

Part III - Administrative, Procedural, and Miscellaneous

Modification of Section 833 Treatment of Certain Health Organizations

Notice 2010-79

SECTION 1. PURPOSE

.01 This notice alerts taxpayers to an amendment made to § 833 of the Internal Revenue Code (Code) by the Patient Protection and Affordable Care Act (H.R. 3590, P.L. 111-148) (the “Affordable Care Act”). Section 833 provides special rules for certain Blue Cross and Blue Shield organizations, and certain other organizations. Effective for taxable years beginning after December 31, 2009, the amendment adds new § 833(c)(5), which limits the application of § 833 to otherwise-qualifying taxpayers with a medical loss ratio that is not less than 85 percent.

.02 This notice also provides interim guidance to taxpayers on the interpretation and application of § 833(c)(5). The Affordable Care Act was enacted on March 23, 2010, adding § 833(c)(5) with retroactive effect for taxable years beginning after December 31, 2009. The Treasury Department and the Internal Revenue Service (Service) are engaged in developing detailed guidance for this provision. That guidance must also take into account other closely related guidance that the Department of Health and Human Services (HHS) has just published. To allow affected taxpayers to

comply with the mid-year change in law while detailed guidance is under development, the Treasury Department and the Service are providing interim guidance on the operation of § 833(c)(5) for the first taxable year beginning after December 1, 2009.

SECTION 2. BACKGROUND

.01 An insurance company other than a life insurance company is subject to tax under § 831.

.02 Section 831(c) provides that for purposes of § 831, the term “insurance company” has the meaning given to such term by § 816(a). Section 816(a) provides the term “insurance company” means any company more than half of the business of which during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies.

.03 Section 832(a) provides that, for an insurance company subject to the tax imposed by § 831, the term “taxable income” means the company's gross income as defined in § 832(b)(1) less the deductions authorized in § 832(c). Under § 832(b)(1), gross income includes underwriting income.

.04 Section 832(b)(3) defines underwriting income as the premiums earned on insurance contracts during the taxable year less losses incurred and expenses incurred.

.05 Section 832(b)(4) defines the term “premiums earned on insurance contracts during the taxable year” as the gross premiums written on insurance contracts during the taxable year, less return premiums and premiums paid for reinsurance. The result so obtained is further adjusted by adding 80 percent of the unearned premiums on outstanding business at the end of the preceding taxable year and deducting 80 percent

of the unearned premiums on outstanding business at the end of the taxable year.

.06 Section 833 provides special rules for existing Blue Cross or Blue Shield organizations and other organizations that meet the requirements of § 833(c)(3)--

(a) Section 833(a)(1) states that such an organization is subject to tax in the same manner as if it were a stock insurance company;

(b) Section 833(a)(2) allows a special deduction for such an organization, determined under § 833(b), which is the excess (if any) of (i) 25 percent of the sum of the claims incurred during the taxable year, liabilities incurred during the taxable year under cost-plus contracts, and expenses incurred during the taxable year in connection with the administration, adjustment, or settlement of claims or in connection with the administration of cost-plus contracts, over (ii) the adjusted surplus as of the beginning of the taxable year; and

(c) Section 833(a)(3) provides that the 20 percent reduction of unearned premiums set forth in § 832(b)(4) does not apply to such an organization.

.07 Section 9016 of the Affordable Care Act added § 833(c)(5) to the Code, effective for taxable years beginning after December 31, 2009. Section 833(c)(5) provides that § 833 does not apply to an otherwise-eligible organization unless the organization's medical loss ratio, as defined, during the taxable year is not less than 85 percent. For this purpose, an organization's medical loss ratio is equal to the amount expended on reimbursement for clinical services provided to enrollees under its policies during the taxable year (as reported under § 2718 of the Public Health Service Act) ("Section 833 MLR Numerator") divided by the organization's total premium revenue

("Section 833 MLR Denominator").

.08 Section 2718 of the Public Health Service Act (the "PHS Act") was added by § 1001 and amended by § 10101 of the Affordable Care Act, and was incorporated into the Code by § 9815(a)(1). Section 2718(a) of the PHS Act requires a health insurance issuer to submit an annual report to the Secretary of HHS concerning the ratio of the incurred loss (or incurred claims) plus the loss adjustment expenses (or change in contract reserves) to earned premiums. The report must include the percentage of total premium revenue, after accounting for collections or receipts for risk adjustment and risk corridors and payments of reinsurance, that the issuer expends (a) on reimbursement for clinical services provided to enrollees; (b) for activities that improve health care quality; and (c) on all other non-claims costs.

.09 Section 2718(b) of the PHS Act requires that a health insurance issuer, beginning not later than January 1, 2011, provide a rebate to each enrollee, on a pro rata basis, if the ratio of (a) the amount of premium revenue expended on reimbursement for clinical services and for activities that improve health care quality to (b) the total amount of premium revenue (excluding Federal and State taxes and licensing or regulatory fees and after accounting for payments or receipts for risk adjustment, risk corridors and reinsurance) is less than a prescribed percentage.

.10 Section 2718(c) of the PHS Act directs the National Association of Insurance Commissioners (NAIC) to establish uniform definitions of the activities required to be reported to the Department of HHS under § 2718(a), and standardized methodologies for calculating measures of these activities, not later than December 31, 2010, and

subject to the certification of the Secretary of HHS. On November 22, 2010, the Department of HHS filed with the Federal Register, for publication December 1, 2010, interim final regulations implementing § 2718. See http://www.ofr.gov/OFRUpload/OFRData/2010-29596_PI.pdf.

SECTION 3. INTERIM GUIDANCE FOR 2010

.01 The Treasury Department and the Service are aware that because § 833(c)(5) applies to taxable years beginning after December 31, 2009 (including the period in 2010 before enactment of the Affordable Care Act), the implementation of § 833(c)(5) presents issues for the first taxable year beginning after December 31, 2009. Moreover, because § 833(c)(5) references § 2718 of the PHS Act, the Treasury Department and the Service, and taxpayers, will need to consider the effect, if any, of the recently-published guidance under § 2718 on issues that arise under § 833(c)(5). Finally, the Treasury Department and the Service anticipate issuing further guidance on § 833(c)(5). Accordingly, this Section 3 provides interim guidance that taxpayers may rely on solely for the first taxable year beginning after December 31, 2009.

Computation of MLR Numerator for Purposes of § 833(c)(5)

.02 For purposes of determining whether a taxpayer's percentage of total premium revenue expended on reimbursement for clinical services provided to enrollees is not less than 85 percent (and thus satisfies the requirement of § 833(c)(5)), taxpayers must use the definition of "reimbursement for clinical services provided to enrollees" that is set forth in HHS interim final regulations.

.03 For purposes of determining whether the 85-percent requirement of

§ 833(c)(5) is satisfied, the Service will not challenge the inclusion of "amounts expended for activities that improve health care quality" as defined in HHS interim final regulations.

Consequences of Nonapplication of § 833 by Reason of § 833(c)(5)

.04 Section 833(c)(5) provides that § 833 does not apply to an organization unless the organization's percentage of total premium revenue expended on reimbursement for clinical services provided to enrollees is not less than 85 percent. Accordingly, the consequences for an organization for which this amount is less than 85 percent are as follows:

(a) The organization is not taxable as a stock insurance company by reason of § 833(a)(1) (but may be taxable as an insurance company if it otherwise meets the requirements of § 831(c));

(b) The organization is not allowed the special deduction set forth in § 833(b);
and

(c) The organization takes into account 80 percent, rather than 100 percent, of its unearned premiums for purposes of computing premiums earned on insurance contracts during the taxable year under § 832(b)(4).

.05 Notwithstanding Section 3.04(a) of this Notice and solely for the first taxable year beginning after December 31, 2009, the Service will not treat a taxpayer as losing its status as a stock insurance company by reason of § 833(c)(5) provided the following conditions are met--

(a) the taxpayer was described in § 833(c) in the immediately preceding taxable

year;

(b) the taxpayer would have been taxed as a stock insurance company for the current taxable year but for the enactment of § 833(c)(5); and

(c) the taxpayer would have met the requirements of § 831(c) to be taxed as an insurance company for the current taxable year but for its activities in the administration, adjustment or settlement of claims under cost-plus or administrative services-only contracts.

Changes in Accounting Method

.06 Section 446(e) of the Code states that, except as otherwise provided, a taxpayer that changes a method of accounting on the basis of which it regularly computes income in keeping its books must secure consent before computing taxable income under a new method. Section 1.446-1(e)(3)(i) of the Income Tax Regulations requires that, except as provided under the authority of § 1.446-1(e)(3)(ii), to secure the Commissioner's consent to change its method of accounting, a taxpayer must file a Form 3115, Application for Change in Accounting Method, during the taxable year in which the taxpayer desires to make the proposed change.

.07 Rev. Proc. 97-27, 1997-1 C.B. 680, as amplified and modified by Rev. Proc. 2002-19, 2002-1 C.B. 696, as amplified and clarified by Rev. Proc. 2002-54, 2002-2 C.B. 432, as modified by Rev. Proc. 2007-67, 2007-2 C.B. 1072, and as clarified and modified by Rev. Proc. 2009-39, 2009-2 C.B. 371, provides the general procedures for obtaining the advance consent of the Commissioner to change a method of accounting. See also Rev. Proc. 2010-1, 2010-1 I.R.B. 1 (or any successor).

.08 The application of § 833 in a taxable year followed by nonapplication of that provision in the subsequent taxable year (or vice versa) may result in one or more changes in accounting method. For example, accounting for 100 percent of unearned premiums under § 833(a)(3) in one year, but only 80 percent of unearned premiums under § 832(b)(4) in the next year, is a change in method of accounting. Likewise, the loss (or recovery) of insurance company status may implicate a number of changes in methods of accounting because some methods of accounting are available only to insurance companies under Subchapter L. The special deduction allowed under § 833(a)(2) and § 833(b) is not, however, a method of accounting.

.09 A taxpayer that is required to change one or more methods of accounting by reason of the application or nonapplication of § 833 must secure consent for these changes under the advance consent procedures of Rev. Proc. 97-27. These accounting method changes are not within the scope of Rev. Proc. 2008-52, 2008-2 C.B. 587, as amplified, clarified, and modified by Rev. Proc. 2009-39.

SECTION 4. PROCEDURAL INFORMATION AND RELIANCE ON INTERIM GUIDANCE

This notice serves as an “administrative pronouncement” as that term is used in § 1.6662-4(d)(3)(iii) of the Income Tax Regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure. If, and to the extent, future published guidance differs from the interim guidance in this notice, the different provisions of that future guidance will be applied without adverse retroactive effect.

SECTION 5. REQUEST FOR COMMENTS

.01 The Treasury Department and the Service request comments on the following:

(a) What guidance, if any, will taxpayers need under § 833(c)(5) for years after the transition year that is addressed in Section 3 of this Notice?

(b) Is more specific guidance needed on accounting method issues that arise when a taxpayer loses its status as an insurance company?

(c) Will guidance be needed in the future on the appropriate Subchapter L treatment of rebates that are paid under § 2718 of the PHS Act?

(d) The Treasury Department and the Service recognize that medical loss ratios are computed under § 2718 of the PHS Act, as well as under § 833(c)(5). Comments are requested on how guidance could coordinate the medical loss ratio computation under § 2718 of the PHS Act with the medical loss ratio computation under § 833(c)(5).

.02 Comments should be submitted in writing on or before March 7, 2011 and should contain reference to this Notice 2010-79. Comments may be submitted to CC:PA:LPD:PR (Notice 2010-79), Room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Alternatively, taxpayers may submit comments electronically to Notice.Comments@irs.counsel.treas.gov. Please include "Notice 2010-79" in the subject line of any electronic communications.

.03 Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (Notice 2010-79), Courier's Desk, Internal Revenue Service, 1111 Constitution Ave., NW, Washington, DC 20224. All comments will be available for public inspection and copying.

DRAFTING INFORMATION

The principal author of this notice is Rebecca L. Baxter of the Office of Associate Chief Counsel (Financial Institutions & Products (CC:FIP:B04)). For further information regarding this notice contact Ms. Baxter on (202) 622-7117 (not a toll-free call).