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subject: **Application of Automatic Change Procedure for Unearned Premiums When A Blue Cross or Blue Shield Organization Changes Its Method of Accounting by Reason of Failing or Subsequently Meeting the Section 833(c)(5) MLR Requirement**

This memorandum responds to your request for assistance dated July 8, 2015. This memorandum may not be used or cited as precedent.

ISSUE

How is section 481(a) of the Internal Revenue Code applied to an insurance company that qualifies as an existing Blue Cross or Blue Shield organization under section 833(c)(1) ("organization") that changes its method of accounting for unearned premiums using the automatic change procedures described in Rev. Proc. 2015-13, 2015-5 I.R.B. 419, and Rev. Proc. 2015-14, 2015-5 I.R.B. 450, section 25.02 (Certain changes in methods of accounting for organizations to which section 833 applies), by reason of failing, or subsequently meeting, the section 833(c)(5) medical loss ratio (MLR) requirement?

CONCLUSION

When an organization requests automatic consent of the Commissioner to change its method of accounting for unearned premiums because it fails the section 833(c)(5) MLR requirement, or because it meets the section 833(c)(5) MLR requirement after failing

the requirement in a prior year, the organization must make a section 481(a) adjustment to prevent amounts from being duplicated or omitted. The organization's section 481(a) adjustment is equal to the (1) the unearned premiums at the end of the preceding taxable year calculated under the organization's old method of accounting minus (2) the unearned premiums at the end of the preceding taxable year calculated under the organization's new method of accounting. In general, the organization is required to take a negative section 481(a) adjustment into account in the year of change and to take a positive section 481(a) adjustment into account ratably over four years, beginning with the year of change. If the organization has a positive section 481(a) adjustment and in a subsequent taxable year the organization meets the section 833(c)(5) MLR requirement, the organization is required to accelerate the remaining balance, if any, of the positive section 481(a) adjustment in the subsequent taxable year in which the organization meets the section 833(c)(5) MLR requirement and changes its method of accounting for unearned premiums using the automatic change under section 25.02 of Rev. Proc. 2015-14.

LAW AND ANALYSIS

Taxation of Blue Cross and Blue Shield Organizations

Section 831(a) imposes a tax on nonlife insurance companies. A nonlife insurance company's taxable income includes premiums earned. Sections 832(b)(1), (3). Premiums earned are gross premiums written less return premiums and premiums paid for reinsurance, plus 80 percent of the company's unearned premiums on outstanding business at the end of the preceding taxable year, and less 80 percent of the company's unearned premiums on outstanding business at the end of the current taxable year. Section 832(b)(4).

Existing Blue Cross or Blue Shield organizations, and certain other qualifying health care organizations substitute 100 percent for 80 percent of the unearned premiums when calculating premiums earned under section 832(b)(4). Section 833(a)(3). An organization is not entitled to substitute 100 percent for 80 percent of the unearned premiums if the organization's MLR for the taxable year is less than 85 percent. Section 833(c)(5).

The section 833(c)(5) MLR requirement is an annual test; an organization may fail to meet the requirement in certain years and may meet the requirement in other years. As a result, an organization may qualify under section 833(a)(1) to calculate premiums earned using 100 percent of its unearned premiums in years when it meets the section 833(c)(5) MLR requirement, while in years when it fails the section 833(c)(5) MLR requirement, it must calculate premiums earned under section 832(b)(4) using 80 percent of its unearned premiums.

Change in Method of Accounting

Section 446(e) states that, except as otherwise provided, a taxpayer that changes a method of accounting on the basis of which it regularly computes income in keeping its books must secure consent before computing taxable income under a new method. To secure the Commissioner's consent to change its method of accounting, a taxpayer must file a Form 3115, Application for Change in Accounting Method, during the taxable year in which the taxpayer desires to make the proposed change. Section 1.446-1(e)(3)(i). Rev. Proc. 2015-13 and Rev. Proc. 2015-14 (or accounting method successors) provide the current procedures for automatic and non-automatic accounting method changes.

When a taxpayer changes its method of accounting, and when the taxpayer's taxable income is computed under a method of accounting that differs from the method of accounting used to compute taxable income for the preceding taxable year, section 481(a) requires the taxpayer to take into account those adjustments necessary to prevent amounts from being duplicated or omitted. The section 481(a) adjustment is equal to the cumulative difference between income or expense recognized under the present method of accounting and income or expense recognized under the proposed method of accounting. The section 481(a) adjustment may increase taxable income (positive section 481(a) adjustment) or decrease taxable income (negative section 481(a) adjustment). In general, the section 481(a) adjustment period is one taxable year (year of change) for a negative section 481(a) adjustment and four taxable years (year of change and next three taxable years) for a positive section 481(a) adjustment. See Rev. Proc. 2015-13, section 7.03. If the change in method of accounting is imposed by the Internal Revenue Service, a change resulting in a positive section 481(a) adjustment ordinarily will be made in the earliest taxable year under examination with a one-year section 481(a) adjustment period. Rev. Proc. 2015-13, section 2.09; Rev. Proc. 2002-18, 2002 C.B. 678, section 5.04(3).

Automatic Change Procedure for Unearned Premiums

Accounting for 100 percent of unearned premiums under section 833(a)(3) in one year, and 80 percent of unearned premiums under section 832(b)(4) in the next year (or vice versa) is a change in method of accounting. To prevent the duplication or omission of income, a section 481(a) adjustment is necessary. The amount of the section 481(a) adjustment is the difference between (1) the organization's unearned premiums at the end of the preceding taxable year that the organization used to calculate its taxable income for the year prior to the year of change and (2) the organization's unearned premiums at the end of the preceding taxable year calculated under the organization's new method of accounting.

Section 25.02 of Rev. Proc. 2015-14 provides an automatic method change for an organization that is required to change its method of accounting for unearned premiums by reason of failing the section 833(c)(5) MLR requirement, or by reason of meeting the section 833(c)(5) MLR requirement after failing to meet the requirement in a prior year. See also Notice 2011-4, 2011-2 I.R.B. 282. The standard section 481(a) adjustment

periods provided under section 7.03 of Rev. Proc. 2015-13 apply, with the exception that the section 481(a) adjustment period will be accelerated in the event that an organization with a remaining balance of a section 481(a) adjustment that arose by reason of a change in method of accounting described in section 25.02 of Rev. Proc. 2015-14 is required to effect another change in method of accounting method described in section 25.02. Rev. Proc. 2015-14, section 25.02(3). Thus, for example, an organization that fails the section 833(c)(5) MLR requirement and as a result has a positive section 481(a) adjustment is required to accelerate the remaining balance, if any, of that adjustment in a subsequent taxable year in which the organization meets the section 833(c)(5) MLR requirement.

EXAMPLES

The organization is an existing Blue Cross or Blue Shield organization under section 833(c)(1). The organization satisfies the applicable scope and eligibility requirements under sections 4 and 5 of Rev. Proc. 2015-13 and section 25.02 of Rev. Proc. 2015-14, and must therefore request to change its method of accounting for unearned premiums using the automatic change procedures. The eligibility rules under sections 5.01(1)(d) and (f) of Rev. Proc. 2015-13 do not apply to this change. Rev. Proc. 2015-14, section 25.02(2). In each of the examples, in every year in which there is a change in the organization’s eligibility for the increased deduction for unearned premiums under section 833(a)(3), the organization complies with all of the requirements to request to change its method of accounting for under section 25.02 of Rev. Proc. 2015-14.

Each of the examples below provides a table showing for each year whether the organization met the section 833(c)(5) MLR requirement, the unearned premiums at the end of the preceding taxable year, the unearned premiums at the end of the current taxable year, and the unearned premiums calculation the organization uses to compute federal income tax. In each of the examples, the organization ceases to engage in the business of issuing insurance contracts in Year 10 and ceases to be taxable under Part II of Subchapter L.

Example 1

The organization fails the section 833(c)(5) MLR requirement in Year 2 and does not meet the section 833(c)(5) MLR requirement again.

(a)	(b)	(c)	(d)	(e)	(f)	(g)
Year	MLR 833(c)(5) Requirement	Applicable Percentage 832(b)(4)(B) vs. 833(b)(3)	Unearned Premiums at End of Preceding Taxable Year	Unearned Premiums at End of Preceding Year Calculation (c) x (d)	Unearned Premiums at End of Current Taxable Year	Unearned Premiums at End of Current Taxable Year Calculation (c) x (f)
1	Meets	100%	---	---	$1,000	$1,000
2	Fails	80%	$1,000	$800	$1,500	$1,200
3	Fails	80%	$1,500	$1,200	$2,000	$1,600
4	Fails	80%	$2,000	$1,600	$2,500	$2,000
5	Fails	80%	$2,500	$2,000	$3,000	$2,400
6	Fails	80%	$3,000	$2,400	$3,500	$2,800
7	Fails	80%	$3,500	$2,800	$2,000	$1,600
8	Fails	80%	$2,000	$1,600	$1,500	$1,200
9	Fails	80%	$1,500	$1,200	$500	$400
10	Fails	80%	$500	$400	---	---
Lifetime Totals			$17,500	$14,000	$17,500	$14,200

The amount of the section 481(a) adjustment in Year 2, when the organization fails to meet the section 833(c)(5) MLR requirement, is a $200 increase in taxable income. This increase is (1) the organization's unearned premiums at the end of the preceding taxable year calculated under the organization's old method of accounting, $1,000, minus (2) the organization's unearned premiums at the end of the preceding taxable calculated under the organization's new method of accounting, $800. Because the section 481(a) adjustment is an increase in taxable income and because the organization does not make a subsequent change in this method of accounting in years 3, 4, or 5, the organization includes one fourth of the adjustment, $50, in its taxable income in each of Years 2, 3, 4, and 5.

Example 2

The organization fails the section 833(c)(5) MLR requirement in Year 2, but meets the section 833(c)(5) MLR requirement in all other years.

(a)	(b)	(c)	(d)	(e)	(f)	(g)
Year	MLR 833(c)(5) Requirement	Applicable Percentage 832(b)(4)(B) vs. 833(b)(3)	Unearned Premiums at End of Preceding Taxable Year	Unearned Premiums at End of Preceding Year Calculation (c) x (d)	Unearned Premiums at End of Current Taxable Year	Unearned Premiums at End of Current Taxable Year Calculation (c) x (f)
1	Meets	100%	---	---	$1,000	$1,000
2	Fails	80%	$1,000	$800	$1,500	$1,200
3	Meets	100%	$1,500	$1,500	$2,000	$2,000
4	Meets	100%	$2,000	$2,000	$2,500	$2,500
5	Meets	100%	$2,500	$2,500	$3,000	$3,000
6	Meets	100%	$3,000	$3,000	$3,500	$3,500
7	Meets	100%	$3,500	$3,500	$2,000	$2,000
8	Meets	100%	$2,000	$2,000	$1,500	$1,500
9	Meets	100%	$1,500	$1,500	$500	$500
10	Meets	100%	$500	$500	---	---
Lifetime Totals			$17,500	$17,300	$17,500	$17,200

The amount of the section 481(a) adjustment in Year 2, when the organization fails to meet the section 833(c)(5) MLR requirement, is a $200 increase in taxable income. This increase is (1) the organization's unearned premiums at the end of the preceding taxable year calculated under the organization's old method of accounting, $1,000, minus (2) the organization's unearned premiums at the end of the preceding taxable year calculated under the organization's new method of accounting, $800. Because the section 481(a) adjustment is an increase in taxable income, the organization includes one fourth of the adjustment, $50, in its taxable income in Year 2.

In Year 3, the organization meets the section 833(c)(5) MLR requirement and is once again eligible to take 100 percent of its unearned premiums into account when calculating its premiums earned. The amount of the section 481(a) adjustment is a $300 decrease in taxable income. This decrease is (1) the organization's unearned premiums at the end of the preceding taxable year calculated under the organization's old method of accounting, $1,200, minus (2) the organization's unearned premiums at the end of the preceding taxable year calculated under the organization's new method of accounting, $1,500. Because the section 481(a) adjustment is a decrease in taxable income, the organization deducts the full amount of the adjustment, $300, in Year 3. At the same time, the remaining amount of the organization's section 481(a) adjustment from Year 2, $150, is accelerated into income. As a result, the organization's taxable income is decreased by $150 (-$300 + $150) in Year 3.

Example 3

The organization meets the section 833(c)(5) MLR requirement in some years (Years 1, 2, 4, 7, 8, and 9), but fails the section 833(c)(5) MLR requirement in other years (Years 3, 5, 6, and 10).

(a)	(b)	(c)	(d)	(e)	(f)	(g)
Year	MLR 833(c)(5) Requirement	Applicable Percentage 832(b)(4)(B) vs. 833(b)(3)	Unearned Premiums at End of Preceding Taxable Year	Unearned Premiums at End of Preceding Year Calculation (c) x (d)	Unearned Premiums at End of Current Taxable Year	Unearned Premiums at End of Current Taxable Year Calculation (c) x (f)
1	Meets	100%	---	---	$1,000	$1,000
2	Meets	100%	$1,000	$1,000	$1,500	$1,500
3	Fails	80%	$1,500	$1,200	$2,000	$1,600
4	Meets	100%	$2,000	$2,000	$2,500	$2,500
5	Fails	80%	$2,500	$2,000	$3,000	$2,400
6	Fails	80%	$3,000	$2,400	$3,500	$2,800
7	Meets	100%	$3,500	$3,500	$2,000	$2,000
8	Meets	100%	$2,000	$2,000	$1,500	$1,500
9	Meets	100%	$1,500	$1,500	$500	$500
10	Fails	80%	$500	$400	---	---
Lifetime Totals			$17,500	$16,000	$17,500	$15,800

The amount of the section 481(a) adjustment in Year 3, when the organization fails to meet the section 833(c)(5) MLR requirement, is a $300 increase in taxable income. This increase is (1) the organization’s unearned premiums at the end of the preceding taxable year calculated under the organization’s old method of accounting, $1,500, minus (2) the organization’s unearned premiums at the end of the preceding taxable year calculated under the organization’s new method of accounting, $1,200. Because the section 481(a) adjustment is an increase in taxable income, the organization includes one fourth of the adjustment, $75, in its taxable income in Year 3.

In Year 4, the organization meets the section 833(c)(5) MLR requirement and is once again eligible to take 100 percent of its unearned premiums into account when calculating its premiums earned. The amount of the section 481(a) adjustment is a $400 decrease in taxable income. This decrease is (1) the organization’s unearned premiums at the end of the preceding taxable year calculated under the organization’s old method of accounting, $1,600, minus (2) the organization’s unearned premiums at the end of the preceding taxable year calculated under the organization’s new method of accounting, $2,000. Because the section 481(a) adjustment is a decrease in taxable income, the organization deducts the full amount of the adjustment, $400, in Year 4. At the same time, the remaining amount of the organization’s section 481(a) adjustment from Year 3, $225, is accelerated into income. As a result, the organization’s taxable income is decreased by $175 (-$400 + $225) in Year 4.

In Year 5, the organization once again fails the section 833(c)(5) MLR requirement. The section 481(a) adjustment is a $500 increase in taxable income. This increase is (1) the organization's unearned premium at the end of the preceding taxable year calculated under the organization's old method of accounting, $2,500, minus (2) the organization's unearned premiums at the end of the preceding taxable year calculated under the organization's new method of accounting, $2,000. Because the section 481(a) adjustment is an increase in taxable income, the organization includes one fourth of the adjustment, $125, in its taxable income in Year 5. In Year 6, the organization includes another one fourth of the adjustment, $125, in its taxable income.

In Year 7, the organization meets the section 833(c)(5) MLR requirement and is once again eligible to take 100 percent of its unearned premiums into account when calculating its premiums earned. The amount of the section 481(a) adjustment is a $700 decrease in taxable income. This decrease is (1) the organization's unearned premiums at the end of the preceding taxable year calculated under the organization's old method of accounting, $2,800, minus (2) the organization's unearned premiums at the end of the preceding taxable year calculated under the organization's new method of accounting, $3,500. Because the adjustment is a decrease in taxable income, the organization deducts the full amount of the adjustment, $700, in Year 7. At the same time, the remaining amount of the organization's section 481(a) adjustment from Year 5, $250, is accelerated into taxable income. As a result, the organization's taxable income is decreased by $450 (-$700 + $250) in Year 7.

In Year 10, the organization fails to meet the section 833(c)(5) MLR requirement. The section 481(a) adjustment is a $100 increase in taxable income. This increase is (1) the organization's unearned premiums at the end of the preceding taxable year calculated under the organization's old method of accounting, $500, minus (2) the organization's unearned premiums at the end of the preceding taxable year calculated under the organization's new method of accounting, $400. The amount is an increase in taxable income, but because Year 10 is the organization's final year in business, the entire amount of the adjustment is taken into account in Year 10.

Please call Rebecca Baxter at (202) 317-6995 if you have any further questions.

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