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Tax Issues for P&C Actuaries

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Summary of Acuity Case

- ACUITY, A Mutual Insurance Company: multiline multistate P&C insurer based in Wisconsin. Workers comp is largest line
- In 2006, per its usual practice, Acuity recorded its inhouse professional actuary's loss reserve estimate on Ann Stmt; confirmed as reasonable by outside Appointed Actuary
- IRS asserted reserve was 15% ($96M) overstated, did not comply with IRS regulation requiring "fair and reasonable" estimate of "actual unpaid losses"
  - Challenged actuarial selections as too conservative
  - Pointed to history of reserve redundancy
- US Tax Court, in 98-page opinion issued Sept. 4, 2013, based on testimony in 2-week trial, upheld taxpayer's carried reserve in full
- Key result: Loss reserve determined in accordance with NAIC and ASOP standards is good (probably best available) evidence of "fair and reasonable" reserve for tax purposes

Background on Loss Reserve Tax Challenges

“Fair and reasonable” tax standard for deducting unpaid losses.

- Internal Revenue Code § 832(b)(5) defines “losses incurred”
  - Losses paid (net of salvage & reinsurance), plus
  - Discounted unpaid losses at end of current year (net), less
  - Discounted unpaid losses at end of prior year (net)
- IRS Reg. § 1.832-4(b) states every insurance company must be prepared to establish that its unpaid losses
  - Represent only “actual unpaid losses” and
  - Are a “fair and reasonable estimate” of such losses

Background on Loss Reserve Tax Challenges

Three Tax Court cases 1998-2001. #1 *Utah Medical*

- Monoline single-state MPL insurer
- Outside actuary employed consistent actuarial methods with increasing reliance on company data; actuary familiar with company's business
- Actual loss experience factored into reserves by actuary
- Actuary developed range of estimates; company chose reserve within predetermined range, near high end. Court upheld
- Reserves must be fair and reasonable but are not required to be accurate based on hindsight
- Midpoint of range is not the only fair and reasonable estimate

Background on Loss Reserve Tax Challenges

Three Tax Court cases 1998-2001. #2 *Minn. Lawyers Mutual*

- Monoline single-state lawyers' professional liability insurer
- Ann Stmt reserves consisted of claims department's case reserves plus management-determined "adverse development reserve" of 37% to 50% of total reserve
- Tax Court (upheld by 8th Circuit) ruled taxpayer's reserves did not meet "fair & reasonable" standard
- No actuarially based support for "adverse development reserve"
- Best evidence of a fair & reasonable reserve was outside Appointed Actuary's point estimate

Background on Loss Reserve Tax Challenges

- **Three Tax Court cases 1998-2001. #3 *Physicians of Wisc.***
- Monoline single-state MPL insurer
- Outside actuaries provided point estimates
- Management increased actuaries' estimates by about 10%, pointing to various factors showing increased uncertainty
- Tax Court ruled taxpayer's reserves did not meet "fair & reasonable" standard
- Management's 10% add-ons not supported by actuarial analysis; court dubious about uncertainty factors
- Best evidence of a fair & reasonable reserve was outside Appointed Actuary's point estimate

Background on Loss Reserve Tax Challenges

IRS Coordinated Issue Paper (CIP) on Loss Reserve "Margins"

- Released November 2009, to provide internal guidance to IRS in performing P&C insurance audits.
  - "Margins or other additions to unpaid losses that are not based upon the company's actual loss experience cannot be included in the deduction for losses incurred"
  - Unallowable "margin" can be "explicit" (management add-on to actuary's point estimate) or "implicit" (overly conservative assumptions buried in actuarial computations)
  - "The Service is not bound by the numbers shown on the annual statement"
  - "The Service 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 of deference"

Explanation of Acuity Decision

Background and trial testimony

- IRS audit of Acuity's 2006 tax year reflected Coordinated Issue Paper approach (though audit started before CIP published).
- IRS ultimately asserted $660M carried reserve was $96M overstated.
- Using language of CIP, Acuity was an "implicit margin" case. IRS assertion was that actuary's estimate reflected overly conservative assumptions built into the analysis.
  - During trial, IRS counsel claimed that an *explicit* margin was hidden within actuary's workpapers.
  - Tax Court rejected this as a factual matter. So case remained an "implicit margin" dispute.

Explanation of Acuity Decision

Background and Trial Testimony cont'd

- Two-week trial in September 2012.
- Six FCAS actuaries presented detailed testimony.
  - Acuity's internal chief actuary.
  - Outside Appointed Actuary.
  - Two independent actuarial consultants as expert witnesses for Acuity.
  - Two independent actuarial consultants as expert witnesses for IRS.
- Tax Court found all testimony useful, did not criticize any witness.

Explanation of Acuity Decision

Tax Court decision – Overview

- Holding: Acuity's 2006 Annual Statement carried reserve upheld in full as "fair and reasonable" estimate for income tax purposes.
- Key evidence that Court said "strongly supports" fair-and-reasonable conclusion:
  - Reported reserve determined by professional inhouse actuary based on NAIC standards and Actuarial Standards of Practice, who testified credibly at trial.
  - Adopted by management on A/S unchanged.
  - Supported by independent actuarial analysis and opinion using ASOP standards by outside appointed actuary, who also testified persuasively and credibly at trial.
- Government did not file an appeal. So Acuity decision is final and can be cited as legal precedent.

Explanation of Acuity Decision

Tax Court decision – Lesson #1 of 6: Key importance of NAIC/ASOP standards

- Reliable reserve estimates prepared in accordance with NAIC accounting standards and Actuarial Standards of Practice are the most persuasive evidence of a "fair and reasonable" reserve for income tax purposes.
  - May seem self-evident but *IRS strongly challenged applicability of NAIC loss reserve standards for tax purposes in Coordinated Issue Paper and in many IRS audits of loss reserves.*
  - IRS argued vigorously in this and many other cases that tax standards were *different* from NAIC/ASOP Annual Statement standards. Acuity case really says **no**.
  - Testimony of internal chief actuary and outside Appointed Actuary, as to their careful actuarial approach and judgment calls, found very credible by the Court.

Explanation of Acuity Decision

Tax Court decision – Lesson #2 of 6: Limited relevance of reserve development considered in hindsight

- Favorable development of reserves for prior years, or for year in issue, does not prove the company's NAIC/ASOP-based reserve estimate was unreasonable.
  - However, important to show that reserve development in prior years was taken into account by the company in developing current year reserve.
- Reserve development considered in "hindsight" viewed by the Court as basically irrelevant.
- Gov't argument on analyzing reserve development in hindsight "reads into Federal tax law a requirement that does not exist."

Explanation of Acuity Decision

Tax Court decision – Lesson #3 of 6: Importance of uncertainty in the insurance business

- Uncertainty in the insurance business generally, and in Acuity's business specifically, makes reserve estimates difficult, and makes sound actuarial judgment based on actual character of taxpayer's business crucial.
- Growth of Acuity's long-tailed workers comp business, growth of business overall, expansion into new states all viewed by Court as crucial factors contributing to uncertainty in unpaid losses. Company took these factors reasonably into account.
- Compare professional liability insurance – similar?

Explanation of Acuity Decision

Tax Court decision – Lesson #4 of 6: Use of actuarial ranges

- Court approves actuarially sound ranges of estimates as useful tool for determining reasonableness of taxpayer's reserve.
- Reasonable width of range, reasonable assumptions underlying range, are key factors.
- 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 figure standing alone is "conclusive."

Explanation of Acuity Decision

Tax Court decision – Lesson #5 of 6: "Margins"

- In the language of the 2009 IRS Coordinated Issue Paper, this was an "implicit margin" case in which IRS challenged the internal actuarial assumptions and judgments underlying the carried reserve. Taxpayer's assumptions and judgment were upheld in full.
- IRS argued that company's reserve included a hidden "explicit margin" component, but Court rejected this argument as a factual matter.
- VERY IMPORTANT: Unclear how Acuity decision will apply to "explicit margin" situations. Future IRS challenges may well focus on "explicit" margin cases.

Explanation of Acuity Decision

Tax Court decision – Lesson #6 of 6: "Our inquiry ends"

- When evidence from inhouse actuary and outside opining actuary, supported by independent experts, showed taxpayer's own reserve was fair and reasonable, **taxpayer wins and the case is over**.
- Taxpayer does NOT have to prove that IRS's contrary loss reserve estimate is *un*reasonable.
- Therefore, Court treated IRS expert witnesses' actuarial reports as basically irrelevant – though judge did cite some of their testimony to confirm the uncertainty in the loss reserving process.
- How this rule will apply in IRS audit process is unclear. Presumably sound judgment of taxpayer's actuary has to be afforded substantial weight, but reasonable actuaries can always differ.

New IRS Memo on Challenging a *Portion* of Reserves

Recent IRS Advice: CCM 201515017 (released 4/10/15

- This Chief Counsel Memorandum concludes that IRS examination teams can challenge a taxpayer's estimate for reinsurance recoverable without challenging other aspects of the losses incurred computation.
- The *Acuity* decision should deter the IRS from challenging unpaid losses if they are fair and reasonable overall.
- However, if a portion of unpaid losses computation is arguably not fair and reasonable, the IRS asserts that it can challenge that portion even if it is immaterial to the total amount reported.
- Practically, though, any adjustment would be immaterial to the total unpaid losses.

Next Steps by IRS and Taxpayers

- IRS seems to be in process of rethinking approach to P&C loss reserve challenges.
  - 2009 CIP on "margin reserves" has been officially revoked.
- Implicit margin challenges are complex and expensive. Acuity suggests it may be hard for IRS to prevail.
- Nevertheless, challenging reserves has been part of P&C loss reserve audits for a long time.
  - New CCM suggests reserve challenges remain active.
- Maybe IRS will refocus challenges on demonstrable "explicit" margins – i.e., only the amount by which Annual Statement reserve exceeds actuary's point estimate.

Next Steps by IRS and Taxpayers

- For insurance companies and their actuaries, lessons include:
  - Maintain clear, comprehensive written records confirming the detailed actuarial analysis underlying reserve estimate.
  - If carried reserve exceeds professional actuary's point estimate, maintain records showing that carried reserve was determined in consultation with actuaries and reflected actuarial input.
  - Disclose comprehensive records early in an IRS audit; may persuade IRS that a challenge would not be appropriate.

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