Office of Chief Counsel
Internal Revenue Service

memorandum

CC:WR:[redacted]:[redacted]:TL-N-1766-99
[redacted]

date: JUN 15 1999

to: Chief, [redacted], [redacted] District
Attn: [redacted] and [redacted], [redacted]

from: District Counsel, [redacted]
[redacted], Assistant District Counsel
[redacted], Attorney

subject: [redacted]--section 832

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By a memorandum dated April 21, 1999, we provided advice on whether [redacted] is deferring an item of revenue when it deducts the portion of the commission paid to sales agents that represents payment for the portion of the insured risk assumed by the agents. We forwarded a copy of this advice to our National Office for review as a Non-Significant Advice Request. The National Office recommended that our advice be modified to omit any references to reinsurance and to rephrase our conclusion. This memorandum constitutes our modified advice.

ISSUE

Whether [redacted] is deferring an item of revenue when it deducts the portion of the commission paid to sales agents that represents payment for the portion of the insured risk assumed by the agents.

FACTS

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

[redacted] is engaged in the business of providing [redacted] insurance. [redacted]'s agents generate certain premiums that they then retain as their fee. [redacted] records these premiums as income. [redacted] also records an expense item for the same amount as a fee paid to the agent who generated and retained the premium. [redacted] deducts [redacted]% of the premiums but reports only [redacted]% of the income. The remaining [redacted]% is added to the Unearned Premium Reserve (UPR). The gross income of [redacted] is reduced by an amount measured with reference to the increase in the UPR for the taxable year. The Service proposed to exclude this [redacted]% from the UPR calculation on the grounds that including it resulted in doubling of expenses deducted and a mismatching of income and expenses. [redacted]'s treatment of this item was, however, in accordance with statutory accounting for state law purposes. In our prior memorandum, we concluded that the [redacted] could not be forced to include this [redacted]% in income.

[redacted]'s policies are sold either directly or by independent agents. If an independent agent sells a policy, the agent retains a portion of the gross premiums collected as a commission or fee. In addition to selling the policy, the agent examines the [redacted] and is required to bring any defects to the attention of [redacted]. [redacted] then decides whether to assume the risk associated with this defect or to exclude it from coverage. Premiums on [redacted] insurance policies are usually paid when the policies are issued.

A sample contract provided by [redacted] indicates that [redacted] will not receive any portion of the premium retained by the agent. If there are losses in excess of a stated percentage of the premiums received by [redacted] in any one year, then the percentage to be paid by the agent to [redacted] is to increase in the following year. The agent bears a portion of the risk of loss but can relieve himself of this liability by bringing it to the attention of [redacted] so that [redacted] can decide whether or not to cover it. The agent's portion of the loss is not defined in the sample contract provided. The contract provides a blank space for a dollar figure. We assume that the dollar amount of the risk is different from the dollar amount of the commission retained and is not based on the amount of the commission. In addition, the agent is liable for losses caused by the agent's intentional elimination of references to title defects, exceptions, conditions, or stipulations. The agent is also liable for error, fault, or negligence in handling [redacted], errors in preliminary [redacted], or negligence in the preparation or issuance of the policy.

The Service has now asked if the deduction for the commission retained should be reduced by the amount retained as payment for these assumed risks on the grounds that [redacted] will receive the benefit of the agent's assumption of the risk and that this will, in effect, result in a repayment to [redacted] of the amount previously deducted.

LAW AND ANALYSIS

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

Section 832(b)(1)(A) of the Code 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 section 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) of the Code 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) of the Code defines "premiums earned on insurance contracts during the taxable year" as 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.

(B) To the amount determined in (A), 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.[1]

(C) To the amount so determined, in the case of a taxable year beginning after December 31, 1986, and before January 1, 1993, add an amount equal to 3-1/3 percent of unearned premiums on outstanding business at the end of the most recent taxable year beginning before January 1, 1987.

[redacted]

First, it should be remembered that an agent is primarily responsible for any losses caused by his own malfeasance, C.S. Zang v. Northwestern Title Co., et al., 135 Cal. App. 3d 159 (1982), and is liable to his principal for failure to execute his duties as required by the contract between them. United States Liability Insurance Co. v. Haidinger-Hayes, Inc., 1 Cal. 3d 586; 463 P.2d 770 (1970). In this situation, the agent is not merely a salesperson. The agent is required to examine [redacted] and determine if there are any defects and to certify the state of the title to [redacted] prior to issuing the policy. [redacted] may be, in part, paying the agent for assuming a risk, but this is not an additional risk. The agent risks potential claims against him by his principal whenever he acts under the principal-agent contract. If anything, the underwriting agreement limits the agent's liability.

Second, this is not the same item as the item of income that

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[1] This 80% rule for the inclusion or exclusion of the change in the unearned premiums is actually a 20% reduction. Under prior law, 100% was taken into account because unearned premiums were not considered current income.

may eventually be recovered if there is a claim filed under the policy. A cost that may later lead to income is not the same item as that income. A deduction may not be denied merely because it may later lead to income.

CONCLUSION

In order to calculate its earned premiums, a [redacted] insurance company applies [redacted] Nothing in the Code or regulations permits the Service to reduce those undiscounted unearned premiums by any portion of the commission expenses a [redacted] insurer incurs in connection with obtaining its premium income.

[redacted]
Attorney