DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

December 1, 1999

Number: 200010016
Release Date: 3/10/2000
CC:DOM:FS:FI&P

UILC: 832.06-02

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR REGIONAL COUNSEL

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CC:DOM:FS

SUBJECT: Reserve for unpaid losses

This Field Service Advice responds to your memoranda dated September 3, 1999, and October 27, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND

Taxpayer =
State A =
Year 1 =
Year 2 =
Year 3 =
Year 4 =
Year 8 =
Year 9 =
Year 10 =
Year 12 =
Date 1 =
Date 2 =
B =
C =

$a	= $
$b	= $
$c	= $
d%	= %
e	=

ISSUE

Whether Taxpayer's reserve for unpaid losses was "fair and reasonable" for purposes of Treas. Reg. § 1.832-4(b)?

CONCLUSIONS

We suggest additional factual development, as set forth, infra.

FACTS

Taxpayer is an issuer of medical malpractice insurance, and has only written policies in State A. Since its incorporation in Year 1, Taxpayer has primarily issued policies on a "claims made" basis, although it has also written an insignificant amount of "occurrence based" policies.[1] Taxpayer characterizes claims as either "formal" or "informal"; a "formal" claim occurs when a claim is filed by a person alleging injury or when a lawsuit is filed, while an "informal" claim occurs when an insured physician reports an incident to Taxpayer that the physician suspects may eventually result in a medical malpractice claim. For book purposes, Taxpayer establishes a case basis reserve whenever it receives either a formal or informal claim.

State A has a mandatory excess medical malpractice insurance carrier ("excess carrier"). Taxpayer's losses were limited to $a per occurrence for occurrences prior to Date 1, Year 2, $b per occurrence for occurrences between to Date 1, Year 2 and Date 2, Year 3, and $c per occurrence for occurrences after Date 2, Year 3. The excess carrier paid for losses above those limits.

At the end of each calendar year, Taxpayer, in consultation with B, an independent actuarial firm, and C, an independent accounting firm, computed Taxpayer's loss reserves for that year. B calculated five point estimates of loss reserves on the

[1] Under a "claims-made" policy, the insurer only provides coverage for claims filed during the policy year, regardless of when the underlying loss event occurred. In contrast, under an "occurrence-based" policy, the insurer only provides coverage for loss events that occurred during the policy period, regardless of when the injury is discovered or the claim is made.

basis of five different actuarial methods. B then provided Taxpayer with a range estimate comprised of the highest and lowest of the five point estimates. In determining the range, however, B did not give weight to any particular method which was most likely to predict the actual reserves needed. Nevertheless, B refined its range estimates by taking into account the limitations of Taxpayer's exposure due to the coverage provided by the excess carrier. B then produced a final recommended point estimate ("final estimate").

The loss reserves reflected on Taxpayer's annual statements[2] and tax returns for Years 8 and 9, the taxable years in issue, are approximately d% higher than the final estimate recommended by B.[3] Taxpayer explains that its claimed loss reserves exceeded B's final estimate due to "qualitative risk factors." Apart from briefly listing these factors, Taxpayer has not provided any information regarding the manner in which it used these factors to calculate the estimate reflected on its tax returns and annual statements.

Upon examination of Taxpayer's returns for Years 8 and 9, the Service determined that Taxpayer's loss reserves were excessive. The Service determined that the proper level of Taxpayer's reserves for Years 8 and 9 was an amount that was lower than both the amounts reflected on Taxpayer's returns and B's final estimate. The Service based its determination on the application of a software program developed by a large accounting firm, and on an analysis of Taxpayer's "weakening" of its reserves for Years 4 through 9.

LAW AND ANALYSIS

Property and casualty insurers must include in gross income the amount of their underwriting income as provided in I.R.C. § 832(b), computed on the basis of the underwriting and investment exhibit of the NAIC annual statement. § 832(b)(1)(A). Section 832(b)(3) defines the term "underwriting income" as the premiums earned on insurance contracts during the taxable year less losses incurred and expenses incurred. With respect to the term "losses incurred," § 832(b)(5) provides that a property and casualty insurance company is entitled to reduce gross income for the taxable year to the extent that its estimated unpaid losses exceed its estimated unpaid losses for the previous taxable year. Conversely, § 832(b)(5) provides that

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[2] The term "annual statement" refers to the statement developed by the National Association of Insurance Commissioners (NAIC) through which an insurance company, as required by the state Insurance Departments where the insurer is authorized to transact business, furnishes information concerning its financial condition and affairs.

[3] We assume that Taxpayer's reserves for tax purposes were discounted in accordance with I.R.C. § 846.

a property and casualty insurance company must increase gross income for the taxable year to the extent that its estimated unpaid losses are less than its estimated unpaid losses with respect to the previous taxable year.

The deduction for unpaid losses is not subject to cash or accrual accounting rules. United States v. General Dynamics Corp., 481 U.S. 239, 246 (1987). Rather, unpaid losses are an estimate, made at the close of the taxable year, of the insurer's liability for claims that it will be required to pay in future years. Western Cas. & Sur. Co. v. Commissioner, 65 T.C. 897, 917 (1976), affd. on another issue 571 F.2d 514 (10th Cir. 1978). Although unpaid losses are an estimate, a taxpayer's determination of unpaid losses at the close of each year must comprise only "actual unpaid losses as nearly as it is possible to ascertain them." Treas. Reg. § 1.832-4(a)(5).[4] Section 1.832-4(b) further provides:

> Every insurance company to which this section applies must be prepared to establish to the satisfaction of the district director that the part of the deduction for "losses incurred" which represents unpaid losses at the close of the taxable year comprises only actual unpaid losses.... These losses must be stated in amounts which, based upon the facts in each case and the company's experience in similar cases, represent a fair and reasonable estimate of the amount the company will be required to pay. Amounts included in, or added to, the estimates of unpaid losses, which, in the opinion of the district director, are in excess of a fair and reasonable estimate will be disallowed as a deduction. The district director may require any insurance company to submit such detailed information with respect to its actual experience as is deemed necessary to establish the reasonableness of the deduction for "losses incurred."

Whether a taxpayer's estimate of unpaid losses is "fair and reasonable" is essentially a valuation issue and a question of fact. Hanover Ins. Co. v. Commissioner, 69 T.C. 260, 270 (1977) affd. 598 F.2d 1211 (1st Cir. 1979); Utah Medical Ins. Ass'n v. Commissioner, T.C. Memo. 1998-458.

A recent Tax Court opinion, Utah Medical, supra, addressed whether a taxpayer's loss reserves were fair and reasonable for purposes of Treas. Reg. § 1.832-4(b). In that case, the taxpayer was a medical malpractice insurer. The taxpayer's actuary suggested that the taxpayer set aside loss reserves within a particular range. For

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[4] Since an unpaid loss reserve can only be comprised of "actual" losses, a taxpayer cannot establish reserves unless the underlying loss event has occurred. See Maryland Deposit Ins. Fund Corp. v. Commissioner, 88 T.C. 1050 (1987) (estimated reserve for anticipated future loss events is not allowable).

both of the taxable years at issue in the case, and for the four preceding years, the taxpayer chose reserve estimates at the high end of its actuary's suggested range.

The Service argued that for tax purposes, the mid-point of an actuarially sound range was the only fair and reasonable estimate. The Service also argued that the taxpayer, by choosing reserves at the high end of its actuary's estimated range for six consecutive years, calculated reserves which were inherently improbable and unreasonable. Moreover, the Service argued that the taxpayer should have realized during the taxable years in issue that its methodology was resulting in excessive reserves, and should have adjusted its reserves accordingly.

The court, in a factually-based opinion, concluded that the taxpayer's reserves were fair and reasonable.[5] The court reasoned that the taxpayer's actuary calculated the taxpayer's reserves by consistently using recognized actuarial methods. The court explained that there was no authority for the Service's assertion that the taxpayer was required to chose the mid-point of its actuary's range; each point in the range was reasonable. In doing so, the court noted that the following factors warranted a large actuarial range: (a) the taxpayer was a modestly-capitalized single line insurer; (b) the average cost of each claim was high, and there were relatively few claims; and (c) medical malpractice insurance is volatile and long-tailed.

Furthermore, the court rejected the Service's argument that the taxpayer should have reduced its reserves during the years in issue since its reserves for prior years were consistently overstated. In so doing, the court noted that the reserve estimates were reasonable at the time that they were made because the frequency and severity of claims was beginning to increase. In addition, the court explained that although insurers receive tax advantages for increasing their loss reserves, additions to loss reserves typically hinder competitiveness by requiring higher premiums, and the reduction in surplus caused by increases in loss reserves invite state regulators to limit the company's ability to write additional premiums.

<u>CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS</u>

[redacted]

[redacted]

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[5] The court concluded that the method employed by the Service's expert was reasonable as well; however, the court explained that since there is no requirement under Treas. Reg. § 1.832-4(b) that a taxpayer's method be more reasonable than the Service's, the taxpayer complied with the requirements of the regulation.

[redacted]

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[redacted]

> [redacted]

[redacted]

[redacted][6]

[redacted]

[redacted]

[redacted]

6 [redacted]

In addition, the Service has recently litigated a Tax Court case involving Minnesota Lawyers Mutual Ins. Co., Tax Court Docket No. 21181-97. [redacted] We will notify you if an opinion is issued in that case.

Lastly, we have reviewed Charts II-A through II-D, regarding the degree to which Taxpayer "weakened" its reserves. These charts, however, do not reflect Taxpayer's paid losses with respect to each such year. When a taxpayer establishes an unpaid loss reserve for a particular year, that reserve is typically reduced as claims are eventually paid. We assume that Taxpayer in this case reduced its unpaid loss reserve beyond the amount by which claims were paid. Nevertheless, we suggest that you confirm that the "weakening" reflected in the charts does not merely reflect the general reduction of an unpaid loss reserve as losses are paid.

Please call if you have any further questions.

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By: ______________________________
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