INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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CASE-MIS No.: TAM-112829-09

, Acting Director of Field Operations (West)
Large & Mid Size Business (LMSB)
Retail, Food, Pharmaceuticals & Health Care

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Year(s) Involved:
Date of Conference:

LEGEND:

Taxpayer =

ISSUE(S):

Whether Taxpayer is entitled to deduct anticipated future retiree medical benefits for claims personnel as unpaid loss adjustment expenses in determining its losses incurred under section 832(b)(5) of the Internal Revenue Code, or whether § 404(a)(5) precludes deductibility of such amounts until the year in which retiree medical benefits are includable in gross income of the employee receiving the benefits?

CONCLUSION(S):

Section 404(a)(5) specifically precludes Taxpayer from deducting the unpaid loss adjustment expenses for retiree medical benefits prior to the taxable year in which such benefits are includible in the gross income of the employee receiving the benefits. These deduction limitations apply regardless of whether the benefits would otherwise be deductible under any other Code provisions.

FACTS:

Taxpayer is taxable under part II of subchapter L of the Code as a non-life insurance company and is the parent corporation of an affiliated group of corporations that file a consolidated Federal income tax return. Taxpayer and certain affiliated insurance companies (collectively referred to as “Taxpayer”) sell property and casualty insurance throughout the United States.

Taxpayer provides retiree medical benefits to its claims personnel. For its 20 and 20 taxable years, Taxpayer included in its calculation of unpaid loss adjustment expenses the discounted amount of the actuarially determined future retiree medical benefits to be provided to claims personnel.

Taxpayer represents that amounts taken into account in computing unpaid loss adjustment expenses for retiree medical benefits for claims personnel were not contributed to a welfare benefit fund within the meaning of § 419(e) of the Code.[1]

LAW:

Section 831(a) imposes a tax for each taxable year on the taxable income of every insurance company other than a life insurance company.

Section 832 provides that the taxable income of an insurance company subject to the tax imposed by § 831 is the gross income as defined in § 832(b) less the deductions allowed by § 832(c).

Section 832(b) provides that the gross income of an insurance company subject to tax under § 831(a) includes the combined gross amount earned for the taxable year from investment income and underwriting income, as provided in § 832(b), computed on the basis of the annual statement approved by the National Association of Insurance Commissioners (“NAIC”). Under § 832(b)(3), underwriting income consists of the premiums earned on insurance contracts during the taxable year, less losses incurred and expenses incurred.

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[1] If post-retirement medical benefits are provided in future years through a welfare benefit fund, then § 419 would govern the deductibility of any amounts contributed to the welfare benefit fund by Taxpayer.

Section 832(b)(5) defines "losses incurred" as an amount equal to the losses paid during the taxable year, reduced by salvage and reinsurance recovered during the taxable year, plus all unpaid losses on life insurance contracts and all discounted unpaid losses (as defined in § 846) outstanding at the end of the taxable year, less all unpaid losses on life insurance contracts and all discounted unpaid losses outstanding at the end of the preceding taxable year; plus estimated salvage and reinsurance recoverable at the end of the preceding year, less estimated salvage and reinsurance recoverable at the end of the taxable year.

Section 832(b)(6) provides that expenses incurred do not include any unpaid loss adjustment expenses shown on the annual statement which are to be treated as part of the insurance company's unpaid losses.

Section 832(c) lists various categories of allowable deductions, including "all ordinary and necessary business expenses incurred, as provided under § 162," taxes as provided under § 164, and other deductions, as provided in part VI of subchapter B (§ 161 and following, relating to itemized deductions for individual and corporations), and subchapter D (§ 401 and following, relating to pension, profit sharing, stock bonus plans, etc.) See § 832(c)(1), (c)(4), and (c)(10). Section 832(c)(4) provides that in computing the taxable income of an insurance company subject to tax under § 831, a deduction is allowed for losses incurred as defined in § 832(b)(5).

Section 1.832-4(b) provides, in part, that an insurance company must be prepared to demonstrate that the part of the deduction for losses incurred which represents unpaid losses comprises only actual unpaid losses. These losses must be stated in amounts which, based upon the facts in each case and the company's experience in similar cases, represents 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 which, in the opinion of the district director, are in excess of a fair and reasonable estimate will be disallowed as a deduction.

Section 846 requires unpaid losses (other than unpaid losses on life insurance contracts) to be discounted to reflect the time value of money. Under § 846(b)(1), the starting point for determining discounted unpaid losses is the amount of unpaid losses reported on the annual statement approved by NAIC that the taxpayer is required to file with insurance regulators of a state.

Section 846(f)(2) states the term "unpaid losses" includes any unpaid loss adjustment expenses shown on the annual statement.

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 of the Code, 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.

Section 404(a)(5) provides that compensation paid under a nonqualified plan (that is, a plan to which the contributions 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.

Section 404(b)(1) provides that if there is no plan, but there is a method or arrangement of compensation which has the effect of a plan deferring the receipt of compensation, § 404(a) shall apply as if there were such a plan. Section 404(b)(2)(A) provides that any plan providing for deferred benefits (other than compensation) for employees, their spouses, or their dependents is treated as a plan deferring the receipt of compensation, and the determination of when benefits are includible in an employee's gross income is to be made without regard to any provision (in chapter 1 of the Code) that excludes the benefits from gross income. Section 404(b)(2)(B) provides that § 404(b)(2)(A) does not apply to any benefit provided through a welfare benefit fund as defined in § 419(e).

Section 1.404(b)-1T, Q&A-1, provides, in part, that § 404(a) governs the deduction of compensation paid or incurred with respect to compensation and benefit plans, or methods or arrangements, however denominated, which 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 exclusion under chapter 1, subtitle A, of the Code).

Section 1.404(b)-1T, Q&A-2(a), provides that, for purposes of § 404(a), (b), or (d), a plan, or method or arrangement, defers the receipt of compensation or benefits to the extent it is one under which an employee receives compensation or benefits 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 of 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.

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 provided. In addition, benefits are "deferred benefits" if, assuming the benefits were cash compensation, such benefits would be considered deferred compensation. Thus, a plan, or method or arrangement, is presumed to be one providing for deferred benefits to the extent benefits for services are received by an employee after the 2 1/2 month period following the end of the employer's taxable year in which the related services are provided.

ANALYSIS:

The claims personnel earned the right to retiree medical benefits through the performance of services in 2005 and 2006. Therefore, the retiree medical benefits are deferred benefits as described in § 1.404(b)-1T, Q/A-2(b)(1).

However, Taxpayer asserts that the timing restrictions in § 404 are not applicable to its liability for payments of accrued retiree medical benefits for claims personnel because the tax treatment of these items is controlled by the loss reserve provisions of subchapter L. In addition, Taxpayer asserts that pursuant to § 832(b) the amounts at issue were included in its determination of unpaid losses, which is a component of gross income, not a deduction. Therefore, the amounts at issue are not subject to § 404(a)(5) because, as a component of gross income, they are not amounts that are “otherwise deductible” under the Code.

Taxpayer emphasizes that it is required to include estimates of its liability for payment of retiree health benefits for claims personnel when determining the amount of unpaid loss adjustments includible in unpaid losses on its NAIC annual statement. For purposes of determining an insurance company’s income from premiums and deductions for losses, the Code adopts the accounting terms and concepts of the NAIC annual statement. See § 832(b)(1)(A). In addition, § 846(b)(1) provides that the starting point for determining discounted unpaid losses on insurance contracts, which are a component of “losses incurred” under § 832(b)(5), is “the unpaid losses shown on the annual statement filed by the taxpayer for the year ending with or within the taxable year of the taxpayer.” Section 846(f)(2) states the term “unpaid losses” includes any unpaid loss adjustment expenses shown on the annual statement. Thus, Taxpayer’s argument is that because it must provide for the estimated liability for the payment of retiree medical benefits for claims personnel as part of the unpaid losses shown on its annual statement, the NAIC accounting treatment required to be used under §§ 832 and 846 for these items is controlling for tax purposes.

Taxpayer's argument that subchapter L is controlling regarding the timing of the deduction is inconsistent with the broad scope of the deduction timing rules of § 404. In the Tax Reform Act of 1984, Congress amended § 404(b)(1) in order to expand the scope of the special accounting rule in § 404(a) to include any “method or arrangement of ... compensation which has the effect of a ... plan deferring the receipt of compensation.” The legislative history indicates that this change was intended to clarify that the deduction timing rules of § 404(a) are not confined to qualifying pension, profit sharing, and stock bonus plans, but are applicable to all compensation arrangements which defer the receipt of compensation by an employee or independent contractor. See H.R. Rep. No. 98-432, Pt. 2, 1283 (1984).

In the Tax Reform Act of 1986, in what was described as a "clarifying amendment" to the 1984 changes with respect to the treatment of deferred compensation arrangements, Congress amended the general rule of § 404(a), eliminating the references to §§ 162 and 212, in order to clarify that the timing restrictions for deferred compensation arrangements apply to all forms of compensation for services rendered, regardless of the provision under which this compensation would be deductible. The legislative history explained the Congressional intent underlying this statutory change as follows:

> The bill clarifies that the deduction-timing rules for deferred compensation arrangements apply to any plan or method of deferring compensation regardless of the section under which the amounts might otherwise be deductible and that the amount shall be deductible under section 404(a)(5) and shall not otherwise be deductible under any other section. This clarification is necessary to prevent taxpayers from asserting that deferred compensation is attributable to capitalizable compensation expenses and, thereby, accelerate the timing of the deduction of such deferred compensation.

See S. Rep. No. 99-313, 1013 (1986).

Accordingly, even if Taxpayer is correct in its assertion that the unpaid loss adjustment expenses would ordinarily be taken into account as part of its losses incurred under § 832(b)(5), the deduction timing rules in § 404(a)(5) take precedence. That is, the timing restrictions in § 404(a)(5) apply for purposes of determining the deductibility of all deferred compensation payments and deferred benefits under chapter 1 of the Code, including deferred compensation payments or deferred benefits that would otherwise qualify for deduction as part of losses incurred under § 832(b)(5).

In addition, the purpose underlying § 404(a)(5) is to ensure that employers do not have the tax incentive to adopt deferred compensation or deferred benefit plans instead of qualified pension plans. See H.R. Rep. No 77-2333, 103 (1942). To achieve this purpose the employer's deduction for deferred compensation or deferred benefits is allowed no earlier than when the compensation or benefits are includible in the gross income of the participants in the plan. Thus, the rules for nonqualified deferred compensation provide a "matching rule" that ensures that the employer is not allowed a deduction with respect to deferred compensation or deferred benefits until such compensation or benefits are taxed to the employee. The "matching rule" applies specifically for the purposes of § 404, and is fundamentally different than the general income and expense matching concepts of § 446(b). Permitting the rules under subchapter L to trump the nonqualified deferred compensation deduction rules under § 404(a)(5) would frustrate this purpose.

Finally, the Taxpayer argues that the timing restrictions of § 404(a)(5) cannot be applied to its estimated liability for payment of retiree medical benefits for claims personnel because, under the definition of "underwriting income" in § 832(b)(3), "losses incurred" are subtracted from the "premiums earned" in determining underwriting income, and such underwriting income is a component of an insurance company's "gross income" under § 832(b)(1). Thus, the amounts included in "losses incurred" under § 832(b)(5) are taken into account in determining insurance company gross income under § 832(b)(1). Taxpayer therefore asserts that § 404(a)(5) is inapplicable here because it applies only to amounts that "would otherwise be deductible" under the Code.

Taxpayer's argument is not persuasive and is inconsistent with the manner in which "losses incurred" are generally characterized. Section 832(c)(4) provides that "losses incurred" as defined in § 832(b)(5) is a deduction for purposes of determining insurance company taxable income.

In addition, the regulations under § 1.832-4(b) specifically refer to the amounts taken into account as losses incurred as a deduction, noting that an insurance company must be prepared to demonstrate that "the part of the deduction for 'losses incurred' that represents unpaid losses at the close of the taxable year comprises only actual unpaid losses."

Moreover, in the overwhelming majority of the cases in which amounts taken into account as losses incurred under § 832(b)(5) have been at issue, the courts have characterized an insurance company's "losses incurred" as a deduction for tax purposes. See, e.g., Western National Mutual Insurance Company v. Commissioner, 102 T.C. 338, 343-44 (1994), aff'd, 65 F.3d 90 (7th Cir.1995); Maryland Deposit Insurance Fund Corp. v. Commissioner, 88 T.C. 1050, 1057-1058 (1987); Minnesota Lawyers Mutual Insurance Co. v. Commissioner, T.C.M. 2000-203, aff'd, 285 F.3d 1086 (8th Cir. 2002).

Accordingly, the anticipated future retiree medical benefits for claims personnel at issue are subject to § 404(a)(5) in accordance with the analysis provided above.

CAVEAT(S):

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

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