[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG-126633-12]

RIN 1545-BL05

Computation of, and Rules Relating to, Medical Loss Ratio

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations that provide guidance to Blue Cross and Blue Shield organizations, and certain other health care organizations, on computing and applying the medical loss ratio added to the Internal Revenue Code by the Patient Protection and Affordable Care Act. This document also contains a request for comments and provides notice of a public hearing on these proposed regulations.

DATES: Comments must be received by **[INSERT DATE 90 DAYS AFTER PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**. Requests to speak and outlines of topics to be discussed at the public hearing scheduled for Tuesday, September 17, 2013, at 10 a.m. must be received by **[INSERT DATE 90 DAYS AFTER PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**.

ADDRESSES: Send submissions to CC:PA:LPD:PR (REG-126633-12), Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of

8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG-126633-12), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, DC, or sent electronically via the Federal eRulemaking Portal at www.regulations.gov (IRS REG-126633-12). The public hearing will be held in the IRS Auditorium of the Internal Revenue Building, 1111 Constitution Avenue, N.W., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Graham R. Green, (202) 622-3970; concerning the submission of comments, the public hearing, and/or to be placed on the business access list to attend the hearing, Oluwafunmilayo Taylor, (202) 622-7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

Section 833 of the Internal Revenue Code (Code) provides that Blue Cross and Blue Shield organizations, and certain other health care organizations, are entitled to: (1) treatment as stock insurance companies; (2) a special deduction; and (3) computation of unearned premium reserves based on 100 percent, and not 80 percent, of unearned premiums under section 832(b)(4). This document contains proposed amendments to 26 CFR part 1 (Income Tax Regulations) under section 833(c)(5). Section 833(c)(5) was added to the Code by section 9016 of the Patient Protection and Affordable Care Act (Affordable Care Act), Public Law 111-148 (124 Stat. 119 (2010)), effective for taxable years beginning after December 31, 2009. Section 833(c)(5) provides that section 833 does not apply to any organization unless the organization's percentage of total premium revenue expended on reimbursement for clinical services provided to enrollees under its policies during such taxable year (as

reported under section 2718 of the Public Health Service Act), a ratio referred to for this purpose as the medical loss ratio (MLR), is not less than 85 percent.

Section 2718 of the Public Health Service Act (42 U.S.C. 300gg-18) (PHSA) was added by section 1001 and amended by section 10101 of the Affordable Care Act and was incorporated into the Code by section 9815(a)(1). Section 2718 of the PHSA is administered by the Department of Health and Human Services. Section 2718(a) of the PHSA requires a health insurance issuer to submit a report for each plan year to the Secretary of the Department of Health and Human Services concerning the percentage of total premium revenue, after accounting for collections or receipts for risk adjustment and risk corridors and payments of reinsurance, that the issuer expends: (1) on reimbursement for clinical services provided to enrollees under such coverage; (2) for activities that improve health care quality; and (3) on all other non-claims costs, excluding Federal and State taxes and licensing or regulatory fees.

Section 2718(b) of the PHSA requires that a health insurance issuer offering group or individual health insurance coverage, with respect to each plan year, provide an annual rebate to each enrollee under such coverage, on a pro rata basis, if the ratio of the amount of premium revenue the issuer expends on costs for reimbursement for clinical services provided to enrollees under such coverage and for activities that improve health care quality to the total amount of premium revenue (excluding Federal and State taxes and licensing or regulatory fees and after accounting for payments or receipts for risk adjustment, risk corridors, and reinsurance under sections 1341, 1342, and 1343 of the Affordable Care Act (42 U.S.C. 18061, 18062, and 18063)) for the plan year is less than a prescribed percentage. Section 2718(b)(1)(B)(ii) provides that

beginning on January 1, 2014, the medical loss ratio computed under section 2718(b) of the PHSA shall be based on expenses and premium revenues for each of the previous three years of the plan.

The Department of Health and Human Services issued interim final regulations on December 1, 2010, effective January 1, 2011, and December 7, 2011, effective January 3, 2012, that were subject to technical corrections on December 30, 2010, and May 16, 2012, and final regulations on December 7, 2011, effective January 3, 2012, May 16, 2012, effective June 15, 2012, and March 11, 2013, effective April 30, 2013 under section 2718 of the PHSA that are codified at 45 CFR part 158 (HHS Regulations). Relevant portions of these HHS Regulations are described in this preamble.

Prior Guidance

On November 23, 2010, the Treasury Department and the IRS issued Notice 2010-79 (2010-49 IRB 809), which provided interim guidance and transitional relief to organizations under section 833(c)(5). The interim guidance applied to an organization's first taxable year beginning after December 31, 2009.

The interim guidance provided that for purposes of determining whether an organization's percentage of total premium revenue expended on reimbursement for clinical services provided to enrollees was at least 85 percent (and thus satisfied the requirement of section 833(c)(5)), organizations were required to use the definition of "reimbursement for clinical services provided to enrollees" set forth in the HHS Regulations. In addition, the interim guidance provided that for purposes of determining whether the 85-percent requirement of section 833(c)(5) was satisfied, the IRS would

not challenge the inclusion of amounts expended for "activities that improve health care quality" as described in the HHS Regulations.

Notice 2010-79 also stated that the consequences for an organization with an MLR of less than 85 percent (an insufficient MLR) were as follows: (1) the organization would not be taxable as a stock insurance company by reason of section 833(a)(1) (but may have been taxable as an insurance company if it otherwise met the requirements of section 831(c)); (2) the organization would not be allowed the special deduction set forth in section 833(b); and (3) the organization would only take into account 80 percent, rather than 100 percent, of its unearned premiums for purposes of computing premiums earned on insurance contracts under section 832(b)(4). However, Notice 2010-79 provided that solely for the first taxable year beginning after December 31, 2009, the IRS would not treat an organization as losing its status as a stock insurance company by reason of section 833(c)(5) provided the following conditions were met: (1) the organization was described in section 833(c) in the immediately preceding taxable year; (2) the organization would have been taxed as a stock insurance company for the current taxable year but for the enactment of section 833(c)(5); and (3) the organization would have met the requirements of section 831(c) to be taxed as an insurance company for the current taxable year but for its activities in the administration, adjustment, or settlement of claims under cost-plus or administrative services-only contracts.

Notice 2010-79 further provided interim guidance on whether the application of section 833 in a taxable year followed by nonapplication of that provision in the

subsequent taxable year (or vice versa) could result in one or more changes in accounting method.

Notice 2010-79 invited comments on: (1) what further guidance, if any, was needed under section 833(c)(5); (2) whether specific guidance was needed on accounting method issues that would arise if an organization lost its status as an insurance company; (3) whether guidance would be needed in the future on the appropriate Subchapter L treatment of rebates that are paid under section 2718 of the PHSA; and (4) how guidance could coordinate the medical loss ratio computation under section 2718 of the PHSA with the computation of MLR under section 833(c)(5).

In Notice 2011-4 (2011-2 IRB 282) and Rev. Proc. 2011-14 (2011-4 IRB 330), the Treasury Department and the IRS provided procedures for an organization to obtain automatic consent to change its method of accounting for unearned premiums by reason of the application of section 833(c)(5).

On June 12, 2011, the Treasury Department and the IRS issued Notice 2011-51 (2011-27 IRB 36) extending the interim guidance and transitional relief provided in Notice 2010-79 to an organization's first taxable year beginning after December 31, 2010. On May 26, 2012, the Treasury Department and the IRS issued Notice 2012-37 (2012-24 IRB 1014) extending the interim guidance and transitional relief provided in Notice 2010-79 and Notice 2011-51, as clarified by Notice 2011-4 and Rev. Proc. 2011-14, through an organization's first taxable year beginning after December 31, 2012. Notice 2012-37 indicated that proposed regulations would be issued and requested comments on all aspects of section 833(c)(5), including how the proposed regulations

might account for the specific reporting required under section 2718 of the PHSA and coordinate the computations under section 2718 of the PHSA and section 833(c)(5).

The Treasury Department and the IRS received four comments in response to Notice 2010-79 and two comments in response to Notice 2012-37 and have considered all comments in drafting these proposed regulations. The comments are discussed in more detail in this preamble.

Explanation of Provisions

1. Determining the MLR

In describing the MLR computation under section 833(c)(5), the statute provides that the elements in the computation are to be "as reported under section 2718 of the Public Service Health Act." As more specifically discussed below, commenters argued that this cross reference indicates that the MLR computation under section 833(c)(5) should be the same as the medical loss ratio computation under section 2718(b) of the PHSA. The Treasury Department and IRS have concluded that this cross reference indicates that Congress intended that, to the extent consistent with the express language in section 833(c)(5), the meaning of terms and the methodology used in the MLR computation under section 833(c)(5) should be consistent with the definition of those same terms and the methodology under section 2718 of the PHSA.

a. MLR numerator

Commenters suggested that the term "reimbursement for clinical services provided to enrollees" in section 833(c)(5) has the same meaning as provided under section 2718 of the PHSA. Both section 833(c)(5) and section 2718 of the PHSA include "reimbursement for clinical services provided to enrollees" in the numerator.

Through the phrase “as reported under section 2718 of the Public Health Service Act,” section 833(c)(5) suggests that the meaning of “reimbursement for clinical services provided to enrollees” should be the same as the meaning of that phrase for section 2718 of the PHSA and the regulations issued under that section. Accordingly, the proposed regulations adopt this suggestion.

Commenters suggested that in addition to amounts expended for reimbursement for clinical services provided to enrollees, the MLR numerator include amounts expended for “activities that improve health care quality” as reported under section 2718 of the PHSA. The proposed regulations do not adopt this suggestion. Unlike the phrase “reimbursement for clinical services provided to enrollees” that appears in the description of the numerator in both section 833(c)(5) and section 2718 of the PHSA, “activities that improve health care quality” appears only in the description of the numerator in section 2718 of the PHSA; it does not appear in section 833(c)(5). Accordingly, the Treasury Department and IRS have concluded that the MLR numerator in section 833(c)(5) does not include costs for “activities that improve health care quality.”

b. MLR denominator

Commenters suggested that term total premium revenue in the MLR denominator under section 833(c)(5) should have the same exclusions as provided for under section 2718(b) of the PHSA. The proposed regulations adopt this suggestion. Section 833(c)(5) refers to total premium revenue in describing the denominator. Section 2718(b) of the PHSA, which sets forth the rules for computing medical loss ratio for that section, also refers to total premium revenue and lists specific exclusions that

should be taken from total premium revenue, including taxes and regulatory fees. These proposed regulations provide that the same exclusions that are permitted from total premium revenue under section 2718(b) of the PHSA are permitted exclusions from total premium revenue under section 833(c)(5) because, while these exclusions are not expressly included in the references to total premium revenue in section 833(c)(5) or section 2718(a) of the PHSA, both section 833(c)(5) and section 2718(b) of the PHSA use the term "total premium revenue." Under the HHS Regulations, these exclusions include assessments and fees imposed by the Affordable Care Act (see 45 CFR 158.221(c) and 158.240(c)). However, an organization's operating costs or any administrative costs associated with taxes or fees are not part of a State or Federal assessment and therefore may not be deducted from total premium revenue for purposes of the MLR calculation.

Accordingly, the proposed regulations provide that the term "total premium revenue" for purposes of section 833(c)(5) means the total amount of premium revenue (excluding Federal and State taxes and licensing or regulatory fees and after accounting for payments or receipts for risk adjustment, risk corridors, and reinsurance under sections 1341, 1342, and 1343 of the Affordable Care Act (42 U.S.C. 18061, 18062, and 18063)) as those terms are used for purposes of section 2718(b) of the PHSA and the regulations issued under that section.

c. Computation of MLR

For purposes of section 2718(b) of the PHSA, section 2718(b)(1)(B)(ii) of the PHSA and the HHS Regulations use a three-year period to compute the medical loss ratio, allowing certain limited adjustments after the end of the year to determine

expenses and premium revenue. (See 45 CFR 158.220(b) and 158.140.) Although section 2718(b) of the PHSA provides that the medical loss ratio is computed for each "plan year," the HHS Regulations interpret the term "plan year" as referring to the "MLR reporting year." The HHS regulations further define the MLR reporting year as the calendar year for medical loss ratio reporting and rebating purposes under section 2718(a) and (b) of the PHSA. (See 45 CFR 158.103.) Section 833(c)(5) refers to expenses and revenues for a taxable year, which is generally a calendar year for the organizations described in section 833(c). See section 843.

The Treasury Department and the IRS have concluded that, for administrative convenience and to be consistent with the medical loss ratio calculation under section 2718(b)(1)(B)(ii) of the PHSA, it is appropriate to compute the MLR for a taxable year under section 833(c)(5) using the same three-year period used under section 2718(b) of the PHSA. Therefore, beginning with the effective date of these regulations, amounts used for purposes of section 833(c)(5) (that is, total premium revenue and total premium revenue expended on reimbursement for clinical services provided to enrollees) for each taxable year should be determined based on amounts reported under section 2718(a) of the PHSA for that taxable year and the two preceding taxable years, subject to the same adjustments that apply for purposes of section 2718 of the PHSA. Comments are requested as to whether organizations should, instead of using the three-year period used for purposes of section 2718(b)(1)(B)(ii) of the PHSA, compute their expenses and total premium revenue only for the taxable year for which the computation is being made under section 833(c)(5), and whether adoption of the

proposed approach would create difficulties with respect to the computation of the MLR for the 2014 taxable year.

2. Nonapplication of Section 833 in Case of an Insufficient MLR

Commenters requested that the consequences of having an insufficient MLR under section 833(c)(5) be limited to losing certain benefits of section 833. Specifically, commenters posited that an organization that fails the MLR requirement under section 833(c)(5) should not lose its status as an insurance company under section 833(a)(1). Rather, the commenters argued that the organization should only suffer the loss of eligibility for the special deduction in section 833(b) and the less favorable computation of unearned premium reserves based on 80 percent, and not 100 percent, of its unearned premiums under section 832(b)(4).

The proposed regulations do not adopt this recommendation. Section 833(c)(5) provides that "this section [833]" shall not apply to any organization unless the organization satisfies the MLR requirement in section 833(c)(5). This language does not contemplate disallowance of some, but not all, of the benefits associated with treatment under section 833. Accordingly, the proposed regulations provide that for an organization described in section 833(c) that fails to satisfy the MLR requirement under section 833(c)(5): (1) the organization is not taxable as a stock insurance company by reason of section 833(a)(1), but may be taxable as an insurance company if it otherwise meets the requirements of section 831(c); (2) the organization is not allowed the special deduction set forth in section 833(b); and (3) if the organization qualifies as an insurance company under section 831(c), it must take into account 80 percent, rather than 100 percent, of its unearned premiums under section 832(b)(4) as it applies to

other non-life insurance companies.

The determination of whether an organization's MLR under section 833(c)(5) is at least 85 percent is made annually. Accordingly, an organization's MLR may be sufficient in one year, but not another. For this reason, the Treasury Department and the IRS have concluded that an organization described in section 833(c) that has an insufficient MLR under section 833(c)(5) will lose the benefits of section 833 only for the taxable year or years for which the organization's MLR is insufficient. If the same organization meets the MLR standard for a later taxable year, the organization would be entitled to claim the benefits of section 833 for that taxable year and subsequent taxable years for which its MLR is sufficient. Comments are requested on whether further guidance is needed for an organization that is described in section 833 for only some taxable years because of section 833(c)(5).

Commenters requested that the Treasury Department and the IRS establish a regime under which an organization that has failed to satisfy the MLR ratio by a de minimis amount would have an opportunity to pay an amount to the IRS to prevent loss of treatment under section 833. The proposed regulations do not adopt this suggestion. The Treasury Department and the IRS understand that the consequences under section 833(c)(5) may be severe if an organization's MLR is insufficient. However, the statutory framework does not contemplate a penalty or other payment to the IRS. The Treasury Department and the IRS request comments on whether there are other possible means consistent with the statute of mitigating these consequences.

3. Other Comments

Commenters requested that the Treasury Department and the IRS permit certain nondeductible fees and taxes imposed by the Affordable Care Act to be taken into account for purposes of calculating an organization's special deduction for items attributable to the health-related business of the organization under section 833(b). Commenters also submitted comments regarding the treatment of MLR rebates as return premiums under section 832(b)(4), and the income and employment tax consequences of MLR rebates. The proposed regulations do not address these issues because they are not within the scope of the proposed regulations.

Proposed Effective Date

These proposed regulations are proposed to apply to taxable years beginning after December 31, 2013.

Availability of IRS Documents

The IRS notices and revenue procedure cited in this preamble are published in the Internal Revenue Cumulative Bulletin and are available at http://www.irs.gov.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866, as supplemented by Executive Order 13563. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these proposed regulations and because the regulations do not impose an information collection on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, this notice of

proposed rulemaking has been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comments on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any comments that are submitted timely to the IRS as prescribed in this preamble under the "Addresses" heading. The Treasury Department and the IRS request comments on all aspects of the proposed rules. Comments are specifically requested on the relationship between section 833(c)(5) and section 2718 of the PHSA. All comments will be available at www.regulations.gov or upon request.

A public hearing has been scheduled for Tuesday, September 17, 2013, at 10 a.m., in the IRS Auditorium of the Internal Revenue Building, 1111 Constitution Avenue, N.W., Washington, DC. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance more than 30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit written (signed original and eight (8) copies) or electronic comments and an outline of the topics to be discussed and the time to be devoted to each topic by **[INSERT DATE 90 DAYS AFTER PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of

the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these regulations is Graham R. Green, Office of Associate Chief Counsel (Financial Institutions & Products). However, other personnel from the Treasury Department and the IRS participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendment to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.833-1 is added to read as follows:

§1.833-1 Medical loss ratio under section 833(c)(5).

(a) In general. Section 833 does not apply to an organization unless the organization's medical loss ratio (MLR) for a taxable year is at least 85 percent. Paragraph (b) of this section provides definitions that apply for purposes of section 833(c)(5) and this §1.833-1. Paragraph (c) of this section provides rules for computing an organization's MLR under section 833(c)(5). Paragraph (d) of this section addresses the treatment under section 833 of an organization that has an MLR of less than 85 percent. Paragraph (e) of this section provides the effective/applicability date.

(b) Definitions. The following definitions apply for purposes of section 833(c)(5) and §1.833-1.

(1) Reimbursement for clinical services provided to enrollees. The term reimbursement for clinical services provided to enrollees has the same meaning as that term has in 42 U.S.C. 300gg-18 and the regulations issued under that section (see 45 CFR 158.140).

(2) Total premium revenue. The term total premium revenue means the total amount of premium revenue (excluding Federal and State taxes and licensing or regulatory fees and after accounting for payments or receipts for risk adjustment, risk corridors, and reinsurance under sections 1341, 1342, and 1343 of the Patient Protection and Affordable Care Act, Public Law 111-148 (124 Stat. 119 (2010)) (42 U.S.C. 18061, 18062, and 18063)) as those terms are used for purposes of 42 U.S.C. 300gg-18(b) and the regulations issued under that section (see 45 CFR Part 158).

(c) Computation of MLR under section 833(c)(5)--(1) In general. An organization's MLR with respect to a taxable year is the ratio, expressed as a percentage, of the MLR numerator, as described in paragraph (c)(2) of this section, to the MLR denominator, as described in paragraph (c)(3) of this section.

(2) MLR numerator. The numerator of an organization's MLR is the total premium revenue expended on reimbursement for clinical services provided to enrollees under its policies for the taxable year, computed in the same manner as those expenses are computed for the plan year for purposes of 42 U.S.C. 300gg-18(b) and regulations issued under that section (see 45 CFR Part 158).

(3) MLR denominator. The denominator of an organization's MLR is the organization's total premium revenue for the taxable year, computed in the same manner as the total premium revenue is computed for the plan year for purposes of 42 U.S.C. 300gg-18(b) and regulations issued under that section (see 45 CFR Part 158).

(d) Failure to qualify under section 833(c)(5). If, for any taxable year, an organization's MLR is less than 85 percent, then beginning in that taxable year and for each subsequent taxable year for which the organization's MLR remains less than 85 percent, paragraphs (d)(1) through (d)(3) of this section apply.

(1) Automatic stock insurance company status. The organization is not taxable as a stock insurance company by reason of section 833(a)(1), but may be taxable as an insurance company if it otherwise meets the requirements of section 831(c);

(2) Special deduction. The organization is not allowed the special deduction set forth in section 833(b); and

(3) Premiums earned. The organization must take into account 80 percent, rather than 100 percent, of its unearned premiums under section 832(b)(4) as it applies to other non-life insurance companies, provided the organization qualifies as an insurance company by meeting the requirements of section 831(c).

(e) Effective/applicability date. This section applies to taxable years beginning after December 31, 2013.

Steven T. Miller

Deputy Commissioner for Services and Enforcement.

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