Tax Court rules insurance company's actuarial estimates of carried loss reserves are 'fair and reasonable'

September 19, 2013

In brief

In *Acuity Mutual Ins. Co. v. Commissioner*, T.C. Memo. 2013-209, the Tax Court held that the amount of carried loss reserves claimed by an insurance company under Section 832 was fair and reasonable because it was actuarially computed in accordance with the rules of the National Association of Insurance Commissioners (NAIC) and Actuarial Standards of Practice (ASOPs) and fell within a range of reasonable estimates determined by the company's appointed outside actuary. The case sheds light on the standards a company must meet to establish its reserves are fair and reasonable, and calls into the question the IRS practice of asserting there is an "implicit margin" solely because the IRS's own actuaries determine that reserves should be lower.

In detail

Acuity is a mutual property and casualty insurance company and the common parent of a consolidated group of corporations. Acuity used an in-house actuary to compute the company's loss reserves for 2006 (and other years) both on a quarterly basis and at year-end. The in-house actuary produced approximately 900 pages of actuarial analysis in performing the loss reserve computations, in which he used eight separate actuarial methods to compute his estimate.

In addition, the company used an outside consulting actuary, appointed by its board of directors, to independently review the company's loss reserves each year and prepare a statement of actuarial opinion, as required by NAIC. The purpose of the outside actuary's engagement was to determine whether Acuity's carried loss reserves for 2006 of $660 million (i.e., the in-house actuary's expected loss reserves) fell within a range of reasonable reserve estimates. The independent actuary computed a "narrow" range of reasonable reserve estimates of $577 million to $661 million for 2006. Under the independent actuary's 'audit' procedures, an insurance company's loss reserves are reasonable if they fall within the range; therefore, the independent actuary determined that Acuity's carried loss reserves of $660 million were reasonable and signed a statement of actuarial opinion stating so. Acuity filed its Annual Statement for 2006 and reported its carried loss reserves at $660 million.

Nonlife insurance companies must compute their taxable income under Section 832. Pursuant to Section 832(b)(1)(A), gross income includes amounts earned from investment and underwriting income, taking into account losses incurred, which are computed using the NAIC-approved annual statement. Under Treas. Reg. sec. 1.832-4(a)(14), the taxpayer is required to establish that its estimate of unpaid losses is 'fair and reasonable' and represents 'only actual unpaid losses.' On its 2006 Form 1120-PC, *U.S. Property and Casualty Insurance Company Income Tax Return*, on Schedule F, *Losses Incurred – Section 832*, Acuity reported discounted unpaid losses of $622 million, which represents Acuity's carried loss reserves of $660 million discounted pursuant to Section 846. In 2011, the IRS issued a notice of deficiency for the 2006 tax year, arguing that Acuity's carried loss reserves of $660 million were overstated by $96 million.

In its analysis, the Tax Court relied on Seventh Circuit case law to the effect that the NAIC-approved annual statement is starting point for computing unpaid losses (see *Sears, Roebuck & Co. v. Commissioner*, 972 F.2d 858, 866 (7th Cir. 1992)). (The Seventh Circuit is the circuit to which the case would be appealed). The IRS argued that the annual statement controls only what is includible in the loss reserve, not the amount of the loss reserve itself. The court, however, disagreed, holding that the annual statement should be used as the source of unpaid losses for federal tax purposes.

The court's analysis was extraordinarily thorough, examining the role and credential of each actuary involved in the valuation, the operation of the relevant actuarial guidance, the multiple methods used to produce a range, and the process by which each element of the determination was carried out and documented.

The court rejected the IRS's argument that the independent actuary was not allowed to provide a range, because ASOP 36 specifically authorizes the computation of a range of reasonable reserve estimates. The fact that the carried loss reserves fell within the range of both the independent actuary and two expert opinions strongly supported Acuity's position. Therefore, the court held that Acuity produced substantial evidence in support of its position that its carried loss reserves for 2006 are fair and reasonable. In contrast, according to the court, the IRS did not produce any persuasive evidence to the contrary. Because the company had produced substantial evidence in support of its position that the unpaid loss reserves for 2006 were fair and reasonable, the company was not required to prove that the IRS-determined amounts were not fair and reasonable.

The takeaway

The Acuity decision is only a Memorandum Decision of the Tax Court, which means that its precedential value is limited. Nevertheless, the case is helpful because it demonstrates clearly the kind of process and documentation that are needed in order to prevail when the IRS asserts that the amount of a non-life insurer's unpaid loss reserves is not fair and reasonable. The case also makes it more difficult for the IRS to assert that a company's unpaid loss reserves include an "implicit margin" solely because they exceed the amount that the IRS's own actuaries would have determined independently.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

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