INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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Director
LMSB:RFPH

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Year(s) Involved:
Date of Conference:

LEGEND:

Taxpayer =

Year 1 =

Year 2 =

b=

c =

d =

e =

f =

$a =

Year 3 =

g =

h =

i =

j =

k =

l =

ISSUES:

1) Whether an accrual basis taxpayer may exclude “contractual allowances” from total receivables in determining gross income under § 451 of the Internal Revenue Code.

2) If so, what amount may be properly taken into account as “contractual allowances”?

3) Whether an accrual basis taxpayer may use estimates to determine the amount of “contractual allowances” which may be taken into account in determining gross income.

4) Whether the Taxpayer, under the facts of this case, may use estimates to determine the amount of “contractual allowances” taken into account in determining gross income assuming the Taxpayer has sufficient information available at the close of the taxable year to determine the exact amount of “contractual allowances.”

CONCLUSIONS:

1) An accrual basis taxpayer generally may exclude “contractual allowances” from total receivables in determining gross income if there exists, at the time a service is performed or a good is provided, a legally enforceable contract that provides that the payor incurs a liability for any particular service/good in an amount that is less than the standard billed charge for the same service/good. Where no such contract exists at the time the service is performed or the good provided, however, no exclusion for a “contractual allowance” is warranted.

2) The amount which may be properly taken into account as a “contractual allowance” consists solely of the difference between the amount that is billed for a service/good and the amount which the taxpayer may legally collect from the responsible payor under the terms of a legally enforceable contract in existence at the time the service is performed or good is provided.

3) An accrual basis taxpayer may use estimates to determine the amount of “contractual allowances” to the extent the use of estimates results in gross income determined with “reasonable accuracy” under § 451 of the Code. In all cases where estimates are properly used, and the “exact” amount is subsequently determined, the difference, if any, shall be taken into account for the taxable year in which such determination is made.

4) The Taxpayer may use estimates to determine the amount of “contractual allowances” to the extent the use of estimates results in gross income determined with “reasonable accuracy” under § 451 of the Code. Whether the Taxpayer’s particular methods of estimating the amount of “contractual allowances” meet the “reasonable accuracy” standard is a question of fact to be determined by the field. The Taxpayer must show that its estimates are reasonably accurate.

FACTS:

During Year 1 and Year 2, the Taxpayer, through its subsidiaries and its affiliates, operated approximately b to c and other medical facilities. The Taxpayer’s medical facilities had approximately d million active patient accounts at the end of Year 1 and Year 2. The Taxpayer’s primary source of revenue is remuneration for the provision of medical “services” to patients at the medical facilities. The term “services” includes the provision of medical devices, prescription drugs, and other items that are necessary to provide proper medical treatment to each patient. The Taxpayer receives payment for its medical services from the government, third-party payors (i.e., managed care payors), and patients.

As a patient is treated in the Taxpayer’s medical facilities, the Taxpayer records locally determined standard charges (e.g., a standard per diem charge for the) in its books for the medical services provided. These standard charges are determined by each medical facility and change over time, typically on an annual basis. The Taxpayer’s medical facilities are not owed, or entitled to receive, the recorded standard charges except with respect to certain self-pay patient accounts, which happens infrequently.

Each medical facility has managed care contracts with third-party payors who insure patients. These contracts incorporate one or more insurance plans ("I-Plans"). These contracts are typically negotiated between each medical facility and the third-party payors; in some cases, the contracts are negotiated on behalf of the Taxpayer's medical facilities on a regional basis rather than by each individual medical facility. The Taxpayer's medical facilities, in the aggregate, have more than e managed care contracts, and these contracts incorporate approximately f I-plans. Managed care contracts are typically renegotiated every g to h years.

These managed care contracts and I-plans establish the reimbursement terms that govern the amount a particular medical facility is owed and is entitled to receive for covered medical services. Each managed care contract/I-plan contains distinct reimbursement rates and formulas. For example, certain medical services may be reimbursed on a case rate basis (e.g., a flat rate reimbursement for all cardiac-related services provided during the patient's stay), others on a per diem basis, a Diagnostic Related Group (DRG) basis, a cost-plus basis, or a combination of these and other reimbursement methodologies. In addition, other managed care contact/I-plan terms, such as stop-loss provisions (i.e., provisions that change the method of reimbursement if gross charges for a particular service exceed a threshold amount), may determine the reimbursement for services rendered to particular patients.

After providing medical services to patients, the Taxpayer's medical facilities submit bills to third-party payors and patients (typically within i - j days after a patient is discharged from a medical facility) that reflect standard charges. For third-party payors, the Taxpayer uses an industry-wide billing format (FORM) that summarizes the standard charges associated with the medical services provided to the patient. The Form does not detail each medical service provided. The Taxpayer's patient accounting system maintains this information for each patient and can prepare a more detailed listing of standard charges, which can be provided to a patient upon request.

The difference between the standard charges and the amounts that the Taxpayer's medical facilities are owed, and entitled to receive, is referred to as a "contractual allowance." Standard charges are reported net of contractual allowances (as computed by the Taxpayer) in the Taxpayer's revenues and accounts receivable. This contractual allowance does not constitute bad debt because the taxpayer is not entitled to receive the standard charge. The Taxpayer's accounting for bad debt adjustments is included in its computation of uncollectible amounts.

The Taxpayer reported "net patient service revenue" as "gross receipts" on line 1 of its tax returns for Year 1 and Year 2, consistent with its financial statement reporting, except for the following two adjustments: (i) a Schedule M-1 adjustment of $a million in Year 1 that related to a Schedule M-1 adjustment posted in Year 3, and (ii) exclusions under § 448(d)(5) of the Code.

At the time of billing, the Taxpayer has in its possession the following information: (a) the identity of the patient; (b) any I-plan information, whether or not correct, provided by the patient; (c) the nature of the medical services provided to the patient; (d) the standard charges then associated with the medical services provided, and (e) the terms of any managed care contract then in effect between the medical facility and the third-party payor and the historical payment experience, if any, with such third-party payor with respect to a particular I-plan.

The Taxpayer's medical facilities use computer programs to compute contractual allowances at the time of billing for governmental receivables and approximately k to l percent of managed care revenue. The medical facilities use these computer programs in determining the expected payment due from a third-party payor for medical services provided to a particular patient by applying the reimbursement terms of the relevant I-plan. This process is referred to as "modeling." Managed care contractual allowances determined through modeling are reported in the patient accounts receivable at the time of billing.

The Taxpayer's methodology for computing contractual allowances for accounts that are not modeled (non-modeled accounts) involves the use of estimates, but the facts concerning the Taxpayer's exact methodology in determining and using the estimates is in dispute between the field and the Taxpayer. According to the field, the Taxpayer utilizes a general method of accounting for determining contractual allowances for non-modeled accounts as well as various "specific accounting techniques." Specific accounting techniques range from "unsupported opinion to application of historical collection percentages to monthly averaging, and include items other than contractual allowances, such as contingencies and collection issues." According to the Taxpayer, however, contractual allowances are determined using a " ( ) process (or substantially similar process) at each month end. Generally, under the process, "large" balance patient accounts are analyzed on an account-by-account basis, and "small" balance patient accounts are analyzed by comparing historic and modeled contractual allowance percentages. For small patient accounts, the modeled percentage is used as the most appropriate determinant, but significant variances among the historic and modeled percentages are taken into account. An additional facility-level adjustment referred to as a " accrual" is sometimes necessary at month end under the process, to adjust for items such as routine administrative adjustments to patient accounts (e.g., waivers of deductibles).

The field agrees conceptually with the manner in which the Taxpayer accounts for contractual allowances for patient accounts that are modeled. Nether the propriety of utilizing modeling to determine a contractual allowance nor the manner in which the Taxpayer utilized modeling during the relevant period (including the amounts reported by the Taxpayer on the respective tax return net of contractual allowances determined thorough the modeling process) are the subject of this TAM request. The field disagrees, however, with the Taxpayer's use of estimates to determine contractual allowances for certain non-modeled accounts.

LAW AND ANALYSIS:

Section 451 of the Code provides rules for determining the taxable year of inclusion for items of gross income. Section 1.451-1(a) of the Income Tax Regulations provides that under an accrual method of accounting, income is includible in gross income in the taxable year in which the "all events" test is met. The two-prong all events test is met when (1) all the events have occurred that fix the right to receive the income and (2) the amount thereof can be determined with reasonable accuracy. Under the first prong of the all events test, a fixed right to receive income occurs when (1) the required performance occurs, (2) payment is due, or (3) payment is made, whichever happens first. See Rev. Rul. 74-607, 1974-2 C.B. 149. When an amount of income is properly accrued on the basis of a reasonable estimate and the exact amount is subsequently determined, the difference, if any, shall be taken into account for the taxable year in which such determination is made.

In this case, the field is challenging the Taxpayer's interpretation of the second prong of the all events test but not the first prong. Thus, the field and the Taxpayer agree that under the first prong, the fixed right to receive income occurs in the taxable year in which the medical services are performed or goods are provided.

Under the second prong, the field and the Taxpayer disagree on what standard is appropriate in determining the amount of contractual allowances, and thus, income with reasonable accuracy. While the field and the Taxpayer agree conceptually that contractual allowances may be excluded from total receivables in determining gross income to the extent the rights to such contractual allowances are set forth under the terms of legally enforceable contracts, the field and the Taxpayer disagree on whether the *amount* of the contractual allowance can be determined using estimates or must be determined utilizing the actual contractual information available at the end of each taxable year. Specifically, the field argues that the Taxpayer has on hand by the end of each taxable year all the contractual information necessary to determine the exact amount of a contractual allowance on a contract by contract basis. Thus, the field believes the Taxpayer must use this contractual information rather than estimates to determine contractual allowances in order to meet the reasonable accuracy standard.

In contrast, the Taxpayer argues that the degree of accuracy necessary to constitute reasonable accuracy does not require taxpayers to measure income with precision. Thus, the Taxpayer argues that even when all information is available from which to make a precise determination if there were unlimited time and resources, the courts and the Service have taken into account the burden, cost and complexity of precision in evaluating the reasonableness of a taxpayer's approach, and have not always required a precise determination.

Neither the Code nor the regulations under §§ 451 or 461 define the term "reasonable accuracy."[1] However, courts have addressed the degree of accuracy required to meet the reasonable accuracy prong, and have acknowledged that absolute precision is not necessary and the use of estimates is sometimes appropriate if the estimate is made on the basis of facts and procedures available to the taxpayer at the end of the taxable year. See George K. Herman Chevrolet, Inc. v. Commissioner, 39 T.C. 846, 850 (1963) ("[w]hile the word 'accuracy' means exactness or precision, when used with 'reasonable' it implies something less than an exact or completely accurate amount"); Kaiser Steel Corp. v. United States, 717 F.2d 1304, 1308 (9th Cir. 1983) (in rejecting the argument that the reasonable accuracy prong does not permit the deduction of estimates, the court stated the standard is "reasonable accuracy" rather than "fixed, definite and determinable by objective facts"). Further, where the use of estimates is appropriate, reasonable accuracy can be determined on an aggregate basis rather than on a case by case basis. See Kaiser Steel at 1309-10; General Dynamics Corp. v. United States, 773 F.2d 1224, 1226 (Fed. Cir. 1985) (court affirmed trial court's holding that there was no need for actual ascertainment of the amount of liability on an employee by employee basis where a canvass of 56,000 employees was theoretically possible, but would have been prohibitively expensive and overly burdensome), rev'd on other grounds, 481 U.S. 239, 242 n.2 (1987). In one situation, however, the Service held a taxpayer's use of estimates was not sufficient to meet the reasonable accuracy standard and required the use of actual information available to determine the exact amount of income. See Rev. Rul. 81-176, 1981-2 C.B. 112 (where the exact amount of refund or additional payment due the taxpayer may be determined with reasonable accuracy at the end of the taxable year because the taxpayer then has all the information necessary to "readily calculate" the exact amount of its compensation under the contract, taxpayer is not entitled to make the determination using estimates). Whether a taxpayer's method of estimating contractual allowances meets the reasonable accuracy standard is a question of fact. See Crescent Wharf & Warehouse Co. v. Commissioner, 518 F.2d 772, 775 (9th Cir. 1975) ("[w]hether the amount of liability can be 'determined with reasonable accuracy' is a question which must be resolved by the trial court upon evidence presented there").

Accordingly, as a general rule, accrual basis taxpayers may use estimates to determine the amount of contractual allowances to be excluded in determining gross income to the extent the use of estimates results in gross income determined with reasonable

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[1] Although this case involves the accrual of income under § 451, the all-events test for determining the accrual of deductions under § 461 also requires that the amount of the liability be determined with reasonable accuracy. See § 1.461-1(a)(2)(i). The Service has acknowledged that the last event necessary to establish the fact of liability under the all-events test of § 1.461-1(a)(2)(i) is the same event that fixes the right to receive income under the all-events test of § 1.451-1(a). Rev. Rul. 98-39, 1998-2 C.B. 198. Accordingly, interpretations of the reasonable accuracy prong of the all-events test of § 1.461-1(a)(2)(i) are applicable in analyzing the reasonable accuracy prong of the all-events test of § 1.451-1(a).

accuracy. In this case, the use of estimates may be appropriate. Whether the Taxpayer's particular methods of estimating the amount of contractual allowances meets the reasonable accuracy standard is a question of fact to be determined by the field. In order to use estimates, the Taxpayer must show that its methods of estimating are reasonable and properly reflect actual experience. If the Taxpayer fails to do this, the field may deny the Taxpayer's methods of estimating the amount of contractual allowances unless the Taxpayer adopts a more reasonable method of estimating that is based on actual experience.

CAVEAT(S):

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.