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INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

JUN 21 1999

Index (UIL) No.: 451.13-01
CASE MIS No.: TAM-102889-99
CC: DOI4: IT; A: BS

Taxpayer's Name:

Taxpayer's Address:

Taxpayer's Identification No:

Years Involved:

Date of Conference:

LEGEND:

State A =

X =

Y =

Year 1 =

Year 2 =

a =

b =

c =

d =

e =

f =

206

g =

h =

Date 1 =

ISSUE:

Whether Taxpayer is permitted to defer under Rev. Proc. 71-21, 1971-2 C.B. 549, the inclusion in gross income of annual payments due and received for services to be performed pursuant to an agreement which has a seven-year term?

CONCLUSION:

Taxpayer is not permitted to defer under Rev. Proc. 71-21 the inclusion in gross income of payments due and received for services to be performed pursuant to an agreement which has a seven-year term.

FACTS:

Taxpayer is an insurance agency whose business consists primarily of negotiating, placing, and servicing insurance coverage and administering a claims. The majority of Taxpayer's clients are b entities in State A. Taxpayer uses the accrual method of accounting and has a calendar year taxable year.

Taxpayer has performed the administration of a insurance claims for its clients for many years. Prior to year 1, all of Taxpayer's clients were self-insured for the majority of their a losses. In those years, Taxpayer administered its clients' self-insured claims for a fixed fee under the terms of service agreements between Taxpayer and its clients. These service agreements were typically 12 months in duration and required Taxpayer to handle all claims activity that occurred during the term, irrespective of when the claim originated. At the end of the term, either the agreement was renewed for a new fee and Taxpayer continued to process the claims, or the contract was not renewed and the claims handling duties were transferred to another claims administrator. While the billing and payment terms varied from client to client, Taxpayer accounted for such agreements for tax and financial accounting purposes by recording the billings in a deferred revenue account and including such amounts in income on a straight-line basis over each 12-month contract period.

In Year 1, State A deregulated a insurance, and insurance companies began quoting for 100% "no-deductible" coverage at rates substantially below the actuarially projected costs of self-insurance. As a result, many of Taxpayer's clients expressed

interest in purchasing annual policies from third-party insurance carriers, rather than remaining self-insured. In order to preserve its claims administration business, Taxpayer entered agreements with insurance carriers that were willing to "unbundle" the claims administration process to Taxpayer. Taxpayer entered into such agreements with X in Year 1 and with Y in Year 2. Under these arrangements, b entities purchased annual policies of no-deductible a insurance from insurance carriers, X or Y, and, instead of handling the claims administration themselves, X and Y contracted with Taxpayer to perform the processing of X and Y's clients' claims. The agreements entered by Taxpayer with X and with Y to provide claims administration services are referred to as "fully-insured contracts" and are the subject of this technical advice memorandum.

According to Taxpayer, individual a claims can vary in duration from a few days to the remaining lifetime of a c. The responsibility for paying and administering a claim is determined by the date of occurrence of the claim. If the d was insured on the date of the occurrence, the insurance company that was providing coverage on that date "owns" the claim and is responsible for the claim until it can be closed. Insurance carriers that contract out their claims processing are not familiar with the facts and circumstances of the claims, since the injured c is not their c , but have to rely on claims administration service providers such as Taxpayer. In addition, if they do not have claims administration resources in house, these carriers need some assurance that their chosen claims administrator will be available to process longer duration claims. Consequently, Taxpayer's fully-insured contracts with X and Y are written with the expectation that Taxpayer will provide claims administration services for a period of seven years, sufficient time for a majority of the claims arising during the policy period to be closed. These contracts specifically provide that Taxpayer shall process claims for benefits covered under the contract for a period of seven years or until closure of the claims, whichever comes first.

Taxpayer's fully-insured contracts with X and Y provide for two separate fees. One fee is paid to Taxpayer for the performance of "loss control services" and equals e% of earned premiums payable f% at policy inception and the remainder payable in g days after policy inception. Loss control services are any services intended to reduce the frequency and severity of claims arising under the policy in question. The accrual of fees attributable to loss control services has not been raised by the examining agent for purposes of this technical advice request, and no opinion is expressed or should be inferred with respect to those amounts.

The second fee paid to Taxpayer under its contracts with X and Y is for the performance of claims processing services. This fee, which is based on a fixed percentage of the premiums collected by X and Y for the policies covered by the contract, is paid to Taxpayer pursuant to a schedule set out in each contract.

Specifically, each contract provides for an annual payment at the inception of each of the seven policy years covered by the contract. Each annual payment is computed, in part, as a pre-determined percentage of the premiums earned by X and Y for the covered policies. The aggregate of the annual payments under a contract equals the agreed-upon compensation for Taxpayer's claims processing services for the seven-year contract term. The percentage of the premiums payable each year varies in accordance with the amount of services the Taxpayer expects to perform in each policy year.

In addition to the annual payment of a percentage of the policy premium, Taxpayer's contracts also require that X and Y pay an annual interest charge to Taxpayer at the inception of each policy year, beginning with the second year. This interest charge each year is calculated by applying an agreed upon fixed rate to the total claims processing fee to be paid by X and Y under their contracts, but that remains unpaid at the end of each policy year. According to Taxpayer, this charge is to compensate it for the benefit that accrues to the insurance carrier as a result of being permitted to pay for Taxpayer's services in annual installments instead of in the year that the entire policy premium is collected by the carrier.

Taxpayer's fully-insured contracts may be terminated by either party with h days notice. If the contract is terminated, Taxpayer is entitled to only the pro-rata fee based on the payment schedule set out in each contract. Any monies paid to Taxpayer in excess of the pro-rata fee shall be refunded to the carrier.

This technical advice memorandum involves the proper accrual in gross income of amounts received by Taxpayer from X and Y for the performance of claims processing services under the fully-insured contracts described above. These amounts were generally due to and received by Taxpayer on approximately July 1 of each calendar year. For tax and financial accounting purposes, Taxpayer recorded these amounts into a deferred revenue account when billed and included these amounts in income on a straight-line basis each month over a twelve-month period. Thus, Taxpayer deferred the inclusion in gross income of a portion of the claims processing fee until the taxable year following the year in which such amounts were due and received.

LAW AND ANALYSIS:

Section 451(a) provides that the amount of any item of gross income shall be included in gross income for the taxable year in which received by the taxpayer, unless under the method of accounting used in computing taxable income, such amount is properly accounted for in a different period.

Section 1.451-1(a) provides, in part, that under an accrual method of accounting, income is includible in gross income when all the events have occurred that fix the right to receive such income and the amount thereof can be determined with reasonable accuracy.

Rev. Proc. 71-21 provides a limited exception to these general rules. Rev. Proc. 71-21 implements an administrative decision made by the Commissioner in the exercise of his discretion under § 446 to allow accrual method taxpayers to defer income in certain specified and limited circumstances. See Section 1 of Rev. Proc. 71-21. Because, in many cases, financial accounting requires the deferral of advance payments for services until the year in which such services are performed, Rev. Proc. 71-21 was intended to reconcile tax and financial accounting treatment for qualifying payments without permitting extended deferral for the inclusion of such payments in gross income. See Section 2 of Rev. Proc. 71-21.

Rev. Proc. 71-21 provides that an accrual method taxpayer who, pursuant to an agreement, receives a payment in one taxable year for services, where all the services under such agreement are required by the agreement as it exists at the end of the taxable year of receipt to be performed by him before the end of the next succeeding taxable year, may include such payments in gross income as earned through the performance of the services, subject to certain limitations. Rev. Proc. 71-21 further provides, however, that any payment received by an accrual method taxpayer pursuant to an agreement for the performance by him of services must be included in his gross income in the taxable year of receipt if under the terms of the agreement as it exists at the end of such year (a) any portion of the services is to be performed by him after the end of the taxable year immediately succeeding the year of receipt; or (b) any portion of the services is to be performed by him at an unspecified future date which may be after the end of the taxable year immediately succeeding the year of receipt.

Section 3.09 of Rev. Proc. 71-21 provides that for purposes of this revenue procedure, the term "agreement" includes other agreements, written or otherwise, between the taxpayer and the person for whose benefit the performance under the first agreement is to be rendered if such other agreements provide for the rendition of substantially similar performance over a period of time that is substantially consecutive to that of the first agreement.

Taxpayer takes the position that it properly deferred income due and received under its fully-insured contracts with X and Y under Rev. Proc. 71-21. In particular, Taxpayer argues that, although its fully-insured contracts extend for a seven-year term, each annual payment made under its contracts relates solely to services to be performed during the one-year period immediately following the receipt or due date. Accordingly, Taxpayer asserts that its accrual of annual payments due and received

under its fully-insured contracts is consistent with the purpose of Rev. Proc. 71-21 to reconcile tax and financial accounting treatment without extended deferral of income. Alternatively, Taxpayer argues that it is not required to include the payments due and received under its fully-insured contracts in income under § 451 because it has no fixed right to the income until all the claims processing services are performed for the policy year. The examining agent, however, contends that Rev. Proc. 71-21 has no application to Taxpayer's fully-insured contracts because such contracts are for the provision of services over a seven-year term. Moreover, the examining agent asserts that, under § 451, payments required under these contracts must be included in Taxpayer's income in the taxable year in which such payments are due and received.

Based on our review of the facts, we believe that Rev. Proc. 71-21 does not permit Taxpayer to defer the inclusion in gross income of payments due and received under its fully-insured contracts with X and Y. As noted above, Rev. Proc. 71-21 provides a limited administrative exception to the general rules under § 451 for inclusion of amounts in gross income by accrual method taxpayers. Rev. Proc. 71-21 expressly applies only to payments received (or amounts due and payable) pursuant to an agreement wherein all the services under such agreement as it exists at the end of the taxable year are to be performed before the end of the next succeeding taxable year. See Section 3.02 of Rev. Proc. 71-21. That provision requires the completion of all of the services required under the agreement, and not merely the completion of the services that relate to any particular payment under the agreement. In contrast, Taxpayer's contracts clearly state that Taxpayer "shall process claims for benefits subject to this agreement for a period of seven years or until closure of claims, whichever comes first..." According to Taxpayer, these contracts are specifically written to provide multi-year terms so that the insurance carriers have some assurance that Taxpayer, as their claims administrator, will be available to process longer-duration claims about which they are more familiar. Therefore, the services to be performed under Taxpayer's contracts are often expected to extend well beyond the end of the next succeeding taxable year. Consequently, the advance payments received under these contracts do not qualify for deferral under the terms of Rev. Proc. 71-21.

Moreover, the fact that Taxpayer's contracts incorporate payment schedules allowing the claims processing fees to be paid by X and Y in annual installments does not change the character of each contract as one agreement to provide services for a seven-year term. This characterization is further supported by Taxpayer's assessment of an annual interest charge, beginning the second policy year, on the unpaid balance of the total claims administration fee due over the entire seven-year contract term. This interest charge further illustrates that each annual payment is part of one integrated contract requiring Taxpayer to perform claims processing services over a seven-year period.

Taxpayer also argues that each annual payment received under the fully-insured contracts should be viewed as an advance payment relating to a one-year contract wherein all of the services to be performed under that contract will be performed over a 12-month period before the end of the next succeeding taxable year. However, even if this were the case, Rev. Proc. 71-21 specifically addresses such situation. Section 3.09 of Rev. Proc. 71-21 provides that, for purpose of this revenue procedure, the term "agreement" includes other agreements, written or otherwise, between the taxpayer and the person for whose benefit the performance under the first agreement is to be rendered if such other agreements provide for the rendition of substantially similar performance over a period of time that is substantially consecutive to that of the first agreement. If Taxpayer's agreements were viewed as seven separate one-year agreements, each agreement would be with the same customer, for precisely the same services, and would extend over periods consecutive to the first agreement. Therefore, under Rev. Proc. 71-21, these agreements would be aggregated and treated as one agreement providing for the performance of services extending beyond the taxable year immediately succeeding the year payments are received. Accordingly, advance payments made pursuant to these agreements still would not qualify for deferral under Rev. Proc. 71-21.

As an alternative argument, Taxpayer takes the position that it is not required to include the annual payments required under its fully-insured contracts in income when such payments are due or received under § 451 because it has no fixed right to the income until all the claims processing services are performed for each policy year. In particular, Taxpayer states that its performance of claims administration services in the future constitutes a substantial contingency that prevents its right to income from being fixed until such services are actually performed.

We disagree with the Taxpayer's interpretation of § 451 and the regulations thereunder. Section 1.451-1(a) provides, in part, that under an accrual method of accounting, income is includible in gross income when all the events have occurred that fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. Both the courts and the Service have consistently held that, under this "all events test," the right to receive income becomes fixed when the required performance occurs, when payment is due, or when payment is made, whichever happens first. See Schlude v. Commissioner, 372 U.S. 128 (1963); Bell Federal Savings & Loan Ass'n & Subs. v. Commissioner, T.C. Memo. 1991-368, rev'd on other grounds, 40 F.3d 224 (7th Cir. 1994); Rev. Rul. 84-31,1984-1 C.B. 127; Rev. Rul. 83-106, 1983-2 C.B. 11; Rev. Rul. 81-176, 1981-2 C.B. 112; Rev. Rul. 80-308, 1980-2 C.B. 162; Rev. Rul. 79-266, 1979-2 C.B. 203; Rev. Rul. 79-195, 1979-1 C.B. 177. Thus, if an amount is received by or due to an accrual method taxpayer for services to be performed at a future date, then the taxpayer must include this amount in income for the taxable year in which it is received or due, whichever is earlier, regardless of when

such services are performed. In the present case, Taxpayer must include each annual payment received or due under its fully-insured contracts with X and Y in gross income in the taxable year that such payments are due or received, whichever is earlier.

In conclusion, based on the above analysis, Taxpayer is not permitted to defer under Rev. Proc. 71-21 the inclusion in gross income of payments due and received for services to be performed pursuant to an agreement which has a seven-year term. Rather, under § 451, Taxpayer must include these amounts in gross income in the taxable year in which such amounts are due or received, whichever is earlier.

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

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