IRS Finally Weighs in on IBNR Deductibility
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In a recent Field Service Advice memorandum, the Internal Revenue Service (“IRS”) concluded that a company providing health-care service that was not an insurance company could nevertheless accrue and deduct incurred but not reported (“IBNR”) reserves. Field Serv. Advice Mem. No. 200110030 (Mar. 12, 2001). <http://ftp.fedworld.gov/pub/irswd/0110030.pdf>. This is an important development for independent practice associations (“IPAs”), group practices, and healthcare entities with risk bearing contracts. Up to this point, the IRS had not specifically indicated whether, and under what circumstances, a risk bearing IPA or other healthcare entity that was not an insurance company could deduct its IBNR reserve.

The Field Service Advice is not binding on the IRS, and does not constitute legal precedent. It is nevertheless an indication of the IRS’s current thinking in this area. The only legal precedent on this issue is the often-cited case, U.S. v. General Dynamics Corp., 107 S. Ct. 1732 (1987), discussed below.

I. General Dynamics

The Supreme Court in General Dynamics held that an accrual basis taxpayer that maintained a self-insured plan for employee medical expenses was not entitled to a deduction for an estimated reserve for reimbursement of employee medical expenses incurred by employees but not reported to the taxpayer. The Court noted that only insurance companies, by specific statutory provision, are allowed a deduction for reserves for claims that have been incurred but not reported. Internal Revenue Code § 832(b)(5).

The Court stated that it is fundamental to the “all events test” for deductibility that, although expenses may be deductible before they have become due and payable, the liability must first be firmly established. This statement is consistent with the Court’s prior holdings that a taxpayer may not deduct a liability that is contingent, nor may a taxpayer deduct an estimate of an anticipated expense, no matter how statistically certain, if it is based on events that have not occurred by the close of the taxable year.

In the situation at issue in General Dynamics, the missing event in order to fix liability was the filing of properly documented claims forms by the medical providers. The Court pointed out that as a matter of law, the filing of a claim was necessary to create liability. As the Court stated, “Such filing is not a mere technicality. It is crucial to the establishment of liability on the part of the taxpayer.” The Court further stated that with regard to the use of actuarial data to estimate the IBNR deduction, even though the taxpayer may have been able to estimate how many claims would be filed for the period at issue, this fact alone did not justify a deduction. Finally, the Court stated that “a reserve based on the proposition that a particular set of events is likely to occur in the future may be an appropriate conservative accounting measure, but does not warrant a tax deduction.”

This is the fundamental problem for risk-bearing IPAs and other healthcare entities that must estimate an amount of claims that will be filed after the close of the accounting period for services rendered to patients before the close of the period. An organization that estimates inaccurately could misinterpret any excess funds as profit, and could distribute them out as compensatory bonuses and/or dividend payments. If this occurs, the result is insufficient funds in the future to pay for claims that will be submitted by providers.
IPAs and healthcare entities that must and do reserve IBNR liabilities naturally wish to ensure that these reserves are tax-deductible.

II. IRS Field Service Advice

The IRS examined a professional corporation owned by physicians and a health maintenance organization (“HMO”). The company received 80% of its income from capitation payments under a contract with the HMO for providing services to the HMO’s members. The company had deducted its IBNR reserve. The IRS field agents argued that the company could not deduct the IBNR reserve because the “all events” test had not been met because, based on General Dynamics, the medical liability required a claim form for payment. The agents requested advice from the IRS National Office.

The company used the accrual method of accounting for both book and tax purposes. Capitation payments from the HMO were recorded in income in the month for which coverage was provided. Revenue from fee-for-services patients was recorded in the period in which the services were performed.

The company often referred patients to outside specialists. Under its contract with the HMO, the company was required to pay for the services provided by the outside specialists. If the HMO approved a claim submitted by an outside specialist, the claim became the company’s liability, subject to a risk/reward clause under which the HMO and the company shared in the referral expense variance. The company recorded the charges for outside medical services provided to the HMO’s members in the period in which the services were provided. These charges included amounts based on estimates for reported charges as well as estimates for services performed by outside specialists but not yet reported (“IBNR”) by the outside specialists to the HMO. The IBNR amount was based on a per member per month actuarially estimated amount. It was not based on the number of referrals outstanding at year-end. The company did not know the cost for an outside specialist until a claim was filed because the cost could vary depending on how many times the patient visited the specialist, and whether the specialist ordered additional treatment.

The IRS field agents believed that the company sought to deduct an actuarial estimate of the claims it expected would be filed in the future, and that the last event creating the liability occurs when a specialist actually submits a claim for payment. The IRS National Office disagreed. In its Field Service Advice memorandum, it stated that this situation was distinguishable from General Dynamics. Specialists provided specific preauthorized medical services with the understanding that they would be reimbursed by the company. There was no reason for the specialists not to seek payment for their services. In this context, the submission of a claim merely verified that medical services had been provided, and it was the provision of services that established the fact of the company’s liability. Thus, the filing of the claim by a specialist was simply a ministerial act, not a condition precedent that was necessary to establish the company’s liability.

The Field Service Advice goes on to note that § 461(h)(2)(A) provides that if the taxpayer’s liability arises out of the providing of services or property to the taxpayer by another person, economic performance occurs as such person provides such services or property. Treas. Reg. § 1.461-4(d)(6)(i) provides that services or property provided to a taxpayer includes services or property provided to another person at the direction of the taxpayer. In this case, the company referred patients to outside specialists, and, under its contract with the HMO, was required to pay for the services that the specialists provided. Thus, the company’s liability arose out of providing medical services, and economic performance occurred as the specialists provided medical services. At the time the medical services were provided, the fact of the liability was established and economic performance occurred with respect to the liability.
Accordingly, under the Field Service Advice, where a claim is for payment in a context where processing the claim is merely ministerial, the fixing of the liability is not delayed until the claim is filed. This is in contrast to the General Dynamics situation in which the claim was essential for the employee to receive reimbursement. Once medical services have been preauthorized and services are provided, an accrual is appropriate if it can be verified that the company has made a reasonably accurate estimate of its liability. Therefore the IBNR accrual was deductible by the taxpayer in the Field Service Advice.

The Field Service Advice notes that in General Dynamics, the Court observed that 82.2% of the accrued reserve amount sought to be deducted was subsequently paid, and that this percentage was well within the reasonably accurate range accepted by the courts for the purpose of satisfying the all events test. The IBNR accrual must therefore be compared each year to the actual amount of claims that were paid for services rendered in the tax year of the IBNR accrual. If the two amounts are materially different, an amended tax return would most likely be required reflecting a reasonable deduction for IBNR.

While the Field Service Advice does not constitute a formal statement of IRS policy, it is nevertheless a welcome indication that non-insurance companies can accrue and deduct IBNR.