

SCRIBNER, HALL & THOMPSON, LLP

SUITE 1050

1875 EYE STREET, N. W.

WASHINGTON, D. C. 20006-5409

(202) 331-8585

FAX (202) 331-2032

THOMAS C. THOMPSON, JR.
MARK H. KOVEY
STEPHEN P. DICKE
PETER H. WINSLOW
SUSAN J. HOTINE
BIRUTA P. KELLY
GREGORY K. OYLER
LORI J. BROWN
SAMUEL A. MITCHELL
JOSEPH A. SERGI

FRED C. SCRIBNER, JR. (1908-1994)
LEONARD W. HALL (1900-1979)

MEMORANDUM

Re: Rev. Proc. 2004-41 — Health Insurers Allowed to Include Certain Health Care Providers' Incentive Payments in Discounted Unpaid Losses

From: Susan J. Hotine

Date: July 9, 2004

Rev. Proc. 2004-41 provides rules under which an insurance company that pays incentive or bonus payments to participating health care providers may include such payments in discounted unpaid losses. It also provides procedures under which companies can obtain automatic consent to change its accounting method for such payments.

As part of efforts to provide cost-efficient health care, health care insurers and HMOs have programs under which a portion of a provider's fees is held back and paid if certain objectives are met, or under which a bonus is paid if specified objectives are met. These objectives generally relate to cost savings, profitability, number of claims, quality of care, or preventive medicine for the year, so these payments generally are paid after the end of the insurer's taxable year. I.R.C. § 404(a) provides that, if compensation is paid or accrued on account of any employee under a plan deferring its receipt, the deduction of the compensation is only deductible under, and subject to the limitations imposed by, I.R.C. § 404 as to the amounts deductible in any year. Specifically, I.R.C. § 404(a)(5) provides a general rule that compensation deferred under a nonqualified plan is deductible in the taxable year in which the amount is includible in the gross income of the recipient. On the other hand, the incentive/bonus payments to health care providers are part of the cost of the health claims payable by the insurer.

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Although the language of I.R.C. § 404(a) arguably trumps any deduction otherwise allowable to insurers under I.R.C. § 832 for these incentive/bonus payments as part of discounted unpaid losses, Rev. Proc. 2004-41 provides an administrative exception that allows the I.R.C. § 832 deduction for certain types of incentive/bonus payments because applying I.R.C. § 404 and the regulations thereunder to the payments would create a substantial administrative burden for the insurers and the IRS. The accounting method — allowing incentive/bonus payments to be included in discounted unpaid losses — is limited to those payments that are made by an insurance company; that are made pursuant to a written agreement that is unilaterally established by the payor to encourage cost-efficient health care (and not, as a principal purpose, to defer income for the recipient); that are dependent on the attainment of pre-established performance goals for a performance period of not more than one year; that the payor records as a liability on its annual statement and includes in discounted unpaid losses under I.R.C. § 846; and that are made to a recipient that does not perform health care services as an employee or agent of the payor. If an insurance company makes provider incentive/bonus payments that meet all of the above restrictions, the company may include those payments in discounted unpaid losses without regard to I.R.C. § 404.

The revenue procedure is effective for taxable years ending on or after December 31, 2003, and a company can obtain an automatic change (without regard to otherwise applicable scope limitations) for either the first or second taxable year ending on or after December 31, 2003. The revenue procedure also provides audit protection for companies currently using an accounting method for incentive/bonus payments that is consistent with that provided in the procedure.

Some practical considerations: Although the revenue procedure provides a clear rule for allowing incentive/bonus payments to be included in discounted unpaid losses, it provides a restrictive definition for what kind of payments they have to be. For example, if a company pays incentive payments for performance goals measured over a three-year period, this revenue procedure will not apply. Thus, companies may have to change their incentive payment arrangements.

For compensation amounts (salaries of claims department employees) that are included in a company’s loss adjustment expenses under SSAP No. 55 (and, therefore, in discounted unpaid losses under I.R.C. § 846), Rev. Proc. 2004-41 may raise new issues. Clearly, the revenue procedure does not apply to such compensation payments. Does the narrow scope and rationale of Rev. Proc. 2004-41 allow for a negative inference that I.R.C. § 404 requires such amounts to be removed from discounted unpaid losses? How would that be done, as a practical matter? Do insurance companies that include loss adjustment expenses in discounted unpaid losses also need an exception from the application of I.R.C. § 404 for the same reason health insurers needed Rev. Proc. 2004-41? Applying I.R.C. § 404 to loss adjustment expenses could create even a greater administrative burden than provider incentive/bonus payments, if an adjustment to loss adjustment expenses is required.