OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: DEBORAH A. BUTLER
ASSISTANT CHIEF COUNSEL (FIELD SERVICE)
CC:DOM:FS

SUBJECT: Special Deduction Under Section 11305(c)(3) of the Revenue Reconciliation Act of 1990

This Field Service Advice responds to your memorandum dated May 10, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

Taxpayer =

State =
Year 1 =
Year 2 =
Year 3 =
Date 1 =
Date 2 =

ISSUE:

Whether, for the Year 1, Year 2, and Year 3 taxable years, Taxpayer is entitled to the special deduction under section 11305(c)(3) of the Revenue Reconciliation Act of 1990 ("the 1990 Act"), 1991-2 C.B. 484, 507.

CONCLUSION:

The issue of whether Taxpayer is entitled to the special deduction provided by section 11305(c)(3) of the 1990 Act ultimately turns on whether the coordination of benefit ("COB") amounts at issue qualify as estimated salvage recoverable under I.R.C. § 832(b)(5)(A)(iii). [redacted]

FACTS:

The facts in the Appeals Officer's Supporting Statement may be summarized as follows. During the Year 1, Year 2, and Year 3 taxable years, Taxpayer was a not-for-profit corporation organized under the laws of State. For federal income tax purposes, Taxpayer was an existing Blue Cross or Blue Shield organization within the meaning of I.R.C. § 833(c)(1)(A) and was taxed as a stock property and casualty insurance company under I.R.C. § 831 et. seq.[1]/

[1]/ Unless otherwise indicated, section references throughout are to the Internal Revenue Code of 1986, as in effect during the taxable years at issue.

During the taxable years at issue, Taxpayer issued individual and group health insurance policies and filed life-nonlife consolidated income tax returns with its subsidiaries.

The health insurance policies contained a Coordination of Benefits ("COB") provision subject to model regulations developed by the National Association of Insurance Commissioners ("NAIC") and adopted by State. The purpose of a COB provision is to prevent a policyholder from recovering for the same coverage more than once from different insurers. A standard COB provision provides ordering of benefits rules, designating a primary policy that will cover claims to the fullest extent of its coverage, and a secondary policy that will cover only amounts not covered by the primary policy.

An insurer that is secondarily liable under a COB provision may adopt either: (1) a "pay and pursue" policy, which means that it will pay the claims as if it were primarily liable and then pursue reimbursement from the primary insurer, or (2) a "pursue and pay" policy, which means that it will only pay what it is liable for as the secondary insurer.

Taxpayer claimed the special deduction allowed under section 11305(c)(3) of the 1990 Act for salvage and subrogation "fresh start." For purposes of determining the special deduction, Taxpayer included in estimated salvage recoverable as of Date 1, amounts unpaid as of Date 1, for which another insurance company was primarily liable under the COB provision.

Taxpayer argues that the savings generated by its COB provision is a form of salvage which has always been netted against its unpaid losses deduction, and maintains that it relied upon and is in full compliance with the disclosure requirements of Rev. Proc. 91-48,1991-2 C.B. 760, and Treas. Reg. § 1.832-4(f)(2). Accordingly, Taxpayer argues, it is entitled to the special deduction under section 11305(c)(3) of the 1990 Act.

The Revenue Agent and Appeals Officer assert, however, that COB should not be characterized as salvage. As a result, Taxpayer is not a netter and does not qualify for the special deduction.

LAW AND ANALYSIS:

The issue of whether Taxpayer is entitled to the special deduction provided by section 11305(c)(3) of the 1990 Act ultimately turns on whether the COB amounts at issue qualify as estimated salvage recoverable under I.R.C. § 832(b)(5)(A)(iii). [redacted] Before discussing the government's position on this issue, we will summarize the relevant provisions of the Code and Treasury Regulations promulgated thereunder.

Prior to 1987, Blue Cross and Blue Shield organizations were exempt from federal income tax. For taxable years beginning after December 31, 1986, Blue Cross and Blue Shield organizations are taxed for federal income tax purposes as stock property and casualty insurance companies under section 831 et. seq.

I.R.C. § 832(a) provides that, for an insurance company subject to tax under section 831 ("property and casualty insurance company"), taxable income means gross income, as defined in section 832(b)(1), less deductions allowed, as defined by section 832(c). Among the deductions allowed is the section 832(c)(4) deduction for losses incurred. Section 832(b)(5)(A) provides, in general, that losses incurred means the losses incurred during the taxable year on insurance contracts computed as follows:

(i) To losses paid during the taxable year, deduct salvage and reinsurance recovered during the taxable year.

(ii) To the result so obtained, add all unpaid losses on life insurance contracts plus all discounted unpaid losses (as defined in section 846) outstanding at the end of the taxable year and deduct all unpaid losses on life insurance contracts plus all discounted unpaid losses outstanding at the end of the preceding taxable year.

(iii) To the results so obtained, add estimated salvage and reinsurance recoverable as of the end of the preceding taxable year and deduct estimated salvage and reinsurance recoverable as of the end of the taxable year.

Section 832(b)(5)(A) also provides that the amount of estimated salvage recoverable shall be determined on a discounted basis in accordance with procedures established by the Secretary.

Section 832(b)(5)(A), as summarized above, incorporates certain 1990 Act amendments. Prior to the 1990 Act, most property and casualty insurance companies accounted for salvage on a cash basis, i.e., took salvage into income only when recoveries were made. Section 11305 of the 1990 Act amended section 832(b)(5)(A) to require property and casualty insurance companies to account for salvage on an accrual basis, i.e., take future salvage recoveries into account on an estimated basis in computing losses incurred, for taxable years beginning after December 31, 1989.

The requirement to convert from a cash method to an accrual method of accounting for salvage would have been considered a change in method of accounting under I.R.C. § 481 but for the fact that the 1990 Act granted relief from the normal operation of section 481. Thus, for property and casualty insurance companies that reported losses incurred gross of estimated salvage for the last taxable year beginning before January 1, 1990 (“grossers”), section 11305(c)(2)(B) of the 1990 Act provides that 87 percent of the section 481 adjustment that would have otherwise been added to income was permanently forgiven. The remaining 13 percent is to be taken into income over a period not to exceed the four taxable years beginning after December 31, 1989. This relief for grossers is often referred to as “fresh start.”

For property and casualty insurance companies that reported losses incurred net of estimated salvage prior to the effective date (“netters”), section 11305(c)(3) of the 1990 Act provides a special deduction equal to 87 percent of the discounted salvage recoverable balance at the end of 1989. Like the fresh start for grossers, the special deduction for netters is generally to be taken into account ratably over the first four taxable years beginning after December 31, 1989. The 1990 Act also requires a change in method of accounting, because although netters took estimated salvage into account, they did not separately state the amount of estimated salvage. The 1990 Act requires netters to report a gross amount for the loss reserve and separately state the amount of estimated salvage.

On March 13, 1991, the Service issued proposed regulations under amended section 832(b)(5)(A). On August 26, 1991, the Service issued Rev. Proc. 91-48, providing rules for computing deductions for losses incurred under section

832(b)(5)(A). On December 19, 1991, the Service issued Notice 92-1, 1992-1 C.B. 493 to advise taxpayers of significant changes in the final regulations.

On January 28, 1992, the Service published final regulations concerning the tax treatment of salvage. The regulations are effective for taxable years beginning after December 31, 1989. Treas. Reg. § 1.832-4(e)(2)(ii) provides for the fresh start for grossers and Treas. Reg. §1.832-4(f)(1) provides for the special deduction for netters.

Treas. Reg. § 1.832-4(f)(1) provides that an insurance company that claims the special deduction must establish to the satisfaction of the district director that the deduction represents only the discounted amount of estimated salvage recoverable that was actually taken into account by the company in computing losses incurred for its last taxable year beginning before January 1, 1990.

Treas. Reg. § 1.832-4(f)(2) provides a safe harbor for fulfilling the requirements of section 1.832-4(f)(1). Under the safe harbor, the requirements of section 1.832-4(f)(1) will be deemed satisfied and the amount that the company reports as bona fide estimated salvage recoverable will not be subject to adjustment if:

(i) The company files with the insurance regulatory authority of the company's state of domicile, on or before September 16, 1991, a statement disclosing the extent to which losses incurred for each line of business reported on its 1989 annual statement were reduced by estimated salvage recoverable,

(ii) The company attaches a statement to its Federal income tax return filed for the first taxable year beginning after December 31, 1989, agreeing to apply the special rule for overestimates under section 11305(c)(4) of the 1990 Act to the amount of estimated salvage recoverable for which it has taken the special deduction, and

(iii) In the case of a company that is a member of a consolidated group, each insurance company subject to tax under section 831 that is included in the consolidated group complies with the requirement in the preceding paragraph with respect to its special deduction, if any.

Treas. Reg. § 1.832-4(b) provides that, for purposes of section 832(b)(5)(A)(ii) (the unpaid losses component of losses incurred), unpaid losses at the close of the taxable year must consist of only actual unpaid losses. The

regulation also provides that any estimate of unpaid losses must be a fair and reasonable estimate of the amount the company will be required to pay.

Treas. Reg. § 1.832-4(c) provides that for purposes of section 832(b)(5)(A)(iii) (the estimated salvage recoverable component of losses incurred), estimated salvage recoverable includes all anticipated recoveries on account of salvage, whether or not the salvage is treated, or may be treated, as a separate asset for state statutory purposes. The regulation also provides that, for purposes of section 832(b)(5)(A) and the regulations thereunder, salvage recoverable includes anticipated recoveries on account of subrogation claims arising with respect to paid or unpaid losses.

As discussed above, whether Taxpayer is entitled to the special deduction under section 11305(c) of the 1990 Act is dependant upon whether the COB amounts can be characterized as salvage. [redacted]

[redacted]

[redacted]

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

[redacted]

[redacted]

[redacted]

[redacted]

Please call if you have any further questions.

By: _____
CAROL P. NACHMAN
Special Counsel
CC:DOM:FS:FI&P

cc: