



# TaxNewsFlash

## United States

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### **IRS Chief Counsel Advice: Treatment of reimbursements on high deductible policies under section 832**

The IRS publicly released a Chief Counsel Advice (CCA) memorandum that concludes that the uncollectible portion of a deductible layer reimbursement under a high deductible insurance policy is not a loss under section 832(b)(5), but may be a section 166 bad debt deductible under section 832(c)(10). CCA 201642034 (released October 14, 2016, and dated July 1, 2016)

Read [CCA 201642034](#) [PDF 80 KB]

#### **Issues**

The two issues that are addressed in the CCA are as follows:

- Is the taxpayer entitled to a loss incurred under section 832(b)(5) for uncollectible deductibles?
- Is the taxpayer entitled to a deduction under section 832(c)(10) for a bad debt within the scope of section 166 for uncollectible deductibles?

#### **Background**

The taxpayer, a nonlife insurance company, writes high deductible policies covering workers' compensation, automobile, and general liability. These policies are implemented through a base policy, with a high deductible endorsement and an accompanying negotiated security agreement.

State law requires an insurer providing workers' compensation or automobile liability coverage to pay claimants on a first-dollar basis without regard to any applicable deductibles that might apply. This requirement is imposed even if the insurer does not expect the insured to reimburse the deductible or the insured is insolvent or bankrupt. Accordingly, the base policy provides that the taxpayer will pay the full amount of all

claims on behalf of the insured, just as it would if the policy did not have any deductible.

The endorsement sets forth the amount and terms of the deductible and provides that the insured will reimburse the taxpayer for claims that the taxpayer pays that are within the deductible limit. The portion of claims for which the insured agrees to reimburse the taxpayer is referred to as the "deductible layer."

If the taxpayer is of the opinion that any portion of a deductible layer reimbursement recoverable has become uncollectible, the taxpayer establishes a "supplemental reserve" for the amount of the uncollectible reimbursement to reverse the reserve credit as required by SSAP 65 ¶ 35. The supplemental reserve only includes deductible layer amounts that relate to claims for which unpaid loss reserves have been established and are deemed uncollectible; it does not include amounts that are an actuarial estimate of deductible amounts that may be uncollectible in the future. When the unpaid loss reserve and supplemental reserve are combined, the taxpayer reports an appropriate level of reserves in compliance with SSAP 65 ¶ 35 on its annual statement.

When a claim is paid, the taxpayer releases the unpaid loss reserve and supplemental reserve attributable to the paid loss. The deductible layer amount is then reported as a receivable and, if uncollectible in whole or part, a bad debt, in which case the uncollectible deductible layer amount is reported as an uncollectible receivable.

## **CCA findings**

### **Issue 1**

The IRS found that because the taxpayer did not include the deductible layer amount in gross premiums written, Reg. section 1.832-4(a)(4)(i) prohibits the taxpayer from including the reimbursable deductible layer amount as a component of section 832(b)(5) losses incurred. If the taxpayer had included the reimbursable deductible in gross premiums, the taxpayer could have included the reimbursable deductible component of losses as losses incurred.

### **Issue 2**

For the uncollectible deductible layer reimbursement amount to be a debt within the scope of section 166, it must be a bona fide debt. A debt is bona fide if the taxpayer's contractual rights to reimbursement are a valid and enforceable obligation to pay a fixed or determinable sum of money under Reg. section 1.166-1(c). Here, prior to the taxpayer's payment of a claim, the taxpayer does not have an enforceable claim to reimbursement; hence, there is no debt from the insured to the taxpayer until the taxpayer's payment of the claim.

The debt would be deemed an enforceable obligation for purposes of Reg. section 1.166-1(c) if the income such debt represents had been included in the return of

income for the year for which the deduction was claimed or for a prior tax year. Here—consistent with the finding under Issue 1 (above) that the deductible layer amount was not included in gross premiums written—it does not appear that the taxpayer included the reimbursement in income for the year for which the deduction is claimed or for a prior tax year.

Once the taxpayer has paid the claim, the taxpayer has a contractual right to reimbursement that is a bona fide debt for purposes of section 166. If all or part of the debt is later determined to be worthless, the taxpayer may claim a full or partial deduction under Reg. section 1.166-2.

If the taxpayer had included both the reimbursable deductible in gross premiums and the reimbursable deductible component of losses as losses incurred, the taxpayer may not also claim a deduction for the bad debt.

### **Tax accounting for uncollectible deductible layer**

The proper accounting for the uncollectible deductible layer reimbursement, given that it was not included in gross premiums written, would be for the taxpayer to take a deduction under section 832(c)(10) (as an allowable section 166 deduction) at the time that the taxpayer's right to reimbursement is determined to be worthless (i.e., uncollectible) under Reg. section 1.166-2. The CCA provides the following example.

*Taxpayer has a loss incurred under section 832(b)(5) of \$100,000 and an obligation to disburse \$400,000. As Taxpayer pays the claims, it should recognize losses paid under section 832(b)(5) of \$100,000 and has a non-deductible disbursement of \$300,000 for which it has a nominal right of recovery, thus creating the bona fide debt of \$300,000. Because Taxpayer has determined consistent with Reg. section 1.166-2 that it is able to collect only \$250,000 of that debt, Taxpayer may claim a deduction under section 832(c)(10) (as an allowable section 166 deduction) for \$50,000.*

### **KPMG observation**

The conclusion of the CCA does fit within the IRS's regulations. However, the CCA fails to address how its conclusion conforms to Reg. section 1.832-4(a)(2)'s requirement of conformity with the annual statement. Similarly, the CCA does not detail the methodology underlying the calculation of the imputed premiums associated with the deductible layer.

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