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DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Deborah A. Butler  
Assistant Chief Counsel (Field Service) CC:DOM:FS

SUBJECT: Special Deduction Under I.R.C. § 833(b)

This Field Service Advice responds to your memorandum dated July 29, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND

Taxpayer =  
Year 1 =  
Year 2 =  
Year 3 =

ISSUES

1. What expenses are intended to be included in the calculation of the "special deduction" allowed to Blue Cross and Blue Shield organizations under I.R.C. § 833(a)(2)?<sup>1</sup>
2. Whether Taxpayer has inappropriately included certain expenses in the calculation of the "special deduction" under section 833(a)(2).

CONCLUSIONS

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<sup>1/</sup> Section references are to the Internal Revenue Code of 1986, as amended and in effect during the taxable years at issue.

1. Section 833(b)(1)(A)(ii) provides that the expenses included in the calculation of the special deduction allowed by section 833(a)(2) are limited to expenses incurred during the taxable year in connection with: (1) the administration, adjustment, or settlement of claims; or (2) the administration of cost-plus contracts.
2. Additional factual development is needed to determine whether Taxpayer has mischaracterized certain solicitation or investment expenses as either claims adjustment or administrative expenses.

## FACTS

The facts as we understand them are as follows. During the Year 1, Year 2, and Year 3 taxable years, Taxpayer was an “existing Blue Cross or Blue Shield organization” within the meaning of section 833(c). As such, Taxpayer was entitled to a “special deduction” under section 833(a)(2).

In calculating the special deduction for each year, Taxpayer included in “expenses incurred,” as defined in section 833(b)(1)(A)(ii), the following expenses reported on its National Association of Insurance Commissioners (“NAIC”) annual statement: (1) “Total expenses incurred” for claims adjustment and administrative purposes, as reported on line 8, line 19, columns 2 and 3; and (2) “Reimbursements by uninsured accident and health plans” for claims adjustment and administrative purposes, as reported on page 8, line 17, columns 2 and 3.

For Year 3 only, Taxpayer reduced “expenses incurred” by “Real estate” income, as reported on page 9, line 4, column 8, net of “Depreciation on real estate,” as reported on page 9, line 12, column 7.

You have concluded that, for purposes of the special deduction, “expenses incurred” includes expenses related to the claims process, but does not include expense related to the solicitation of new insureds and the management of investments. Thus, you agree that Taxpayer appropriately excluded from “expenses incurred” amounts characterized on its annual statement as expenses and reimbursements for solicitation and investment purposes, as reported on page 8, lines 19 and 17, columns 2 and 3. However, you question whether Taxpayer erroneously allocated certain expenses to claims adjustment or administrative purposes rather than to solicitation or investment purposes. In this regard, you note that Taxpayer has included in claims adjustment or administrative expenses nearly all of its advertising, salary, equipment, and printing expenses.

## LAW AND ANALYSIS

Section 833(a)(1) treats Blue Cross and Blue Shield organizations as stock property and casualty insurance companies subject to part II of Subchapter L. Section 833(a)(2) allows a “special deduction” as determined under section 833(b).

Section 833(b)(1) provides that the special deduction for any taxable year is equal to the excess, if any, of (A) 25% of the sum of (i) the claims incurred during the taxable year and liabilities incurred during the taxable year under cost-plus contracts, and (ii) the expenses incurred during the taxable year in connection with the administration, adjustment, or settlement of claims or in connection with the administration of cost-plus contracts, over (B) the adjusted surplus as of the beginning of the taxable year.

Section 833(b)(2) limits the special deduction to taxable income for the taxable year, determined without regard to the special deduction. Section 833(b)(4) clarifies that the special deduction applies only to health-related business.

Section 833 was added to the Code by section 1012 of the Tax Reform Act of 1986 (“the 1986 Act.”) As originally enacted, and during the taxable years at issue, section 833(b)(1)(A) did not include specific rules for liabilities and expenses associated with cost-plus contracts.<sup>2/</sup> Subsequently, however, section 1012 of the 1986 Act was amended by section 1604 of the Taxpayer Relief Act of 1997, P.L. 105-34 (August 5, 1997) to clarify that liabilities incurred during the taxable year under cost-plus contracts are added to “claims incurred” under section 833(b)(1)(A)(i) and expenses incurred during the taxable year in connection with cost-plus contracts are added to “expenses incurred” under section 833(b)(1)(A)(ii). The cost-plus amendments are effective as if included in the 1986 Act and, therefore apply to the taxable years at issue. See H.R. Conf. Rep. No. 105-220, 105<sup>th</sup> Cong., 1<sup>st</sup> Sess. 766 (1997).

In this case, the Service must determine what Congress intended when it provided that a component of the special deduction is “expenses incurred during the taxable year in connection with the administration, adjustment, or settlement of claims or in connection with the administration of cost-plus contracts.” The Service must also determine whether Taxpayer’s characterization of claims adjustment and administrative expenses on page 8 of the annual statement is controlling for purposes of the special deduction calculation. No Treasury regulations have been issued under section 833, and there is no specific guidance or case law on point on these special deduction issues. Accordingly, they are issues of first impression that

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<sup>2/</sup> Cost-plus contracts differ from traditional insurance products in the manner in which they are financed. See TAM 9803003 for a discussion of characteristics common to cost-plus contracts.

are appropriate for technical advice. Therefore, we recommend that the Examination Division seek technical advice in this case.

### CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

We further recommend that the Examination Division request a presubmission conference prior to the submission of a request for technical advice. In preparation for the presubmission conference, we suggest that you pursue the following areas of factual development:

1. General Allocation Methodology -- It would be helpful to know how Taxpayer allocated its expenses on page 8 of its annual statement. In this regard, you should determine the methodology of Taxpayer's allocations to claims adjustment and administrative expenses (columns 2 and 3) versus soliciting and investment expenses (columns 4 and 5), e.g., by square footage of departments or by the nature of the expense.
2. Advertising Expense Allocation -- Of particular concern is the fact that Taxpayer is allocating nearly all of its advertising expenses as claims adjustment and administrative expenses rather than investment expenses. You should determine how much of Taxpayer's business is attributable to new business versus renewals. If possible, you should also develop facts to demonstrate what portion of Taxpayer's advertising is focused on new business, renewals, or both.

In this inquiry, we suggest that you look beyond Taxpayer's accounting records to determine how Taxpayer conducts its advertising activities. For example, television or magazine advertisements might suggest that the advertising is geared towards attracting new subscribers rather than renewals. Depending on their content and distribution, brochures might be focused on both new subscribers and renewals.

3. Claims Versus Cost-Plus Contracts -- Since "expenses incurred" for cost-plus contracts are limited to administrative expenses, it would be helpful to know what portion of Taxpayer's business relates to claims versus cost-plus contracts.

Please call if you have any further questions.

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