TAXATION OF PROPERTY AND CASUALTY INSURANCE COMPANIES

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I. General Considerations

A. Types of organizations -- P&C insurers are primarily chartered under state law as stock or mutual companies.

B. Economic functions

1. Underwriting -- Issuance of property and liability insurance (automobile, casualty, fire, malpractice, title, accident and health, etc.)

2. Investment -- Invest primarily in bonds, including tax-exempt bonds, and corporate stock.

II. Major Tax Concepts

A. Should special rules apply to property and casualty insurance companies? If so, what special rules should apply?

B. Policy obligations generally are short term, as opposed to the long-term policy obligations of life insurers. The short-term nature of the liabilities is reflected in the types of reserves held.

C. The tax accounting principles (TAP) applicable to property and casualty insurance companies are greatly affected by the statutory accounting principles (SAP) applicable to those companies. Statutory accounting principles are analogous to, but differ from, generally accepted accounting principles (GAAP). See Treas. Reg. § 1.832-4(a)(1) & (2).

D. P&C's generally are taxed on both their investment and underwriting income. The computation of underwriting income involves two key elements: (1) unearned premiums, and (2) losses and expenses incurred.

1. Reserves for unearned premiums

a. A P&C insurer includes in income only the portion of premiums that has been "earned" (but, see below).

b. As of any year end, the "unearned" portion of any premium is the amount attributable to the unexpired term of the policy -- the portion which would be returned if the policy were cancelled.

c. Note that ordinary taxpayers are subject to the claim of right doctrine and are not similarly entitled to defer income. AAA v. U.S., 367 U.S. 687 (1961); RCA Corp. v. U.S., 664 F.2d 881 (2d Cir. 1981).

d. Courts have held that unearned premium reserves may also include other amounts, such as a reserve for retrospective rate refunds.

Bituminous Casualty Corp. v. Comm'r, 57 T.C. 58 (1971). Regulations now provide that such "retro credits" are excluded from unearned premium reserves. Treas. Reg. § 1.832-4(a)(8).

e. Unlike other casualty insurers, a title insurance company can be considered to have earned the entire premium upon payment. Also, no part of the premium is refundable, even if the title insurance policy is canceled. However, state law usually requires that a portion of the premiums received be set aside. The IRS does not consider that portion to be an unearned premium. Rev. Rul. 83-174, 1983-2 C.B. 108. For tax years beginning after December 31, 1986, however, section 832(b)(8) provides a special rule for calculating the "discounted unearned premiums" of a title insurance company. See Rev. Rul. 91-22, 1991-1 C.B. 91.

2. Reserves for unpaid losses

a. A P&C insurer may deduct from income its "losses incurred." A loss is incurred when the event that is insured against occurs.

In Sears, Roebuck & Co. v. Comm'r, 96 T.C. 61 (1991), rev'd, 972 F.2d 858 (7th Cir. 1992), the courts considered the issue of when a loss is incurred in the context of mortgage guarantee insurance -- when the borrower defaults or when the lender secures title to the mortgaged property. See also AIG, Inc. v. U.S., 38 Fed. Cl. 272 (1997).

b. The term "incurred" is far broader than the term "accrued" and, unlike the term "accrued," does not rely on the "all events test." Moreover, section 461(h) should not apply to incurred losses.

c. Losses incurred include (both actual and anticipated) claims payments for benefits under policies that have been:

Reported (or case) losses:

- incurred, reported, adjusted, and paid

-incurred, reported, adjusted, but not yet paid (even if the claim is resisted)

-incurred, reported, but not yet adjusted

IBNR losses:

-incurred, but not yet reported

d. Reserves for unpaid losses must be "a fair and reasonable estimate of the amount that the company will be required to pay." Treas. Reg. § 1.832-4(b).

(1) In Utah Medical Ins. Ass'n v. Comm'r, 76 TCM (CCH) 1100 (1998), the Tax Court held that a medical malpractice insurer's estimates for reserves for unpaid losses were "fair and reasonable." The Tax Court accorded deference to the opinion of the taxpayer's expert actuary, who was also the taxpayer's actuary during the years in issue.

(2) But see, Minnesota Lawyers Mutual Ins. Co. v. Comm'r, 79 TCM (CCH) 2234 (2000), aff'd, 285 F.3d 1086 (8th Cir. 2002), where the Tax Court held that a portion of a professional liability insurer's estimates for unpaid loss reserves was not "fair and reasonable." The portion of the reserves that was found not to be fair and reasonable was called the "adverse loss development" reserve, which was (1) a bulk reserve (i.e., it was not case-specific), (2) established by the insurer's CEO and President, not the company's actuaries, and (3) increased the insurer's unpaid loss reserves by 37 to 50 percent.

e. Unpaid loss reserves for reported losses are based either upon an average value or statistical method, or upon the facts of the specific reported claims. IBNR reserves are estimated, based on experience, as a percentage of insurance in force.

f. The IRS will test unpaid loss reserves to determine the reasonableness of their estimation.

g. The IRS first relied on the "Closed Case Method."

(1) The method tests the portion of the reserve computed on the individual case (not the formula) basis.

(2) The test identifies cases that are open as of the end of each year during a three-year period that ends five years prior to the audit year.

(3) The amounts of the loss estimates in the cases that close during the five-year development period are compared to actual payments on those closed cases made in years through the audit year. (Cases still open are disregarded.)

(4) That comparison creates an experience rate. For example, if on a case a $1,000 loss was estimated, and $800 was

paid, the experience rate is 125 percent. (25 percent over-reserving.)

(5) The experience rate is applied to the unpaid loss reserves in the audit year.

(6) See Example #18.

(7) Note: The test is applied separately to each line of business. The test may be modified in various ways. An insurer may be able to rebut proposed adjustments by developing the reserves for the year in audit.

(8) IBNR reserves also are tested. For example, for 1993, test claims incurred during or before 1993, but not reported until after 1993.

h. The IRS's view of the test

(1) Most claims that will be paid are paid within the five year development period. Any payments made after that period also can be considered.

(2) Allowing addition of an estimate as to amounts that will be paid after five years would be inaccurate ("testing an estimate with an estimate"). See LTR 8817001 (July 28, 1987).

i. The P&C company view of the test

(1) Many claims are not paid within the five year period. Some types of cases, in the "long-tail" lines of business, often are closed later. Any test should allow for this.

(2) Payments in "short-tail" cases are more likely to be less than or equal to the loss estimate. Schedule O lines (fire, theft, auto physical damage, and group A&H) are usually short-tail.

(3) Payments in "long-tail" cases are more likely to exceed the loss estimate. (Inflation, more hotly contested claims, larger claims.) Schedule P lines (auto liability, medical malpractice, workmen's comp.) are usually long-tail.

(4) The method ignores cases that are "open," yet which are making payments over time (for example, workmen's compensation cases).

(5) Since the method only tests case reserves, it ignores IBNR reserves.

(6) The test requires payments be reduced by salvage and subrogation recovered. This skews the results, since the losses incurred reserves must be estimated without considering such recoveries.

(7) There should be a tolerance factor.

j. Under a "Modified Closed Case Method," announced by the IRS in response to various criticisms, some of the foregoing concerns were addressed. See "IRS' Coordinated Issues List for Property/Casualty Insurance Companies is Available," 90 Tax Notes Today 158-11(July 31, 1990). However, many of the same problems continued to exist.

k. Currently, the most commonly used method is the "Age-to Ultimate Method," or the "Paid Loss Extrapolation Method."

(1) The theory of the method is that, because losses develop according to a pattern that remains relatively constant from year-to-year (a key assumption), the actual development of paid losses at any time can be extrapolated to the ultimate total of losses to be paid.

(2) The method depends on creating a matrix of developed losses at successive stages, referred to as the "loss development pattern." This pattern will show that X% of losses are paid after one year, Y% of losses are paid after two years, etc.

(3) Using this pattern, it is possible to estimate the amount of losses that ultimately will be paid.

(4) The amount of the reserve being held should equal the ultimate amount of losses minus the amount of losses already developed. If the reserve exceeds that amount, the IRS may claim that the reserve is redundant.

(5) See Example #19.

(6) The Age-to-Ultimate Method also has shortcomings. Primarily, it is based on the assumption that previous loss payment patterns accurately reflect more current patterns. However, various factors may undermine that assumption.

3. Reserves for unpaid loss adjustment expenses (LAE)

a. A P&C insurer may deduct loss adjustment expenses.

(1) LAE are expenses of adjusting, recording, and paying policy claims. (Such as employee salaries, legal fees, etc.)

(2) LAE are either "allocated" or "unallocated" expenses. Allocated LAE are directly attributable to specific cases. Unallocated LAE are general overhead-type expenses.

(3) LAE are either "paid" or "unpaid." Unpaid LAE are estimates of future expenses to be incurred in connection with unpaid losses.

b. Estimates of unpaid LAE are deductible, even though such expenses do not meet the all events test. Section 461(h) does not apply.

c. LAE estimates are usually prepared on a formula basis. A ratio is determined, based on prior years' numbers, of paid LAE to paid losses. That ratio is then applied to the current year reserve for unpaid losses.

d. The IRS will test estimates of unpaid LAE. Generally, the test applies a paid expense/paid loss ratio to adjusted reserves for unpaid losses.

E. These two elements -- unearned premiums and losses incurred -- have figured prominently in the taxation of P&C insurance companies over the years.

1. Prior to the 1986 Act, the Code utilized annual statement amounts. Under these Code provisions, companies could fully defer unearned premiums, and fully deduct estimated unpaid losses and LAE.

2. In an attempt to match income with expenses, and to reflect the time value of money, the 1986 Act significantly altered the taxation of reserves for unearned premiums and reserves for unpaid losses and loss adjustment expenses, for years after 1986. (See discussion below.)

III. <u>Income Subject to Tax</u>

A. <u>In General</u>

1. P&C companies are insurance companies that do not qualify as life insurance companies under section 816.

2. HMOs, other than staff model HMOs, can qualify as P&C insurance companies. Rev. Rul. 68-27, 1968-1 C.B. 315; LTR 9412002 (Dec. 17, 1993). However, the IRS has taken the position that a company jointly

owned by an HMO and physicians is not an insurance company, because the predominant business activity of the company is the provision of medical services. FSA 200104011 (Oct. 19, 2000).

3. Extended warranty providers for automobiles and other manufactured products can qualify as P&C insurance companies if they (1) bear the economic risk of loss on the contracts and (2) do not directly provide the warranted services. See, e.g., LTR 200028018 (Apr. 14, 2000) (extended product warranty company); LTR 200042018 (July 21, 2000) (extended auto warranty company); LTR 200140057 (July 9, 2001) (extended warranty company that issues auto, plumbing, electrical, and heating contracts); LTR 200242027 (July 17, 2002) (extended auto service and tire contract company); LTR 200237010 (June 5, 2002) (extended auto warranty company).

B. Accounting Methods

1. P&C insurers do not use either the cash method or the accrual method of accounting. Instead, they base their taxable income (section 832(b)(1)) and expenses (section 832(b)(6)) on their NAIC annual statements. Treas. Reg. § 1.832-4(a)(1) & (2). See Home Group, Inc. v. Comm'r, 89-1 U.S.T.C. ¶9329 (2d Cir. 1989).

2. Taxable income so computed is subject to tax as provided in section 11. Section 831(a).

C. Two Alternatives for Small Companies

1. Instead of being subject to tax on their regular taxable income, certain small companies (either stock or mutual) may be exempt from tax or, if not exempt, may elect to be taxed on their "taxable investment income." Sections 501(c)(15) and 831(b).

2. These two provisions, which were enacted in the 1986 Act, replace prior provisions that gave special treatment to small mutuals. Former sections 501(c)(15), 821, and 824.

3. First, certain P&C insurers may be exempt from tax under section 501(c)(15).

a. For tax years beginning on or after January 1, 2004, a P&C insurer generally must meet three tests to qualify for tax-exemption: (1) it must qualify as an "insurance company" as defined in section 816(a); (2) its gross receipts must not exceed $600,000; and (3) more than 50% of its gross receipts must be premiums. For mutual insurance companies, the gross receipts limit is reduced to $150,000 and the percent of premiums requirement is reduced to 35%. Certain related person and related entity rules apply for

purposes of these tests. See also, IRS Notice 2004-64, 2004-41 I.R.B. 598 (alerting taxpayers to amendments to section 501(c)(15)).

b. For tax years beginning before January 1, 2004, P&C insurers that receive premiums during the year in the amount of $350,000 or less qualify as tax-exempt organizations under section 501(c)(15).

4. Second, P&C insurers that receive premiums of less than $1,200,000 for a taxable year may elect to be taxed on their "taxable investment income." Section 831(b)(2). For tax years prior to 2004, a company must also receive premiums of more than $350,000. This requirement was eliminated by the Pension Funding Equity Act of 2004.

a. Taxable investment income is defined as "gross investment income" less specified investment-type deductions. Section 834.

b. Taxable investment income for P&C insurers is very similar to Phase I income of life insurers under the 1959 Act. Former section 804. It is somewhat analogous to current sections 812(c) and (d) applicable to life insurance companies.

c. Rules are provided to aggregate the incomes of members of a "controlled group." Section 831(b)(2)(B).

IV. Insurance Company Taxable Income

A. P&C insurance companies generally are subject to tax on their "taxable incomes." Section 831(a). Taxable income is computed as "gross income" less various deductions. Section 832(a).

B. "Gross income" is the sum of the items specified in section 832(b)(1). Generally, these items are:

1. Investment income.

2. Underwriting income.

3. Gains from dispositions of property.

4. Other items of gross income.

C. "Investment income" is the sum of the interest, dividends, and rent received, plus the increase in the accrual for such items of income. Section 832(b)(1)(A) and 832(b)(2).

1. These items are computed on the basis of the company's NAIC annual statement.

2. Many issues concerning, for example, accrual of discount and amortization of premium, arise in this area.

D. "Underwriting income" is computed as "premiums earned" less "losses incurred" and "expenses incurred." Section 832(b)(1)(A) and 832(b)(3).

1. Premiums earned

a. In general, only 80 percent of the increase in the unearned premium reserve may be deducted. Section 832(b)(4)(B).[1]

b. What is included in "Premiums Written" for a given tax year?

Treas. Reg. §1.832-4(a)(4)(i) defines gross premiums written as "all amounts payable for the effective period of the insurance contract." Under Treas. Reg. § 1.832-4(a)(4) and (5) the following items are included in gross premiums written:

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[1] Under pre-1986 Act law, earned premiums equaled gross premiums written less the sum of (1) premiums paid for reinsurance, (2) return premiums (for errors, policy cancellations, etc.), and (3) the increase in the reserve for unearned premiums (see above). The reserve amounts were as reported on the NAIC annual statement.

As part of the change to the 80% method, the reserve for unearned premiums as of year-end 1986 is reduced by 20 percent, and that amount is included in income ratably over a 6-year period, from 1987 until 1992; i.e., 3-1/3 percent of the year-end 1986 reserve per year. Section 832(b)(4)(C). Thus, no "fresh start" is provided, except for title insurers.

Section 832(b)(7)(D) waives such inclusion for a company exempt from tax in pre-1987 years.

Treatment of companies' pre-1963 unearned premium balance

1. Some mutual companies were exempt from tax prior to 1963 and, therefore, their pre-1963 unearned premium reserves provided no tax benefit.

2. These companies object to having 20% of their unearned premium reserves brought into income to the extent of their pre-1963 reserves.

3. The IRS counters that the year-end 1986 reserves reflect no unearned premiums from 1963.

This 20% reduction provision does not apply to life insurance reserves that are included in unearned premium reserves. Section 832(b)(7)(A). As to premiums on these life insurance contracts, see the section 848 DAC rules, discussed infra.

In the case of certain insurance on securities, the reduction is only 10 percent. Section 832(b)(7)(B).

(1) Premiums actually received during the year. Treas. Reg. §1.832-4(a)(5)(i).

(a) The regulations also appear to require that premiums attributable to an insurance contract that has an effective date during a tax year be included in premiums written for that year, even if the premiums are not received by the insurance company until a later year. Treas. Reg. §1.832-4(a)(5)(i).

(2) Premiums payable in installments. See, e.g., Treas. Reg. §1.832-4(a)(10), Example 1.

If premiums on an insurance contract are payable in installments, the full amount of the installments attributable to the effective coverage period (e.g., a one year period on an annually renewable contract, or a longer contract with 12 month rate guarantees) must be included in premiums written for the tax year that includes the effective date of coverage, even if an installment or installments will be received in a later year.

(a) An exception to this reporting rule for installment payments is available for cancellable accident and health ("A&H") insurance contracts with effective periods of 12 months or less. Treas. Reg. § 1.832-4(a)(5)(iv). Under the exception, an installment premium on a cancellable A&H contract is reportable in the earlier of (1) the tax year in which the installment premium is due, or (2) the tax year in which the installment premium is received.

(b) In order to qualify for this exception, the insurance company's deductions for premium acquisition expenses (e.g., commissions, state premium taxes) related to its cancellable A&H contracts with installment premiums, are limited. Treas. Reg. §1.832-4(a)(5)(vii). See, e.g., Treas. Reg. § 1.832-4(a)(10), Example 5. See also, Rev. Proc. 2002-46, 2002-28 I.R.B. 1 (providing a safe harbor method for determining a company's premium acquisition expenses, and providing change in method of accounting rules for use of safe harbor method). An insurance company that adopts the method of reporting allowed by this exception must apply that

method to all of its cancelable A&H insurance contracts.

(c) The IRS has ruled that insurance contracts issued to states to cover their obligations under Medicaid benefit programs qualify as cancellable A&H contracts under the regulations. LTR 200044028 (Aug. 7, 2000).

(3) Advance premiums. Treas. Reg. § 1.832-4(a)(5)(i) and (iii).

(a) Treas. Reg. § 1.832-4(a)(5)(i) requires that if an advance premium is received, the full gross premium due must be reported as premium written, and as unearned premium. This is required regardless of annual statement treatment.[2]

(b) An exception to this reporting rule for advance premiums is available. Treas. Reg. § 1.832-4(a)(5)(iii). Under this exception, only the amount of the advance premium is includible in taxable income for the year in which it is received. The remainder of the full premium is included in income for the taxable year that includes the effective date of the contract. See, e.g., Treas. Reg. §1.832-4(a)(10), Example 3.

(c) Similar to the rule applicable to installment premiums, in order to qualify for this exception, the insurance company's deductions for premium acquisition expenses (e.g., commissions, state premium taxes) are limited. Treas. Reg. § 1.832-4(a)(5)(vii). See also, Rev. Proc. 2002-46 (providing safe harbor method for determining premium acquisition expenses). An insurance company that adopts the method of reporting allowed by this exception must apply that method to all contracts with advance premiums.

(4) Additional Premiums Due to Increases in Risk Exposure.

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[2] Formerly, on the annual statement, advance premiums (i.e., premiums received prior to the effective date of insurance coverage) were recorded as written premiums, and then as unearned premiums. Now, companies can place advance premiums in a suspense account and report a write-in liability.

(a) Methods of reporting indeterminate premiums on policies with fluctuating risks.

i) Some insurance policies do not have premiums fixed in advance, but premiums that vary with factors subsequently determined (e.g., number of employees). Nevertheless, premiums are billed and paid periodically. There are two methods to account for this.

ii) Under the "Eastern Method," the company includes in gross premiums an estimated annual premium, and includes the unbilled portion of the estimated premium in unearned premiums.

iii) Under the "Western Method," the company includes amounts in gross premiums only as the amounts are billed. Since amounts billed are for prior coverage, there are no unearned premiums.

iv) Thus, the "Western Method" avoids the 20% unearned premium reduction.

(b) The IRS's regulations reject the "Western Method."

(c) Treas. Reg. §§ 1.832-4(a)(4)(ii)(A) and (a)(5)(ii) require that additional premiums charged and/or received due to increases in risk exposure are included in gross premiums written.

(d) Treas. Reg. §1.832-4(a)(5)(ii) provides that the full amount of additional premiums due to changes in risk exposure are included in gross premiums written for the taxable year in which the change in risk exposure occurs. See, e.g., Treas. Reg. §1.832-4(a)(10), Example 6.

i) The regulations contain an exception to this reporting rule for additional premiums due to a change in risk exposure, if the change in risk exposure is of temporary duration. Treas. Reg. § 1.832-4(a)(5)(ii). See, e.g., Treas. Reg. § 1.832-4(a)(10), Example 7.

(5) Amounts subtracted from a premium stabilization reserve to pay for insurance coverage. Treas. Reg. § 1.832-4(a)(4)(ii)(B).

(6) Consideration in respect of assuming insurance liabilities not issued by the taxpayer (e.g., payments of cash or transfers of property received in an assumption reinsurance transaction). Treas. Reg. § 1.832-4(a)(4)(ii)(C).

c. Gross premiums written are reduced by return premiums. Section 832(b)(4)(A); Treas. Reg. §1.832-4(a)(3).

(1) "Return premiums" are amounts previously included in the insurance company's gross premiums written which are refundable to the policyholder (or ceding insurance company, if for reinsurance) and fixed by the insurance contract, i.e., they do not have the characteristics of policyholder dividends. Treas. Reg. § 1.832-4(a)(6)(i).

(2) Return premiums include (1) amounts paid as premiums that are refundable by the insurance company due to policy cancellations or reduced risk exposure; (2) amounts reflecting the unearned portion of unpaid premiums that are refundable due to policy cancellations or reduced risk exposure; and (3) amounts paid or amounts reflecting the unearned portion of unpaid premiums for an insurance contract arising from the redetermination of a premium due to correction of posting or other errors. Treas. Reg. § 1.832-4(a)(6)(ii).

(3) Return premiums attributable to the cancellation of an insurance contract are reported for the year in which the contract is cancelled. Return premiums attributable to reduced risk exposure are reported for the year in which the reduction occurs.

(4) The IRS has ruled that increases in premium stabilization reserves for group accident and health contracts are deductible as return premiums. Rev. Rul. 2005-33; LTR 200116041 (Jan. 24, 2001).

d. The 80% rule applies to "unearned premiums." What are "Unearned Premiums"?

(1) IRS regulations define "unearned premiums" generally as "the portion of the gross premium written that is attributable to future insurance coverage during the

effective period of the insurance contract." Treas. Reg. § 1.832-4(a)(8)(i).

(2) Accounting for "retro credits" and "retro debits" as unearned premiums

(a) Under the regulations, retro credits and retro debits are not included in unearned premium. Treas. Reg. § 1. 832-4(a)(8)(1).[3]

(3) Generally, unearned premiums are determined prorata over the policy period. The proposed regulations suggest that some other result may be required if the risk of loss is not uniform over the policy period. Treas. Reg. §1.832-4(a)(9).

e. Special rules apply to title insurance premiums. Title insurance companies are treated as having unearned premiums. The reserve for unearned premiums is discounted to present value, and the increase in the discounted reserve for the year is deducted from gross premiums. Section 832(b)(8).

(1) The annual statement reserve is discounted using a statutory rate, and reflects the period over which the unearned premiums are to be included in income under state law.

f. A P&C company's reserves for noncan and guaranteed renewable A&H contracts are calculated under 807. Unearned premiums on these contracts are subject to the 20% reduction provision.

g. Example #20 illustrates the computation of "premiums earned."

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[3] In LTR 9647002 (July 29, 1996) and 9648002 (Aug. 2, 1996) the IRS held that the liability to make retrospective refunds is includible in unearned premium reserves.

Prop. Treas. Reg. § 1.832-4(a)(4) provided that retro debits (the additional premiums estimated to be received) must be included in gross premiums written (and not as offsets to unearned premiums). Prop. Treas. Reg. § 1.832-4(a)(5) provided that retro credits (the premiums estimated to be refunded) are included in return premiums (and not in unearned premiums). The final regulations differ from the proposed regulations.

The proposed regulations included a reporting rule for retro credits and retro debits, under which they were to be reported in the year in which they could be "reasonably estimated." The final regulations do not include a specific reporting rule applicable to retro credits and retro debits.

2. Losses incurred

a. There are three major rules for the determination of losses incurred.[4]

b. First, the term “unpaid losses” is defined to include “unpaid loss adjustment expenses” (“LAE”) Section 846(f)(2).

(1) Unpaid LAE are deductible under section 832(b)(5) as “losses incurred.”[5]

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[4] Under pre-1986 Act law, losses incurred equaled:

1. “Losses paid” (net of salvage and reinsurance received), less

2. The increase in outstanding salvage and reinsurance recoverable with respect to paid losses, plus

3. The increase in the reserve for “unpaid losses.”

“Salvage” consists of amounts recovered by the insurer through the sale of damaged property to which it has acquired title.

“Reinsurance” or “subrogation” is the right of the insurer to proceed against third parties for recovery of amounts paid on claims.

The IRS made efforts to require that estimated recoveries of salvage and subrogation attributable to unpaid losses must reduce unpaid losses. Temp. Reg. § 1.832-4T(b). See also Allstate Ins. Co. v. U.S., 936 F.2d 1271 (Fed. Cir. 1991) (effect of tax benefit rule).

In general, P&C insurers (including title insurers) are given a “fresh start” adjustment (a forgiveness of income) for the reduction of the yearend 1986 reserves for unpaid losses and expenses from an undiscounted to a discounted basis. 1986 Act section 1023(e).

If a company “strengthens” reserves in 1986 (thus getting a deduction), the fresh start is denied to the extent of the strengthening. 1986 Act § 1023(e)(3).

Treas. Reg. § 1.846-3 provides that all 1986 increases in estimated losses for pre-1986 accident years constitute reserve strengthening.

In Western Nat’l Mutual Ins. Co. v. Comm’r, 102 T.C. 338 (1994), aff’d, 65 F.3d 90 (8th Cir. 1995), the regulation was held invalid. However, in Atlantic Mutual Ins. Co. v. Comm’r, 98-1 U.S.T.C. ¶ 50,341 (1998), the Supreme Court affirmed the Third Circuit and held the regulation valid. 523 U.S. 382 (1998).

c. Second, the amount included in the losses incurred deduction for "unpaid losses" (other than unpaid losses on life insurance contracts) is limited to the annual increase in discounted reserves for unpaid losses, in order to reflect the time value of money. Sections 832(b)(5)(A)(ii) and 846.

(1) The theory is that an insurer should not be allowed a current $1 deduction for $1 to be paid in the future.

(2) To reflect the time value of money, the current deduction is discounted. (Note that this method of discounting differs from the economic performance rules of section 461(h).)

(3) The present value of the unpaid losses is determined using (see section 846(a)(2)):

(a) The undiscounted unpaid losses reserves,

(b) An assumed interest rate, and

(c) An assumed loss payment pattern.

(d) The NAIC annual statement reserves are a "cap" on the discounted reserves. Section 846(a)(3).

(4) The undiscounted reserves are the reserves per the annual statement. Section 846(b). For a foreign insurance company electing to be taxed as a U.S. corporation under section 953(d), undiscounted unpaid losses reported on its GAAP financial statement may be used. LTR 9811041 (Dec. 11, 1997).

(a) If annual statement reserves are already discounted, that discounting can be reversed and disregarded. Treas. Reg. § 1.846-1(a)(3)

(b) If annual statement reserves are reduced for estimated salvage recoverable, that reduction also can be reversed. Treas. Reg. § 1.846-1(a)(4).

(5) The interest rate is a 60-month average of mid-term AFRs. Section 846(c).

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[5] Under pre-1986 Act law, unpaid LAE were deductible under section 832(b)(6) as "expenses incurred."

(6) A loss payment pattern will be determined by the IRS for 1987, and every five years thereafter, for each line of business on the basis of published aggregate industry data. Section 846(d)(1). See Rev. Proc. 90-23, 1990-1 C.B. 507; Rev. Proc. 92-76, 1992-2 C.B. 453; Rev. Proc. 2004-9, 2004-2 I.R.B. 275 (2003 loss payment patterns).

(a) For Schedule O lines, the pattern will assume payment in the accident year and the following 3 years.

(b) For Schedule P lines, the pattern will assume payment in the accident year and the following 10 years.

(c) For long-tail Schedule P lines, the payment period may be extended by up to 5 additional years.

(7) If an insurer has large enough reserves in a line of business, it may elect to use its own historical payment pattern. Section 846(e). Treas. Reg. § 1.846-2. LTR 9228003 (Mar. 26, 1992).

(8) As noted above, title insurers must discount (under similar rules) their reserves for unearned premiums. Section 832(b)(8). Treas. Reg. § 1.846-1(b)(2). In addition, they must discount their unpaid loss reserves (known as claims reserves).

(9) Under section 847, companies that are required to discount unpaid loss reserves are allowed a special deduction, if they make special estimated tax payments.

d. Third, the total "losses incurred" deduction is reduced by an amount equal to 15 percent of the tax-exempt interest income and the dividends received deductions for the year. Section 832(b)(5)(B).

(1) The theory is that no deduction for losses should be allowed to the extent that such losses are paid with untaxed income.

(2) An exception is provided for certain dividends from affiliated corporations.

(3) There is a grandfather exception for interest and dividends an obligations and stock acquired before August 8, 1986. Section 832(b)(5)(c).

(4) For contracts issued after June 8, 1997, the "prorated amount" also includes the increase for the taxable year in policy cash values of certain corporate owned life insurance policies and annuity and endowment contracts subject to section 264(f). Section 832(b)(5)(B)(iii).

(5) The IRS Office of Chief Counsel has concluded that the amount of tax-exempt interest subject to proration for a taxable year may be reduced by that year's portion of amortizable bond premium attributable to tax-exempt instruments, i.e., only the net amount of exempt income is subject to proration. IRS CCA 200234013 (May 9, 2002).

e. The losses incurred deduction is reduced by the increase in estimated salvage and reinsurance recoverable.[6] 832(b)(5)(A).

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[6] The 1990 Act, for years after 1989, amended section 832(b)(5)(A) to change the treatment of salvage and reinsurance in the computation of losses incurred. See Treas. Reg. § 1.832-4.

As a result of the 1990 Act change in method of accounting for salvage, a section 481 adjustment would ordinarily result. In the case of a company that formerly did not take salvage into account (a "grosser"), the section 481 adjustment would ordinarily equal the amount of discounted salvage and reinsurance recoverable as of December 31, 1989. This amount would have to be included in income.

However, 87% of this amount is given a "fresh start." The balance of 13% must be included in income over a period not to exceed 4 years beginning with 1990. Treas. Reg. § 1.832-4(e)(2).

Some companies, as of 1990, already were reflecting salvage for tax purposes ("netters"). To accord these companies equal treatment, they are allowed to deduct (over 4 years beginning with 1990) 87% of the balance of salvage recoverable as of December 31, 1989. Treas. Reg. § 1.832-4(f).

Some companies reflected salvage for some lines, but not for others. Under the regulations, a company that claims the special deduction cannot also have fresh start relief. Treas. Reg. § 1.832-4(f).

A company that took salvage into account can elect to "gross up" its December 31, 1989, reserves, and then claim the "fresh start." Treas. Reg. § 1.832-4(d). Rev. Proc. 92-77, 1992-2 C.B. 454. However, the IRS will not permit a company that claimed the special deduction to choose the "fresh start" instead. LTR 9516001 (Dec. 8, 1994).

The IRS has ruled that a "grosser" that makes changes in its statutory accounting method and becomes a "netter" for statutory purposes is not required to recognize income for tax purposes. TAM 200006007 (Sept. 2, 1999).

(1) Treasury Regulation § 1.832-4 sets forth the manner in which the discounting calculations are to be performed. See Rev. Proc. 92-72, 1992-2 C.B. 439; Rev. Proc. 2004-10, 2004-2 I.R.B. 288 (2003 salvage discount factors).

f. Example #21 illustrates the computation of "losses incurred".

g. Treatment of uncollectible reinsurance

(1) If a company has reinsured, and the reinsurer has not or is not expected to pay, what is the proper treatment?

(2) Companies would like to include amounts of (and estimates of) unrecoverable reinsurance in losses incurred.

(3) Over the years, the IRS has argued that unrecoverable reinsurance should be deducted as a bad debt. However, this argument was rejected by the IRS National Office in a private letter ruling. LTR 9732004 (Apr. 30, 1997) (uncollectible reinsurance may be written off as part of "losses incurred").

3. Expenses incurred

a. Expenses incurred means all expenses shown on the NAIC annual statement. Section 832(b)(6).

b. Expenses incurred are allowed in an amount equal to "expenses paid," plus the increase in "expenses unpaid" (excluding unpaid LAE).

c. No expense is allowable under section 832(b)(6) as an "expense incurred" unless that expense is allowed as a deduction by section 832(c).

(1) Allowable deductions include ordinary and necessary business expenses, interest, taxes, losses, etc. See Home Group, Inc. v. Comm'r, 89-1 U.S.T.C.¶9329 (2d Cir. 1989).

In Blue Cross & Blue Shield of Texas v. Commissioner, 115 T.C. 148 (2000), the Tax Court held that the differences between what the taxpayer, a health insurance company, would have paid as a primary insurer on all claims and what it actually paid as a secondary insurer (i.e., coordination of benefits, or "COB" savings) did not constitute estimated salvage recoverable for purposes of the 87% special deduction rule.

(2) Capital losses from investment assets sold to obtain funds to pay abnormal insurance losses or policyholder dividends are deductible from ordinary income. Section 832(c)(5).

(3) Policyholder dividends paid by mutual P&C insurers to policyholders are fully deductible. Section 832(c)(11). The 1986 Act states that this provision is to be studied by the Treasury Department. 1986 Act Bluebook at 621.

E. See Example #22

V. Blue Cross and Blue Shield Organizations

A. Under pre-1986 Act law, the "Blues" were exempt from Federal income tax.

B. In general, the 1986 Act provides that for years after 1986 the Blues will be taxable as stock P&C insurance companies. Sections 501(m), and 833(a)(1) and (c).

C. However, the section 832(b)(4) provision requiring a 20-percent reduction of the unearned premium reserve deduction does not apply to the Blues. Section 833(a)(3).

D. Moreover, the Blues are allowed a special deduction. Section 833(a)(2) & (b). The deduction equals the excess of 25% of claims and expenses for the year over adjusted surplus at the beginning of the year. In calculating claims incurred and expenses incurred, the Blues include claims and expenses incurred under cost-plus contracts. Section 833(b)(1). 1997 Blue Book at 486.

E. Similar organizations also qualify. Section 833(c)(4).

F. Upon conversion to taxable status, the Blues were allowed to take a fair market value basis in their assets. 1986 Act § 1012(c)(3)(A)(ii). Some Blues began treating certain intangible assets, e.g., customer lists, provider networks, and workforce in place, as separate assets and have claimed losses upon the termination of those customer, provider, and employee contracts.

G. In Notice 2000-34, 2000-33 I.R.B. 1 (July 26, 2000), the IRS announced that it will challenge deductions claimed by Blue Cross Blue Shield organizations for termination of customer, provider, and employee contracts.

1. In Trigon Insurance Co. v. U.S., 215 F. Supp.2d 687 (E.D.Va. 2002), the court held that a Blue Cross/Blue Shield organization was not entitle to a tax refund arising in connection with the abandonment of appraised, intangible assets consisting of terminated health insurance subscriber and provider contracts. While the "fresh start" basis rule applied to allow a basis step-up for the contracts, the valuation conducted by the taxpayer's expert of the fair market value of the subscriber and provider contracts

was neither accurate nor reliable. Accordingly, the taxpayer failed to establish by a preponderance of the evidence that it had overpaid its taxes. See also Capital Blue Cross v. Comm'r, 431 F. 3d 117 (3d. Cir. 2005) (held that a Blue Cross and Blue Shield organization could deduct losses related to the termination of customer insurance contracts in an amount to be determined on remand of the case to the Tax Court).

2. In Highmark, Inc. v. U.S., 78 Fed. Cl. 146 (2007), the court held that a Blue Shield organization was entitled to claim refunds for tax overpayments and interest based on loss deductions for terminated and cancelled health insurance coverage contracts. Because the health care contracts produced value and could be transferred for consideration, they were assets covered by the "fresh start rule." The court found that the fresh start rule applied to any losses, including those arising from termination or cancellation of the organization's contracts. See also Hospital Services Ass'n v. U.S., 78 Fed. Cl. 434 (2007) (the "fresh start rule" applied to loss deductions claimed by a Blue Cross/Blue Shield organization on termination of its health insurance coverage contracts that were in place when it was a tax-exempt entity).