Internal Revenue Service

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Department of the Treasury

Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:
CC:FIP:4 PLR-107958-00
Date: AUGUST 7, 2000

Legend

Parent =

Subsidiary =

Contract =

State X =

Agency =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Dear :

This responds to the letter dated April 5, 2000 (and to the supplemental letter) requesting a ruling that, under the facts presented, a contract that

otherwise qualifies as an insurance contract is a “cancellable accident and health insurance contract” within the meaning of section 1.832-4(a)(5)(iv) of the Treasury Regulations.

The information submitted indicates that Subsidiary is taxed under Part II of Subchapter L of the Internal Revenue Code and is an indirectly wholly subsidiary of Part. Subsidiary is part of an affiliated group of corporations that join in the filing of a consolidated federal income tax return. Subsidiary is licensed by State X to transact the business of life, health, and accident insurance.

Subsidiary’s insurance underwriting activities are currently confined to one Contract with Agency, pursuant to which Subsidiary insures certain Medicaid benefit programs. The Contract between Subsidiary and Agency commenced on Date 1, and continues through Date 2. A has four one-year extension options under the Contract, which will allow Agency, in its sole discretion, to extend the Contract for one year starting Date 3 and for up to three additional one-year periods thereafter through Date 4.

Prior to completion of the Contract term, the Contract may be terminated for any of the following reasons:

(a) mutual agreement by the parties,
(b) termination in the best interest of the state,
(c) termination by Agency for cause, such as (i) failure of Subsidiary to comply with the Contract, (ii) breach of confidentiality by Subsidiary, (iii) admission by Subsidiary of its inability to pay debts or its insolvency, and (iv) bankruptcy of Subsidiary, and
(d) termination by Subsidiary for failure by Agency to pay the monthly premiums.

Pursuant to the Contract, Subsidiary issues certain contracts insuring certain Medicaid benefit programs in exchange for which Agency pays Subsidiary premiums on a monthly basis. The Contract guarantees rates for insurance coverage for each 12-month period, running from September 1 through August 31 of each fiscal year. However, adjustments may be negotiated during a rate guarantee period under certain circumstances. Subsidiary does not incur commissions state premium taxes, overhead reimbursements to agents or brokers, or other similar amounts in respect of the Contract. Subsidiary represents that the Contract is an accident and health insurance contract under State X law and otherwise qualifies as an insurance

contract for federal income tax purposes. Subsidiary does not carry a reserve in addition to the unearned premiums to cover an obligation to renew or continue coverage at a specified premium..

Applicable Law and Rationale

Internal Revenue Code § 832(a) provides that, for an insurance company subject to the tax imposed by § 831, the term "taxable income" means the gross income as defined in § 832(b)(1) less the deductions authorized in § 832(c). Under § 832(b)(3), underwriting income, which is a component of an insurance company's gross income under § 832(b)(1), is equal to the amount of premiums earned on insurance contracts during the taxable year less losses incurred and expenses incurred. Section 832(b)(6) provides that the term "expenses incurred" means all expenses shown on the annual statement and is equal to the expenses paid during the taxable year adjusted by the net change in unpaid expenses during the year.

Section 832(b)(4) provides that the amount of premiums earned includes the gross premiums written on insurance contracts during the taxable year. Section 1.832-4(a)(4) of the Treasury Regulations defines "gross premiums written" as follows:

> (4) *Gross premiums written*–(i) *In general.* Gross premiums written are amounts payable for insurance coverage. . . Gross premiums written on an insurance contract include all amounts payable for the effective period of the insurance contract.

Section 832(b)(4) provides that, in computing premiums earned, gross premiums are reduced by return premiums and premiums paid for reinsurance. The result so obtained is further adjusted by adding 80 percent of the unearned premiums on outstanding business at the end of the preceding taxable year and deducting 80 percent of the unearned premiums on outstanding business at the end of the taxable year.

Section 1.832-4(a)(5) sets forth the method by which gross premiums written are reported:

> (5) *Method of reporting gross premiums written*–(i) *In general.* Except as otherwise provided under this paragraph (a)(5), an insurance company reports gross premiums written for the earlier of the taxable year that includes the effective date of the insurance

> contract or the year in which the company receives all or a portion of the gross premium for the insurance contract. The effective date of the insurance contract is the date on which the insurance coverage provided by the contract commences.

As indicated above, gross premiums written includes all amounts that are to be paid for the period the insurance contract is in effect. A company's gross premiums written must be reported either for the taxable year which includes the effective date of the insurance contract or the year in which all or a portion of the gross premium is received, whichever is earlier. Section 1.832-4(a)(5)(iv) provides the following exception to that general rule for certain cancellable accident and health insurance contracts with installment premiums:

> If an insurance company issues or proportionally reinsures a cancellable accident and health insurance contract (other than a contract with an effective period that exceeds 12 months) for which the gross premium is payable in installments over the effective period of the contract, the company may report the installment premiums (rather than the total gross premium for the contract) in gross premiums written for the earlier of the taxable year in which the installment premiums are due under the terms of the contract or the year in which the installment premiums are received.

Pursuant to § 1.832-4(a)(5)(iv), a company may adopt this method of reporting gross premiums written only if the company's deduction for premium acquisition expenses for the first taxable year in which an installment premium is due or received under the contract does not exceed the limitation on deduction of premium acquisition expenses set forth in § 1.832-4(a)(5)(vii). The regulation thus requires a matching of expenses and income.

In United Benefit Life Insurance Co. v. McCrory, 414 F.2d 928, 931 (8th Cir. 1969), the Eighth Circuit considered the issue of whether reserves set aside under health and accident policies for payment of amounts still unaccrued on claims from permanent and total disability qualify as life insurance reserves under the Internal Revenue Code. The Court stated that accident and health insurance policies generally fall into one of three groups: noncancellable, guaranteed renewable, and cancellable. Although the term "cancellable accident and health insurance policy" is not defined by the Internal Revenue Code or regulations promulgated pursuant thereto, the terms "noncancellable life, health or accident insurance policy" and "guaranteed renewable life, health, or accident insurance policy" are defined by regulation. The term

"noncancellable life, health, or accident insurance policy" is defined by § 1.801-3(c)[1] as:

> a health and accident contract, or a health and accident contract combined with a life insurance or annuity contract, which the insurance company is under an obligation to renew or continue at a specified premium and with respect to which a reserve in addition to the unearned premiums. . . must be carried to cover the obligation. Such a health and accident contract shall be considered noncancellable even though it states a termination date at a stipulated age, if, with respect to the health and accident contract, such age termination date is 60 or over.

The term "guaranteed renewable life, health, and accident insurance policy" is defined in § 1.801-3(d) as:

> a health and accident contract . . . which is not cancellable by the company but under which the company reserves the right to adjust premium rates by classes in accordance with its experience under the type of policy involved, and with respect to which a reserve in addition to the unearned premiums . . . must be carried to cover that obligation. Section 801(c) provides that such policies shall be treated in the same manner as noncancellable life, health, and accident insurance policies.

A health and accident insurance policy that does not fall within the category of either noncancellable or guaranteed renewable is considered to be a cancellable health and accident policy.

In the present case, the contract is an insurance contract for federal income tax purposes. Under the contract, State X agrees to pay monthly

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[1] Section 1.801-3 was adopted pursuant to the predecessor of section 816 (defining life insurance company and life insurance reserves). Where a provision of Subchapter L was carried over from prior law by the *Deficit Reduction Act of 1984*, Congress intended the new provision to be interpreted in a manner consistent with the prior law provision and regulations adopted pursuant thereto. Senate Committee on Finance, 98th Cong. 2d Sess., *Deficit Reduction Act of 1984*. *Explanation of Provisions Approved by the Committee on March 21, 1984*, Vol. 1, 524 (Comm. Print 1984)..

premiums to Subsidiary in return for which Subsidiary insures certain Medicaid benefit programs. Subsidiary collects premiums under the Contract on a monthly basis. Subsidiary does not carry a reserve in addition to the unearned premiums to cover an obligation to renew or continue coverage at a specified premium. Accordingly, provided the Contract otherwise qualifies as an insurance contract, we conclude that the Contract is a cancellable accident and health insurance contract within the meaning of § 1.832-4(a)(5)(iv).

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

This ruling is directed only to the taxpayer(s) requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

A copy of this letter must be attached to any income tax return to which it is relevant.

Sincerely,

Acting Associate Chief Counsel
(Financial Institutions and Products)

By: /S/
Mark Smith
Chief, Branch 4