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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9651]

RIN 1545-BL05

Computation of, and Rules Relating to, Medical Loss Ratio

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations that provide guidance to Blue Cross and Blue Shield organizations, and certain other qualifying 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.

DATES: Effective Date: These regulations are effective on **[INSERT DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**.

Applicability Date: These regulations apply to taxable years beginning after December 31, 2013.

FOR FURTHER INFORMATION CONTACT: Graham R. Green, (202) 317-6995 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

**Background**

Section 833 of the Internal Revenue Code (Code) provides that Blue Cross and Blue Shield organizations, and certain other qualifying health care organizations, are

entitled to: (1) treatment as stock insurance companies; (2) a special deduction under section 833(b); and (3) computation of unearned premium reserves under section 832(b)(4) based on 100 percent, and not 80 percent, of unearned premiums. This document contains final 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 an organization unless the organization's medical loss ratio (MLR) for a taxable year is at least 85 percent. For purposes of section 833, an organization's MLR is its 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 (PHSA)).

The Treasury Department and the IRS issued proposed regulations under section 833(c)(5) on May 13, 2013 (78 FR 27873). The Treasury Department and the IRS received four written comments in response to the notice of proposed rulemaking and notice of public hearing. After consideration of all comments, these final regulations adopt the provisions of the proposed regulations with certain modifications, the most significant of which are highlighted in the Summary of Comments and Explanation of Revisions. All comments are available at [www.regulations.gov](http://www.regulations.gov) or upon request.

## Summary of Comments and Explanation of Revisions

### 1. Determining the MLR

The proposed regulations generally provided that an organization's MLR with respect to a taxable year is the ratio, expressed as a percentage, of the MLR numerator to the MLR denominator. The MLR numerator was defined as the organization's total premium revenue expended on reimbursement for clinical services provided to enrollees under its policies for the taxable year. The MLR denominator was defined as the organization's total premium revenue for the taxable year, after excluding Federal and State taxes and licensing or regulatory fees and after accounting for payments or receipts for risk adjustment, risk corridors, and reinsurance. The final regulations retain these definitions.

#### a. MLR numerator

The proposed regulations provided that the MLR numerator does not include amounts expended for "activities that improve health care quality." Two commenters requested that the MLR numerator include amounts expended for "activities that improve health care quality" as reported under section 2718 of the PHSA, arguing that Congress intended to include amounts expended for "activities that improve health care quality" in the MLR numerator. Two other commenters agreed with the proposed rule that amounts expended for "activities that improve health care quality" should not be included in the MLR numerator.

The final regulations retain the rule in the proposed regulations because the alternative is not supported by the statute. Section 2718 of the PHSA provides that the MLR numerator is based on both "reimbursement for clinical services provided to

enrollees” and “activities that improve health care quality.” By contrast, the express language of section 833(c)(5) provides that the MLR numerator is based on “reimbursement for clinical services provided to enrollees” without any reference to “activities that improve health care quality.” Accordingly, the final regulations provide that the MLR numerator in section 833(c)(5) does not include costs for “activities that improve health care quality.”

b. Computation of MLR

The proposed regulations provided that 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 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. In the preamble to the proposed regulations, the Treasury Department and the IRS requested comments 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 three-year approach would create difficulties with respect to the computation of the MLR for the 2014 taxable year.

Two commenters suggested that each organization described in section 833(c) be permitted a one-time, permanent election to compute its MLR over either the three-year period provided in the proposed regulations or over a one-year period based on

the taxable year. The commenters further suggested that if a three-year period is used, transition relief should be provided to phase in the three-year period.

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.” The Treasury Department and the IRS have concluded that this cross reference indicates that Congress intended that, to the extent consistent with the express language of 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. Section 2718(b)(1)(B)(ii) of the PHSA and the associated regulations issued by the Department of Health and Human Services 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.) Accordingly, the Treasury Department and the IRS have concluded that amounts used for purposes of section 833(c)(5) for each taxable year should be determined based on amounts reported under section 2718 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.

In light of the comments received, the Treasury Department and the IRS have concluded that transition rules to phase in the three-year period provided in these final regulations are appropriate. Accordingly, the final regulations provide that for the first taxable year beginning after December 31, 2013, an organization’s MLR will be computed on a one-year basis. Thus, for the first taxable year beginning after

December 31, 2013, an organization's MLR is computed based on its total premium revenue expended on reimbursement for clinical services provided to enrollees for its first taxable year beginning after December 31, 2013, and its total premium revenue for its first taxable year beginning after December 31, 2013.

For the first taxable year beginning after December 31, 2014, an organization's MLR will be computed on a two-year basis. Thus, for the first taxable year beginning after December 31, 2014, an organization's MLR is computed based on the sum of its total premium revenue expended on reimbursement for clinical services provided to enrollees for its first taxable year beginning after December 31, 2013, and for its first taxable year beginning after December 31, 2014, and the sum of its total premium revenue for its first taxable year beginning after December 31, 2013, and for its first taxable year beginning after December 31, 2014.

For the first taxable year beginning after December 31, 2015, and for all succeeding taxable years, the final regulations provide that the MLR is determined based on amounts reported under section 2718 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.

The final regulations do not adopt the commenters' suggestion to allow organizations to make an election between the three-year period provided in the proposed regulations or the one-year period based on the taxable year. The statutory framework does not contemplate an election or provide for more than one method for computing the MLR. Further, any election would be administratively burdensome for

the IRS.

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

The proposed regulations provided that the consequences of having an MLR of less than 85 percent (an insufficient MLR) are as follows: (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.

In response to the proposed regulations, two commenters requested that the consequences of having an insufficient MLR under section 833(c)(5) be limited to the loss of only some of the 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 be subject to the less favorable computation of unearned premium reserves based on 80 percent, rather than 100 percent, of its unearned premiums under section 832(b)(4). Another commenter agreed with the proposed rule that the consequences of having an insufficient MLR under section 833(c)(5) include the loss of automatic stock insurance company status under section 833(a)(1).

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. Because the benefit of automatic stock insurance company status is provided to section 833(c) organizations in section 833(a)(1), this benefit is lost upon a failure to satisfy the MLR under section 833(c)(5). Accordingly, the Treasury Department and the IRS have concluded 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.

In the proposed regulations, the Treasury Department and the IRS declined to adopt a proposal to allow an organization that would have otherwise failed to satisfy the MLR by a de minimis amount to pay an amount to the IRS to retain eligibility for the benefits of section 833 because the statutory framework does not contemplate a penalty or other payment to the IRS. The Treasury Department and the IRS requested comments on whether there are other possible means consistent with the statute of mitigating the consequences of having an insufficient MLR.



In response to the proposed regulations, two commenters requested that, in limited circumstances, an organization with an insufficient MLR be permitted to rebate premiums to one of the following to satisfy the section 833(c)(5) MLR requirement: (1) the Secretary of Health and Human Services; (2) policyholders; (3) a State Comprehensive Health Insurance Plan or other health related program, foundation, or guarantee fund association; or (4) a risk adjustment, reinsurance, or risk corridor program under the Affordable Care Act. Another commenter suggested that allowing any rebating of premiums to comply with section 833(c)(5) would fail to address consumers' needs for affordable coverage at the time of purchase. The Treasury Department and the IRS continue to consider whether, and, if so, how to permit organizations to address de minimis failures to satisfy the MLR under section 833(c)(5).

### 3. No Material Change

Commenters requested clarification that an organization's loss of eligibility for treatment under section 833 by reason of section 833(c)(5) will not be treated as a material change in the operations of such organization or in its structure for purposes of section 833(c)(2)(C). Section 833(c) restricts the application of section 833 to any existing Blue Cross or Blue Shield organization, and any other qualifying organization meeting the requirements of section 833(c)(3). Section 833(c)(2)(C) defines the term "existing Blue Cross or Blue Shield organization" to mean any Blue Cross or Blue Shield organization if such organization was in existence on August 16, 1986, such organization was determined to be exempt from tax for its last taxable year beginning before January 1, 1987, and no material change has occurred in the operations of such

organization or in its structure after August 16, 1986, and before the close of its current taxable year.

The final regulations adopt this suggestion. Consistent with the annual determination of whether an organization's MLR under section 833(c)(5) is at least 85 percent, which allows eligibility for treatment under section 833 to be recovered if lost by reason of section 833(c)(5), the Treasury Department and the IRS have concluded that a change in an organization's eligibility for treatment under section 833 solely by reason of section 833(c)(5) will not be treated as a material change in the operations of such organization or in its structure for purposes of section 833(c)(2)(C).

#### 4. Accounting for Unearned Premiums

In Notice 2011-4 (2011-2 IRB 282 (December 29, 2010)) and Rev. Proc. 2011-14 (2011-4 IRB 330 (January 11, 2011)) (both of which are available at [www.irs.gov](http://www.irs.gov)), the Treasury Department and the IRS provided procedures for an organization to obtain automatic consent to change its method of accounting for unearned premiums because of the application of section 833(c)(5). Two commenters raised questions about the continued application of Notice 2011-4. The guidance provided in Notice 2011-4 and Rev. Proc. 2011-14 continues to apply in its current form and is not superseded by these final regulations. See §601.601(d)(2)(ii)(b).

#### **Applicability Date**

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

#### **Special Analyses**

It has been determined that this Treasury decision 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 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, the proposed regulations preceding these regulations were submitted to the Chief Counsel for Advocacy of the Small Business Administration for comments on its impact on small business. No comments were received.

### **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.

### **Adoption of Amendments to the Regulations**

Accordingly, 26 CFR part 1 is 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 section. 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 this section.

(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 section 300gg-18 of title 42, United States Code 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. sections 18061, 18062, and 18063)) as those terms are used for purposes of section 300gg-18(b) of title 42, United States Code and the regulations issued under that section (see 45 CFR Part 158).

(c) Computation of MLR under section 833(c)(5)--(1) In general. Starting with the first taxable year beginning after December 31, 2015, and for all succeeding taxable years, 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)(1)(i) of this section, to the MLR denominator, as described in paragraph (c)(1)(ii) of this section.

(i) 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 using a three-year period in the same manner as those expenses are computed for the plan year for purposes of section 300gg-18(b) of title 42, United States Code and regulations issued under that section (see 45 CFR Part 158).

(ii) MLR denominator. The denominator of an organization's MLR is the organization's total premium revenue for the taxable year, computed using a three-year period in the same manner as the total premium revenue is computed for the plan year for purposes of section 300gg-18(b) of title 42, United States Code and regulations issued under that section (see 45 CFR Part 158).

(2) Transition rules. The transition rules in paragraphs (c)(2)(i) and (c)(2)(ii) of this section apply solely for the first taxable year beginning after December 31, 2013, and the first taxable year beginning after December 31, 2014.

(i) First taxable year beginning after December 31, 2013. For the first taxable year beginning after December 31, 2013, 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 first taxable year beginning after December 31, 2013, and the denominator of an organization's MLR is the organization's total premium revenue for the first taxable year beginning after December 31, 2013.

(ii) First taxable year beginning after December 31, 2014. For the first taxable year beginning after December 31, 2014, the numerator of an organization's MLR is the sum of the total premium revenue expended on reimbursement for clinical services provided to enrollees under its policies for the first taxable year beginning after December 31, 2013, and for the first taxable year beginning after December 31, 2014, and the denominator of an organization's MLR is the sum of the organization's total premium revenue for the first taxable year beginning after December 31, 2013, and for the first taxable year beginning after December 31, 2014.

(d) Failure to qualify under section 833(c)(5)--(1) In general. 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)(i) through (d)(1)(iii) of this section apply.

(i) 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);

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

(iii) 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).

(2) No material change. An organization's loss of eligibility for treatment under section 833 solely by reason of section 833(c)(5) will not be treated as a material

change in the operations of such organization or in its structure for purposes of section 833(c)(2)(C).

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

John Dalrymple  
Deputy Commissioner for Services and Enforcement.

Approved: January 2, 2014

Mark J. Mazur  
Assistant Secretary of the Treasury (Tax Policy).

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