IRS Large Business & International

Who's Watching Me Now – the IRS?

Federal Income Tax Issues Affecting the Property / Casualty Actuary

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Casualty Loss Reserves Seminar
September 16, 2020

INTRODUCING YOUR SPEAKER

Larry White, ACAS – Presenter

- P&C Actuary, Internal Revenue Service
- 40 years of actuarial experience
- At the IRS, Larry's focus is on loss reserving and risk transfer issues.
- Prior experience includes working at a regional WC insurer, as a consultant at a big 4 accounting firm, and at a top 10 insurer
- Larry is a frequent speaker at actuarial conferences

Peter Tomopoulos, ACAS, MAAA – Moderator

- Senior Manager, Deloitte Consulting
- New York City- based
- Nearly 25 years of insurance industry actuarial experience
- Experience with reserving analyses, financial exams, mergers & acquisitions, and fair value of loss reserves

DISCLAIMER

This presentation and the accompanying slides represent the personal opinions of the presenter and in no way should be considered a representation of the official position of the Internal Revenue Service.

The presenter is neither an attorney nor a legal expert; any interpretation of regulations, laws, or court decisions is his personal opinion only and should not be considered legal advice.

ISSUES TO BE DISCUSSED

- **Brief review of audit procedures**
- **Main focus will be LOSS RESERVES**
- **Touch base on:**
  - Uncollectible reinsurance
  - Risk transfer

WHY DOES THE IRS AUDIT INSURERS?

IRS audits all types of taxpayers – corporate and personal

- up to seven years past filing date
- reviews submitted tax returns
- may, either at random or based on info in tax returns, ask for additional information

Audits cross-check arithmetic, review payments and receipts, and examine deductions of all sorts, including loss reserves.

WHY DOES THE IRS AUDIT INSURERS?

Formal audits may include Information Document Requests for supporting workpapers and/or more detailed explanations of amounts or interpretations used in tax calculation.

Generally, the largest deduction affecting income for insurance companies is for unpaid claim liabilities – that is, LOSS RESERVES.

Loss reserves (or, more precisely, the *change* in loss reserves) are a major component in determining income.

IRS Audit of Insurers

IRS will ask for your support for the reserve booked.

(In theory, insurer will have SAP documentation showing why booked amount is “best estimate.”)

Generally, this documentation can include:

- **actuarial analysis**
- **management explanation of differences between actuarial estimate and booked amount (if any)**
- **Risk transfer analysis (CEO and CFO must make formal attestation attached to Annual Statement)**

Insurers have this information available on the shelf.

PRINCIPLES BEHIND LOSS RESERVE STANDARD

Purpose of reserves:

1) To reflect the liabilities of the insurance company

General Ledger

ACCOUNT: ACCOUNT NO.

Date	Description	Post Ref.	Debit	Credit	Balance

2) Reserves represent money put aside to pay claimants

PRINCIPLES BEHIND LOSS RESERVE STANDARD

Audit implies checking the accounting.

The accounting principle that applies is the MATCHING PRINCIPLE, which requires that *revenues and any related expenses be recognized together in the same period.*

When funds aren't actually paid, an *accrual* is established to match revenue and expenses.

PRINCIPLES BEHIND LOSS RESERVE STANDARD

Effects of a poor accrual (reserves)

- **misstatement of financial condition**
- **misstatement of income**

Affects shareholders and policyholders who expect dividends based on the results of that year, both in the year of misstatement and in the year of correction.

PRINCIPLES BEHIND LOSS RESERVE STANDARD

The ideal is to get the accrual right,

recognizing that these are just estimates.

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In computing "losses incurred," the determination of unpaid losses at the close of each year must represent actual unpaid losses...

recognizing that these are just estimates.

... as nearly as it is possible to ascertain them.

This is Treasury Regulation 1.832-4(a)(14)

PRINCIPLES BEHIND LOSS RESERVE STANDARD

The other main IRS reserve regulation:

Treasury Regulation 1.832-4(b)

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* ... 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. (*emphases added*)

OTHER LOSS RESERVE STANDARDS

STATUTORY ACCOUNTING PRINCIPLES

from SSAP 55:

“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.”

OTHER LOSS RESERVE STANDARDS

IFRS – expected value

(separate risk margin is added later)

New Zealand – 75th percentile

Actuarial Opinion

QUESTION - Does an unqualified Statement of Actuarial Opinion mean that the insurer's carried reserves are "the best estimate" of its liabilities?

OTHER LOSS RESERVE STANDARDS

Isn't it prudent – or maybe even necessary – to provide for times when losses are worse than expected?

Health Reserves Model Regulation specifically states:

> ***The total contract reserve established shall incorporate provisions for moderately adverse conditions.***

Why *not* include some provision for adverse deviation (PAD) - aka "margin" or "risk load"- from expected losses within the carried loss reserve?

OTHER LOSS RESERVE STANDARDS

Is concern over loss reserves being adequate for adverse conditions *obsolete*?

OTHER LOSS RESERVE STANDARDS

Is concern over loss reserves being adequate for adverse conditions *obsolete*?

Answer seems to be YES

- **Risk-Based Capital**
- **A. M. Best’s BCAR**
- **Enterprise Risk Management**

LEGAL CASES ABOUT INSURANCE RESERVES

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Insurance companies generally contend that the Annual Statement rules are "controlling" for tax purposes

New Hampshire Fire Insurance Co. v. Commissioner, 146 F.2d 697 (1st Cir. 1945), aff'g, 2 T.C. 708 (1943); and Columbia Casualty Co. v. Commissioner, 7 CCH Tax Ct. Mem. 282 (1948).

The IRS contends that Annual Statement rules can be a "general guide", but are not compelling

Rev. Rul. 61-167, 1961 C.B. 130; Rev. Rul. 60-306, 1960-2 C.B. 211. See Commissioner v. U.S. Guarantee Company, 190 F.2d 152 (2d Cir. 1951), rev'g and rem'g 8 CCH Tax Ct. Mem. 510 (1949); Commissioner v. General Reinsurance Corp., 190 F.2d 148 (2d Cir. 1951), rev'g and rem'g 9 CCH Tax Ct. Mem. 141 (1950); Pacific Insurance Co., Ltd. v. United States, 90 F. Supp. 328 (Hawaii D.C. 1950), aff'd, 188 F.2d 571 (9th Cir. 1951); and Pacific Employers Insurance Company v. Commissioner, 89 F.2d 186 (9th Cir. 1937), aff'g 33 B.T.A. 501

Last word? *Hanover v. Commissioner* (1979):

(taxpayer's) "adherence to the N.A.I.C. annual statement did not prevent the Commissioner from contesting the figures contained therein."

IRS

LEGAL CASES ABOUT INSURANCE RESERVES

Utah Medical case (1998)

- monoline, single-state medical malpractice insurer
- company booked reserve at high end of large (26% wide) actuarial range
- actuary testified any point in range would have been reasonable

Court upheld company's booked reserves

Interesting comments by court:

"For the years in issue, the medical malpractice industry overstated reserves to virtually the same extent as petitioner."

Actuaries "testified that insurance companies have an incentive not to overstate their unpaid losses because overstating their losses may result in higher premiums, may make them less competitive with other companies."

LEGAL CASES ABOUT INSURANCE RESERVES

Minnesota Lawyers Mutual case (2000)

- monoline, single-state medical malpractice insurer
- company’s booked reserve included “adverse development reserves” of 37 – 50% above actuary’s point estimate

<u>Court upheld IRS position (to reduce reserves)</u>

<u>Rationale</u>: Actuary’s range (70% - 120%) too wide to be reliable; court declined to state that if reserves were certified as “reasonable” and unchallenged by state insurance department, they would satisfy IRS requirements

LEGAL CASES ABOUT INSURANCE RESERVES

Physicians Ins. Co. of Wisconsin case (2001)

- monoline, single-state medical malpractice insurer
- outside actuaries provided point estimate but no range
- company added 10% to actuarial estimate
- accepted by state regulators

Court upheld IRS position (to reduce reserves)

Rationale:

- reserves were not supported by actuarial analysis;
- company can not “imply” a range of reserves; and
- court again rejected idea that IRS must accept statutory amounts

LEGAL CASES ABOUT INSURANCE RESERVES

Acuity case (decided 2013, audit was of 2006 financials)

- multiline, multistate P/C insurer
- company booked internal opining actuary's point estimate
- co. treasurer described reserves as having 10% "margin" to A.M. Best
- outside actuaries had booked reserves in their "ranges"

Court upheld company's booked reserves

Court assigned substantial weight to evidence that loss reserves:

1) were actuarially computed in accordance with the NAIC rules and ASOPs; and
2) fell within a range of reasonable reserve estimates as determined by the insurance company's appointed actuary in accordance with the ASOPs

LEGAL CASES ABOUT INSURANCE RESERVES

Acuity case (2013) *continued*

NOTE: court upheld reasonableness of company actuary's estimate; the company booked exactly that amount.

"Neither *Acuity* case nor *Utah Medical* says that if you 'fall in the range,' the case is over. Ranges are a useful tool, but are not 'conclusive' any more than the Annual Statement reserve amount standing alone is "conclusive" for tax purposes."

source: Richard Riley (Acuity's attorney in this case), presentation at the 2017 Casualty Loss Reserve Seminar

ACTUARIAL STANDARDS REGARDING RESERVE ESTIMATES

ACTUARIAL STANDARDS REGARDING RESERVE ESTIMATES

STATEMENT OF ACTUARIAL OPINION

Actuary does pass/fail on whether reserve
"makes reasonable provision"

According to American Academy of Actuaries (which issues ASOPs):

- "Solvency monitoring is **THE** purpose for writing the statement of actuarial opinion (SAO). No other purpose exists"
- "Reasonable" in SAO does NOT mean "prudent," "proper," "adequate," or other terms
- ASOP 36 has "no definition of what is material"
  - Materiality may differ if used for purpose other than solvency, e.g., income

(source: 2/14/2013 webinar by AAA, "Risk of Material Adverse Deviation Disclosure in U.S. Statements of Actuarial Opinion")

ACTUARIAL STANDARDS REGARDING RESERVE ESTIMATES

Actuarial Standard of Practice 36

Statements of Actuarial Opinion regarding P/C Loss & LAE Reserves

3.7 Reserve Evaluation — The actuary should consider a reserve to be reasonable if it is

- within a range of estimates that could be produced by an unpaid claim estimate analysis that is, in the actuary's professional judgment
- consistent with both ASOP No. 43, Property/ Casualty Unpaid Claim Estimates, and
- (consistent with) the identified stated basis of reserve presentation

ACTUARIAL STANDARDS REGARDING RESERVE ESTIMATES

Actuarial Standard of Practice 43

Property / Casualty Unpaid Claim Estimates

3.1 Purpose or Use of the Unpaid Claim Estimate
The actuary should identify the intended purpose or use of the unpaid claim estimate…
Where multiple purposes or uses are intended, the actuary should consider the potential conflicts arising from those multiple purposes.

3.4 Materiality
The actuary should evaluate materiality based on professional judgment, taking into account the requirements of applicable law and the intended purpose of the unpaid claim estimate.

ACTUARIAL STANDARDS REGARDING RESERVE ESTIMATES

Actuarial Standard of Practice 43

Property / Casualty Unpaid Claim Estimates (continued)

3.6.2 Assumptions

The actuary should use assumptions that, in the actuary's professional judgment, have *no known significant bias to underestimation or overestimation of the identified intended measure* and are not internally inconsistent. (*emphasis added*)

Note the consistent emphasis that the estimate be appropriate for its intended use

Is the IRS standard the same as SAP? as SAOs?

ACTUARIAL STANDARDS REGARDING RESERVE ESTIMATES

Actuarial Syllabus (now removed))

A *risk margin* adjusts the present value (at a risk-free rate) of a cash flow to its market value.

A *reserve margin* is an accounting entry to ensure that the estimated liability supports the actual cash flows.

IRS loss reserve discounting includes no risk margin, and reserve margins are not permitted in tax reserves.

(all from “IRS Loss Reserve Discounting” study note, 2017)

ACTUARIAL STANDARDS REGARDING RESERVE ESTIMATES

Actuarial Central Estimate ("ACE") is defined in ASOP 43 as "an estimate that represents an expected value over the range of reasonably possible outcomes"

Is ACE equivalent to SAP's "best estimate"?

Is ACE equivalent to IRS standard of "fair and reasonable estimate" of "actual unpaid losses as nearly as it is possible to ascertain them"?

RANGES OF LOSS RESERVES

RANGES OF LOSS RESERVES

WHAT ABOUT RANGES?

Actuarial Opinion: “makes reasonable provision”

SSAP 55: “If, for a particular line of business, management develops its estimate considering a range of …reserve estimates bounded by a high and a low estimate, *management's best estimate of the liability within that range* shall be recorded”. *(emphasis added)*

IRS regulation: “as nearly as can be ascertained”

RANGES OF LOSS RESERVES

Remember different contexts of reserve estimates

Two types of ranges are commonly discussed:

- **Range of possible outcomes**: includes the full range of potential results of the claim process
- **Range of reasonable estimates**: expresses the degree of uncertainty in an estimate

Sometimes, both are referred to as "ranges," but they have very different meanings

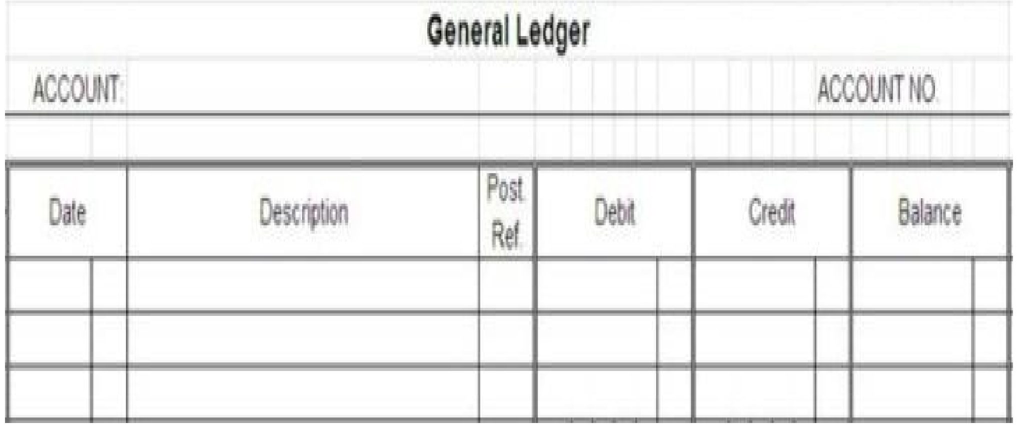
A **range of possible outcomes** is not the same as a **range of reasonable estimates**!

The type of range will vary depending on its intended purpose or use.

From the American Academy of Actuaries 1/11/18 webinar:
"P/C Loss Reserve Opinion Writing: RMAD and Reserve Ranges," slide 34

RANGES OF LOSS RESERVES

<u>Remember different contexts for reserve estimate:</u>



For INCOME

How <u>close</u> can I get?

Variability of ESTIMATES

For SOLVENCY

How <u>far off</u> can it be?

Variability of OUTCOMES

RANGES OF LOSS RESERVES

Definitions:

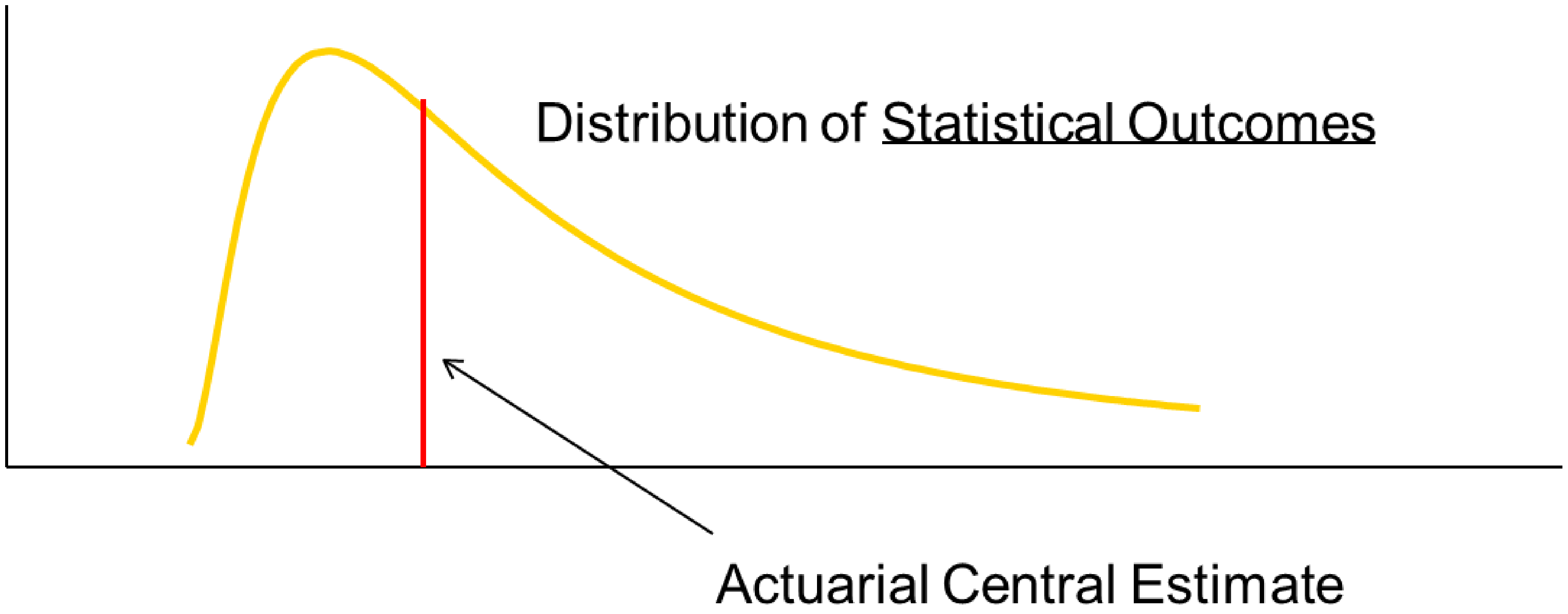
*A range of reasonable actuarial central estimates considers primarily **parameter** and **model** risk, not **process** risk*

- ❑ **Process Risk: the randomness of future outcomes** *given a known distribution of possible outcomes*
- ❑ **Parameter Risk: the potential error in the estimated parameters** used to describe the distribution of possible outcomes, *assuming the process generating the outcomes is known*
- ❑ **Model Risk: the chance that the model ("process") used** to estimate the distribution of possible outcomes is incorrect or incomplete

From the American Academy of Actuaries 1/11/18 webinar:
"P/C Loss Reserve Opinion Writing: RMAD and Reserve Ranges," slide 37

RANGES OF LOSS RESERVES

What is a range of reasonable actuarial central estimates?



From the American Academy of Actuaries 1/11/18 webinar:
"P/C Loss Reserve Opinion Writing: RMAD and Reserve Ranges," slide 38

RANGES OF LOSS RESERVES

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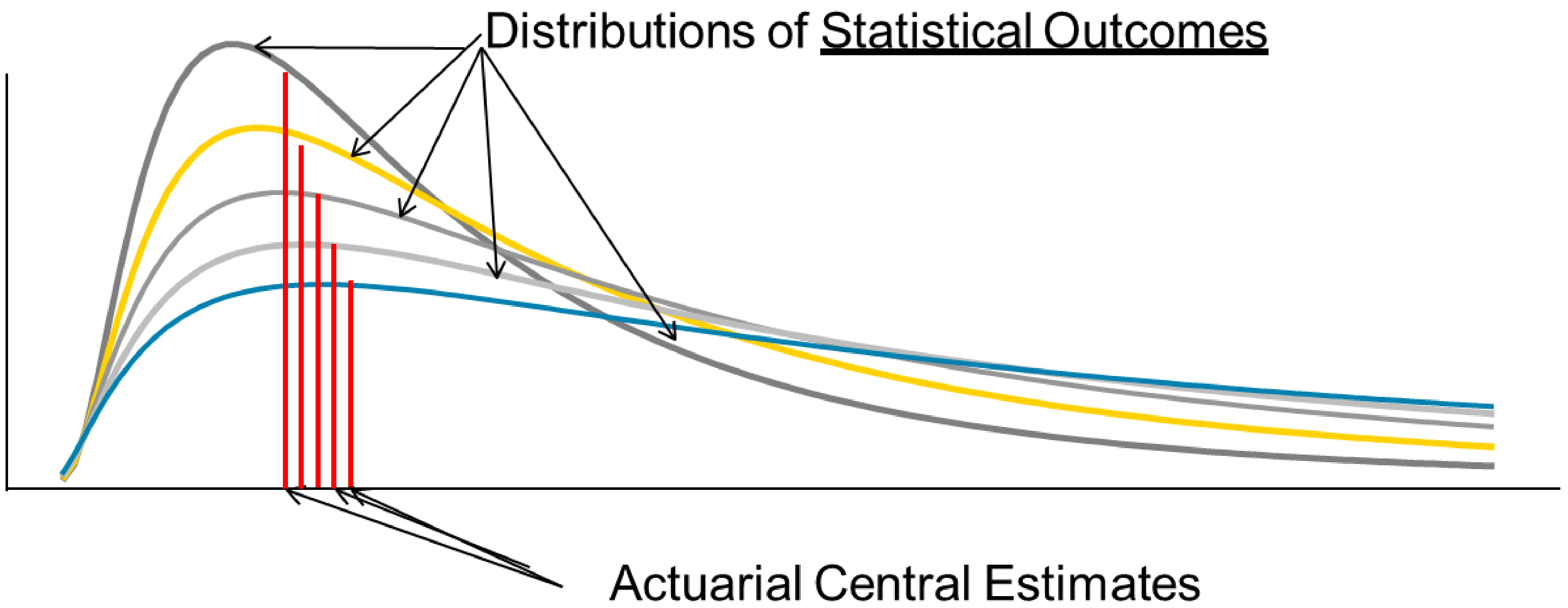

From the American Academy of Actuaries 1/11/18 webinar:
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RANGES OF LOSS RESERVES

How does this work in real life?

Objective for IRS is variability in ***estimates,***

not variability of ***outcomes***

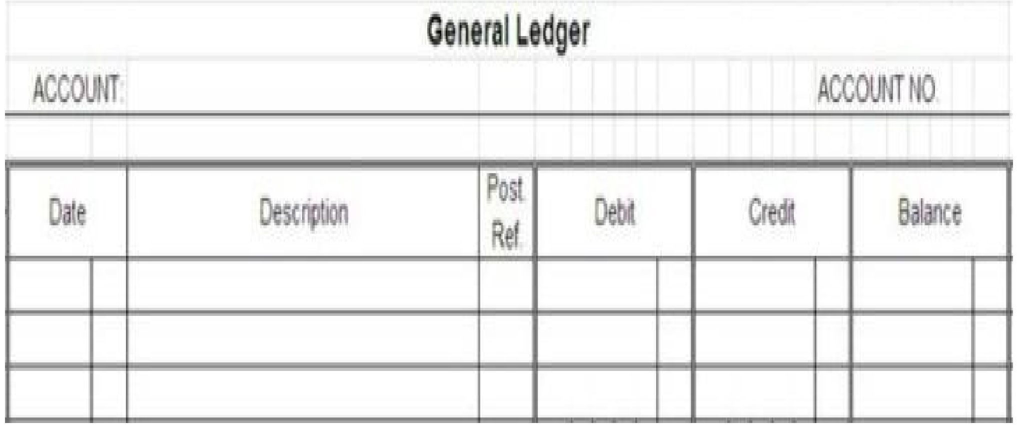
Coin flip example:

What is a “reasonable” range for the number of heads if flipping a “fair” coin 10 times? 100 times?

(Hint: “if you knew the underlying distribution, you could have a very large range around the possible outcomes, but no range around the ACE at all.” – from 1/11/18 AAA webinar, slide 55)

RANGES OF LOSS RESERVES

Remember different contexts for reserve estimate:



For INCOME

How close can I get?

For SOLVENCY

How far off can it be?

RANGES OF LOSS RESERVES

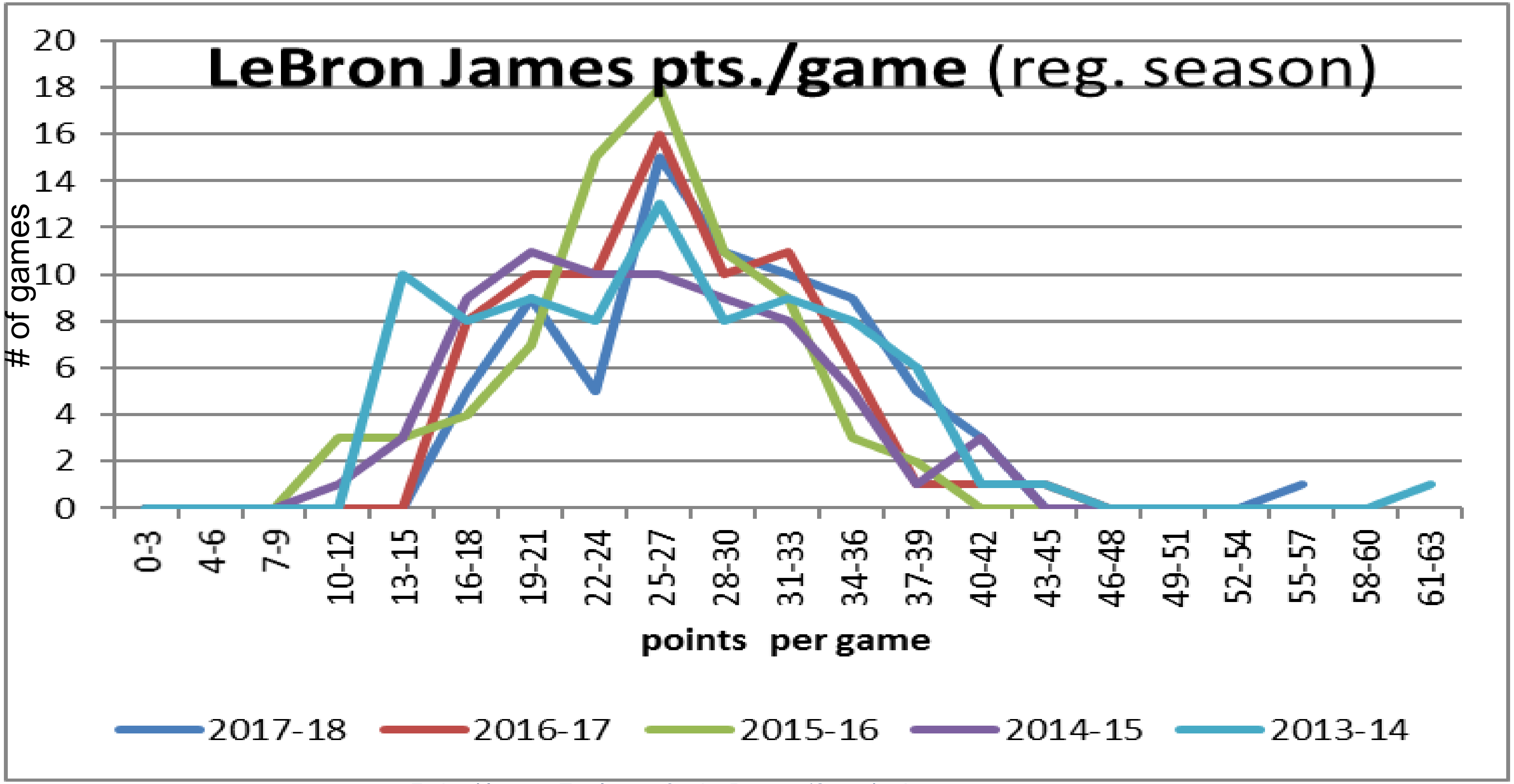
AUDIENCE QUESTION:

Two insurers both expect to pay 75% loss ratio.

- **Insurer A writes basic limits auto coverage in numerous states.**
- **Insurer B writes one liability line of business in one state.**

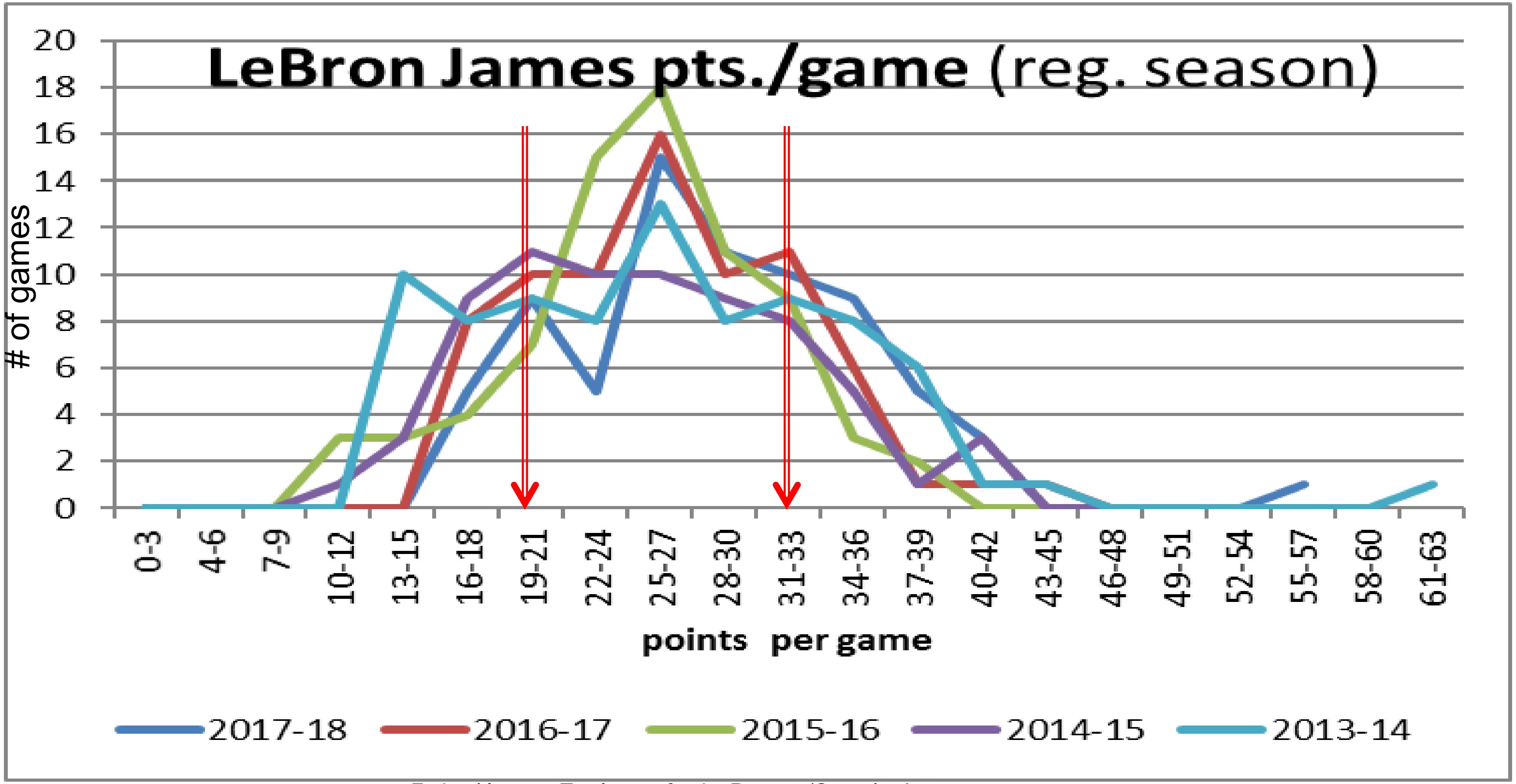
Should they book different LOSS RATIOS?

One more example of RANGES



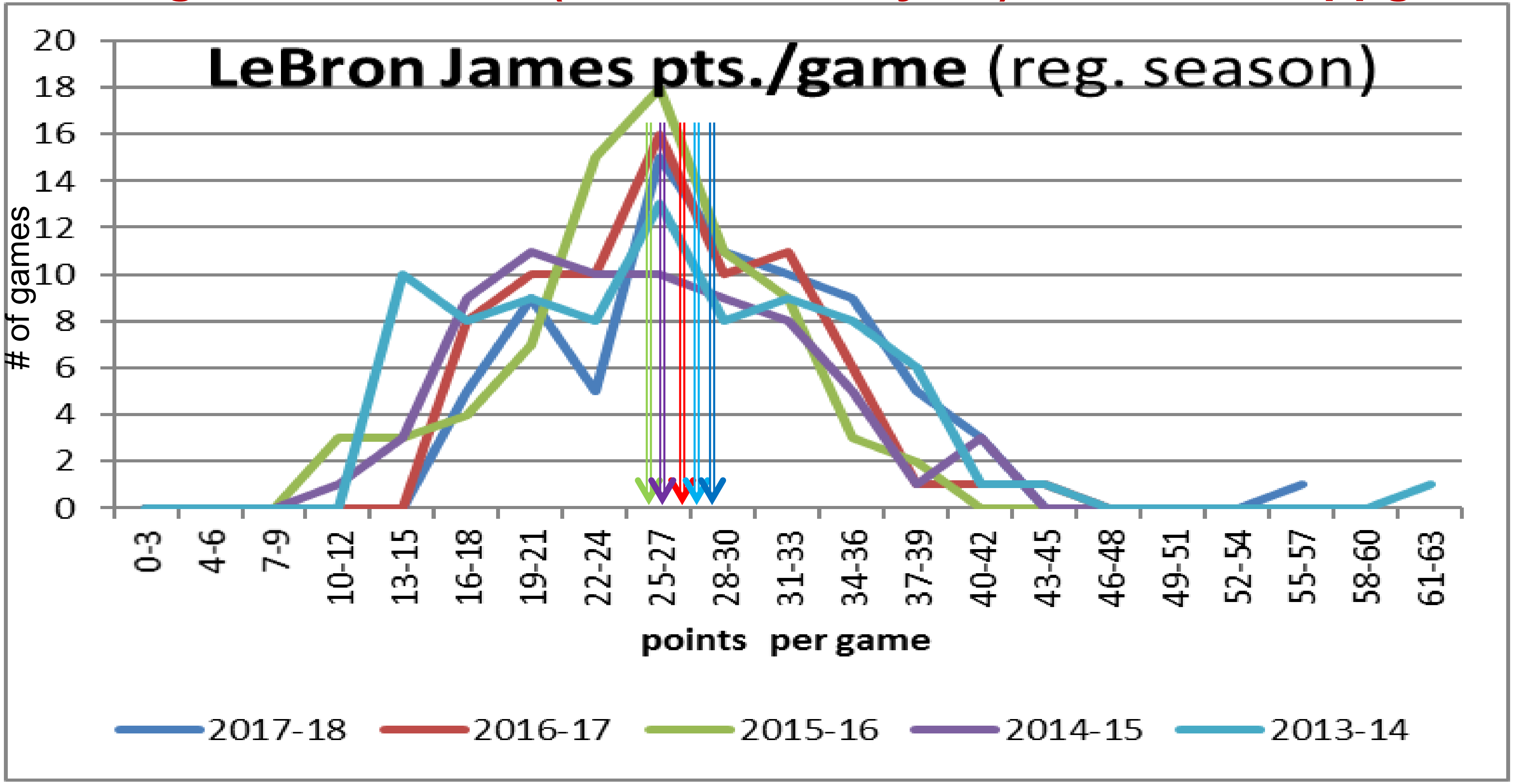
One more example of RANGES

Range of Outcomes (20th - 80th percentile): 20 – 32 ppg



One more example of RANGES

Range of Estimates (mean of each year): 25.1 – 27.5 ppg



SUMMARY OF IRS POSITION ON LOSS RESERVES

Often the IRS standard is stated as being a "reasonable" estimate.

SUMMARY OF IRS POSITION ON LOSS RESERVES

Often the IRS standard is stated as being a "reasonable" estimate.

THIS IS AN OVER-SIMPLIFICATION, and

not "objectively determinable"

The estimate of unpaid losses must be a

- **"fair and reasonable estimate" of**
- **only "actual unpaid losses"**
- **"as nearly as it is possible to ascertain them"**

OTHER IRS ISSUES OF CONCERN

Transfer of Risk

to be reinsurance, must

- "assume significant insurance risk" and
- "may realize a significant loss"
  (Financial Accounting Standard 113)

OTHER IRS ISSUES OF CONCERN

REINSURANCE

Uncollectible reinsurance

- Can be examined separately from loss reserves
  (IRS tax memorandum 201515017)

Summary

IRS audits insurance companies' income, just as it audits numerous corporate and individual taxpayers.

Loss reserves are a key component in determining insurer income, and so can be an object of audit.

Other issues of relevance to actuaries might arise.

As with any deduction, the key is documentation. Often, a review of available documentation is sufficient.