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MEMORANDUM

Re: IRS Rules that Rev. Proc. 2002-46 Safe Harbor for Premium Acquisition Expenses Does Not Override I.R.C. § 404

From: Samuel A. Mitchell
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Date: March 14, 2006

The IRS ruled in a Technical Advice Memorandum that the safe harbor accounting treatment in Rev. Proc. 2002-46, 2002-2 C.B. 105 for premium acquisition expenses does not override the matching requirements in I.R.C. § 404 for deferred compensation. TAM 200610016 (published March 10, 2006). Rev. Proc. 2002-46 provides that the yearly increase in unpaid premium acquisition expenses reported on the annual statement, plus the yearly net increase in certain additional "pro forma" premium acquisition expenses, can be treated as expenses incurred under I.R.C. § 832. The stated purpose of the Revenue Procedure is to make the recognition of premium acquisition expenses consistent with the operation of the 20-percent haircut on unearned premiums as interpreted in the regulations promulgated in 2000 (Treas. Reg. § 1.832-4). The 20-percent haircut is a proxy disallowance of premium acquisition expenses in order to match the recognition of the expenses with the associated premiums. In the Revenue Procedure, the IRS acknowledged that the requirement in Treas. Reg. § 1.832-4 to recognize estimated premium in gross written premium can result in an acceleration of the recognition of gross premiums (and related premium acquisition expenses) ahead of the time they are recognized on the annual statement, thus inflating the 20-percent haircut beyond its intended effect. The Revenue Procedure safe harbor is designed to correct this distortion by allowing current recognition of premium acquisition expenses reported on the annual statement plus a pro forma amount.

The taxpayer in the TAM filed a Form 3115 under the Revenue Procedure's automatic consent procedure. It included in the Form 3115 amounts from an agents' compensation fund reported on its annual statement for deferred agents' commissions that would otherwise be subject to deferral under I.R.C. §§ 404(a) and 404(d). In the TAM, the National Office recognized that deferred agents' commissions may meet the definition of premium acquisition expenses in the Revenue Procedure (expenses that "directly vary" with gross premium). The National Office also acknowledged that the Revenue Procedure safe harbor overrides the economic performance rules in I.R.C. § 461. The TAM states that the incurred expenses are deductible under I.R.C. §§ 832(b)(6) and 832(c) even if they would not otherwise be treated as incurred under general accounting rules, and acknowledges that this position is inconsistent with Western Casualty and Surety Co. v. Commissioner, 571 F.2d 514 (10th Cir. 1978), and The Home Group v. Commissioner, 875 F.2d 377 (2d Cir. 1989). The TAM erases any doubt IRS agents may have had regarding the override of the economic performance rules. However, the National Office drew the line at I.R.C. § 461, stating that nothing in the Revenue Procedure would indicate that the safe harbor also overrides I.R.C. § 404. The National Office ruled that, in spite of the conclusion that the deferred commissions could be premium acquisition expenses, the taxpayer still had to defer recognition of the expenses until such time as the commissions were includable in the agents' income.

This is not the first time the IRS has had to reconcile subchapter L rules with the deferred compensation matching provisions in I.R.C. § 404. In Rev. Proc. 2004-41, 2004-30 I.R.B. 90, the IRS held that reserves for doctors' incentive payments not included in the doctors' income in the current year could be deducted if the payments were made within one year of the service, regardless of whether I.R.C. § 404 would otherwise apply. The TAM provides no explanation why the same treatment should not apply to premium acquisition expenses under I.R.C. § 832. Presumably, the IRS determined that the same administrative and timing considerations that led to the doctors' incentive Revenue Procedure did not apply to the deferred agents' commissions in the TAM.

The TAM may have implications beyond the treatment of traditional deferred compensation plans included in premium acquisition expenses. For example, does the rationale of the TAM apply to typical agents' compensation arrangements under which payment is made after the policy is issued, yet under the regulations unpaid premiums are includable in income? Also, how would the IRS treat potential deferred compensation included in Loss Adjustment Expenses? It could be argued that the LAE issue presents the same administrative and timing concerns that led the IRS to the limited override for doctors' incentive payments in Rev. Proc. 2004-41. However, the TAM's silence regarding Rev. Proc. 2004-41 is troubling. The TAM provides no hint regarding how the IRS would treat such expenses.