



SOCIETY OF ACTUARIES

**Health Spring Meeting  
May 2008**

**Session # 26: Update—Recent Tax Guidance for  
Health Insurers and Products**

Gerald J. Bell

Rodney D. Davis, ACAS, MAAA

Randall J. Wichinski, CPA, MBA

**Moderator:**

Shari A. Westerfield, FSA, MAAA



**BlueCross BlueShield  
Association**

An Association of Independent  
Blue Cross and Blue Shield Plans

A Blue Cross and Blue Shield Association Presentation

# Recent Tax Guidance for Health Insurers and Products

Society of Actuaries  
Spring Health Meeting  
May 28, 2008  
Session 26

## Recent Tax Guidance for Health Insurers and Products

Moderator: Shari Westerfield, FSA, MAAA  
Actuary, BCBS Association

Presenters:

- Gerald J. Bell, CPA  
Technical Advisor, Internal Revenue Service
- Rodney D. Davis, ACAS, MAAA  
Actuary, Internal Revenue Service
- Randall J. Wichinski, CPA, MBA  
Managing Director, BCBS Association

## Recent Tax Guidance for Health Insurers and Products – Agenda

- Legislative Developments
- Company Developments
- Product Developments
- Reserve Developments
- Standards for Tax-Basis Claim Reserves
- IRS Review of Companies and Reserves

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## Recent Legislative Developments for Health Insurers

- Bush “Affordable Health Care” – eliminate unfair employer bias and expand consumer choice through health insurance deduction
- Clinton “America Health Choices Plan” – can keep current health coverage or choose plan similar to Congress or a quality public plan
- Obama “Plan for a Healthy America” – provides universal health coverage similar to federal employees

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## Recent Legislative Developments for Health Insurers (*cont'd*)

- Administration FY 2009 Budget proposals, released on February 4:
  - Form W-2 reporting for value of employee health coverage;
  - Expanded information reporting to all corporations;
  - Increased penalties for information reporting
- Sen Baucus calls for increased health care tax credit under TAA free trade agreement

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## Recent Legislative Developments for Health Insurers (*cont'd*)

- TIPRA of 2005, Sec 511 – 3% withholding on all federal, state, and local government payments for property and services
- Taxpayer Assistance and Simplification Act of 2008, HR 5719 – calls for one-year delay of 3% withholding; imposes substantiation rules on HSA administrators; reduces requirements for employer-provided cell phones; and, ends IRS use of private debt collection

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## Recent Legislative Developments for Health Insurers (*cont'd*)

- Taxpayer Assistance and Simplification Act, approved by the House on April 15:
  - Significant impact on HSAs, new substantiation rules similar to FSAs
  - Unsubstantiated distributions from an HSA must be reported by trustees and custodians
  - Distributions will be subject to tax and 10% penalty
  - Effective for distributions after December 31, 2008
  - No similar measure in the Senate

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## Recent Legislative Developments for Health Insurers (*cont'd*)

- Various health insurance/plan proposals:
  - Kerry – Kids Come First Act (S 95)
  - Snowe – SIMPLE Cafeteria Plan Act of 2007 (S 555)
  - Cardin – Universal Health Coverage Act of 2007 (S 1899)
  - Cantor – HSA Improvement/Expansion Act of 2007 (HR 3234)
  - Paul – Comprehensive Health Reform Act of 2007 (HR 3343)
- Grassley – September 27 letter to 11 long-term care companies regarding claims administration; and, request for GAO study

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## Recent Health Insurance Company Developments

- Treasury 2007-2008 Priority Guidance, 303 projects including HSAs, welfare benefit funds, insurance arrangements
- IRS LMSB “Industry Issue Focus,” with tiered issues based on prevalence and risk
- Treasury Circular 230, Notice 2007-39, practitioners, firms, and employers may be subject to penalties

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## Recent Health Insurance Company Developments (*cont'd*)

- GLAM 2007-0015, July 27 – concludes that a realtor fee paid from a lump-sum settlement is not a non-deductible fee or similar penalty under IRC §162(f)
- PLR 200746003, November 16 – company does not qualify under IRC §831(c) if more than half of its business is non-insurance

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## Recent Health Insurance Product Developments

- Notice 2007-7 – guidance on changes under the Pension Protection Act of 2006; Q&A 23 was modified to include self-insured(Notice 2007-99)
- Rev Rul 2007-65 – limitations on contributions to certain trusts funded by cash value life insurance
- Notice 2007-83 – certain trusts funded by cash value life insurance may be “listed transactions”
- Notice 2007-84 – abusive trusts that provide nondiscriminatory post-retirement benefits

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## Recent Health Insurance Product Developments (*cont'd*)

- Rev Rul 2007-72 – certain diagnostic procedures and devices are deductible under IRC §213(d)
- Notice 2008-1 – a 2% shareholder-employee in S Corp can deduct health insurance premiums
- Notice 2008-5 – rules to determine if qualifying relative is dependent under IRC §§105 & 152(d)
- Rev Proc 2008-3 – “no ruling area” if discriminatory self-insured medical plan payments are excludable
- DOL Final Regs on Form 5500 and new Schedules A & C issued November 15; effective for 2009

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## Recent Health Insurance Product Developments – Letter Rulings

- PLR 200708006 – retiree health benefits provided by employer trust are excludable under IRC §106
- PLR 200709007 – retiree health benefits provided by trust to retired management employees/spouses
- PLR 200736020 – City sponsored retiree health plan benefits to domestic partners are “taxable”
- PLR 200805006 – mandatory salary reduction contribs to union retiree health trust are excludable
- PLR 200806013 – LT care benefits to employees under profit-sharing plan are not excludable

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## Recent Health Insurance Product Developments – FSA, HRA, HSA

- Notice 2007-22, February 15 – rollovers from FSAs or HRAs to HSAs, relief for pre-March 15
- HSA “Grab Bag” Project – Harry Beker, IRS Chief Counsel, 40-50 submitted questions
- Rev Proc 2007-36 – IRS/Treasury 2008 HSA COLA amounts based on March 31 CPI data
- DOL released March 31 CPI data on April 16, 2009 HSA COLA amounts can be estimated
- DOL Field Assistance Bulletin 2008-02 provides wellness program checklist based on factors

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## Recent Health Insurance Product Developments – HSA, FSA, MSA

- Final Regs §54.4980G-0 (4/16/08) – employer HSA comparable contributions under certain instances; no change from proposed regs
- Prop Regs §1.125-1 (8/6/07) – 124 pages of very comprehensive and potentially onerous results for inadvertent errors
- Ann 2007-44 – since fewer than 750,000 Archer MSAs were filed in 2005 and 2006, they are not cutoff years

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## Recent Health Insurance Reserve Developments

- Rev Proc 2008-10 – prescribes the 2007 IRC §846 unpaid loss discount factors; A&H is 98.0675%
- Rev Proc 2008-11 – prescribes the 2007 IRC §832 salvage discount factors; A&H is 98.0722%
- Notice 2008-18 – alerts insurers to possible income tax issues regarding life reserves due to two current NAIC and AAA reserve valuation projects
- Notice 2008-23 – safe harbor for supplemental health insurance excepted from HIPAA under Group Health Plan Rqmnts, Chapter 100, IRC §9801-9833

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## Recent Health Insurance Reserve Developments (*cont'd*)

- Health Actuarial Opinion Subgroup developing expanded instructions:
  - Must follow all relevant Actuarial Standards of Practice (ASOP) and document
  - Supplemental Actuarial Memorandum required
  - Support for the adequacy of the implicit and explicit reserve margins required by ASOP 5
- NAIC Principles-Based Reserving Working Group on October 22, 2007 recommended that there be no proposed changes for “major medical, dental, and other similar health products...reserve represents a claim reserve”

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## Standards for Tax-Basis Health Insurance Claim Reserves

- Computation of insurance company taxable income has two starting points:
  - IRC §832, Insurance company taxable income
  - NAIC Annual Statement
- According to IRC §832(b)(1), “gross income” means:
  - Investment income and underwriting income computed on basis of NAIC annual statement;
  - Gain from sale/disposition of property; plus,
  - All other items constituting gross income.

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## Standards for Tax-Basis Health Insurance Claim Reserves (*cont'd*)

- IRC §846(b) and (f)(2) defines undiscounted unpaid losses as unpaid losses and any loss adjustment expenses shown in the annual statement
- Treasury Regs §1.832-4(b), states: “Every insurance company...must be prepared to establish to the satisfaction of the (IRS) that the part of the deduction for ‘losses incurred’ which represents unpaid losses...comprises only actual unpaid losses. ...These losses must be...based upon the facts in each case and the company’s experience with similar cases, represent a fair and reasonable estimate of the amount the company will be required to pay.”

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## Standards for Tax-Basis Health Insurance Claim Reserves (*cont'd*)

- “Fair and Reasonable” standard, what does it mean?
  - Case law: Utah Medical; Minnesota Lawyers Mutual Insurance Co.; and, Physician’s Insurance Co. of Wisconsin
  - Case law bottom line: reserves established within a reasonable range using recognized actuarial methods will be upheld even if conservative; and, a margin for conservatism added by management, not based on actuarial analysis or historical experience can be disallowed

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## Standards for Tax-Basis Health Insurance Claim Reserves (*cont'd*)

➤ “Fair and Reasonable” standard, what does it mean?

- IRS Technical Guidance: Technical Advice Memo 200115002, “...considered fair and reasonable... recognized methodology that is appropriate for its particular line of business, ...in accordance with actuarial standards, ...prior experience.”
- IRS guidance bottom line: the use of hindsight is inappropriate, and reserves merely need to be reasonable at the time they were established

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## IRS Review of Health Insurance Claim Reserves

➤ IRS review of health insurance claim reserves could include all of the following:

- Review of the annual statement
- Review of tax and actuarial workpapers
- Issuance of Information Document Request (IDR)
- Application and analysis with ReservePro
- Review by an IRS actuary
- Meeting with company actuary

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## IRS Review of Health Insurance Claim Reserves (*cont'd*)

- Recent “IDR” included the following questions:
  - Provide correspondence if any other party provided advice on reserve margin or addition
  - Provide documentation/studies to support margin
  - Provide historical experience or loss events in current or prior year to support reserve additions
  - If margins/additions in prior years, how were they considered in establishing current year additions
  - Provide any hindsight analyses to support margins

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## IRS Review of Health Insurance Reserves

- Specific considerations for claim reserves:
  - Unpaid claims, bulk vs. case-basis
  - Loss adjustment expenses
  - Incurred But Not Reported / Not Paid
  - Resisted claims reserves
- Specific considerations for other reserves:
  - Premium deficiency reserves
  - Noncancelable or guaranteed renewable
  - Medicare Part D

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## IRS Review of Health Insurance Reserves (*cont'd*)

- Avenues for resolution or settlement options:
  - IRS Examination team / actuary
  - IRS Appeals: Regular; Early; Fast-track
  - Post-Appeals mediation
  - Litigation: Tax Court; Federal Court of Claims
- Possible settlement options:
  - Percentages: explicit margin, redundancy, runoff
  - Excess over highest point in reasonable range
  - Adjustment in only certain years

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## HMOs—Insurance Companies?

- Insurance Company - primary & predominant business activity issuing insurance contracts (Reg §1.801-(a)(1))
- Contract whereby for adequate consideration one party undertakes to indemnify another against loss for specified contingencies or peril. *Epmeier v. US*, 199 F2d 508; 509-10 (7<sup>th</sup> Cir. 1952)
- Risk shifting and risk distribution are fundamental, *Helvering v. Legierse*, 312 US 531(1941)
- Risk transferred must be risk of economic loss, *Allied Fidelity Corp v. Comm*, 66 TC 1068 (1976)
- Risk shifting - transfer some or all consequences of loss; Rev Rul 88-72, clarify. Rev Rul 89-61

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## HMOs–Insurance Companies? (*cont'd*)

- *Rush Prudential HMO v. Moran No. 00-1021*  
(Supreme Court)
  - All HMOs are combination of **insurer** and provider
  - Capitation contracts do not relieve the HMO of its obligations to beneficiary
- *Kentucky Assoc Health Care Plans v Miller No. 00-1471* (Supreme Court)
- IRS Position – *most HMOs **are** insurance companies!*

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## HMOs–Insurance Companies? (*cont'd*)

- TAM 9412002 — fee-for-service, regulated and taxed by state as insurance company was considered to be insurance company subject to tax under IRC §832
  - *Humana Inc v Com*, Docket No 17309-92
- TAM 200033046 — providers compensated on a discounted fee for service with no withhold are engaging in commercial-type insurance
- *Haynes v. United States*, 353 U.S. 81, 83 (1957)  
US Supreme Court

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## HMOs–Tax Exempt, IRC §501(c)?

- 1985 – approximately 225 tax exempt HMOs in US
- GCM 39829 – legal basis to apply IRC §501(m) which provides that an entity with commercial-type insurance is not exempt
- TAM 9412002 – IPA model HMO is an insurance co.
- TAM 200033046 – healthcare services by HMO under fee-for-service or point-of-service is commercial-type insurance
- *IHC Inc v Com*, Doc 2003-9187 Tenth Circuit – affirmed tax court in the revocation of IRC §501(c)(3) status
- Notice 2003-31 – IRS/Treasury intend to propose regulations that define “commercial-type insurance” under IRC §501(m)

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## HMOs with No Risk Contracts?

- IRS rulings determine that entity is not an insurance company but can compute reserves
- Underlying tax concept is that economic performance occurs when services are provided
- Entities compute IBNR on actuarial basis, might include percent additions for margins and LAE
- Subject to IRC §§461 and 404

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## Premium Deficiency Reserves

- Required by Codification — SSAP Nos. 53 & 54
  - *“When the expected claims payments or incurred costs, claim adjustment expenses, and administration costs exceed the premiums to be collected for the remainder of a contract period, a premium deficiency reserve shall be recognized by recording an additional liability for the deficiency.”*
- GAAP — FAS 60 short duration contracts
- SSAP — No. 53-15, 54-18, 59-13
  - Reserve recognized when losses, LAE, commissions and other costs exceed UPR
  - Disclosure required

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## Premium Deficiency Reserves (*cont'd*)

- Final Regs §1.832-4(a)(8)(i) — provide that unearned premiums do not include any additional liabilities established to cover premium deficiencies
- For life companies, refer to IRC §801(b) and Regs §1.801-4(e)(4) which states premium deficiency reserves do not qualify as life insurance reserves

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## LMSB Industry Issue Focus

- LMSB is advancing its capability to focus on specific tax issues that are potentially high risk and require compliance review, analysis, guidance, and/or action
- Tier I Issues: high strategic importance with significant impact on one or more industries; resolution of issue is of critical importance
- Tier II Issues: potential high non-compliance and/or significant risk to LMSB or an industry
- Tier III Issues: typically industry-related and identified as issues that should be considered when conducting risk analysis

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## Final Regs §1.6012-2(c) Corporations Required to Make Returns of Income

- (i) *In general* — A life insurance company subject to tax under section 801 shall make a return on Form 1120-L, "U.S. Life Insurance Company Income Tax Return." Except as provided in paragraph (c)(4) of this section, such company shall file with its return —
  - (A) A copy of its annual statement which shows the reserves used by the company in computing the taxable income reported on its return
- (2) *Domestic nonlife insurance companies.* — Every domestic insurance company other than a life insurance company shall make a return on Form 1120-PC, "U.S. Property and Casualty Insurance Company Income Tax Return." This includes organizations described in section 501(m)(1) that provide commercial-type insurance and organizations described in section 833. Except as provided in paragraph (c)(4) of this section, such company shall file with its return a copy of its annual statement (or a pro forma annual statement), including the underwriting and investment exhibit (or any successor thereto) for the year covered by such return.

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## Final Regs §1.6012-2(c) (*cont'd*)

(5) *Definition.* — For purposes of this section, the term annual statement means the annual statement, the form of which is approved by the National Association of Insurance Commissioners (NAIC), which is filed by an insurance company for the year with the insurance departments of States, Territories, and the District of Columbia. The term annual statement also includes a pro forma annual statement if the insurance company is not required to file the NAIC annual statement.

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## Final Regs §1.6012-2(c) (*cont'd*) Annual Statement

- The Regulations do not state what constitutes a pro forma annual statement or what may be sufficient to meet the requirements, they do suggest that companies:
  - either complete an actual statutory annual statement or maintain records prepared in a manner consistent with statutory accounting principles that provides information similar to that provided in an annual statement
- GCM 38057 (1979) — IRS noted if an insurance company return is filed "without a copy of the annual statement or a satisfactory explanation for its absence" the taxpayer:
  - has not made a return according to the forms and regulations as required by IRC §§6011(a) and 6001; and,
  - has not set forth fully and clearly the information required to be included with the return as required by Regs §1.6011-1(b)
- Under the Regulations, it is possible that the IRS might refuse to accept returns filed without all required information

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**Questions?**

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**THANK YOU!**

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