Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:CTM:[redacted]:TL-N-6395-00
[redacted]

date: February 20, 2001

to: LMSB:CTM:[redacted]
[redacted]

from: Office of Chief Counsel, LMSB Division, [redacted]
[redacted], Associate Area Counsel
[redacted], Senior Attorney

subject: [redacted] -- I.R.C. § 832

DISCLOSURE STATEMENT

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CASE HISTORY

You had previously requested that Counsel render advice on this issue for the taxable years of the taxpayer ended [redacted], [redacted], [redacted], and [redacted]. By memorandum dated [redacted], you requested that Counsel render advice on this issue for the taxable years of the taxpayer ended [redacted], [redacted], [redacted], and [redacted].

We have previously rendered advice to you concerning whether the exclusion of a fraction of the premiums received by [redacted]

[redacted] (and added to its Unearned Premium Reserve under statutory accounting principles) can be excluded from the calculation of the Unearned Premium Reserve for Federal income tax purposes on the grounds that it would constitute a double deduction or a failure to properly match income and expenses. We advised that this item could not be excluded from the calculation of the Unearned Premium Reserve for Federal income tax purposes. We concluded that this does not constitute a double deduction and that Congress had addressed the issue of properly matching income and expenses by allowing a deduction only for the present value of the additions to the reserve. We rendered the same advice later with regard to the question of whether a portion of the premium retained by the agents as their fee could be excluded from the calculation of the unearned premium reserve on the grounds that it represents direct payment by the customer to the agent for the agent's assumption of part of the inherent risk in the policy issued.

This current request for advice is a renewal of a request previously made and then withdrawn by revenue agent [redacted]. That request asked whether "Other Title Fees and Service Charges" and "Escrow and Settlement Service Charges" as listed on the taxpayer's Forms 9 for the years in question meet the definition of I.R.C. § 832(b)(4). Since Parts 2C of the taxpayer's Forms 9 for the years at issue clearly show that the majority of the "Other Title Fees and Service Charges" is composed of fees for title searches, abstracts, and examinations,[1] we will render advice only with regard to the portion that is not composed of such fees. Fees for title searches, abstracts, and examinations, are, of course, covered by our prior advice.

ISSUE

Whether Taxpayer is entitled to defer escrow fees and other amounts it has received if they are included in unearned title insurance premiums on Form 9, Schedule 2B (Annual Statement for Title Insurance) for [redacted] through [redacted]?

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[1] For the years at issue:

	[redacted]	[redacted]	[redacted]
Title Examinations	$[redacted]	$[redacted]	$[redacted]
Searches & abstracts	[redacted]	[redacted]	[redacted]
Aggregate write-ins for service charges	[redacted]	[redacted]	[redacted]
Totals	$[redacted]	$[redacted]	$[redacted]

CONCLUSION

To the extent that they are included in "Total charges for policies of title insurance" as required by [redacted], Taxpayer's Escrow and Settlement Charges and Other Title Fees and Service Charges are to be included in Taxpayer's undiscounted unearned premiums described in Internal Revenue Code § 832(b)(8)(C)(i) (except when otherwise noted, all statutory references in this memorandum are made to the Internal Revenue Code of 1986, as amended).

FACTS

Taxpayer is engaged in the business of issuing title insurance policies. For the years at issue, Taxpayer had $[redacted], $[redacted], and $[redacted] in Net Premiums Written, according to Parts 2A of its Forms 9 for those years. Taxpayer also reported Escrow and Settlement Service Charges of $[redacted], $[redacted], and $[redacted], and Aggregate write-ins for service charges of $[redacted], $[redacted] $[redacted]. (This memorandum will refer to these amounts as "the relevant amounts.")

Sections [redacted] Insurance Code provide, inter alia, that out of "Total charges for policies of title insurance", a title insurer shall add to its unearned premium reserve an amount equal to [redacted]% of the sum of its "Direct Written Premiums" and "Other Income", as set forth on Schedule T of its Annual Statement. Section [redacted]. At least some portion, and possibly all, of the relevant amounts were included in its "Total Charges for policies of title insurance" as defined in [redacted] Insurance Code.

LAW AND ANALYSIS

In the case of an insurance company subject to the tax imposed by § 831, § 832(a) provides that the term, "taxable income", means gross income as defined in § 832(b)(1), less the deductions allowed by § 832(c).

Section 832(b)(1)(A) defines the term "gross income" to include the combined gross amount earned during the taxable year from investment income and from underwriting income as provided in § 832(b), computed on the basis of the underwriting and investment exhibit of the annual statement approved by the National Association of Insurance Commissioners (NAIC).

Section 832(b)(3) provides that the term "underwriting income" means the premiums earned on insurance contracts during the taxable year, less losses and expenses incurred.

Section 832(b)(4) provides that "premiums earned on insurance contracts during the taxable year" is the amount computed as follows:

> (A) From the amount of gross premiums written on insurance contracts during the taxable year, deduct return premiums and premiums paid for reinsurance.
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> (B) To the result so obtained, add 80 percent of the unearned premiums on outstanding business at the end of the preceding taxable year and deduct 80 percent of the unearned premiums on outstanding business at the end of the taxable year.
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> (C) To the result so obtained, in the case of a taxable year beginning after December 31, 1986, and before January 1, 1993, add an amount equal to 3⅓ percent of unearned premiums on outstanding business at the end of the most recent taxable year beginning before January 1, 1987.

For premiums attributable to title insurance, step (B) is applied using discounted unearned premiums rather than 80 percent of unearned premiums, and step (C) is omitted. See §§ 832(b)(8)(A)-(C). For such premiums, the amount of undiscounted unearned premiums is determined by applying a present value formula to "undiscounted unearned premiums." The term, "undiscounted unearned premiums", is defined as the "unearned premiums shown in the yearly statement filed by the taxpayer for the year ending with or within such taxable year." See § 832(b)(8)(C)(i). Rev. Rul. 91-22, 1991-1 C.B. 91, indicates that "discounted unearned premiums" are determined by discounting the amounts added during the tax year to a "state statutory title insurance unearned premium reserve at the interest rate generally applicable to property and casualty unpaid loss reserves."

The Service is concerned that the inclusion of amounts other than premiums in the amounts taken into account in calculating a taxpayer's unearned premium reserve will result in the unwarranted deferral of income tax on a portion of the taxpayer's income.

For a substantial period of time prior to the enactment of the Tax Reform Act of 1986, the proper tax treatment of title insurance unearned premium reserves was unclear. See, Rev. Rul.

83-174, 1983-2 C.B. 108, as modified by Rev. Rul. 84-107, 1984-2 C.B. 122. Rev. Rul. 83-174 holds that amounts set aside by a title insurance company in a state required reserve do not constitute "unearned premiums" under § 832(b)(4) as in effect for tax years beginning prior to January 1, 1987. That ruling indicates that in the case of a title insurance policy, the risk insured against[2] is mature on issuance of the policy. Because the amounts a title insurer reflects as unpaid losses are sufficient to protect the interests of policyholders and to provide for reinsurance, it concludes that amounts added to a state required title insurance unearned premium reserve are, in effect, set aside for solvency purposes.

Rev. Rul. 83-174 revoked two previous revenue rulings in which the Service had recognized that state required title insurance reserves qualified as unearned premium reserves for federal income tax purposes so long as the reserves met certain standards. See Rev. Rul. 59-251, 1959-2 C.B. 167, and Rev. Rul. 71-598, 1971-2 C.B. 261.

Rev. Rul. 84-107, 1984-2 C.B. 122 announced that the Service was reconsidering the holding of Rev. Rul. 83-174 in the case of certain title insurance companies that did not include estimates of incurred but unreported losses in the computation of losses incurred under then § 832(b)(5). Those title insurance companies that had deducted both net additions to a state required unearned premium reserve together with incurred but not reported losses were required to change their method of accounting for the first tax year beginning on or after November 28, 1983. In those cases, however, Rev. Rul. 84-107 permitted taxpayers either to (i) comply with the holding of Rev. Rul. 83-174, or (ii) adopt the prevailing industry practice of deducting additions to a state required unearned premium reserve as unearned premiums under then § 832(b)(4), and case reserves as losses incurred under then § 832(b)(5).

In 1991, the Service released Rev. Rul. 91-22, 1991-1 C.B. 91. That ruling was intended to eliminate any uncertainty respecting the status of title insurance unearned premium reserves during 1985 and 1986 caused by the varying effective dates of Rev. Ruls. 83-174, as modified by Rev. Rul. 84-107, and §§ 832(b)(4) and (8) enacted in the Tax Reform Act of 1986. Rev. Rul. 91-22 also addresses whether the holdings of Rev. Ruls. 83-174 and 84-107 continue to apply after the effective date of § 832(b)(8). Rev. Rul. 91-22 holds specifically that "discounted unearned premiums" described in § 832(b)(8) "are determined by

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[2] The risk insured against is the unmarketability of real estate due to a title defect or encumbrance.

discounting the amounts added during the tax year to a state statutory title insurance unearned premium reserve" at the interest rate generally applicable to property and casualty unpaid loss reserves. That ruling goes on to provide that in view of the enactment of § 832(b)(8) by the Tax Reform Act of 1986, the holdings of Rev. Ruls. 83-174 and 84-107 are obsolete with respect to taxable years of a title insurance company beginning after December 31, 1986.

Although Rev. Rul. 83-174 is obsolete, its statement that a title insurer's risks are mature at the time it enters into a title insurance contract remains true. Thus, as an economic matter, unlike the premiums received on other property and casualty insurance policies, the premiums received on a title insurance policy can not be considered to be "earned" ratably or otherwise over a limited and defined period during which an insured risk is outstanding.

In many cases a title insurer's statutory unearned premium reserve is not a function of the premium paid on the relevant title insurance policy. See: 215 Illinois Compiled Statutes, § 155/11 providing that a title insurance company's statutory unearned premium reserve should initially be equal to 12½ cents for each $1000 of net retained liability under each title insurance policy on a single risk written on Illinois property after January 1, 1990; § 38.2-4610.1 D.2 of the Code of Virginia providing that a title insurer's statutory unearned premium reserve should initially be equal to $1.50 for each policy of insurance covering a single risk written after June 30, 1986, plus a sum equal to 12½ cents of each $1000 of net retained liability under each such policy; and, Connecticut General Statutes § 38a-408(d)(2) providing that a title insurer's statutory unearned premium reserve should initially be equal to 15 cents for each $1000 of net retained liability on a single risk written on properties located in that state written after October 1, 1990.

Even in those cases where a title insurer's unearned premium reserve is calculated by reference to its income or receipts, there is a significant variation among the amounts different states require to be included in the relevant reserve. See: New Jersey Statutes §§ 17:18-13 (a) and (b) providing that a title insurer's statutory unearned premium reserve should initially be equal to 3% of its total gross premiums and fees during its first ten years of doing business, and 2% of the total of those gross premiums and fees thereafter; Ohio Revised Code, § 3953.11(B) and 40 Pennsylvania Statutes § 152, each of which provide that a title insurer's statutory unearned premium reserve should initially be equal to 10% of the title insurance premium received during the preceding calendar year for the issuance of policies,

not to exceed the aggregate amount of $250 thousand; and, Texas Insurance Code, Art. 9.16 providing that a title insurer writing $250 million or more in direct premiums is initially to set up a statutory unearned premium reserve equal to 6½% of the total of its direct premiums, escrow and settlement service fees, other title fees and service charges, and premiums for reinsurance assumed less premiums for reinsurance ceded.[3] New York combines the approaches of New Jersey, Ohio and Texas by providing that beginning January 1, 1986, the amount of a title insurer's unearned premium reserve shall be equal to (i) $1.50 for each policy issued, plus 1/80th of 1% of the face amount of insurance effected thereby, and, (ii) 3% of the gross fees and premiums a title insurer receives for guaranteed certificates of title, guaranteed searches and guaranteed abstracts of title not included in (i).

In view of:

(a) the disparity in the rules in the various states regarding the amounts of unearned premium reserves a title insurer is required to maintain;

(b) the facts that a title insurer's unearned premium reserve is not necessarily related to the premiums it receives and that a title insurance premium, unlike other property and casualty insurance premiums, can not be said to be earned ratably or otherwise over the period a risk is outstanding; and,

(c) Congress' specific reference in § 832(b)(8)(C)(i) to the relevant title insurer's unearned premiums shown in its statutory annual statement,

we conclude that the extent that they are included in "Total charges for policies of title insurance" as required by [redacted], [redacted]% of Taxpayer's Escrow and Settlement Charges and Other Title Fees and Service Charges are to be included in Taxpayer's undiscounted unearned premiums described in § 832(b)(8)(C)(i).

[redacted]

Senior Attorney

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[3] The rate applicable to a Texas title insurer writing less than $250 million in direct premiums is 3½ percent.