26 CFR 601.204: Changes in accounting periods and in methods of accounting.
(Also: Part I, §§ 404, 832, 846; 1.404(b)–1T, 1.404(d)–1T, 1.832–4.)

Rev. Proc. 2004–41

SECTION 1. PURPOSE

This revenue procedure sets forth 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 § 404 of the Internal Revenue Code. The revenue procedure also provides procedures under which a taxpayer may obtain automatic consent of the Commissioner to change its method of accounting for such payments.

SECTION 2. BACKGROUND

.01 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 (§§ 1 through 1400L), but if the compensation would otherwise be deductible, it is deductible under § 404, subject to the limitations imposed by § 404 as to the amounts deductible in any year.

.02 Section 404(a)(5) provides the general rule that compensation paid under a nonqualified plan (contributions to which are not deductible under §§ 404(a)(1), (2), or (3)) of deferred compensation is deductible in the taxable year in which an amount attributable to the contribution is includible in the gross income of employees participating in the plan.

.03 Section 404(b) provides that if there is no plan, but there is a method or arrangement that has the effect of a plan deferring the receipt of compensation, § 404(a) shall apply as if there were a plan.

.04 Section 404(d) extends the application of § 404(a) to benefits or compensation paid to nonemployees by providing that if a plan would be covered by § 404(a) (as modified by § 404(b)) but for the fact that no employer-employee relationship exists, the contributions or compensation (if otherwise deductible under chapter 1 of subtitle A) shall be deductible for the taxable year in which an amount attributable to the compensation is includible in the gross income of the persons participating in the plan.

.05 Section 1.404(b)–1T, Q&A–1, of the temporary Income Tax Regulations provides, in part, that section 404(a) and (d) govern the deduction of compensation paid or incurred with respect to plans, or methods or arrangements, however denominated, that defer the receipt of any amount of compensation or benefit, including fees and other payments. Under §§ 404(a) and (b), if otherwise deductible, a contribution paid or incurred with respect to a nonqualified plan, or method or arrangement, is deductible in the taxable year of the employer in which or with which ends the taxable year of the employee in which the amount attributable to the contribution is includible in the gross income of the employee (without regard to any applicable exclusions under chapter 1, Subtitle A).

.06 Section 1.404(d)–1T provides, in part, that in the case of deferred benefits or compensation for service providers with respect to which there is no employer-employee relationship, §§ 404(a) and (b) and the regulations thereunder apply as if the person providing the services were the employee and the person to whom the services are provided were the employer.

.07 Section 1.404(b)–1T, Q&A–2(a), provides that a plan, or method or arrangement, defers the receipt of compensation or benefits to the extent an employee receives compensation or benefits thereunder more than a brief period of time after the end of the employer's taxable year in which the services creating the right to such compensation or benefits are performed. The determination whether a plan, or method or arrangement, defers the receipt of compensation or benefits is made separately with respect to each employee and each amount of compensation or benefit.

.08 Section 1.404(b)–1T, Q&A–2(b)(1), provides that a plan, or method or arrangement, is presumed to be one that defers the receipt of compensation for more than a brief period of time after the end of an employer's taxable year to the extent that compensation is received after the 15th day of the third month after the end of the employer's taxable year in which the services are rendered (the 2½ month period).

.09 Under § 1.404(b)–1T, Q&A–2(b)(2), the taxpayer may rebut this presumption only by demonstrating that it was impracticable to avoid the deferral of the receipt by an employee of the amount of compensation or benefits beyond the applicable 2½ month period and that, as of the end of the employer's taxable year, such impracticability was unforeseeable.

.10 Section 832(a) defines the taxable income of an insurance company subject to tax under § 831 as the gross income defined in § 832(b)(1), less the deductions authorized by § 832(c).

.11 Section 832(b)(1) provides that the gross income of an insurance company subject to tax under § 831 includes the combined gross amount earned during the taxable year from investment income and from underwriting income, computed on the basis of the underwriting and investment exhibit of the annual statement approved by the National Association of Insurance Commissioners.

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

.13 Section 832(c)(4) authorizes a deduction for "losses incurred" on insurance contracts during the taxable year, as defined in § 832(b)(5).

.14 Section 832(b)(5) defines losses incurred during the taxable year on insurance contracts as follows: (1) from losses paid during the taxable year, deduct salvage and reinsurance recovered; (2) to the results so obtained, add all unpaid losses on life insurance contracts plus all discounted unpaid losses (as defined in § 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; (3) 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.

.15 Section 1.832–4(b) provides, in part, that the part of the deduction for losses incurred that represents unpaid losses must comprise only actual unpaid losses. These losses must be stated in amounts that, based on the facts of 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. Amounts included in, or added to, the estimates of unpaid losses that, in the opinion of the director, are in excess of a fair and reasonable estimate will be disallowed as a deduction. The director may require any insurance company to submit such detailed information with respect to its actual experience as is deemed necessary to establish the reasonableness of the deduction for "losses incurred."

.16 Section 846 provides that the amount of discounted unpaid losses as of the end of the taxable year attributable to any accident year is equal to the present value of the losses, determined by using the amount of undiscounted unpaid losses at such time, the applicable interest rate, and the applicable loss payment pattern. Section 846(b)(1) provides, in general, that the term "undiscounted unpaid losses" means the unpaid losses shown in the annual statement filed by the taxpayer for the year ending with or within the taxable year of the taxpayer. For purposes of determining discounted unpaid losses attributable to accident and health insurance contracts (other than certain disability insurance contracts), § 846(f)(6)(B) provides that the unpaid losses are considered to be paid in the middle of the taxable year following the accident year.

.17 Under § 446(e) and § 1.446–1(e)(2)(i), a taxpayer generally must secure the consent of the Commissioner before changing a method of accounting for federal income tax purposes. Section 1.446–1(e)(3)(ii) authorizes the Commissioner to prescribe administrative procedures setting forth the terms and conditions necessary to obtain consent to change a method of accounting. Rev. Proc. 2002–9, 2002–1 C.B. 327 (as modified and clarified by Announcement 2002–17, 2002–1 C.B. 561, modified and amplified by Rev. Proc. 2002–19, 2002–1 C.B. 696, and amplified, clarified, and modified by Rev. Proc. 2002–54, 2002–2 C.B. 432), provides procedures by which a taxpayer may obtain automatic consent to change to a method of accounting described in the Appendix of Rev. Proc. 2002–9.

.18 Many taxpayers that are taxable under Part II of subchapter L of Chapter 1, including both health insurance companies and health maintenance organizations (HMOs), have developed arrangements with physicians and other health care providers that encourage participating providers to provide quality health care to subscribers in a cost-efficient manner. Under one such arrangement, a portion of the provider's fees is held back and paid after the end of the insurer's taxable year if certain objectives are met. Under another such arrangement, the provider is entitled to a bonus payment if specified objectives are met. The objectives set by the insurer often relate to cost savings, profitability, number of claims, quality of care, or preventive medicine. The terms of these incentive programs are not negotiated between the taxpayers and the health care providers and the taxpayers do not offer providers the alternative of not participating in these arrangements.

.19 The incentive payments described in Section 2.18 often are based on data for a performance period that can only be collected after the end of the taxpayer's taxable year. As a result, the payments often are made to providers more than 2½ months after the end of the taxpayer's taxable year.

.20 For purposes of the annual statements filed with their state insurance commissioners, health insurers and HMOs treat the amount of incentive payments made to health care providers during the year as part of claims paid. The taxpayers also are required to include estimates of the liability for incentive payments incurred during the year as part of their total incurred but not paid claims reserves. The taxpayers usually determine the liability for incentive payments on the basis of an actuarial calculation, taking into account the relevant contractual arrangements with health care providers, the contractually defined experience outcomes by which the incentive payments will become payable to the health care providers, and an analysis of the taxpayers' aggregate health care costs through the valuation date.

.21 Applying § 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 health insurance companies and HMOs generally are not broken down into amounts that will be owed to specific health care providers. In light of existing rules and limitations placed on the deductibility of loss reserves under subchapter L, and in order to reduce controversy regarding the treatment of these incentive payments, the Service has decided that it will not apply § 404 to provider incentive payments described in section 4 of this revenue procedure.

SECTION 3. SCOPE

This revenue procedure applies to taxpayers using or changing to the method of accounting for provider incentive payments set forth in section 5 of this revenue procedure.

SECTION 4. PROVIDER INCENTIVE PAYMENTS

A payment by a taxpayer to a health care provider is a "provider incentive payment" within the meaning of this revenue procedure if—

.01 the taxpayer is taxable as an insurance company under Part II of subchapter L;

.02 the payment is made pursuant to a written arrangement the purpose of which is to encourage participating health care providers to provide quality health care to the taxpayer's subscribers in a cost-efficient manner;

.03 the taxpayer's liability for the payment is dependent on the attainment of one or more preestablished goals during a performance period consisting of not more than 12 consecutive months;

.04 the terms of the arrangement pursuant to which the payment is made are established unilaterally by the taxpayer, and are not negotiated with the health care providers;

.05 the taxpayer normally makes payments to health care providers under the arrangement within 12 months after the close of the performance period referred to in section 4.03 of this revenue procedure;

.06 deferring the receipt of income by the health care provider or otherwise providing a tax benefit to the provider is not a principal purpose of the arrangement;

.07 the taxpayer records a liability for the payment on its annual statement filed for state regulatory purposes, and includes this liability in the determination of discounted unpaid losses under § 846; and

.08 the health care provider is not an employee, and is not providing health care as an agent, of the taxpayer.

SECTION 5. APPLICATION

A taxpayer that makes provider incentive payments within the meaning of this revenue procedure is permitted to include those payments in discounted unpaid losses without regard to § 404.

SECTION 6. CHANGE IN METHOD OF ACCOUNTING AND AUDIT PROTECTION

.01 *Change in method of accounting*. A change in an insurance company's method of deducting provider incentive payments to the method provided in section 5 of this revenue procedure is a change in method of accounting to which the provisions of §§ 446 and 481 apply. If a taxpayer within the scope of this revenue procedure wants to change its method of deducting the liability for provider incentive payments to the method provided in section 5 of this revenue procedure, the taxpayer must follow the automatic change in method of accounting provisions of Rev. Proc. 2002–9, with the following modifications:

(1) The scope limitations in section 4.02 of Rev. Proc. 2002–9 do not apply to a taxpayer that wants to make the change for either its first or second taxable year ending on or after December 31, 2003.

(2) A taxpayer that wants to make the change for its first taxable year ending on or after December 31, 2003, and that on or before September 24, 2004, files its original federal income tax return for that year, and that did not change to the method described in section 5 of this revenue procedure on that return is not required to comply with the filing requirement in section 6.02(3)(a) of Rev. Proc. 2002–9, provided the taxpayer complies with the following filing requirements. The taxpayer must instead complete and file the Form 3115, *Application for Change in Accounting Method*, in duplicate. The original Form 3115 must be attached to an amended federal income tax return for the taxpayer's first taxable year ending on or after December 31, 2003. This amended return must be filed no later than January 24, 2005. The copy of the Form 3115 must be filed with the national office (see section 6.02(6) of Rev. Proc. 2002–9 for the address) no later than when the taxpayer's amended return is filed; and

(3) For purposes of Line 1a of Form 3115, the designated number for the automatic accounting method change is "90".

.02 *Audit protection*. If a taxpayer within the scope of this revenue procedure currently uses a method consistent with the method described in section 5 of this revenue procedure, the method of accounting for the taxpayer's provider incentive payments will not be raised as an issue by the Service in a taxable year that ends before December 31, 2003. Also, if a taxpayer currently uses a method consistent with the method described in section 5 of this revenue procedure, and its use of that method is an issue under consideration (within the meaning of section 3.09 of Rev. Proc. 2002–9) in examination, before an appeals office, or before the U.S. Tax Court for any taxable year that ends before December 31, 2003, that issue will not be further pursued by the Service.

SECTION 7. EFFECTIVE DATE

This revenue procedure is effective for taxable years ending on or after December 31, 2003.

SECTION 8. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 2002–9 is modified and amplified to include this automatic change in method of accounting in section 4B of the APPENDIX.

SECTION 9. DRAFTING INFORMATION

The principal authors of this revenue procedure are Gary E. Geisler of the Office of Associate Chief Counsel (Financial Institutions & Products) and William C. Schmidt of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt & Government Entities). For further information regarding this revenue procedure, contact Mr. Geisler at (202) 622–3970 (not a toll-free call) or Mr. Schmidt at (202) 622–6030 (not a toll-free call).