experience with the particular insured group and are not discretionary. Further, Taxpayer has a contractual liability to return the amounts in the premium stabilization reserve because the group policyholder has the right to have any amount in the reserve applied against its future years' premiums or benefit costs, as well as the right to a refund of the reserve balance upon cancellation of the group accident and health insurance contract. Finally, the premium stabilization reserves are distinguishable from deposit funds because Taxpayer retains the premium stabilization reserves as part of an on-going group insurance arrangement to pay extraordinary claims or to offset premium increases, and because the amounts in the premium stabilization reserve cannot be withdrawn at the discretion of the group policyholder except upon cancellation of the related group accident and health insurance contract.

Based on the above, it is ruled as follows:

For purposes of applying the provisions of §§ 1.832-4(a)(4) through (8), as in effect for taxable years beginning after December 31, 1999, Taxpayer will deduct additions to or increases in a premium stabilization reserve maintained in conjunction with a group accident and health insurance policy as "return premiums" within the meaning of § 1.832-4(a)(6) in the taxable year of the increase in the premium stabilization reserve, and will include subtractions or decreases in a premium stabilization reserve as part of "gross premiums written" within the meaning of § 1.832-4(a)(4) to the extent that such subtraction or decrease reduces the premiums otherwise required to be paid under the group accident and health insurance policy.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Pursuant to a power of attorney on file in this office, a copy of this ruling letter is being sent to Taxpayer's authorized representative. Further, a copy of this ruling letter should be attached to Taxpayer's consolidated federal income tax return for the first taxable year beginning after December 31, 1999.

The rulings contained in this letter are based upon information and representations submitted by Taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,
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(Financial Institutions and Products)
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Branch 4