

Part III

Administrative, Procedural, and Miscellaneous

26 CFR 601.204: Changes in accounting periods and methods of accounting.
(Also Part I, §§ 832, 846; 1.832-4, 1.846-1(b))

Rev. Proc. 2002-74

SECTION 1. PURPOSE

This revenue procedure clarifies that for certain insurance companies subject to tax under § 831 of the Internal Revenue Code the composite method set forth in Notice 88-100, section V, 1988-2 C.B. 439, for computing discounted unpaid losses is permitted but not required. This revenue procedure further provides alternative methods for computing discounted unpaid losses that are permitted for insurance companies not using the composite method, and sets forth a procedure for insurance companies to obtain automatic consent of the Commissioner to change to one of the methods described in this revenue procedure.

SECTION 2. BACKGROUND

.01 Section 831 imposes a tax for each taxable year on the taxable income of

every insurance company other than a life insurance company. Section 832(a) provides that, in the case of an insurance company subject to the tax imposed by § 831, the term “taxable income” means gross income, as defined in § 832(b)(1), less the deductions allowed by § 832(c).

.02 Section 832(b)(1) provides that the gross income of an insurance company subject to the tax imposed by § 831 includes the combined gross amount earned during the taxable year from investment income and from underwriting income, computed on the basis of the National Association of Insurance Commissioners (NAIC) annual statement. For this purpose, § 832(b)(3) defines underwriting income as premiums earned on insurance contracts during the taxable year less losses incurred and expenses incurred.

.03 Section 832(b)(5) defines losses incurred during the taxable year on insurance contracts as follows: (1) from losses paid during the taxable year, deduct salvage and reinsurance recovered; (2) to the results so obtained, add all unpaid losses on life insurance contracts plus all discounted unpaid losses (as defined in § 846) outstanding at the end of the taxable year and deduct all unpaid losses on life insurance contracts plus all discounted unpaid losses outstanding at the end of the preceding taxable year; (3) to the results so obtained, add estimated salvage and reinsurance recoverable as of the end of the preceding taxable year and deduct estimated salvage and reinsurance recoverable as of the end of the taxable year. The amount of estimated salvage recoverable is determined on a discounted basis in accordance with procedures established by the Secretary. See § 1.832-(4)(c) of the Income Tax Regulations.

.04 Section 846(a)(2) provides that the amount of discounted unpaid losses as of the end of any taxable year attributable to any taxable year is equal to the present value of the losses (as of such time) determined by using (1) the amount of the undiscounted unpaid losses as of such time; (2) the applicable interest rate; and (3) the applicable

loss payment pattern.

.05 Section 846(d) instructs the Secretary to determine a loss payment pattern for insurance companies to use for each line of business by reference to the historical payment pattern applicable to such line of business. Section 846(d)(2) and (3) provide rules for the Secretary and insurance companies to use in determining the loss payment patterns. Each year, the Secretary publishes tables in the Internal Revenue Bulletin setting forth the loss payment patterns and discount factors for that accident year. See, e.g., Rev. Proc. 2001- 60, 2001-53 I.R.B. 643. Alternatively, § 846(e) permits insurance companies to elect to use their own historical payment pattern for purposes of computing discounted unpaid losses.

.06 After Congress enacted § 846, the Treasury Department published Notice 88-100, 1988-2 C.B. 439, to provide guidance with respect to several issues expected to be addressed in forthcoming regulations under § 846. Section V of Notice 88-100 stated that regulations under § 846 would provide that taxpayers cannot use information not appearing on their NAIC annual statements to allocate aggregate unpaid losses among several accident years. Instead, the notice set forth a method for computing a composite discount factor by (i) determining the fraction of losses unpaid at year-end for each such accident year includible in the payment pattern for a given line of business, (ii) determining the discounted fraction of losses unpaid for each of these accident years, and (iii) dividing the sum of the fractions determined under (ii) by the sum of the fractions determined under (i). The notice provided an example to illustrate the operation of this formula.

.07 Sections 1.846-1, 1.846-2, and 1.846-3 of the regulations were promulgated by T.D. 8433 in 1992. These regulations provided guidance on several issues addressed in Notice 88-100. Accordingly, portions of Notice 88-100 were obsoleted in 1992 by the publication of T.D. 8433. Section V of Notice 88-100 was not, however, obsoleted.

SECTION 3. APPLICATION

.01 Insurance companies are permitted to use the method of section V of Notice 88-100 (the composite method) to compute discounted unpaid losses with respect to accident years not separately reported on the NAIC annual statement. Beginning in 2002, the Secretary will publish composite discount factors for use by insurance companies who use the composite method and have not elected under § 846(e) to use their historical payment patterns. These factors will be published annually along with the Secretary's tables containing the § 846 loss payment patterns and discount factors and the § 832 salvage discount factors. Insurance companies that have elected under § 846(e) to use their historical payment patterns should apply the composite method based on their historical payment patterns.

.02 Insurance companies that do not use a composite method described in section 3.01 should instead use the discount factors for the appropriate year in the Secretary's table for the appropriate line of business. If insurance companies have unpaid losses relating to an accident year that is older than the last accident year for which a discount factor is presented in the Secretary's table, those unpaid losses should be discounted using the factor for the last accident year in the Secretary's table. Insurance companies that have elected under § 846(e) to use their historical payment patterns should compute the appropriate discount factors in accordance with § 846(e) based on their historical payment patterns.

.03 An insurance company using a method provided in section 3.01 or a method provided in section 3.02 to compute discounted unpaid losses, must use the same method to compute discounted estimated salvage recoverable.

SECTION 4. SCOPE

This revenue procedure applies to insurance companies that are required to discount unpaid losses under § 846.

SECTION 5. AUDIT PROTECTION FOR TAXPAYERS CURRENTLY USING A

METHOD PROVIDED IN SECTION 3

An insurance company within the scope of this revenue procedure that is using a method provided in section 3 of this revenue procedure on December 4, 2002, may continue to use that method without filing a Form 3115, Application for Change in Accounting. The use of a method provided in section 3 will not be raised as an issue in any taxable year. Moreover, if an insurance company's use of a method provided in section 3 is already an issue under consideration (within the meaning of section 3.09 of Rev. Proc. 2002-9, 2002-3 I.R.B. 327 (as modified and amplified by Rev. Proc. 2002-19, 2002-13 I.R.B. 696, modified and clarified by Announcement 2002-17, 2002-8 I.R.B. 561, and amplified, clarified, and modified by Rev. Proc. 2002-54, 2002-35 I.R.B. 432) in a taxable year that ends before December 4, 2002, the issue will not be further pursued by the Service.

SECTION 6. CHANGE IN METHOD OF ACCOUNTING

.01 In general. A change in an insurance company's method of discounting unpaid losses and estimated salvage recoverable to a method described in section 3 is a change in method of accounting to which §§ 446 and 481 apply. An insurance company that wants to change its method of accounting to a method consistent with this revenue procedure must follow the automatic change in method of accounting provisions in Rev. Proc. 2002-9, 2002-3 I.R.B. 327 (as modified and amplified by Rev. Proc. 2002-19, 2002-13 I.R.B. 696, modified and clarified by Announcement 2002-17, 2002-8 I.R.B. 561, and amplified, clarified, and modified by Rev. Proc. 2002-54, 2002-35 I.R.B. 432) with the following modifications:

(1) The scope limitations in section 4.02 of Rev. Proc. 2002-9 do not apply to an insurance company that wants to make the change for its first taxable year ending on or after December 4, 2002, provided the insurance company's method of discounting unpaid losses addressed in this revenue procedure is not an issue under consideration for taxable years under examination, within the meaning of section 3.09 of Rev. Proc.

2002-9, at the time the Form 3115 is filed with the national office.

(2) To assist the Service in processing changes in method of accounting under this section of the revenue procedure, and to ensure proper handling, section 6.02(4)(a) of Rev. Proc. 2002-9 is modified to require that a Form 3115 filed under this revenue procedure include the statement: "Automatic Change Filed Under Rev. Proc. 2002-74." This statement should be legibly printed or typed on the appropriate line on any Form 3115 filed under this revenue procedure.

.02 Pending applications with national office. If an insurance company filed an application or ruling request with the national office to make a change in method of accounting to a method provided in section 3, and the application or ruling request is pending with the national office on December 4, 2002, the insurance company may change its method of accounting in accordance with this procedure. However, the national office will process the application or ruling request in accordance with the authority under which it was filed (including the year of change) unless, prior to the later of March 4, 2003, or the issuance of the letter ruling granting or denying the requested change, the insurance company notifies the national office that it wants to change its method of accounting under this revenue procedure. If the insurance company timely notifies the national office that it wants to change its method of accounting in accordance with this revenue procedure, any user fee that was submitted with the application or ruling request will be returned.

SECTION 7. EFFECTIVE DATE

This revenue procedure is effective for taxable years ending on or after December 4, 2002.

SECTION 8. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 2002-9 is modified and amplified to include this automatic change in section 5 of the APPENDIX.

Section V of Notice 88-100 is obsolete to the extent it provides the composite

method for computing discounted unpaid losses is mandatory.

DRAFTING INFORMATION

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