Casualty Actuarial Society

September 20 & 21, 2010
Orlando, Florida

2010 Casualty Loss Reserve Seminar:
Current Development Regarding Tax Issues Pertinent to P &C Actuaries

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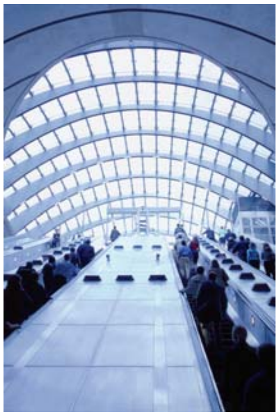
IRS Coordinated Issue Paper:

Margins and Other Unsubstantiated Additions to Insurance Company Reserves for Unpaid Losses and Claims: 11-18-2009



Coordinated Issue Paper Summary

- The IRS's Large and Mid-Size Business Division (also referred to as the "LMSB") generally issue coordinated issue papers (CIPs) in an attempt to identify and resolve industry-wide issues that the IRS views as being significant.

- CIPs typically result in a change of approach by IRS Examination Teams

- The CIP notes that estimates of insurance company unpaid losses must be **fair and reasonable** in amount and must represent **actual unpaid losses**, and suggests insurance companies are not meeting this standard.

- The CIP notes that SSAP No. 55 establishes statutory accounting principles for "Unpaid Claims, Losses, and Loss Adjustment Expenses." These principles require that management record its best estimate of liabilities for unpaid claims, unpaid losses, and loss/claim adjustment expenses. (Please note that SSAP No. 55 refers to **management's best estimate, not the actuary's best estimate.)**

Coordinated Issue Paper Summary (Continued)

- The CIP asserts that state insurance regulators are concerned with solvency and that regulatory accounting favors conservatism. The CIP references the NAIC's Health Reserves Guidance Manual 9 (Nov 6, 2000) which indicates that conservatism can be "explicit" or "implicit", and it defines those terms as follows:
  - a. Explicit conservatism means that a preliminary reserve is determined using assumptions that represent expected experience. Then, a separate provision for adverse deviations from expected - the "load" or "margin" - is added to provide conservatism.
  - b. Implicit conservatism means the reserve is determined using assumptions that are more conservative than what is actually expected.
- The CIP concludes that irrespective of whether these reserve increases are acceptable to state regulators, for federal tax purposes, under Treasury Regulations Sections 1.832-4(a)(14) and 1.832-4(b), these amounts are not allowable deductions.

Coordinated Issue Paper Summary (Continued)

The CIP asserts the following conclusions:

- Not all “reserves” shown in the annual statement or allowed by state insurance regulators are allowable as deductions for federal income tax purposes.
- The IRS is not bound by the numbers shown on the annual statement. The IRS's position is that the NAIC annual statement is merely a **"general guide"**. According to the IRS, the annual statement numbers for loss reserves are not determinative for federal income tax purposes. The taxpayer must satisfy the Treasury Regulation's requirement for inclusion of only **"actual unpaid losses"** that represent a **"fair and reasonable"** estimate of the amount the company will be required to pay and the IRS apparently assumes that the annual statement numbers may not satisfy the Treasury Regulation's requirement.
- Similarly, the IRS has determined it is not bound by the Statement of Actuarial Opinion included in the annual statement, and the actuary's opinion is not entitled to any presumption or deference.

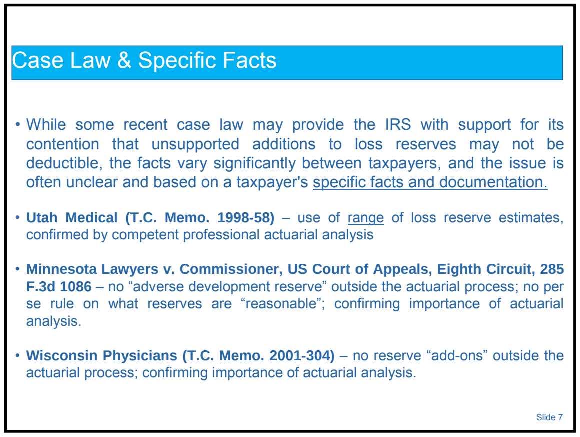
Coordinated Issue Paper Summary (continued)

The CIP asserts the following conclusions (continued):
The deduction for unpaid losses must be based on **actual loss events. “Formula”** reserves are not allowable.

No administrative “margin” or “tolerance” is required or allowable.

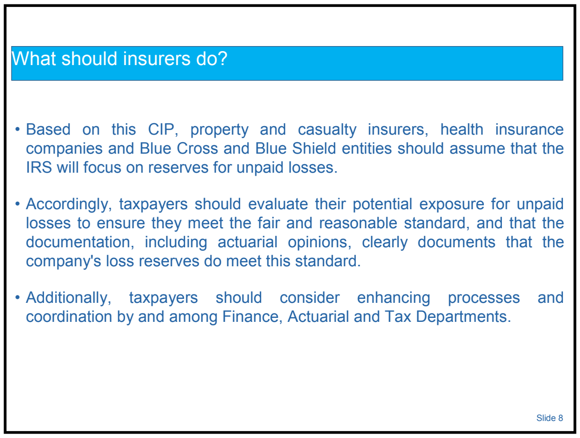
The determination of a fair and reasonable estimate of unpaid losses is a factual determination to be made based on the standards set forth in Treas. Reg. 1.832-4(a)(14) and -4(b), and not on the standards of the AS.

Taxpayer must establish that the deduction for unpaid losses is comprised of only **actual unpaid losses,** and the taxpayer may be required to submit detailed information with respect to its actual experience as the IRS deems necessary to establish the reasonableness of the loss reserves.



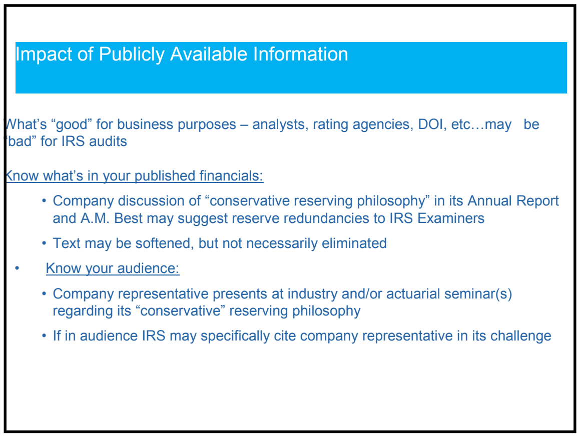
Case Law & Specific Facts

- While some recent case law may provide the IRS with support for its contention that unsupported additions to loss reserves may not be deductible, the facts vary significantly between taxpayers, and the issue is often unclear and based on a taxpayer's specific facts and documentation.
- **Utah Medical (T.C. Memo. 1998-58)** – use of range of loss reserve estimates, confirmed by competent professional actuarial analysis
- **Minnesota Lawyers v. Commissioner, US Court of Appeals, Eighth Circuit, 285 F.3d 1086** – no "adverse development reserve" outside the actuarial process; no per se rule on what reserves are "reasonable"; confirming importance of actuarial analysis.
- **Wisconsin Physicians (T.C. Memo. 2001-304)** – no reserve "add-ons" outside the actuarial process; confirming importance of actuarial analysis.



What should insurers do?

- Based on this CIP, property and casualty insurers, health insurance companies and Blue Cross and Blue Shield entities should assume that the IRS will focus on reserves for unpaid losses.
- Accordingly, taxpayers should evaluate their potential exposure for unpaid losses to ensure they meet the fair and reasonable standard, and that the documentation, including actuarial opinions, clearly documents that the company's loss reserves do meet this standard.
- Additionally, taxpayers should consider enhancing processes and coordination by and among Finance, Actuarial and Tax Departments.



Impact of Publicly Available Information

What's "good" for business purposes – analysts, rating agencies, DOI, etc…may be "bad" for IRS audits

Know what's in your published financials:

- Company discussion of "conservative reserving philosophy" in its Annual Report and A.M. Best may suggest reserve redundancies to IRS Examiners
- Text may be softened, but not necessarily eliminated

- Know your audience:
  - Company representative presents at industry and/or actuarial seminar(s) regarding its "conservative" reserving philosophy
  - If in audience IRS may specifically cite company representative in its challenge

Risk Transfer

Risk Shifting / Risk Distribution

“Insurance” - not defined in the Code or Regulations.

No universal definition exists – creating frequent disputes between the Service and taxpayers.

Areas of relevance:

- Captives
- Insurance
- Reinsurance

Le Gierse

Helvering v. Le Gierse (1941) - Early Supreme Court case cited over 1000 times in primary/secondary sources.

Defined what constitutes “insurance.”

To qualify as insurance for federal income tax purposes, an arrangement must involve “risk shifting” and “risk distribution.”

“Investment risk alone is not sufficient to create insurance.

Le Gierse (cont'd)

FACTS:

Desiring to transfer $25,000 to her heir (daughter) estate tax free, Ms. Edith Le Gierse simultaneously purchased an annuity contract and a life insurance policy.

Premium paid in cash: $4,179 for annuity contract and $22,949 for life insurance policy.

Annuity benefit: IC agreed to pay annuity of $589 for life.

Death benefit: IC agreed to pay $25,000 to heirs upon her death.

Although IC treated both as two distinct transactions, neither referred to the other, neither premium was computed with reference to the other, HOWEVER, the insurance company would not have issued life policy without the annuity contract.

80 year old Ms. Le Gierse died less than one month later.

Le Gierse (cont'd)

INSURANCE COMPANY	Yr 1 (1 Month)	Year 2	Year 3	Year 4	Year 5	Years 6-10
Premium Received / Remaining	4,179	4,179	3,798	3,398	2,978	1,564
Plus: Investment Income	NA	209	190	170	149	78
Total Income received	NA	4,388	3,988	3,568	3,127	1,642
Annuity Payment to Policyholder	-	(590)	(590)	(590)	(590)	(590)
Profit (loss) Annuity	4,179	3,798	3,398	2,978	2,537	1,053
Life Insurance premium received	22,946	22,946	22,946	22,946	22,946	22,946
Plus: Investment income at 5%	NA	1,147	2,352	3,617	4,945	9,418
Total proceeds	22,946	24,093	25,298	26,563	27,891	32,364
Life insurance paid	(25,000)	(25,000)	(25,000)	(25,000)	(25,000)	(25,000)
Profit (loss) Life Insurance	(2,054)	(907)	298	1,563	2,891	7,364
Combined Profit to Ins. Co.	**2,125**	**2,891**	**3,696**	**4,541**	**5,428**	**8,417**

Le Gierse (cont'd)

EDITH LE GIERSE	Yr 1 (1 Month)	Year 2	Year 3	Year 4	Year 5	Years 6-10
Cost of annuity contract	(4,179)	(3,798)	(3,398)	(2,978)	(2,537)	(1,053)
Cost of life insurance policy (@5%)	(22,946)	(24,093)	(25,298)	(26,563)	(27,891)	(32,364)
Total cost to policyholder	(27,125)	(27,891)	(28,696)	(29,541)	(30,428)	(33,417)
Less: death benefit proceeds	25,000	25,000	25,000	25,000	25,000	25,000
Gain / (Loss) (Same as IC G/L)	**(2,125)**	**(2,891)**	**(3,696)**	**(4,541)**	**(5,428)**	**(8,417)**
Tax savings (15%*$25k)-exempt proceeds	3,750	3,750	3,750	3,750	3,750	3,750
Profit (loss) to Le Gierse	**1,625**	**859**	**54**	**(791)**	**(1,678)**	**(4,667)**

Recap -Le Gierse (cont'd)

Recap - Economics of risk of the IC in ***Le Gierse***:

- Cash payments received exceeded face value of insurance policy
- No risk shifting as policyholder did not transfer any risk of loss to IC, on the contrary she was worse off with the policies.
- No risk distribution - IC assumed no risk to distribute among others. Considering all possible outcomes and taking into account investment income, IC could never lose money.
- Economics of Le Gierse not helpful – no loss possible. As such, Court did not have to consider tax benefits.

Tax Standard - IRS

Rev. Rul. 89-96 - Retroactive Insurance

FACTS:

MGM Hotel in Las Vegas suffered a large catastrophe loss due to a fire and incurred a liability to injured persons expected to exceed $130M.

MGM's current coverage totaled $30M.

For a premium of $50M, Frank B. Hall Ins. Co provided additional coverage up to $100M (cap) for losses incurred in excess of $30M

Tax Standard – IRS (cont'd)

Rev. Rul. 89-96 (cont'd)

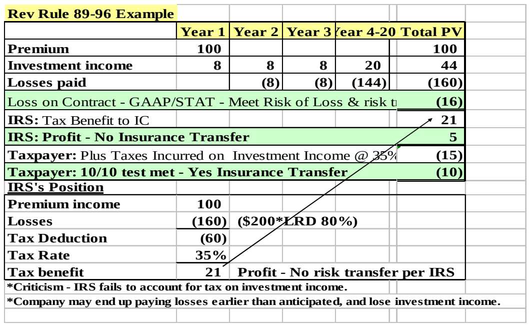
IRS HELD:

Catastrophe had already occurred and the coverage was capped at $100M. The economic terms of the contract demonstrate the absence of any transfer of risk apart from an investment risk.

Retroactive arrangement fails to create a insurance, as insurance company only assumed (1) timing risk (pay earlier than expected) and (2) investment risk (yield lower than forecast).

PV of premiums + Investment income + Tax savings of insurance company
= Exceeded maximum ($100M) anticipated liability under the contract

Tax Standard – IRS (cont'd)



Rev Rule 89-96 Example					
	Year 1	Year 2	Year 3	Year 4-20	Total PV
Premium	100				100
Investment income	8	8	8	20	44
Losses paid		(8)	(8)	(144)	(160)
Loss on Contract - GAAP/STAT - Meet Risk of Loss & risk t					(16)
IRS: Tax Benefit to IC					21
IRS: Profit - No Insurance Transfer					5
Taxpayer: Plus Taxes Incurred on Investment Income @ 35%					(15)
Taxpayer: 10/10 test met - Yes Insurance Transfer					(10)
IRS's Position					
Premium income	100				
Losses	(160)	($200*LRD 80%)			
Tax Deduction	(60)				
Tax Rate	35%				
Tax benefit	21	Profit - No risk transfer per IRS			

*Criticism - IRS fails to account for tax on investment income.

*Company may end up paying losses earlier than anticipated, and lose investment income.

Tax Standard – IRS (cont'd)

Rev. Rul. 2000-47 **– (Rev. Rul. 89-96 is amplified)**
FACTS:

US Corp. (USC) is engaged in a business process that is inherently harmful to people and property.

Per governmental regulations, once USC ceases its business process, it will incur future costs to restore the business location to its previous condition.

The exact amount and timing of the costs depend on many factors but it is certain the costs will be incurred.

USC estimated the value of the costs to be $150x. USC paid IC $150x to reimburse its future costs up to $300x.

Tax Standard – IRS (cont'd)

Rev. Rul. 2000-47 (cont'd)

HELD:

The arrangement lacked the requisite insurance risk to constitute insurance.

Upon entering into the transaction, it was certain that IC will have to perform under the contract and will have to reimburse USC for costs incurred subject to contract limit of $300x.

Economically, the arrangement is a prefunding by USC of its future obligations.

IC assumed the risks of the **timing** of when the costs would be incurred, and the potential shortfall on projections of investment earnings.

This risk is akin to the timing and investment risks that Rev. Rul. 89-96 concludes are not insurance risks.

Tax Standard – IRS (cont'd)

Field Attorney Advice (FAA) 20072502F –Retroactive Reinsurance

Note: This FAA dealt with Reinsurance whereas Rev. Rul 89-96 dealt with insurance.

FACTS: Cedent reinsured 90% of its business to multiple reinsurers. B-Re assumed 30% and other reinsurers assumed 60%. Cedent retained a portion of the premium. Cedent set up a funds withheld account.

HELD:

IRS found that Cedent's retroactive reinsurance contract does not transfer insurance risk as described in Rev. Rul 89-96.

Similar to 89-96, the liability assumed by the reinsurer cannot be exactly ascertained but a potential range of losses were established which included the aggregate limit of the contract.

Tax Standard – IRS (cont'd)

(FAA) 20072502F (cont'd)

HELD (cont'd)

NAIC risk transfer does not control for tax. IRS states that if the arrangement fails SSAP 62 risk transfer requirements it is almost certain to fail for tax, satisfying SSAP 62, however, is no guarantee of success for federal tax purposes.

Key - STAT is only a guide but is not binding on the IRS

IRS reinforces its position in its consideration of current year tax benefit (economics) as part of risk transfer analysis: The IRS contends that in essence Rev. Rul 89-96 equates the tax savings received (when booked as an underwriting loss) to an additional premium which the reinsurer can invest to cover expected claims. Therefore to evaluate the economics, this tax savings along with the actual premium is compared to the NPV of anticipated losses. If the NPV of the anticipated loss does not materially exceed the premium plus the tax savings, the transaction does not transfer insurance risk for federal tax purposes.

Example

FAS 113 – Application of 9a/9b Tests

Contract : an excess of loss reinsurance contract that covers P&C Insurance Company's general liability book of business and is expected to pay claims over the next seven years for losses occurring in the current year

Cover: $1,000,000 of loss per occurrence in excess of $1,000,000

- Reinstatement Premium (usually limits # of occurrences)

Annual Premium paid to Reinsurer: $2,000,000

Commission paid to cedent: 15% of the premiums ceded (15%*$2M)

Loss ratio: It is reasonably possible that the ultimate ratio on the contract could range from 75% to 120% of premiums ceded (Range: $1.5M-$2.4M)

Payment pattern: (This is Key): Expected to vary; the majority of claims may be paid in years 2, 3 or subsequent from the occurrence date. It is reasonably possible that the payments may be made in three payment speeds under each reasonably possible loss ratio. The companies have estimated these payment patterns as "fast," "medium," and "slow."

FAS 113 – Application of 9a/9b Tests

Years		**1**	**2**	**3**	**4-7**	**TOTAL**
Estim. Pmt Pattern		10%	20%	30%	40%	100%
Premium	2,000,000					2,000,000
Commission	(300,000)					(300,000)
Loss Payments		(240,000)	(480,000)	(720,000)	(960,000)	(2,400,000)
Cash Flows	1,700,000	(240,000)	(480,000)	(720,000)	(960,000)	(700,000)
PV of Cash Flows:						
US Treasury Yield	0	3.525%	4.374%	4.872%	6%	-
Present Value	1,700,000	(231,828)	(440,612)	(624,243)	(732,393)	(329,076)
TEST						
Total PV of Cash Flows				(329,076)		**Gain/(loss)**
Total PV of amts to be paid to reinsurer (gross)				2,000,000		-16%

FAS 113 – 9a/9b Tests (cont'd)

FAS 113 Example:

Step 1: Does the contract transfer underwriting risk

- Yes
- The contract has reasonable potential variability in loss payments.
- No other features that would serve to reduce variability are included in the contract

Step 2: Does the contract transfer timing risk

- Yes
- The contract has an expected payout of seven years. The majority of these losses could be paid in the first few years or later years

Step 3: Does the reinsurer have a reasonable possibility of significant loss on the contract

- Yes

Accounting - Risk Transfer Summary

Risk Transfer Met?		Risk Types
IRS	Accounting	
No	No	Investment return
No	Yes	Timing of payments
Yes	Yes	Amount of payments

“Reinsurance through Financial Instruments”

SWAP Arrangement to Eliminate Risk:

- Offshore reinsurance company makes §953(d) election
  - Assumes reinsurance business from U.S.
- Enters into a swap transaction with parent corporation whereby all economic risk of reinsurance is assumed by parent through swap or other financial instrument transaction.
- Is it still an insurance company even though all risk has been eliminated?
  - Warranty rulings etc. more than 50% of activity ISSUING Insurance Contracts
- What about a company in runoff which no longer issues insurance policies?

Tax Proposals

Tax proposals to limit Deduction of Reinsurance Premiums paid to Foreign Affiliates:

- On July 14, 2010, a hearing was held before Select Revenue Measures Sub –committee of the House
- On July 12, 2010 Joint Committee Staff paper issued
- Provides Present Law and Analysis relating to Tax treatment of affiliated reinsurance

Tax Proposals (cont’d)

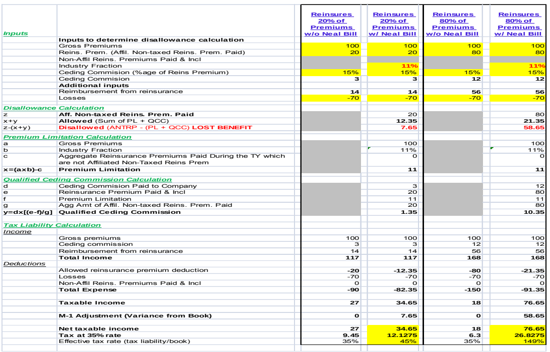
Reinsurance has increased dramatically 1980 – 2008

Affiliated Reinsurance with Foreign Reinsurers = 54% of total premiums

Neal Proposal

Obama Proposal

Neal Bill Calculation Workbook



Inputs		Reinsures 20% of Premiums w/o Neal Bill	Reinsures 20% of Premiums w/ Neal Bill	Reinsures 80% of Premiums w/o Neal Bill	Reinsures 80% of Premiums w/ Neal Bill
	Inputs to determine disallowance calculation				
	Gross Premiums	100	100	100	100
	Reins. Prem. (Affil. Non-taxed Reins. Prem. Paid)	20	20	80	80
	Non-Affil Reins. Premiums Paid & Incl				
	Industry Fraction		11%		11%
	Ceding Commision (%age of Reins Premium)	15%	15%	15%	15%
	Ceding Commision	**3**	**3**	**12**	**12**
	Additional inputs				
	Reimbursement from reinsurance	**14**	**14**	**56**	**56**
	Losses	-70	-70	-70	-70
Disallowance Calculation					
z	**Aff. Non-taxed Reins. Prem. Paid**		20		80
x+y	**Allowed** (Sum of PL + QCC)		**12.35**		**21.35**
z-(x+y)	**Disallowed** (ANTRP - (PL + QCC) **LOST BENEFIT**		**7.65**		**58.65**
Premium Limitation Calculation					
a	Gross Premiums		100		100
b	Industry Fraction		11%		11%
c	Aggregate Reinsurance Premiums Paid During the TY which are not Affiliated Non-Taxed Reins Prem		0		0
x=(axb)-c	**Premium Limitation**		**11**		**11**
Qualified Ceding Commission Calculation					
d	Ceding Commision Paid to Company		3		12
e	Reinsurance Premium Paid & Incl		20		80
f	Premium Limitation		11		11
g	Agg Amt of Affil. Non-taxed Reins. Prem. Paid		20		80
y=dx[(e-f)/g]	**Qualified Ceding Commission**		**1.35**		**10.35**
Tax Liability Calculation					
Income					
	Gross premiums	100	100	100	100
	Ceding commission	3	3	12	12
	Reimbursement from reinsurance	14	14	56	56
	Total Income	**117**	**117**	**168**	**168**
Deductions					
	Allowed reinsurance premium deduction	**-20**	**-12.35**	**-80**	**-21.35**
	Losses	-70	-70	-70	-70
	Non-Affil Reins. Premiums Paid & Incl	0	0	0	0
	Total Expense	**-90**	**-82.35**	**-150**	**-91.35**
	Taxable Income	**27**	**34.65**	**18**	**76.65**
	M-1 Adjustment (Variance from Book)	**0**	**7.65**	**0**	**58.65**
	Net taxable income	**27**	**34.65**	**18**	**76.65**
	Tax at 35% rate	**9.45**	**12.1275**	**6.3**	**26.8275**
	Effective tax rate (tax liability/book)	35%	45%	35%	149%

Tax Issues

Transfer Pricing

Section 845

Excise Taxes

Earnings Stripping

Business reasons for use of reinsurance recognized