

*Casualty Loss Reserve Seminar
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What to Do When the IRS Comes Calling:

Loss Reserves & Other Current Tax Issues

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Topics to Be Covered

- Current IRS audit approach to P&C insurers
 - IRS challenges to P&C loss reserves
- IRS Coord. Issue Paper on P&C reserves
- Position of IRS Appeals Office
- Current application of tax authorities
- Preparing for the IRS audit
- Some open issues

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Current IRS Audit Approach

- Reasonableness of P&C loss reserves is an active area of IRS examination.
 - Why? Hunting where the ducks are. IRS asserts loss reserves are overstated industry-wide, pointing to pattern of reserve take-downs. Very large adjustments being proposed.
- Other current IRS audit issues?
 - Loss reserves for extracontractual obligations (*State Farm*).
 - Statutory accounting versus accrual accounting: retiree medical benefits as LAE (TAM 200939019); dividends paid (TAM 201006029).
 - Basic insurance accounting issues: reasonableness of reserves for uncollectible reinsurance.
 - Accounting for insurance acquisitions under sec. 338 regulations.

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Current IRS Audit Approach

- P&C companies are being actively audited – some recent audits driven by 2008-09 loss carrybacks.
- Loss reserves will certainly be examined. IRS will seek:
 - Company’s internal reserve analysis and conclusions.
 - Reserve analysis and conclusions of outside actuary (if any).
 - Outside auditor’s reserve analysis and conclusions.
 - Submissions to/inquiries from state regulators on loss reserves.
 - Statements to investors and other outsiders on reserve philosophy.
- IRS will propose reduction in loss reserve if it perceives (i) reserve redundancy over time, and (ii) relatively substantial overstatement of current reserves.
- Initial position likely developed by IRS P&C actuaries Rodney Davis or Larry White. IRS estimate likely a point estimate (not a range), and aggressively low.

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Current IRS Audit Approach

- Next step – Taxpayer files written protest with **IRS Appeals Office**, the internal administrative review function at IRS.
- Case can be settled any time in the process.
- Next step: Litigation.
- There are two P&C loss reserve cases now pending in Tax Court: *Acuity*, *Sentry*.

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IRS Coordinated Issue Paper On P&C Loss Reserves

- Not binding precedent, but states IRS LB&I division’s audit position. Released November 2009. Online at www.irs.gov/businesses/article/0,,id=215618,00.html.
- Basic position: “Margins or other additions to unpaid losses that are not based upon the company’s actual loss experience cannot be included in the [loss reserve].”

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IRS Coordinated Issue Paper

- IRS paper conflates “explicit margins” *added* to actuarially determined reserves, and “implicit conservatism” in the underlying actuarial analysis and reserve setting.
- Published tax precedents do question “margins” added to reserves outside the actuarial process (*MN Lawyers; WI Physicians*).
- Unclear in my opinion how tax precedents really apply to “implicit conservatism.”

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IRS Coordinated Issue Paper

- Other positions taken in IRS Issue Paper:
 - Statutory accounting and NAIC guidance “favor conservatism” while tax rules do not follow this principle.
 - Use of NAIC *Health Reserves* guidance on “margins” to suggest all P&C reserves are overly conservative.
 - The Annual Statement is only a “general guide” in computing insurance company taxable income.
 - No deference to the taxpayer’s actuary.
 - Dubious about any reliance on industry data.

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Position of IRS Appeals Office

- Loss reserve cases are now “coordinated” as Appeals, and may be reviewed by a panel of IRS Appeals Officers.
- Loss reserves are so fact-intensive, Appeals has had difficulty resolving on a “coordinated” basis.
- Some frustration with the Coordinated Issue Paper.
- In absence of very clear “explicit margin,” Appeals approach continues to be based on facts and circumstances of each case.

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Loss Reserve Tax Authorities

- Basic tax test for unpaid loss reserve: "fair and reasonable."
 - Reg. § 1.832-4(a)(14) – EOY unpaid losses "must represent actual unpaid losses as nearly as it is possible to ascertain them."
 - Reg. § 1.832-4(b) – EOY unpaid 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. ... [IRS may require submission of] detailed information with respect to [taxpayer's] actual experience ... to establish the reasonableness of the deduction for 'losses incurred.' "
 - How do phrases "company's experience" and "actual experience" affect use of industry data?

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Loss Reserve Tax Authorities

- TAM 200115002 – Quite favorable to taxpayers. Relationship to new Coordinated Issue Paper unclear.
 - Regs. §§ 1.832-4(a)(14) and 1.832-4(b) impose the same standard for estimated unpaid losses, which is "fair and reasonable."
 - "Fair and reasonable" means "reasonable," not more than reasonable.
 - "Actuarial estimates of unpaid losses are inherently uncertain...."
 - Taxpayer's estimate need not be "most accurate." IRS cannot impose a "more" reasonable estimate.
 - Whether taxpayer's estimate is reasonable depends on the information available at the time the estimate was made.
 - "Only a consistent pattern of overstating estimates of unpaid losses leads to substantial unwarranted tax deferral."

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Loss Reserve Tax Authorities

- Earlier cases
 - *Hanover Insurance Co.* (Tax Court 1976; 1st Cir. 1979) – confirming IRS ability to require estimate of unpaid losses to be "fair and reasonable" under Reg. § 1.832-4(b) even if that results in a different estimate from the amount appearing on the annual statement for the year.
 - To hold otherwise would amount to "sanctification of the estimated figures [on the annual statement] ... no matter how unfair or unreasonable."
 - Rejecting argument that McCarran-Ferguson requires deference to annual statement for tax purposes.
 - *Western Cas. & Sur. Co.* (Tax Court 1976; 10th Cir. 1978) – "test of reasonableness should be directed at the total unpaid loss reserve."
 - Rev. Proc. 75-56 – unpaid losses "shall be the aggregate of the estimates for each line of business...."

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Loss Reserve Tax Authorities

- *Utah Medical Ins. Ass'n* (Tx Ct Memo 1998).
 - Upholding use of *range of reasonable estimates* of unpaid losses. Any point in the range is acceptable, if the range is actuarially sound.
 - Midpoint of the range not necessary – court rejects government's "tax equipoise" concept.
 - Company's actuary, unlike IRS expert, was familiar with the company's operations, reserving process, and business environment.
 - Industry-wide data have their place. Industry loss experience utilized during early years, transitioning to company's own experience over time.

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Loss Reserve Tax Authorities

- *Minnesota Lawyers Mut. Ins. Co.* (Tx Ct Memo 2000; 8th Cir 2002).
 - Cited in Coordinated Issue Paper as authority against use of "margin."
 - Court rejected management's addition of a 37% to 50% "adverse development reserve," a "bulk" reserve on top of the case reserves arrived at by the company's claims department.
 - Management's "adverse development reserve" rejected even though total reserve approved by outside actuarial consultant.
 - "Point estimate selected by petitioner's qualified actuary" was most reasonable estimate of unpaid losses. *Sound actuarial analysis wins.*
 - Court of Appeals rejected a per se rule of reasonableness suggested by taxpayer: annual statement estimate should be deemed "reasonable" for tax purposes if made by professional management and not tax-motivated; certified by a qualified actuary, within a reasonable actuarial range; and accepted by a state regulator.

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Loss Reserve Tax Authorities

- *Physicians Ins. Co. of Wisconsin* (Tx Ct Memo 2001).
 - Cited in Coordinated Issue Paper as authority against use of "margin."
 - Tax Court rejected management's 10% qualitative "add-ons" to the actuarially determined unpaid loss estimates derived by the professional actuarial consultants who performed all the company's actuarial services.
 - *Sound actuarial analysis wins.*
 - Court seemed to suspect that the "qualitative factors" recited in support of the 10% add-ons had probably already been taken into account in the actuarial analysis, so the add-ons represented double counting.
 - Industry trend toward increased claims.
 - Greater uncertainty in new states and new lines of business.
 - Increased litigation because of more aggressive defense posture.
 - Would IRS accept "qualitative factors" at all?

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Preparing for the IRS Audit

- Proactive/pre-audit:
 - Well-documented, transparent, reproducible reserving process.
 - Recognized actuarial methods applied by qualified actuarial team.
 - Input from Underwriting, Claims and other appropriate business units.
 - Actuarial analysis and recommendations discussed throughout the year.
 - Opinion, “reality check” from outside actuary and/or auditors.
 - Know what company executives are saying to investment community, regulators, A.M. Best, and other audiences. Make sure company representatives understand sensitivities. Is a term other than “conservative” appropriate?

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Preparing for the IRS Audit

- Defensive; responding to audit:
 - Appropriate involvement of outside tax professionals.
 - Careful preparation of IRS Information Document Request (IDR) responses.
 - Engagement of outside actuarial consultants.
 - Confidentiality/privilege/work product.
 - Look ahead to Appeals and possible litigation and plan strategy accordingly.

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Some Questions

- Is Annual Statement mere “general guidance” for tax purposes, as stated in Coordinated Issue Paper? (Internal Revenue Code indicates otherwise.)
- How will courts respond to Coordinated Issue Paper?
- Impact of range of estimates?
- Use of industry data?
- Qualitative factors (new states; new lines; claim trends)?



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