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Internal Revenue Service
Memorandum

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subject: Treatment of Reimbursements on High Deductible Policies under § 832

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Taxpayer =
Tax Period =

ISSUES

1. Is Taxpayer entitled to a loss incurred under § 832(b)(5) for uncollectible deductibles?

2. Is Taxpayer entitled to a deduction under § 832(c)(10) for a bad debt within the scope of § 166 for uncollectible deductibles?

CONCLUSIONS

1. Under § 832(b)(5), as constrained by § 1.832-4(a)(4), Taxpayer is not entitled to a loss incurred for uncollectible deductibles using its current methodology.

2. Under § 832(c)(10), Taxpayer is entitled to a deduction for a bad debt within the scope of § 166 for an uncollectible deductible, to the extent consistent with § 832(d).

FACTS

Taxpayer writes high deductible policies covering workers' compensation, automobile, and general liability. These policies are implemented through a base policy with a high deductible endorsement and an accompanying negotiated security agreement. State law requires an insurer providing workers' compensation or automobile liability coverage to pay claimants on a first-dollar basis without regard to any applicable deductibles that might apply. This requirement is imposed even if the insurer does not expect the insured to reimburse the deductible or the insured is insolvent or bankrupt. Accordingly, the base policy provides that Taxpayer will pay the full amount of all claims on behalf of the insured, just as it would if the policy did not have any deductible.

The endorsement sets forth the amount and terms of the deductible and provides that the insured will reimburse Taxpayer for claims that Taxpayer pays that are within the deductible limit. The portion of claims for which the insured agrees to reimburse Taxpayer is referred to as the "deductible layer." The separately negotiated security agreement addresses the amount and type of collateral Taxpayer requires.

For purposes of annual statement reporting, unpaid loss reserves for high deductible plans shall be determined in accordance with the National Association of Insurance Commissioners' (NAIC) *Statement of Statutory Accounting Principles* (SSAP) 55. Reserves for claims arising under high deductible plans shall be established net of the deductible; however, no reserve credit shall be permitted for any claim where any amount due from the insured has been determined to be uncollectible. SSAP 65 ¶ 35.

Taxpayer complies with this statutory accounting guidance. Taxpayer monitors bankruptcy filings, delinquent premium payments, and other legal notices as well as information provided by underwriters, brokers, agents, and others to determine if the insured is unlikely to be able to fulfill its obligations to reimburse Taxpayer for the deductible layer amount. If Taxpayer is of the opinion that any portion of a deductible layer reimbursement recoverable has become uncollectible, Taxpayer establishes a "supplemental reserve" for the amount of the uncollectible reimbursement to reverse the reserve credit as required by SSAP 65 ¶ 35. The supplemental reserve only includes deductible layer amounts that relate to claims for which unpaid loss reserves have been established and are deemed uncollectible; it does not include amounts that are an actuarial estimate of deductible amounts that may be uncollectible in the future. When the unpaid loss reserve and supplemental reserve are combined, Taxpayer reports an appropriate level of reserves in compliance with SSAP 65 ¶ 35 on its annual statement.

When a claim is paid, Taxpayer releases the unpaid loss reserve and supplemental reserve attributable to the paid loss. The deductible layer amount is then reported as a receivable and, if uncollectible in whole or part, a bad debt, in which case the uncollectible deductible layer amount is reported as an uncollectible receivable.

Taxpayer provided the following example illustrating the methodology:

Assume a policy with a $5 million limit and a $300,000 reimbursable deductible layer. Loss events occur that Taxpayer values at $400,000. Taxpayer initially adds $400,000 to unpaid losses,[1] and nets the reimbursable deductible layer amount of $300,000, producing a final unpaid loss of $100,000.

Assume the insured posted $200,000 of collateral, and Taxpayer learns the insured is in bankruptcy and the estimated bankruptcy recoverable is $50,000. Accordingly, the actual deductible layer amount reimbursement will be $250,000 rather than the contractually mandated $300,000. Accordingly, Taxpayer increases the supplemental reserve by $50,000 which is then added to unpaid losses, producing aggregate unpaid losses of $150,000.

When Taxpayer pays the claim, it reduces unpaid losses by $150,000. Taxpayer posts a receivable of $300,000 (the nominal reimbursement) and applies the collateral of $200,000, for a net receivable of $100,000. Taxpayer also reports a contra asset of $50,000 to reflect the portion of the receivable that it does not expect to recover.

Although the specific terms of each contract may vary, common to each specimen submitted to our office is that Taxpayer is not entitled to reimbursement until Taxpayer has actually paid the claim.[2]

The issues presented, as with most issues arising under the application of subchapter L, is not whether an item is includible in or deductible from gross income, but the time of recognizing the item and the analytical reason for that recognition and timing.

LAW AND ANALYSIS

Issue 1

Section 831(a) imposes tax computed as provided in § 11 for each taxable year on the taxable income of every insurance company other than a life insurance company.

Section 832(a) defines taxable income for a company subject to § 831 to be the gross income defined in § 832(b)(1) less the deductions allowed by § 832(c).

Section 832(b)(1)(A) defines gross income to include the combined gross amount earned during the taxable year, from investment income and from underwriting income,

[1] For purposes of illustration, discounting required by § 846 is ignored.

[2] For example, one endorsement specimen provides "[Taxpayer] will pay part of all of any Deductible Amounts or 'allocated loss adjustment expense' to effect settlement of any claim and, upon notification of the action taken, [the insured] will reimburse us for such part of any Deductible Amounts or 'allocated loss adjustment expenses' as shown on the billing from us." Another provides "[the insured] will be billed [periodically] following the effective date of [the contract] for the following: paid losses within the deductible amounts plus applicable paid ALAE paid during [the period]."

computed on the basis of the underwriting and investment exhibit of the annual statement approved by the NAIC.

Section 832(b)(3) defines underwriting income to be premiums earned on insurance contracts during the taxable year less losses incurred and expenses incurred. See also, § 832(c)(4) (allowing a deduction for losses incurred, as defined in § 832(b)(5)).

Section 1.832-4(a)(2) of the Income Tax Regulations provides that the Underwriting and Investment Exhibit of the 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. All items of the exhibit, however, do not reflect an insurance company's income as defined in the Code.

Section 832(b)(4) defines premiums earned as gross premiums written on insurance contracts during the taxable year, reduced by return premiums and premiums paid for reinsurance, plus 80 percent of unearned premiums on outstanding business at the end of the preceding taxable year and reduced by 80 percent of the unearned premiums on outstanding business at the end of the taxable year.

Section 1.832-4(a)(4)(i) defines gross premiums written as amounts payable for insurance coverage. The label placed on a payment in a contract does not determine whether an amount is a gross premium written. Gross premiums written do not include other items of income (for example, charges for providing loss adjustment or claims processing services under administrative or cost-plus arrangements). Gross premiums written on an insurance contract include all amounts payable for the effective period of the insurance contract.

Section 832(b)(5) defines losses incurred to be losses incurred during the taxable year on insurance contracts, computed by taking losses paid during the taxable year, reduced by salvage and reinsurance recovered during the taxable year, adding all unpaid losses on life insurance contracts plus all discounted unpaid losses outstanding at the end of the taxable year, deducting unpaid losses on life insurance contracts plus all discounted unpaid losses outstanding at the end of the preceding taxable year, and adding estimated salvage and reinsurance recoverable at the end of the preceding year and deducing estimated salvage and reinsurance recoverable as of the end of the taxable year.

Section 1.832-4(a)(4)(i) provides that to the extent that amounts paid or payable with respect to an arrangement are not gross premiums written, the insurance company may not treat amounts payable to customers under the applicable portion of such arrangements as losses incurred described in § 832(b)(5).[3]

[3] In general, a taxpayer is not allowed to deduct an otherwise deductible amount if the taxpayer is entitled to reimbursement, unless the reimbursement is included in gross income, is worthless, or is unlikely to be collected. Glendinning, McLeish & Co. v. Commissioner, 61 F.2d 950, 952 (2d Cir. 1932), aff'g 24 B.T.A 518 (1931); Addressograph-Multigraph Corp. v. Commissioner, 4 T.C.M. 147, 177 (1945); Findley v U.S.,

F.W. Services, Inc. v. Commissioner, T.C. Memo. 2010-128, aff'd, 459 Fed. Appx. 389 (5th Cir. 2012) (unpublished opinion), involved funding of the deductible layer of a workers' compensation policy and an employer's liability policy with a "reserve fund" contract entered into with an affiliate of the insurers. The court upheld disallowance of a deduction for amounts paid into the reserve fund in excess of the actual claims and expenses paid during the year, holding that the payments to the reserve fund provided only assurance that the deductible amounts would be paid and did not alter the risk inherent in the true insurance; "a reserve arrangement does not morph into insurance just because there is an insurance policy next to it."

Taxpayer did not include the deductible layer amount in gross premiums written. Therefore, section 1.832-4(a)(4)(i) prohibits Taxpayer from including the reimbursable deductible layer amount as a component of § 832(b)(5) losses incurred. If Taxpayer had included the reimbursable deductible in gross premiums, Taxpayer could have included the reimbursable deductible component of losses as losses incurred.

Issue 2

Under § 832(a) the taxable income of an insurance company taxable under § 831 is the gross income as defined in § 832(b)(1) less the deductions allowed by § 832(c).

Section 832(c)(10) allows deductions (other than those specified in § 832(c)) as provided in §§ 161 – 199 and in §§ 401 – 420.

Section 1.832-4(a)(2) provides that the underwriting and investment exhibit of the 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. Accordingly, Taxpayer is generally subject to the accrual method of accounting. Sections 448(a); 446. See also, e.g., Western Casualty & Surety Co. v. Commissioner, 65 T.C. 897, 903 (1976) ("We note that petitioner, in accordance with the instructions on filling out the income statements of the underwriting and investment exhibit on the annual statement form, is required to use the accrual method of accounting."), aff'd in part, 571 F.2d 514 (10th Cir. 1978); City Investing Co. v. Commissioner, T.C. Memo. 1987-36, aff'd sub nom., 875 F.2d 377 (2nd Cir. 1989), cert. den. sub nom., 493 U.S. 1069 (1990);

Section 166(a)(1) allows as a deduction any debt which becomes worthless within the taxable year while § 166(a)(2) provides that when satisfied that a debt is recoverable only in part, the Secretary may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction. Section 166(b) provides that for purposes of § 166(a), the basis for determining the amount of the deduction for any bad

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28 F.Supp. 715, 719 (W.D. La. 1939); Standard Oil Co. of N.J. v. Commissioner, 11 T.C. 843, 848-49 (1948), supplementing 7 T.C. 1310 (1946); Pittsburgh Indus. Eng'g Co. v. Commissioner, 9 T.C.M. 1132, 1140 (1950). See Weihrauch v. Commissioner, 37 T.C.M. 28, 32 (1978); Rev. Rul. 75-46, 1975-1 C.B. 55.

debt shall be the adjusted basis provided in § 1011 for determining the loss from the sale or other disposition of property.

Section 1.166-1(c) provides that only a bona fide debt qualifies for purposes of § 166; a bona fide debt is a debt which arises from a debtor-creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable sum of money. A debt arising out of the receivables of an accrual method taxpayer is deemed to be an enforceable obligation for these purposes to the extent that the income such debt represents has been included in the return of income for the year for which the deduction as a bad debt is claimed or for a prior taxable year. That the bad debt is not due at the time of deduction shall not itself prevent its allowance under this section.

Under § 1.166-2(a), in determining whether a debt is worthless in whole or part, the Service will consider all pertinent evidence, including the value of the collateral, if any, securing the debt and the financial condition of the debtor.

Section 1.166-3(a)(1) provides that a deduction under § 166(a)(2) on account of partially worthless debts shall be allowed with respect to specific debts only.

Section 832(d) provides that nothing in § 832 shall permit the same item to be deducted more than once.

For the uncollectible deductible layer reimbursement amount to be a debt within the scope of § 166, it must be a bona fide debt. A debt is bona fide if Taxpayer's contractual rights to reimbursement are a valid and enforceable obligation to pay a fixed or determinable sum of money. Section 1.166-1(c). Here, prior to Taxpayer's payment of a claim, Taxpayer does not have an enforceable claim to reimbursement; hence there is no debt from the insured to the Taxpayer until Taxpayer's payment of the claim.

The debt would be deemed an enforceable obligation for purposes of § 1.166-1(c) if the income such debt represents has been included in the return of income for the year for which the deduction is claimed or for a prior taxable year. Here, consistent with the finding under *Issue 1* that the deductible layer amount was not included in gross premiums written, it does not appear that Taxpayer included the reimbursement in income for the year for which the deduction is claimed or for a prior taxable year.

Once Taxpayer has paid the claim, Taxpayer has a contractual right to reimbursement that is a bona fide debt for purposes of § 166. If all or part of the debt is later determined to be worthless, Taxpayer may claim a full or partial deduction. Section 1.166-2.

If Taxpayer had included both the reimbursable deductible in gross premiums and the reimbursable deductible component of losses as losses incurred, Taxpayer may not also claim a deduction for the bad debt. Section 832(d).

Accounting for Uncollectible Deductible Layer

The proper accounting for the uncollectible deductible layer reimbursement, given that it was not included in gross premiums written, would be for Taxpayer to take a deduction under §§ 832(c)(10) (as an allowable §166 deduction) at the time Taxpayer's right to reimbursement is determined to be worthless (i.e., uncollectible) under § 1.166-2.

This conclusion can be illustrated through the above example, involving a policy with a $5 million limit and a $300,000 reimbursable deductible layer amount under which loss events occur that Taxpayer values at $400,000. Taxpayer will be required to disburse $400,000 and nominally should be reimbursed for $300,000, with the balance of $100,000 borne by Taxpayer.

However, in addition to the posted collateral of $200,000, consistent with § 1.166-2, Taxpayer has determined that it is able to recover only an additional $50,000, leaving a $50,000 deficit in the amount reimbursed.

Taxpayer has a loss incurred under § 832(b)(5) of $100,000[4] and an obligation to disburse $400,000. As Taxpayer pays the claims, it should recognize losses paid under § 832(b)(5) of $100,000 and has a non-deductible disbursement of $300,000 for which it has a nominal right of recovery, thus creating the bona fide debt of $300,000. Because Taxpayer has determined consistent with § 1.166-2 that it is able to collect only $250,000 of that debt, Taxpayer may claim a deduction under §§ 832(c)(10) (as an allowable §166 deduction) for $50,000.

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Please call (202) 317-6995 if you have any further questions.

[4] For illustration purposes the discounting required by § 846 is ignored.