Property/Casualty

Holding Pattern

The IRS continues to aggressively challenge property/casualty insurers' deductions for loss reserves.

by Susan J. Forray and Richard F. Riley Jr.

Beginning in 2008 and continuing today, insurance tax specialists at the Internal Revenue Service have been accelerating challenges to the loss reserve tax deductions taken by property/casualty insurance companies.

The IRS claims that some property/casualty insurers are intentionally and systematically overstating their loss reserves to inflate tax deductions beyond what is "fair and reasonable," the legal standard for the tax deduction in IRS regulations. The IRS points to a recent industrywide pattern of reserve releases to buttress its position.

The IRS examiners lay out the case in support of their aggressive policy on loss reserves in a Coordinated Issue Paper published in November 2009. Titled *Margins and Other Unsubstantiated Additions to Insurance Company Reserves for Unpaid Losses and Claims*, the paper contends insurers are too conservative in estimating the payouts they will need to make in the future—that they are, as the title suggests, adding "unjustified" or "unsubstantiated" margins to their loss reserves. These added margins result in excessive deductions and a corresponding deferral of the correct tax liability, the agency claims.

The primary arguments put forward in the IRS paper are that added margins inflate insurance company losses beyond the "fair and reasonable" estimate permitted by IRS regulations. Estimated losses must represent the "actual unpaid losses" incurred as of the given evaluation date for which the deduction is being claimed. "If a taxpayer cannot establish that a margin or other addition to unpaid losses represents actual unpaid losses," the IRS writes, "the deduction will be disallowed to the extent it exceeds a fair and reasonable estimate."

The IRS points to two types of "margins" that it claims can inflate a company's loss reserve deductions beyond the fair and reasonable level. "Explicit margins" are dollar amounts added to an actuarially determined estimate of unpaid losses, while "implicit margins" are the supposedly improper use of "implicit conservatism" in establishing a company's loss reserves.

"Explicit" margins, unsupported by any actuarial analysis, have been disallowed in some court decisions. To the extent the IRS is raising questions about loss reserve "add-ons" proposed by company management that lack sufficient actuarial guidance or support, the IRS has some legal basis for its opposition (although every case will turn on its specific facts).

The rejection of "implicit" margins is the more troubling and aggressive aspect of the IRS's stance. It is also

Key Points

- **The Issue:** The Internal Revenue Service is aggressively auditing so-called "implicit margins" in property/casualty insurers' loss reserves.
- **The Background:** The agency's stepped-up scrutiny of loss-reserve tax deductions has been ongoing since 2008. The IRS position is described in a November 2009 Coordinated Issue Paper.
- **The Outlook:** Loss reserve audits can be expected to continue for several years, until the cycle of industry reserve releases ends.

the more difficult charge for insurance companies to defend against successfully, as "conservatism" in establishing reserves is, at least for some purposes, a core element of the accounting practices of the property/casualty insurance industry.

With its indictment against implicit conservatism, the IRS is contending that even when property/casualty loss reserves are developed by credentialed actuaries and consistent with accepted actuarial and insurance industry standards, the reserves may still be subject to a tax challenge if they are based on some unspecified and supposedly inappropriate degree of conservatism.

Competing Interests

The IRS suggests that a possible conflict exists between reliance upon the statutory accounting methods employed in the annual statement that insurance companies must file with state regulators and the "fair and reasonable" standard for loss reserves in the IRS regulations. In particular, the Issue Paper states, "the fact that the statement of actuarial opinion concludes that the numbers shown on the annual statement make a 'reasonable provision' for unpaid losses

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does not establish that those numbers are 'fair and reasonable' for federal income tax purposes."

This places insurance companies in a quandary—pulled in opposite directions between two different governing authorities. Insurance companies in the United States are regulated by state governments and agencies, which ultimately favor a principle of solvency. The primary, though not exclusive, interest of state regulators is to ensure that insurance companies operating within their borders will be able to pay claims now and in the future.

The primary interest of the IRS is in collecting, in a timely manner, all of the tax revenue it believes it is owed. The government's interest in maximizing revenue collections may be particularly strong in the current budget-deficit environment.

There is, however, little legal precedent to support the IRS's rejection of any degree of "conservatism" in developing loss reserves. In general, the estimation of unpaid losses appears in some sense to be inevitably conservative in the insurance industry, taking into account the many risks generated by the insurance business.

No enterprise wants to drive itself out of business by ignoring the array of risks that might be encountered on a day-to-day basis. But while all businesses face some risk, the insurance industry is in the business of taking on risk. Property/casualty insurers therefore must be prepared to satisfy claims under current policies that, in some cases, can stretch out to include many years—even decades—of payments into the future.

Professional actuarial standards and National Association of Insurance Commissioners' accounting standards are consistent with this kind of conservatism. As explained in the preamble of the NAIC's *Accounting Practices & Procedures Manual*, "in order to provide a margin of protection for policyholders, the concept of conservatism should be followed when developing estimates."

Nevertheless, companies must be aware that the current IRS audit position is to reject any perceived conservatism in loss reserves. Statements about conservatism made to regulators, investors or other constituencies may be a red flag to the IRS.

A Timing Issue?

Since insurance companies deduct their losses and loss adjustment expenses either when reserved or, ultimately, when actually paid out, the question has come up, "Isn't this just a timing issue?"

In the end, the answer is yes—but not entirely. Frequent and aggressive audits consume companies' time and money.

The tax liability and other financial impacts of aggressive and frequent audits on insurance company expenses can be substantial for several reasons. Beyond the obvious time and expense involved in defending carried loss reserves, there are the following factors to consider:

The amounts of money involved can be substantial, with some of the larger companies risking denial of hundreds of millions of dollars in loss reserve deductions.

The interest paid by companies on these adjustments can be correspondingly substantial; interest due to the IRS from large companies is calculated at approximately 5% to 6% per year for the annual statement years currently under review—far more than insurance companies can earn on their investments in today's low-interest environment.

Some property/casualty companies face the threat of being challenged every year, which continually reduces their loss reserve deductions year after year, leading to the equivalent of a permanent adjustment and, ultimately, the burden of a truly larger tax liability.

The reserve for unpaid losses is typically the largest deduction on a property/casualty insurer's tax return. Companies that have released reserves in the past several calendar years may feel the deck is stacked against them in a tax audit. But writers of long-tailed coverage in particular should keep in mind that having released reserves does not necessarily indicate that these reserves were unreasonable to begin with, based on the experience observed at the time.

In fact, it is entirely possible to release reserves each year in the aggregate, but leave tail liabilities such as workers' compensation or asbestos and environmental claims underfunded. Consider that while the property/casualty industry as a whole has released $50 billion of reserves during the past five calendar years, A.M. Best currently estimates that the property/casualty industry's reserves are deficient by nearly $43 billion. (*A.M. Best Special Report: U.S. Property/Casualty Review & Preview*, Feb. 14, 2011)

When an individual receives an audit notice from the IRS, the typical response might be "Did I do something wrong?" or "They've caught me!" But that is not the case with the current spate of property/casualty insurance company audits. Well-run and highly respected companies are being regularly and aggressively audited by the IRS for loss reserves that are considered reasonable by the state regulators charged with their oversight.

Companies need to be prepared for such audits, but can take some comfort in knowing that this level of audit activity might only continue for a few years more. The property/casualty business is cyclical in nature, although the degree of future cyclicality cannot be predicted easily. This affects the reserving process, resulting in alternating periods of reserve additions and reserve releases as companies respond to their most recent claims experience.

In another year or two, companies may begin to experience adverse development again. It is possible that at that point the IRS's appetite for aggressive property/casualty loss reserve audits will begin to diminish. BR