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DEFERRED COMPENSATION NOT DEDUCTIBLE IN UNPAID LAE

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The Internal Revenue Service ("the Service" or "IRS") recently released Technical Advice Memorandum 200939019 ("the TAM"). The TAM initially caused a stir among some in the insurance tax industry because it disallows a tax deduction that was permitted on the NAIC[1] Annual Statement (hereinafter "NAIC statement"). Specifically, the TAM states that unpaid loss adjustment expenses ("LAE") for retiree medical benefits may only be deducted in the tax year in which the benefits are included in income by the employee who earned the benefits, despite the fact the amounts were properly included on the NAIC statement and regardless of deductibility of the unpaid LAE under the Internal Revenue Code ("the Code").[2]

The Taxpayer in the TAM was an affiliated group of nonlife insurance companies that provided retiree medical benefits to its claims personnel. The TAM states that the retiree medical benefits qualified as deferred compensation and were, therefore, subject to the deductibility limitations of section 404(a)(5) of the Code. However, the TAM is most notable for what it does not discuss, rather than what it does discuss. While some taxpayers might claim that the brightness of the line the TAM presents for broadly applying section 404(a)(5) is not actually as vivid, or as straight, as the TAM appears to reflect,[3] the TAM illustrates the risk that the IRS can and will assert Code provisions that it believes are inconsistent with the NAIC statement.

A SUMMARY OF THE TAM

The facts in the TAM are straightforward. The Taxpayer is a U.S. parent company. Together with certain of its affiliates—all of which are property and casualty insurers—it files a consolidated federal income tax return (collectively referred to hereinafter as "the Taxpayer"). The Taxpayer provides retiree medical benefits to its claims personnel. For the two years at issue in the TAM, the Taxpayer included in its calculation of unpaid LAE, the discounted amount of the actuarially determined future retiree medical benefits to be provided to claims personnel. The right to these benefits had been earned by the employees through the performance of services in 2005 and 2006. Benefits will be paid as medical benefits are needed in retirement. The Taxpayer represented that the unpaid LAE amounts were not contributed to a welfare benefit fund as defined in section 419(e).

The IRS identified the issue in the TAM as whether the Taxpayer was entitled to deduct "anticipated future retiree medical benefits" for claims personnel as unpaid LAE in determining its losses under section 832(b)(5), or whether section 404(a)(5) precludes deductibility of such amounts until the year in which retiree medical benefits are includable in gross income of the employee receiving the benefits. The TAM concludes that section 404(a)(5) "trumps" the provisions of subchapter L (sections 801- 848) and, therefore, the amounts were not currently deductible as losses incurred.

The IRS then set forth the statutory and regulatory provisions it considers relevant to a determination as to which deduction timing rules apply in this case: the rules of subchapter L specifically applicable to insurance expenses or the rules of subchapter D that are generally applicable to deferred compensation and benefits.

SUBCHAPTER L AND THE TAXPAYER

Basically, the statutory scheme for taxing insurance companies has evolved since the adoption of the income tax in 1913 as a creature unto itself,[4] with special provision upon special provision that frequently create irritation when they come into contact with noninsurance provisions of the Internal Revenue Code.[5]

> Since 1921, insurance companies have been subject to special tax provisions of great complexity, which can be understood only in the context of the industry's financial practices and are not susceptible to examination in a work intended for general consumption.[6]

This is one case that demonstrates the importance of a holistic view of the U.S. tax system and presents one circumstance in which tax professionals are forced to consider which set of rules prevails over another when more than one arguably applies to a specific set of facts.

Part II of Subchapter L of the Code provides the tax rules applicable to property and casualty insurance companies; it defines taxable income for such companies as gross income[7] less deductions allowed by section 832(c). Section 832(b) provides that gross income of a property and casualty insurance company includes the combined gross amount earned from investment income and underwriting income, "*computed on the basis of the annual statement approved by the National Association of Insurance Commissioners."* [Emphasis added.] Treasury Regulation section 1.832-4(a)(2) provides:

> The underwriting and investment exhibit [of the NAIC annual statement] is presumed to reflect the true net income of the company, and insofar as it is not inconsistent with the provisions of the Code will be recognized and used as a basis for that purpose.

Thus, taxpayers computing their taxable income under section 832(b) must first compute the sum of investment income[8] and underwriting income,[9] and then deduct allowable expenses as provided in section 832(c) using the methodology approved by the NAIC. Section 832(b)(3) provides that underwriting income consists of the premiums earned on insurance contracts during the taxable year, *less losses incurred and expenses incurred*. [Emphasis added.] Accordingly, earned premiums reduced by losses incurred and expenses incurred equals underwriting income. A property and casualty insurance company computes gross income by adding the underwriting income thus obtained to investment income. It then reduces this gross income amount by deductions permitted to reach net taxable income.

Section 832(b)(5) defines "losses incurred" in relevant part as an amount equal to the losses paid during the taxable year, plus all unpaid losses on life insurance contracts and *all discounted unpaid losses (as defined in section 846),* outstanding at the end of the taxable year. [Emphasis added.] Section 832(b)(6) provides that "expenses incurred" do not include any unpaid LAE shown on the annual statement—that unpaid LAE shown on the annual statement are to be included in unpaid losses. Section 846(f) states that the term "unpaid losses" includes any unpaid LAE shown on the annual statement.

The Taxpayer in this TAM appropriately included expenses associated with the unpaid retiree medical expenses for its claims personnel in unpaid losses on its annual statement filed with the NAIC. As a result, in compliance with sections 846(f) and 832(b)(6), the Taxpayer included these amounts in unpaid losses on its federal income tax return for the years at issue. In accordance with section 832(b)(3), this inclusion reduced underwriting income and therefore gross income of the Taxpayer. The IRS conceded in the TAM that the Taxpayer's inclusion of estimates of its liabilities for retiree health benefits in unpaid LAE (and thus in unpaid losses) on the NAIC statement was appropriate. LAE are not defined in the Code or the regulations for tax purposes; therefore, taxpayers generally must rely on the guidance provided by the NAIC for purposes of the annual statement. Furthermore, because neither the Code nor the treasury regulations specifically define LAE, there is, arguably, no opportunity for the NAIC statement to be "inconsistent with the provisions of the Code" on this point. As noted above, the Taxpayer in the TAM included the discounted amounts for retiree medical benefits as unpaid losses on the NAIC statement and, following sections 832(b)(6) and 846(f), used the amount of unpaid losses on its NAIC statement to reduce underwriting income in computing taxable income under section 832(b).

Thus, looking at those provisions in isolation, it would appear that the Taxpayer had no choice but to include these amounts in LAE in the computation of its taxable income. So why, then, did the IRS disallow the Taxpayer's inclusion of unpaid LAE attributable to the retiree medical benefits of its claims personnel?

SECTION 404 AND CURRENT DEDUCTIONS FOR DEFERRED BENEFITS

An Overview of Section 404 of the Code

Section 404(a) provides that if compensation is paid or accrued on account of any employee under a plan deferring the receipt of compensation, the compensation is not deductible under chapter 1 of subtitle A of the Code; but if the compensation would "otherwise be deductible," it is deductible under section 404 subject to the limitations imposed thereunder as to the amounts deductible in any year. Section 404(a)(5) provides that compensation paid under a "nonqualified plan of deferred compensation"[10] is deductible in the taxable year in which the employees participating in the plan include in gross income an amount attributable to the contribution.[11]

Future Retiree Medical Benefits

Section 404(b) generally disallows a deduction by an employer for a contribution paid under a "nonqualified plan of

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deferred compensation" until the employee includes the value of the compensation in taxable income. These rules generally follow the "usual requirements of the tax law for deductibility (for example, the item must be an ordinary and necessary business expense or an expense with respect to property held for the production of income)."[12] In 1984, Congress had two fundamental concerns regarding deferred compensation. One was that an employer might "promise" to pay an employee or independent contractor with future compensation and claim a current deduction under the "usual requirements of the tax law for deductibility" without a matching inclusion in income by the employee. The second was that an employer might promise an employee a deferred benefit (such as retiree medical benefits) and claim a current deduction. Congress addressed both concerns by amending section 404(b) to include future benefits in the definition of deferred compensation for purposes of limiting deductibility under section 404(a)(5).

Treasury promulgated temporary regulations in 1986 (modified in 1992) establishing a presumptive period after which a payment is deemed to be deferred compensation for purposes of chapter 1 of the Code. Treasury Temp. Reg. section 1.404(b)-1T, Q&A-2(b)(1) provides that if compensation or benefits are received more than 2 ½ months after the end of the employer's taxable year in which the services giving rise to the right to receive such compensation or benefits are performed, then such plan, method, or arrangement is presumed to be a deferred compensation or deferred benefits program.[13] Thus, the IRS concluded that the retiree medical benefits earned by the Taxpayer's claims personnel qualified as deferred benefits, regardless of any other characterization as unpaid LAE under subchapter L.

Congress also expanded the application of section 404(a)(5) to apply in the absence of a formal plan of deferred compensation to a "method or arrangement of compensation which has the effect of a plan deferring receipt of compensation."[14]

> The Act [DEFRA 1984] provides generally that whether or not the deferral of compensation takes place under a benefit plan, rather than a compensation plan, is immaterial for the purpose of determining whether the deduction-timing rules of section 404 apply to the plan. Under the Act, any plan, method, arrangement providing for deferred benefits for employees, their spouses, or their dependents is to be treated as a plan deferring the receipt of compensation. The test is to be applied by determining whether a benefit would, if considered to be compensation, be considered to be deferred compensation. A benefit that would be considered deferred compensation under this test is a deferred benefit.[15]

Congress wished to emphasize that the special rules governing employer deductions with respect to deferred compensation are provided in lieu of the general deduction timing rules of the Code relating to compensation and that their applicability should be carefully considered in all cases involving the timing of deductions with respect to compensation for services.[16]

Still concerned about potential abuses in the deduction-timing rules for deferred compensation and benefits,[17] Congress enacted a clarifying amendment to section 404 in the Tax Reform Act of 1986,[18] which eliminated references to sections 162 and 212[19] in section 404(a) and replaced them with "under this chapter; but if they would otherwise be deductible…," thereby broadening the limitations on deductibility of section 404 to the entire chapter of the Code. The Senate Report stated with respect to this "clarifying amendment:"

> The bill clarifies that the deduction-timing rules for deferred compensation arrangements apply to any plan or method of deferring compensation regardless of the section under which the amounts might otherwise be deductible and that the amounts shall be deductible under section 404(a)(5) and shall not otherwise be deductible under any other section. This clarification is necessary to prevent taxpayers from asserting that deferred compensation is attributable to capitalizable compensation expenses and, thereby accelerate the timing of the deduction for such compensation.[20]

Section 832 had not been referenced in prior versions of section 404(a); therefore, Congress had no reason to specifically mention it when broadening section 404. How did the IRS conclude that unpaid LAE constituted deferred benefits such that the inclusion of said amount on its tax return would be subject to section 404(a)(5)?

This is one area where the TAM is silent. The facts do not provide a detailed description of the transaction giving rise to the tax issue. The TAM states only that actuarially determined and discounted amounts associated with future retiree medical benefits earned by claims personnel were included in unpaid LAE. There is no mention of a policy being issued or a premium being paid to cover the employer's liability for these benefits. Rather, this arrangement is an unfunded, unsecured promise to pay benefits in the future, *i.e.,* deferred compensation. This is distinguished from Rev. Rul. 92-93 where the IRS concluded that a life insurance company could issue life insurance contracts on its own employees and increase reserves to reflect the assumption of those life risks.

Had the benefits been insured, the IRS would have followed the conclusions it reached in two private letter rulings—PLRs 9245006 and 9752061—that an insurer's risk of uncertainty as to its funding obligation for retiree health benefits qualifies as a noncancellable accident and health ("A&H") contract risk.

In PLR 9245006, a life insurance company marketed a policy that indemnified an employer-policyholder for retiree health benefit liabilities incurred under the policyholder's health plan. The policy specified either a single premium or multiple premium payments to be made by the employer-policyholder on the date or dates specified in the policy. The insurer reported the policy as a group A&H insurance contract on its annual statement filed with the state insurance commissioner. The Service concluded that the policy was a noncancellable A&H insurance contract for federal tax purposes and that the reserves required in addition to the unearned premium reserve qualified as life insurance reserves under section 816(b). The IRS reached the same conclusion in PLR 9752061.

If the TAM had presented an insured arrangement, the analysis could have been different. Instead, the TAM concludes that unpaid LAE associated with unfunded promises to employees are deferred benefits under Treas. Temp. Reg. section 1.404-1T, Q&A-2(b)(1).

THE CLASH OF THE TITANS

The Taxpayer's situation presented a "perfect storm" for the clash of section 404 and its general policy of matching deductions for deferred compensation and benefits with the specific tax accounting rules applicable to the insurance industry. The Taxpayer argued first that because the future retiree medical benefits were includible in unpaid LAE under the NAIC statement, the tax treatment of those costs was controlled by subchapter L. Second, the Taxpayer argued that under section 832(b) of subchapter L, unpaid LAE are a component of gross income rather than a deduction and that section 404(a)(5) governs the timing of deductions and is therefore inapplicable to the calculation of taxable income under section 832.

In its analysis, the IRS addressed the Taxpayer's first argument by conceding that the annual statement required by the NAIC is the starting point for determining taxable income of insurance companies, including the amount of discounted unpaid losses on insurance contracts; and that the term "unpaid losses" includes unpaid LAE as shown in the annual statement. However, the IRS emphasized the "broad scope of the deduction timing rules of section 404" and concluded that "even if Taxpayer is correct in its assertion that the unpaid loss adjustment expenses would ordinarily be taken into account as part of its losses incurred under section 832(b)(5), the deduction timing rules in section 404(a)(5) take precedence."

> In PLR 9245006, a life insurance company marketed a policy that indemnified an employer-policyholder for retiree health benefit liabilities incurred under the policyholder's health plan.

The IRS rejected the Taxpayer's second argument as "not persuasive" and "inconsistent with the manner in which 'losses incurred' are generally characterized." The IRS bolstered its "generally characterized" statement by citing section 832(c)(4), which refers to losses incurred as one of the "deductions allowed" in computing the taxable income of an insurance company, and Treas. Reg. section 1.832-4(b), which specifically states that every insurance company taxable under section 831 must be prepared to establish that the part of the "deduction for 'losses incurred' which represents unpaid losses at the close of the taxable year comprises only actual unpaid losses." The IRS then cited court cases wherein losses incurred were at issue and the court characterized losses incurred as a deduction for tax purposes.[21]

AN INTERESTING EXCEPTION FOR HEALTH CARE PROVIDERS

In TAM 9723005 (Feb. 6, 1997), the IRS addresses the same issue involved in the subject TAM—whether the deduction timing rules of section 404 took precedence over the rules of subchapter L—but the facts were different. The taxpayers in the 1997 TAM were an affiliated group of health maintenance organizations ("HMOs") that were taxed as nonlife insurance companies. The payments at issue were certain "risk

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withholds" and "surplus distributions," amounts prescribed in the HMO's individual provider agreements with various physicians and other health care providers. The taxpayers included the amounts in incurred but unpaid claims reserves and reported the amounts as deductions on the taxpayers' NAIC statements. The IRS went through the same analysis presented in the subject TAM and reached the same conclusions—that the amounts in question qualified as deferred compensation under section 404 and, therefore, the deductibility-timing rules of section 404(a)(5) took precedence over the rules of subchapter L with respect to the timing of reserve deductions.

In the 1997 TAM, the IRS raised the possibility of the taxpayer rebutting the presumption that the "risk withholds" and "surplus distributions" were deferred for at least 2 ½ months after the close of the HMO's taxable year in which the amounts were earned.[22] The IRS stated that the taxpayer did not provide any information to rebut the presumption of deferred status:

> The taxpayer may rebut the presumption established under the previous subparagraph with respect to an amount of compensation or benefits only by setting forth facts and circumstances the preponderance of which demonstrate that it was impracticable, either administratively or economically, to avoid the deferral of the receipt by an employee of the amount of compensation or benefits beyond the applicable 2 ½ month period and that, as of the end of the employer's taxable such impracticability was unforeseeable.[23]

The subject TAM did not discuss or even cite Rev. Proc. 2004-41, 2004-2 C.B. 90. That revenue procedure sets out the circumstances under which an insurance company that makes incentive payments to health care providers will be permitted to include those payments in discounted unpaid losses without regard to the deductibility-timing rules of section 404.[24] In the revenue procedure, the IRS acknowledged the following:

> Applying section 404 and the regulations thereunder to incentive payments made by the taxpayers would create a substantial administrative burden for the taxpayers and the Service, since the liabilities for incentive payments shown on the annual statements filed by the health insurance companies and HMOs generally are not broken down into amounts that will be owed to specific health care providers.

Rev. Proc. 2004-41 addressed an extremely narrow set of facts, a very specific administrative difficulty with limited application to other taxpayers. Although it is not clear from the revenue procedure or the two TAMs (the subject TAM and the 1997 TAM) what constitutes an administrative burden significant enough to warrant an exception to the application of section 404, it is clear the IRS will consider such situations.

CONCLUSION

The taxation of insurance companies is complex, specialized, and generally self-contained in subchapter L of the Code. There are instances, however, when it becomes necessary to determine how the provisions of subchapter L and tax rules of more general applicability work in conjunction with each other. TAM 200939019 presents one such circumstance. The IRS has taken the position that the deduction-timing rules applicable to deferred compensation and benefits consider and negate the deduction-timing rules contained in subchapter L with respect to the LAE that were the subject of the TAM.

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END NOTES

1 National Association of Insurance Commissioners.

2 Unless otherwise indicated, all references to section are to the Internal Revenue Code of 1986, as amended ("the Code").

3 *See* TAM 9723005 (February 6, 1997) and Rev. Proc. 2004-41, discussed *infra.*

4 The first insurance company specific rules entered the Code in 1921.

5 "While there are many who complain that the Internal Revenue Code is incomprehensible, there are some few who revel in the intricacies of its labyrinthine composition. But those who take delight in such pursuits and who also understand the mystic processes of establishing reserves in the life insurance industry are an even rarer specie of the ornithological world. Such are the vagaries of assignments, however, that it has fallen to the lot of this panel to decide a case where the two sciences conjoin. We therefore tread into the thicket with some trepidation." *The Mutual Benefit Life Insurance Co. v. Commissioner*, 488 F.2d 1101 (3rd Cir. 1973).

6 B. Bittker and L. Lokken, *Federal Taxation of Income, Estates and Gifts* (2009), RIA, para. 99-7. *See also, Bituminous Casualty Corp. v. Commissioner*, 57 T.C. 58 (1971) (discussion of the complexities of subchapter L and the policy supporting the special rules).

7 Section 832(b).

8 Section 832(b)(2).

9 Section 832(b)(3).

10 A plan to which the contributions are not deductible under section 404(a)(1), (2), or (3).

11 *See also*, Treas. Temp. Reg. section 1.404(b)-1T, Q&A-1.

12 Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 (H.R. 4170, 98th Cong., P.L. 98-369)*, (December 31, 1984) pp. 804-806.

13 *See also*, Treas. Temp. Reg. section 1.404(b)-1T, Q&A-2(a) (a deferred compensation plan, method, or arrangement is one under which an employee receives compensation or benefits "more than a brief period" after the end of the employer's taxable year in which the services creating the right to receive such compensation or benefits are performed.

14 P.L. 98-369, section 512(a) (1984).

15 *Id.*

16 *Id.*

17 Section 404(b)(2) provides that any plan providing for deferred benefits (other than compensation) for employees, their spouses, or their dependents shall be treated as a plan deferring the receipt of compensation. In the case of such a plan, for purposes of this section, the determination of when an amount is includible in gross income shall be made without regard to any provisions of this chapter excluding such benefits from gross income.

18 P.L. 99-514.

19 Relating to trade or business expenses and expenses for the production of income, respectively.

20 S. Rep. No. 313, 99th Cong., 2d Sess., 1013, May 29, 1986.

21 *See e.g., Western National Mutual Insurance Company v. Commissioner*, 102 T.C. 338. 343-44 (1994), aff'd, 65 F.3d 90 (7th Cir. 1995); *Maryland Deposit Insurance Fund Corp. v. Commissioner*, 88 T.C. 1050, 1057-1058 (1987); *Minnesota Lawyers Mutual Insurance Co. v. Commissioner*, T.C.M. 2000-203, aff'd, 285 F.3d 1086 (8th Cir. 2002).

22 *See,* Treas. Temp. Reg. section 1.404-1T, Q&A-2(b)(1), *supra.*

23 Treasury reg. sec. 1.404-1T, Q&A-2(b)(2).

24 The revenue procedure also provided procedures under which a taxpayer may obtain automatic consent of the Commissioner to change its method of accounting for such payments.