

October 29, 2004

**AMERICAN
LAND TITLE
ASSOCIATION**

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Re: Section 6041 – Information Reporting by Title Insurance Companies to General Agents

Dear Ms. Butler:

This is in response to your letter of September 7, 2004 addressed to Daniel J. Wiles as representative of The American Land Title Association (“ALTA”). In that letter you asked a series of factual questions with respect to the operations and procedures of title insurance companies¹ and their general agents. This letter attempts to fully answer those questions, based upon the practices and policies of the members of ALTA.

The answers to your questions, we believe, support the position we expressed earlier, that title insurance companies have no obligation under current law, and should have no obligation, to report agents’ retention on title insurance policies because income received by these independent agents on title policies is not reportable under current law and regulations. Specifically, these agents qualify as general agents. Income received by general agents is not reportable under treasury regulation Sec. 1.6041-3(g) and Rev. Rul. 57-474, 1957-2 C.B. 841. From the very inception of this regulatory exception for general agents, the concern of the insurance industry was that it was not and could not be aware as to what constituted gross income to its agents and when that income arose.

Because of state laws and industry practices, the amount of the income earned by the title insurance agents is not reported to the companies and can only be projected, with attendant estimating problems. The time that income is earned is also not generally known or knowable by the insurance companies as the companies are generally notified that a policy has been written months after issuance. Thus, any information returns submitted by a title insurance company would not match correct information included on the income tax returns of the agents. It would not benefit the administration of the tax system to require inaccurate reports. Further, as there is no flow of those funds from the agent who collects and retains the agent’s premium to the underwriter, there are no funds available for backup withholding. These issues and other operational problems outlined below make reporting inadvisable.

Given the number and variety of the members of ALTA, we believe the responses provided below are an accurate depiction of the entire industry. However, several caveats are necessary to place the questions and answers into context.

¹ These companies have, at various times, been referred to as “land” title companies, but modern practice includes the insurance of good title to other property as well, such as watercraft and aircraft.

First, there are inevitable variations amongst land title companies with respect to their policies and practices. Some are historically based; others vary because of the size and modernization of the information technology of the company. However, even within a company, there are differences depending upon the location of the agent. This arises because the underwriter and the agent are governed principally by state laws with respect to title insurance. Thus the compensation and reporting arrangements are different as required or permitted under the differing state laws. We have attempted to answer each question as to the predominant response by ALTA's members; we point out variations where great deviations occur. However, even where exceptions are not noted, there may be, in fact, individual companies or states that are not described.

Second, many of the questions from the Service use the term "commissions." However, as Mr. Parcell noted in our meeting of February 20, 2004, and as we agree, this is an inaccurate depiction of the compensation of the agents. The agents who are compensated with part of the premium charged to the customer are also compensated directly by the customer for other services that they may perform. For example, agents may be compensated for title searches, the conduct of settlement, or as escrow agents. Depending on the state, these ancillary services may be included on the settlement sheet within "title insurance premium" or they may be specifically listed as separate items. The full amounts of compensation of the agents for a transaction may often differ from the amount retained for selling the policy. However, the compensation for selling the policy is always retained by the agent and not forwarded to the underwriter. Therefore an accurate description of the amount is a "retention." It is that term we substitute for "commission" wherever you have used it.

**(1) How does the underwriter know that a policy was issued?
Does the agent notify the underwriter that the policy was issued?**

In nearly all cases, the underwriter learns of the issuance of the policy from the agent. Sometimes, a claim is made by the owner of the policy before the underwriter is advised of the issuance by the agent. In that event, the underwriter contacts the agent to verify the issuance and validity of the policy.

When does the agent notify the underwriter that a policy was sold?

Usually about 3-4 months after the settlement of the property and payment of the premium by the Insured. This is due to several reasons. Policies are typically issued after closing and recording of the deed or mortgage. Recorders of deeds are often not up to date, particularly in high volume seasons and/or years; thus the timing of the issuance of the policy (and subsequent notification of the company) is not within the control of the agent. Further, individual companies may have delays based on uneven workload.

(2) Is there a delay between the agent selling the policy and notifying the underwriter that the policy was sold?

Yes. The policy is "sold" to the Insured before settlement of the property either by direct contact between the Insured and the agent or by referral to the agent by the seller, realtor or lender or other party. The Insured pays for the policy generally at

settlement from proceeds of the settlement escrow. However, the policy is not effective at that time. The insurance by its terms becomes effective upon policy issuance. The underwriter becomes liable at that time.

The agent often creates the final policy some time after the recording of the deed. The underwriter is notified when that policy, or a summary of that policy is sent by the agent.

(3) How long is the delay?

Obviously, this can vary. The average is 4 months and the range is anywhere from one month to six months. Some members report incidents where policies have been received up to 2 or 3 years after issuance.

(4) If there is a delay, explain the reason.

As noted above, there is a structural component to the delay, that caused by the land recording offices. This delay is beyond both the agent's and underwriter's control. Additional delays are caused by the usual business delays and workload imbalances in the offices of the agents (most closings are scheduled at the beginning or end of each month). However, it has been the industry custom to tolerate delays of several months and this is the norm. Some underwriters have agreements with the agents that specify notification one month after policy issuance.

(5) How does the agent notify the underwriter that a policy was sold?

Usually, the agent notifies the underwriter by mail, that is, by sending a copy of the policy itself, or for some underwriters, a summary of the policy but not the policy itself (the policy is never received by the underwriter). The underwriter learns of the issuance of the policy when the document is received in its offices. In about 2 or 3 percent of the policies, the agent will notify the underwriter by electronic transmission. In these cases, limited to the larger underwriters, the policy itself is also never received.

(6) What information does the agent provide the underwriter?

Information about the Insured?

Yes, but limited to the name or names of the insured.

Information about the Property?

Yes, including the address, legal description, and amount of premium.

A copy of the policy?

In most cases, yes. However, some agents send in a summary of the policy by mail or by electronic transmission in lieu of the actual written policy.

The amount for which the policy was sold, i.e., the total premium?

Not always. This information varies somewhat between underwriters, agents, and areas of the country. In some states, the total amount of the policy might be determined because the premium and the split of that premium are determined by state law. Where not specified by state law, the amount of the premium might be estimated by the agreed split between the underwriter and the agent.

The amount of the agent's retention as provided by the contract between the agent and underwriter?

No. The amount of the retention is often estimated by the underwriter based on the agreed split between the underwriter and the agent. However, the agent may have discounted his split in order to sell the policy, so that estimate may be inaccurate. In addition, it may not be possible to determine the amount retained by the agent for other services performed by the agent for the Insured at settlement.

The amount of retention retained by the agent? If the policy is sold at a discount, is the underwriter informed?

See immediately above answer. The agent does not report its retention. If the policy is sold at a discount, it would be rare for this information to be shared with the underwriter.

The amount of premium to be paid to the underwriter?

Not as a separate item, but this amount is generally remitted to the underwriter at the time the information is transmitted. It is upon this basis that the underwriter estimates the total premium and retention.

If the information is provided at different times, please indicate when each item of information is received.

Typically, all of the information received by the underwriter arrives with the copy of the policy or notification that the policy has been issued. There are some occasions when the remittance of the premium split is not sent with the policy, and based upon the information received with the policy, the underwriter will bill the agent for the portion of the premium due to the underwriter. Sometimes this occurs because, due to the nature of the contract, the calculation of the remittance is a complex calculation. Then, the underwriter may perform this calculation and bill the agent.

If the agent does not notify the underwriter that a policy was sold, how does the underwriter know that a policy was sold?

Almost all underwriters have some sorts of recurring audits of its agents to ensure that, through negligence or fraud, all of the policies upon which the underwriter is liable is received and the appropriate amount of the premium split has been remitted to the underwriter. Note that this audit is done for the protection of the underwriter and does not entail examination of whether the agent has discounted the policies. So long as the proper documentation of the policies and remittances have been made to the

underwriter, the profit of the agent is of no concern during these audits. Also, because many agents write for more than one underwriter, the underwriter will only be auditing a portion of the agent's book of business.

Some underwriters also require the agents to submit management (summary) reports to the underwriters that may be used to determine the accuracy of what has been received. Other underwriters use the sequential numbering of its policies to ensure that for policies issued, all information has been sent to the underwriter (e.g., if policy 12345A has been issued and policy 12345C has been issued, where is policy 12345B?). Also, on occasions, underwriters discover policies when claims are filed against them.

2. and 3. How and when does the underwriter account for the sale of the policy for GAAP and tax purposes?

Because all of the sub-questions of questions 2 and 3 are identical, we answer them together, pointing out where differences between financial accounting and tax accounting exist. Note, however, that the below questions do not describe General Accepted Accounting Principles (GAAP) because ALTA members do not ordinarily keep their books or report in that manner. Rather, as recognized by I.R.C. § 832(b)(1)(A), the financial records of insurance companies, such as ALTA members, are maintained in accordance with principles and regulations approved by the National Association of Insurance Commissioners (“NAIC”). This is referred to in the industry as “stat” accounting, or in other words, accounting required by the state statute.² Therefore, the sub-questions under 2 and 3 are answered in terms of stat accounting and not GAAP accounting. Note also, that stat accounting does not have the concept of a “deduction.” Rather, stat accounting has the concept of “expense.” Finally, because tax accounting for insurance companies generally begins with stat accounting, there are very few differences between the result of stat accounting and tax accounting. See I.R.C. § 832.

a. What amount does the underwriter record as premium income? Does this amount include the agent's retention?

The entire premium charged for the policy, including the estimated agent's retention is recorded for stat accounting purposes. Generally, for tax purposes, the treatment is the same. While under general tax principles an argument could perhaps be made that the retention by the agent should not be included in gross income, I.R.C. § 832(b)(1)(A) requires that “gross income” for tax purposes follow NAIC schedules and NAIC rules require that the full amount of the premium, including the agent split, be included.

The stat rules with respect to the estimating the amount of premiums that have been paid to agents, but have not been reported to the underwriters are not clear or uniform.

² While the NAIC suggests uniform rules, each state has the flexibility to set differing rules and state agencies sometimes interpret NAIC rules differently than other states. Therefore, reporting may not be totally uniform across all states.

Some of our members report that, for stat purposes, they estimate the amount of premiums that have likely been paid to agents but not yet reported to them.

(1) If yes, is the retention included the standard amount of the commission provided for in the Contract between the agent and the underwriter or the amount actually retained?

The full amount of the premium is reported. The retention itself is not separated from the underwriter's portion of the premium in reporting gross income. The amount of the agent's retention may be roughly calculated from the portion of the premium remitted to the underwriter. For example, if the premium split is 80 percent to the agent, and the agent remits a premium of \$100, the underwriter calculates a total premium of \$500 (because \$100 is 20 percent of that amount), and reports that amount as gross income. It is assumed that the agent has received a retention of \$400 (80 percent of the total premium), but that amount is not separated in reporting gross income. The underwriter does not generally know the actual amount of any agent retention, and estimates may well be over the total premium charged by the agents.

b. Does the underwriter record the retention as an expense/deduction?

Yes.

(1) What amount does the underwriter record as the retention?

For policies that have been reported, the underwriter records the retention, as calculated above, as an expense. The actual retention amount is generally not known. As for retentions which have not yet been reported, a majority of companies also make an actuarial estimate of those expenses; a substantial portion, however, do not make estimates of those expenses, but make a calculation of the retention when the policy is reported. Stat and tax accounting does not differ.

Note that when underwriters make an estimate of unreported premiums and retentions, they do so only on a gross basis, and not agent by agent. Thus, these estimates are not usable for individual agent information reporting.

Note also, that although the full amount of the premium and the agent retention on a reported policy are calculated as above, and may in fact be incorrect, the net income reported by the underwriter is correct, because this is the amount that is reported to and remitted to it by the agent.

(2) What other amounts, if any, does the underwriter record as a deduction?

With respect to the compensation of the agents, generally none. Where other compensation elements for the agents exist, such as search and exam fees (whether billed separately or as part of the "title insurance" line of the settlement), these fees are removed from the gross amount before calculation of the gross insurance premium and the retention. They therefore do not figure into the calculation and are not expensed or deducted by the underwriter for financial and tax purposes.

c. Does the underwriter account for policies sold by agents in the same manner as agent-Employees?

No. Most underwriters have direct operation “agent/employees,” that may engage in “direct selling” of policies. These “agent/employees” are considered employees of the underwriter. Those employees do not have retentions and the full amount of the premium is reported to and remitted to the underwriter. The employees’ compensation is reported on a Form W-2 and normal withholdings and employment taxes are calculated. Because of the corporate connectivity of the underwriter and the employee, the time delays and estimates described above in the situation of general agents, do not generally exist. There is no difference in treatment between stat and tax accounting.

d. If the policy is sold at a discount, how does the underwriter account for the policy?

If any discounting is done, it is done by the agents and the discount is taken from their retentions, not the portion remitted to the underwriter. Because the underwriter will generally not know if a discount was provided by the agent, it does not account for that discount in calculating the total premium (gross income) or retention (deduction). However, the net income to the underwriter is unaffected. Continuing the example from above, assume that the agent sold the policy for a total premium of \$450 rather than \$500. Nevertheless, it must report and remit to the underwriter its \$100. From that remittance, the underwriter calculates a total premium of \$500 (overstating it by \$50) and a retention of \$400 (overstating it by \$50 as well). While the underwriter believes that the agent received a gross profit of \$400 rather than the correct amount of \$350, it properly records its gross profit of \$100 for both stat and tax accounting.

4. Once the underwriter is notified that a policy is sold, how does the underwriter track the policy?

a. Does the underwriter have a database system or other similar system that tracks the policies sold?

Nearly all underwriters have electronic databases and filing systems sufficient to account for its policies. These may be local, state, or regional, rather than national. Because title insurance is risk-avoidance insurance, and problems are supposed to be corrected before closing, not much “tracking” is necessary. There is generally no need to “track” the policies except in the event of a claim. Unlike many other insurance policies, title insurance policies are single-premium policies and there is no reason for the underwriters to contact the insureds or to follow-up on the policies in any way. There are rarely subsequent billings or other activities with respect to the policies for which a database would be routinely referenced. The database is generally used for management reports or reports that need to be filed with insurance commissioners or other governmental agencies.

b. Does the underwriter enter the information?

Yes. In nearly all cases, the information is keyed-in by employees of the underwriter. In the 2 or 3 percent of the cases where agents report electronically, the system may permit the transference of the information directly into the database without additional underwriter entry. However, in some cases, even electronic submission is printed and re-keyed by underwriter employees because of quality control and system compatibility concerns.

c. What information does the underwriter enter into its systems?

Generally, such information includes the policy information (taken from the policy or policy summary submitted) but not the policy itself, the effective date, the amount of the policy, transaction type, property information, and the name of the insured. The premium may, but is not always, entered into the database. Retentions of the agents would not be included in the database because they are not known or relevant for the business purposes for which the database is maintained.

d. If the underwriter does not have a database system, how does the underwriter track the policies sold?

As noted above, nearly all ALTA members have some sort of database systems. However, some smaller members, not yet automated, have worksheets or paper filing systems by which to account for policies and prepare the necessary reports.

5. How does the underwriter track its agents?

a. Does the underwriter have a database system or other similar system that tracks its agents?

Nearly all ALTA members have information with respect to agents in their databases, but this may not be in a central database; agent relationships may be managed at a regional, local or state level. Obviously, retained information allows the Companies to produce the number of policies issued, claims against those policies, etc. However, most members have local or regional managers who interface with the agents on a routine basis for business purposes, and these managers generally are aware of the agents' performance.

b. What information does the underwriter maintain about its agents?

It appears that the degree and type of information maintained by ALTA member underwriters varies greatly. In general, however, one might expect to find management reports written with respect to agent performance. Some sort of filing of agent-underwriter contracts is maintained (though sometimes contracts are not updated as industry practices change, so the contract may not actually reflect the current course of conduct). The contract is likely to be in paper and not in the underwriter database. Audit reports of the agent are maintained, as are other managerial comments. Information as to the profitability of agents is not usually maintained.

c. Is information about the policies sold by the agent maintained?

Yes, though this is limited to those policies that have been reported by the agent to the underwriter. As noted above, this information does not always accurately reflect the retention by the agent.

d. If the underwriter does not have a database to track its agents, how does the underwriter track its agents?

Either by regional or local coordinators.

6. Does the underwriter have any agents who qualify as employees of the underwriter?

No. One must be careful in the concept of “agent” in this regard. Under state laws, underwriter employees, who are direct sellers of the underwriter’s policies may be considered “agents” by the state insurance commissioners. These are all corporations, not individuals. State laws differ as to whether the direct seller business is licensed or whether its employees are licensed to sell title insurance. Thus whether these employees are also considered “agents” under state law may vary. They are not considered “general agents” as that term is used in the regulation and ruling.

However, regardless of definition, these direct seller employees do not present the same issues that have been discussed in this matter with respect to general agents. These employees receive Forms W-2 to reflect their compensation, including any compensation for policies sold. This information is maintained in the business records. Generally, the same issues with respect to delays and retentions do not exist with respect to direct seller agents, and complete and accurate information returns are filed with respect to their compensation.

7. a. What percentage of agents do business in corporate form?

This information is not known to ALTA or its members as there has been no necessity to record this information.

b. What percentage of the agents do business as sole proprietors?

This information is not known to ALTA or its members as there has been no necessity to record this information.

c. What percentage of the agents do business as members of a partnership?

This information is not known to ALTA or its members as there has been no necessity to record this information. However, it is the belief that very few operate as members of partnerships today.

d. What percentage of the agents are attorneys and how are they identified?

ALTA does not collect this information. As a general rule, an attorney would establish a separate legal entity (an LLC or LLP) for title insurance business.

8. Does the agent always perform the title search? If not, do the terms of the agent agreement differ?

Either the agent performs the title search or contracts with another person to do so. The underwriter will not ordinarily know which of these situations exist for a given policy. The agent agreement and the retention are not affected by the incidence of who performed the search.

9. What would the underwriter need to do to comply with the new reporting requirements?

No title insurance company to our knowledge has systems in place to produce the information returns that would be required if the Treas. Reg. § 1.6041-3(g) exception is not applicable. Historically, there has been no reason to create such systems or gather the necessary information, and the creation of such systems would be very expensive for the industry. The burden on the industry would be great. However, given significant time and expense, the industry could mechanically produce the information returns that the regulations would otherwise require. Accuracy is another question.

The more difficult problem is the acquisition of information to determine whether a return is otherwise due, and to annually obtain accurate information to put on Forms 1099. First, the underwriters would need to determine the nature of the recipient to determine whether another reporting exception might apply. More fundamentally, however, because of the historic background of the industry and the very nature of general or independent agents, all of the information to be placed on the forms on an on-going basis would come from those agents who would receive the calculated Form 1099. Thus, in a very real sense, the underwriters would serve only a bookkeeping or accounting function of mathematically accumulating the information generated by the agents.³

In addition, not only is the information generated by the agents and provided to the underwriters, the flow of funds itself is from the agent to the underwriters. In most "commission" situations, the flow of funds is from the principal to the agent, allowing for the principal to backup withhold if necessary, and to comply with the IRS "B Notice" requirements. Given the flow of funds here, there is no mechanism for the underwriters to ensure accurate reporting and no funds from which the underwriters could withhold under the regulations. The underwriters would need to be exempted from these requirements even if information returns were required.

Yet more fundamental would be the necessity to shift or modify the agents' contracts so as to require earlier, different, and more accurate information. It is doubtful that the underwriters could do this without a law change making the agents submit such information. As noted above, there is no current business need for accurate reporting by the agents to the underwriters of their exact retentions; the underwriters need only

³ Again, it is worth stressing that it is difficult to imagine any benefit to the IRS in such an endeavor.

make a rough calculation based on the amounts remitted. Further, the industry has accepted fairly lengthy delays between the time the premium was paid by the Insured and the time the information was made known to the underwriters. As noted above, part of this delay is attributable to uncontrolled third parties, the land records offices, and part due to generations of tolerance. Thus, one part of the delay cannot be modified, and the other part modified only by a change in the business culture.

The original administrative reason for the -3(g) exception was the difficulty of obtaining information and hence the lack of accuracy in any attempt by property insurance companies to report premium shares of their general agents. This rationale is stated in the 1954 memo accompanying the 1954 regulation. This rationale still pertains to the practical problems that exist in the Title Insurance industry today. This problem is not one that can be solved by technology or computerization; rather the entire relationship between the agents and the companies would need to be changed. It is that historic and continuing relationship that causes the inaccuracy.

10. How do underwriters monitor agents to ensure each agent is meeting Agency agreements and turning in information promptly? Do underwriters have a history of terminating agents?

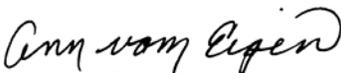
Accuracy of the information provided by agents is tested by internal audits of the agents – but not all are done regularly. Most companies audit only sporadically as they view the need for such audits based on risk and cost. Thus, troublesome agents are subject to frequent audits, but good agents may only be audited every three years. The detail of the audits also may differ. Also, the purpose of the audits is to certify that the insurance company has gotten everything it is entitled to (its proper split of the premium and that all policies are reported) and does not audit the amounts retained by the agents.

There are some jurisdictions, e.g., Florida, where state law requires agents to report annually the status of policies issued. Where this happens, audits are adjusted depending upon the detail of the reports. Finally, area representatives of the underwriter may undertake monitoring or limited audits of the agents as they see fit, again based upon a risk-based analysis.

ALTA members have a consistent history of terminating agents in the event of fraud or persistent non-payment of premiums.

If we can be of further assistance or information to you in this project, please do not hesitate to contact either me, at 202-296-3671, ext. 214, or ann_vomeigen@alta.org, or Daniel J. Wiles of PricewaterhouseCoopers, LLP, at 202-414-4586.

Sincerely,


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