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Lessons for insurers and actuaries from the U.S. Tax Court's Acuity decision

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In a 98-page opinion handed down on September 4 of this year, the U.S. Tax Court held that the loss and loss adjustment expense (LAE) reserves carried by Acuity Insurance, a multiline mutual P&C insurer based in Wisconsin, as of year-end 2006 were "fair and reasonable" within the meaning of U.S. income tax regulations. The court rejected the position of the Internal Revenue Service (IRS), which had sought to reduce Acuity's reserve by close to $100 million–an amount that would have had sizeable implications for Acuity.

The dispute between the IRS and Acuity dated back to 2008, when the IRS first notified Acuity of its intent to review the carried loss and LAE reserves as part of an audit. The IRS developed its proposed adjustment of approximately $100 million the following year. Acuity challenged the proposed adjustment through IRS and court procedures for several years, culminating in a U.S. Tax Court trial in late 2012 and then the court opinion issued in September.

This recent verdict has significant implications for insurers:

- The IRS argued that the Statement of Actuarial Opinion (SAO) is essentially irrelevant in the context of tax regulations, as the SAO does not include an opinion on whether the reserves are "fair and reasonable" for tax purposes. Acuity argued that the SAO is performed under standards of the National Association of Insurance Commissioners (NAIC) and Actuarial Standards of Practice (ASOP) and that the Tax Court has looked to these standards in the past–setting a precedent for the current case.

- As with many property and casualty companies, Acuity experienced favorable reserve development in the years before and after the IRS's challenge to its reserves. The IRS argued that the prior and the subsequent development both demonstrated overstated reserves. Acuity argued that the favorable reserve development was not foreseeable and that, to the extent developing payments and case reserves were less than initially estimated, this was reflected in ongoing reserve analyses.

- As part of its arguments in court, Acuity submitted expert witness reports prepared by two independent consulting firms, both concluding that Acuity's reserves were reasonable. Each actuary reached this conclusion by developing a range of reasonable reserves and observing that Acuity's carried reserve fell within the range. The IRS argued that "a range cannot be entered on a tax return or NAIC Annual Statement." Acuity's response was straight from the Casualty Actuarial Society's Statement of Principles–"a range of reserves can be actuarially sound"–and from Actuarial Standard of Practice 43–"the actuary may present the unpaid claim estimate in a variety of ways, such as … a range of estimates."

- The IRS also objected to the use of actuarial judgment within all of the reserve analyses presented, arguing that a formulaic approach is preferable because it evidences a lack of bias. Acuity argued for the importance of sound actuarial judgment and again referenced the statements of statutory accounting principles and ASOPs, citing support for actuarial judgment in both SSAP 55 and ASOP 36.

In each of the above arguments, the Tax Court sided with Acuity. In particular, the decision ruled that, for tax purposes:

- The guidance of SSAPs and ASOPs is persuasive evidence in determining fair and reasonable reserves.

- The analysis of the opining actuary should be considered "highly probative."

- Favorable development—whether prior or subsequent to the evaluation at issue—is not evidence that a reserve is unreasonable. Rather, such development demonstrates the uncertainty inherent in loss reserves. The IRS's argument, the court stated, "reads into federal tax law a requirement that does not exist."

- The development of a range of unpaid claim estimates is acceptable as a way of supporting the reasonableness of a reserve.

- Sound actuarial judgment is an important part of any reserve analysis.

There are several lessons for the reserving actuary as a result of the Acuity verdict:

- The ability to quote directly from the ASOPs in support of a reserve analysis proved integral to Acuity's victory. Familiarity with the ASOPs—both allowing them to guide an analysis and the ability to rely on them for subsequent support—is seen to be an essential actuarial skill and a good business practice.

- The Acuity case provides an excellent illustration of the importance of both point estimates and ranges in the reserving process, and confirms the appropriateness of relying on a range of reserves to opine on the reasonableness of a carried reserve. Many reserving actuaries continue to rely on a point estimate when a range of reserves might be more appropriate; the Acuity case is an opportunity to rethink this approach.

- Lastly, terminology took on significant import in the case. Disagreements took place regarding the meaning of terms such as "indicated," "margin," "conservative," and "strength." Actuaries should consider the appropriateness of their own terminology in light of this case. For example:

  – If the reserve is reasonable, there is no redundancy or deficiency. The terms "redundancy" or "deficiency" should not be used synonymously with "difference." Analogous terms such as "margin" or "strength" can also be misinterpreted in such a context.

  – The term "conservative," in particular, has a wide range of meanings that can be misinterpreted by the audience. Third parties could misconstrue the labeling of appropriate reserving practices as "conservative."

  – Even the term "indicated" was subject to dispute in the Acuity case. This suggests the actuary may want to take care to rely on one of the terms from ASOP 43 to describe the unpaid claim estimate—for example, actuarial central estimate—and document what the actuary considers that term to mean.

  – Similarly, the terms "low" and "high" have been misinterpreted in other contexts. Typically, the actuary uses these terms to refer to the lowest and highest amounts, respectively, that the actuary would consider to be a reasonable provision for the unpaid claim liabilities. The actuary should take care to document definitions for these terms in the work product.

The Acuity case demonstrates the importance of well-considered and well-documented reserve analyses performed by multiple parties. Each actuary involved in the case spent several hours—in some cases a full day—testifying on the witness stand. Questions ranged from the general—"Why did you develop a range and not a point estimate?"—to the specific—"Why was an average of the last three development factors relied upon rather than a longer-term average?" The most important lesson for actuaries here may be that, expected or not, our work could one day find us similarly questioned. With each analysis we perform, we should answer the question, "Am I ready to defend this work on the witness stand?"

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