

Casualty Actuarial Society Casualty Loss Reserve Seminar

Federal Income Tax Issues

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Circular 230

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Agenda

- Unpaid Losses
 - Determination of Amount of Unpaid Losses for Tax Purposes
 - What's Includible in Unpaid Losses for Tax Purposes?
 - Extra-Contractual Damages
 - OPEB -- Other Post-Retirement Benefits
- Tax Definition of Insurance/Reinsurance
- Developments Relating to Reinsurance

Section 832(b)(5)

- A deduction is allowed for “losses incurred” including “discounted unpaid losses” as defined in I.R.C. section 846
- “Undiscounted unpaid losses” means “...the unpaid losses shown in the annual statement filed by the taxpayer...” (section 846(b)(1))
- Unpaid losses includes ULAE

Treas. Regs. Sec. 1.832-4

- **(a)(14)** In computing “losses incurred” the determination of unpaid losses at the close of each year must represent actual unpaid losses as nearly as it is possible to ascertain them.
- **(b) Losses incurred.** Every insurance company to which this section applies must be prepared to establish to the satisfaction of the district director that the part of the deduction for “losses incurred” which represents unpaid losses at the close of the taxable year comprises only actual unpaid losses... These losses must be stated in amounts which, based upon the facts in each case and the company's experience with similar cases, represent a fair and reasonable estimate of the amount the company will be required to pay. Amounts included in, or added to, the estimates of unpaid losses which, in the opinion of the district director, are in excess of a fair and reasonable estimate will be disallowed as a deduction...

Case Law

- *Utah Medical Ins. Assn. v. Comm.*, TC Memo 1998-458
- *Minnesota Lawyers Mutual Ins. Co. v. Comm.*, TC Memo 2000-23, affirmed, 285 F.3d 1086 (8th Cir. 2002)
- *Physicians Ins. Co. of Wisconsin v. Comm.*, TC Memo 2001-304

Summary of Decisions

- Importance of use of recognized actuarial methodologies
- Reserves are reasonable if within the actuarial range, even if at the high end of the range
- “Margin” or “adverse development” reserves not allowed if based on arbitrary formulas or percentage
- Estimate need only be “fair and reasonable” not “best”
- Court in each case allowed deduction for highest reserve amount certified by an actuary

TAM 200115002

- “National Office position for the deduction of ‘losses incurred’”
- Taxpayer is not required to use the “most accurate estimate”, only a “fair and reasonable” estimate
- Taxpayer’s estimate will be considered “fair and reasonable” if it is estimated on the basis of a recognized methodology that is appropriate for the particular line of business, is in accordance with actuarial standards, and takes into account prior experience.
- Use of hindsight to test reasonableness is inappropriate

SSAP 55

- 9. Various analytical techniques can be used to estimate the liability for IBNR claims, future development on reported losses/claims, and loss/claim adjustment expenses. These techniques generally consist of statistical analysis of historical experience and are commonly referred to as loss reserve projections...The decision to use a particular projection method and the results obtained from that method shall be evaluated by considering the inherent assumptions underlying the method and the appropriateness of those assumptions to the circumstances. No single projection method is inherently better than any other in all circumstances. The results of more than one method should be considered.

SSAP 55

- 10. For each line of business and for all lines of business in the aggregate, **management** shall record its best estimate of its liabilities for unpaid claims, unpaid losses, and loss/claim adjustment expenses. Because the ultimate settlement of claims is subject to future events, no single claim or loss and loss/claim adjustment reserve can be considered accurate with certainty. **Management's** analysis of the reasonableness of claim or loss and loss/claim adjustment expense reserve estimates shall include an analysis of the amount of variability in the estimate. If, for a particular line of business, management develops its estimate considering a range of claim or loss and loss/claim adjustment expense reserve estimates bounded by a high and a low estimate, **management's** best estimate of the liability within that range shall be recorded. The high and low ends of the range shall not correspond to an absolute best-and-worst case scenario of ultimate settlements because such estimates may be the result of unlikely assumptions. **Management's** range shall be realistic and, therefore, shall not include the set of all possible outcomes but only those outcomes that are considered reasonable.

SSAP 55

- 12. In the rare circumstance when, for a particular line of business, after considering the relative probability of the points within management's estimated range, it is determined that no point within management's estimate of the range is a better estimate than any other point, the midpoint within management's estimate of the range shall be accrued. It is anticipated that using the midpoint in the range will be applicable only when there is a continuous range of possible values, and no amount within that range is any more probable than any other... This guidance is not applicable when there are several point estimates which have been determined as equally possible values, but those point estimates do not constitute a range. If there are several point estimates with equal probabilities, management should determine its best estimate of the liability.

ASOP 36

- 3.3.2(c) Determination of Redundant or Excessive Provision-When the stated reserve amount is greater than the maximum amount that the actuary believes is reasonable, the actuary should issue a statement of actuarial opinion that the stated reserve amount does not make a reasonable provision for the liabilities associated with the specified reserves.

ASOP 36

- 4.6(e)-If the actuary determines that the stated reserve amount is redundant or excessive, the actuary should disclose the amount by which the stated reserve amount exceeds the maximum amount that the actuary believes is reasonable.

SOX 404

- Documentation of procedures around methodology for determination of reserve amounts
- Documentation of controls around the determination of the reserve amount

Current Environment

- Actuarial estimates v. management determinations
- Hindsight
- Importance of ranges
- SSAP 55 requirements
- Documentation and control environment
- Actuarial standards

Current Environment

- For a period of time, relatively few adjustments on exam
 - Cycle of underreserving?
 - Taxpayer friendly court decisions?
 - Better documentation and controls?
 - Appeals Conference experience?
- For 2005-07 cycle, larger number of reserve issues being raised
- Current IRS exam approach
 - Use of actuaries
 - Audit techniques
- Coordinated issue -- “Reserve additions” or “Margins for adverse development”
- Premium deficiency reserves
- Uncollectible reinsurance

Treatment of Extra-Contractual Damages

- Involves claims/lawsuits against insurer alleging failure of insurer to handle and resolve claims in appropriate manner
- Includes “bad faith” lawsuits
- Does not include fines or punitive damages
- Definitional issue -- Are they properly part of losses or LAE for tax purposes?

Treatment of Extra-Contractual Damages

- Taxpayer's position:
 - Properly treated as a component of unpaid losses or ULAE for statutory accounting purposes
 - Considered to relate to accident year in which loss giving rise to policy claim occurred
 - Deduct in year incurred

Treatment of Extra-Contractual Damages

- IRS position:
 - Rejects treating as part of LAE or losses
 - Asserts are regular business expenses
 - Deduct when “all events” test and “economic performance” rules satisfied
 - Essentially, would mean deduct when the amount is paid

Treatment of Extra-Contractual Damages

- Relevant IRS pronouncement
- IRS Field Service Advice 1999-1054 (3/24/1992)
 - Involved punitive damages
 - IRS concluded that whether punitive damages could be considered part of losses or LAE for tax purposes was controlled by statutory accounting
 - FSA stated

“If the award is properly characterized as an unpaid loss or an unpaid loss adjustment expense, then the taxpayer’s inclusion of the [amount] in its computation of the ‘losses incurred’ deduction . . . is correct. The treatment . . . on the annual statement by the state insurance regulators is determinative of how the amounts are to be characterized for federal tax purposes.”
- Statutory accounting does not treat punitive damages as part of losses or LAE.

Treatment of Extra-Contractual Damages

- But extra-contractual obligations are treated as part of losses for annual statement purposes
- SSAP 55 and INT 03-17 -- Classification of Liabilities from Extra Contractual Obligation Lawsuits
 - “Adjustment expenses arising from claims related lawsuits such as extra contractual obligations and bad faith lawsuits shall be included in ‘adjusting and Other’ per SSAP No. 55, paragraph 5.c.ii,
 - “Claims related extra contractual obligations losses and bad faith losses shall be included in losses, and disclosed in a note”
- Currently no definitive answer for tax purposes

Treatment of OPEB -- Other Post-Retirement Benefits

- Involves issue of proper tax treatment of liabilities of P&C insurers for post-retirement benefits already earned by claims personnel who have met service and age requirements to qualify for such benefits on retirement.
- Taxpayer P&C company includes liabilities in unpaid LAE
 - Required by statutory accounting principles
 - Required by state law

Treatment of OPEB -- Other Post-Retirement Benefits

- Taxpayer treats as part of unpaid LAE for tax purposes
- Recent IRS Technical Advice Memorandum 112829-09
 - IRS asserts that OPEB with respect to claims personnel must be deducted under tax rules applicable to noninsurers
 - Would mean deductible only in the year employee includes in his/her income

Definition of Insurance/Reinsurance

Traditional Tax Definition of Insurance

- U.S. Supreme Court's definition in *LeGierse* case
 - Risk shifting
 - Risk distribution
- Insurance Risk
- Commonly accepted notion of insurance

Traditional Tax Definition of Insurance

- But, *Sears* case may provide a different framework for analysis
 - “[B]ut it is a blunder to treat a phrase in an opinion as if it were statutory language The [Supreme] Court was not writing a definition [of insurance] for all seasons”
 - “Corporations . . . do not insure to protect their wealth and future income, as natural persons do Instead, corporations insure to spread the costs of casualties over time.”
 - “A corporation thus buys loss-evaluation and loss-administration services, which insurers have a comparative advantage, more than it buys loss distribution.”

Traditional Tax Definition of Insurance

- “If retrospectively-rated policies . . . are insurance for tax purposes -- [as IRS counsel conceded for purposes of the case] -- then it is impossible to see how risk shifting can be a *sine qua non* of ‘insurance.’”
- “[I]nsurance does not shift risk so much as the pooling transforms and diminishes risk.”
- Recognized by both issuers and regulators as insurance

FAS 113

- Indemnification of the ceding enterprise against loss or liability relating to insurance risk in reinsurance of short duration contracts requires both of the following:
 - The reinsurer assumes significant insurance risk
 - It is reasonably possible that the reinsurer may realize a significant loss from the transaction

FAS 113

Risk transfer testing must include:

1. A thorough understanding of contract provisions,
2. A model of the incidence of cash flows between parties,
3. A single, appropriate discount rate, and
4. Insurance risk only

FAS 113

Precluded from consideration are:

1. Income taxes
2. Reinsurer expenses
3. Brokerage
4. Credit risk

SSAP 62

- 9. The essential ingredient of a reinsurance contract is the transfer of risk. The essential element of every true reinsurance agreement is the undertaking by the reinsurer to indemnify the ceding entity, i.e. reinsured entity, not only in form, but in fact, against loss or liability by reason of the original issuance...
- 10. Insurance risk involves uncertainties about both (a) the ultimate amount of net cash flows from premiums, commissions, claims, and claim settlement expenses (underwriting risk) and (b) the timing of the receipt and payment of those cash flows (timing risk). Actual or imputed investment returns are not an element of insurance risk. Insurance risk is fortuitous-the possibility of adverse events occurring is outside the control of the insured.
- 12. Indemnification of the ceding entity against loss or liability relating to insurance risk in reinsurance requires both the following:
 - A) The reinsurer assumes significant insurance risk under the reinsured portions of the underlying insurance agreements; and
 - B) It is reasonably possible that the reinsurer may realize a significant loss from the transaction.

Risk-Shifting-Revenue Ruling 89-96

- **Is an insurance company entitled to claim a deduction for ‘losses incurred’ during the taxable year on retroactive insurance contracts?**
- **Losses expected in excess of \$130 million**
- **Liability coverage totaled \$30 million**
- **Insured paid \$50 million premium for \$100 million retroactive coverage**
- **Does not involve requisite risk shifting**
- **Catastrophe has already occurred**
- **Absence of risk apart from investment risk**
 - **Make payments of known loss earlier than expected**
 - **Investment yield will lower than expected**

Risk-Shifting-LTR 200711017

- Reinsurance from sub to parent
- Loss portfolio transfer
 - 100% quota share of prior year losses (including IBNR)
 - Lines of business included environmental
 - Reinsurance premium equal to statutory reserves
 - Aggregate limit in excess of statutory reserves
 - Notional account in case of commutation
 - Agreement met SSAP 62 requirements for treatment as reinsurance
 - Statutory accounting as prospective reinsurance since between related parties
- Ruling
 - LPT is not reinsurance because “the element of fortuity is absent because the Agreement serves only to finance Taxpayer’s present obligation for incurred losses.”
 - Not insurance in the commonly accepted sense because the arrangement could not be entered into with an unrelated third party
- Stat/tax conformity issues: “Taxpayer should make any necessary reconciliation between the reserve amount shown on subsequent annual statements and the amount properly allowable under section 832(b)(5).”

Risk-Shifting-LAFA 20072502F

- Taxpayer is the assuming company on a reinsurance contract transferring prior year losses. Agreement was treated as transferring risk for purposes of SSAP 62, and, although not indicated in the ruling, presumably for FAS 113.
- IRS indicated that Rev. Rul. 89-96 requires a comparison of the net present value (NPV) of anticipated losses with the premium paid for the insurance. Only if the NPV exceeds the premium, including tax savings, is insurance risk transferred.
$$PVL > PVP$$
- The taxpayer entered into a retroactive reinsurance contract and in its underwriting file put forth five cash flow scenarios. The Service computed the NPVs for those scenarios and found that three of them failed to satisfy Rev. Rul. 89-96 even before tax savings were considered, while the other two failed after tax savings were taken into account.
- IRS also ruled that SSAP 62 is “not controlling” for federal income tax purposes. “While an arrangement that fails the risk transfer requirements of SSAP 62 is almost certain to fail the risk transfer requirements for federal income tax purposes, satisfying SSAP 62 is not guarantee of success for federal income tax purposes.”

Notice 2005-49

- Rev Rul 2001-31
- Rev Rul 2005-40
- Request comments on the qualification of additional arrangements as insurance
 - Cell captive arrangements
 - Loan-backs of premiums
 - The relevance of homogeneity
 - Involving finite risk

Risk-Distribution-Rev Ruling 2005-40

- Risk shifting and risk distribution are necessary to qualify an arrangement as insurance for federal income tax purposes
- Risk distribution requirement is not met if the issuer of an “insurance” contract enters into such a contract with only one policyholder

Risk-Distribution-TAM 200816029

- If an entity classified as a partnership has a general partner, it is the risk of loss of the general partner that is shifted and the general partner who is considered the insured for purposes of determining whether an arrangement constitutes insurance
- If a partnership does not have a general partner, the entity itself should be considered the insured

Fortuity-Revenue Ruling 2007-47

Nuclear power plant clean up cost ruling

- It is certain that costs will be incurred in the future
- Up to a contract limit
- Economically a prefunding of future obligations
- Insurance company assumed the risk of:
 - Scope of required measures
 - Projections of future labor and material costs
 - Likely time frame when cost would be incurred
 - Projections of future earnings.
- Not fortuitous

Would they reach the same conclusion if no cap?

Fortuity-Warranties

- TAM 200827006, TAM 200453013
- Fortuity not found where a manufacturer's warranty covered the product sold for defects likely to have existed at the time of sale and within the manufacturer's control
- A warranty contract for which a separately stated charge is paid for coverage of only defects in material and workmanship that are sold incident to the business of selling or leasing automobiles are not insurance if the seller (other than a manufacturer, distributor, or importer) of the agreement has an insurance policy with an admitted insurer covering the agreements

Critique of Rulings

- The apparent lack of a principled approach leads to uncertainty, inconsistency, and “making it up as you go along”
- Why the disregard of statutory accounting rules and definitions? They establish a framework for analysis of the issue acceptable to the insurance regulators.
 - Elements of insurance risk
 - Definition of fortuity
- Why the focus on definition of insurance, e.g., fortuity rulings, rather than on adequacy of risk transfer which is the more traditional actuarial and accounting analytical tool?

Developments Relating to Reinsurance

- Legislative-Neal proposal relating to reinsurance ceded to offshore affiliates
- Administrative-cascading excise tax
- Administrative-845 ruling-FAA 20092101F

Questions