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

OFFICE OF
CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR DISTRICT COUNSEL

FROM: DEBORAH A. BUTLER
ASSISTANT CHIEF COUNSEL (FIELD SERVICE)
CC:DOM:FS

SUBJECT: Unpaid loss reserve

This Field Service Advice responds to your undated memorandum received in the National Office on June 24, 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	=
X	=
Y	=
Year 1	=
Year 2	=
Year 3	=
Year 4	=
Year 5	=
Year 6	=
Year 7	=
Year 8	=
Year 9	=
Year 10	=
$a	= $
$b	= $

$c	= $
$d	= $
$e	= $
$f	= $
$g	= $
$h	= $
$i	= $
$j	= $
$k	= $
$l	= $
$m	= $
$n	= $

ISSUE:

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

(2) Whether the Service should litigate this issue with respect to Year 4 only, rather than on the basis of Years 2 through 4?

CONCLUSION:

(1) The recent Tax Court opinion in Utah Medical illustrates the difficulty in litigating this issue. As explained infra, this issue requires further clarification. [redacted]

(2) On the basis of the facts presented to us, the lack of expert analysis, and substantial litigating hazards, we conclude that the Service should not pursue litigation with respect to Years 2 and 3. [redacted]

FACTS:

Taxpayer is a property and casualty insurance company. Taxpayer's 10-K reflects that its reserve for unpaid losses at the end of Years 1 through 10 was deficient or redundant (i.e., excessive) as follows:

YEAR	(DEFICIENCY)/REDUNDANCY
Year 1	($d)
Year 2	($e)
Year 3	($f)
Year 4	$g
Year 5	$h
Year 6	$i
Year 7	$j
Year 8	$k
Year 9	$l
Year 10	$m

Your submission reflects that, pursuant to an examination of Taxpayer's returns for Years 2 through 4, Exam proposed adjustments to Taxpayer's reserve for unpaid losses in the amount of $a for Year 2, $b for Year 3, and ($c) for Year 4.[1] The adjustments proposed by Exam were primarily based upon the application of a software program created by X. When Taxpayer disputed this adjustment, Exam hired Y to prepare an actuarial analysis of Taxpayer's reserves for Year 4 only. Y analyzed Taxpayer's reserves for losses and loss adjustment expenses (LAE) for Year 4 on a line by line basis, and limited its analysis to Taxpayer's major lines of business. Furthermore, Y based its computations on a net of reinsurance basis; accordingly, Y considered the proper level of Taxpayer's reserves in light of salvage and reinsurance recoverable. Y concluded that Taxpayer's total net loss and LAE reserves as of the end of Year 4 were redundant by the amount of $n.

The time remaining on the statute of limitations is insufficient to allow the Service to modify its contract with Y in order to analyze Taxpayer's reserves for Years 2 and 3. Moreover, your submission indicates that the Service has recently closed its examination of Taxpayer's returns for Years 5 through 7. Accordingly, you have proposed that the Service issue a notice of deficiency with respect to Year 4, which may then be consolidated for presentation to the Tax Court pursuant to a subsequent notice of deficiency issued with respect to Years 5 through 7.

[1] We assume that the Agent's proposed adjustment for Year 4 is a negative adjustment.

LAW AND ANALYSIS

(1) Whether Taxpayer's reserve for unpaid losses was "fair and reasonable."

Applicable Law

Property and casualty insurers must include in gross income the amount of their underwriting income as provided in § 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 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). Unpaid losses must comprise only "actual unpaid losses as nearly as it is possible to ascertain them." Treas. Reg. § 1.832-4(a)(5). 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) (reserve for anticipated future loss events is not allowable). Section 1.832-4(b) further provides that the deduction for unpaid losses must be stated in amounts which "represent a fair and reasonable estimate of the amount the company will be required to pay." 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.

Utah Medical

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 both of 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. In this regard, 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 concluded that the taxpayer's reserves were fair and reasonable. 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. Moreover, 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. The court also 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.

The opinion in Utah Medical illustrates the difficulty that the Service will encounter in litigating loss reserve cases. The Code allows insurers to claim deductions for losses that have been incurred but not paid. Due to the inherent complexity of predicting losses for certain lines of insurance, courts will continue to accord deference to taxpayers' actuaries in certain cases. Therefore, in cases where a taxpayer establishes reserves pursuant to its actuary's recommendation, the Service's expert will have to convincingly persuade the court that the level of reserves recommended by taxpayer's actuary did not satisfy the fair and reasonable standard reflected in regulations. To do so, the Service's expert in such cases should be prepared to:

[redacted]

In light of the opinion in Utah Medical, we conclude that in the present case, additional factual development is necessary. This discussion is set forth infra, in the section discussing case development, hazards and other considerations.

(2) Whether the Service should litigate this issue with respect to Year 4 only.

This issue is discussed infra, in the section discussing case development, hazards and other considerations.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

Litigation strategy and suggested factual development.

[redacted]

Our conclusion in this regard is consistent with Treas. Reg. § 1.832-4(a)(5), which requires that the determination of unpaid losses at the close of each taxable year must represent actual unpaid losses as nearly as it is possible to ascertain them. In general, where a number of reasonable actuarial techniques, fairly applied, generate differing estimates of expected losses, a court will likely conclude that any one of those estimates satisfies both the "fair and reasonable estimate" standard in regulations, and the "near as it is possible to ascertain them" standard in § 1.832-4(a)(5). At a minimum, § 1.832-4(a)(5) prevents a taxpayer from establishing contingency reserves for losses that not have occurred. See Maryland Deposit, supra.

[redacted]

Need To Consider Tax Years Together.

Due to the lack of expert analysis with respect to Years 2 and 3, any attempt to dispute the level of Taxpayer's reserves for those years would carry substantial litigation hazards. Accordingly, the Service should not attempt to litigate the agent's proposed findings for those years. [redacted]

If you have any further questions, please call (202)-622-7870.

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By: ______________________________
JOEL E. HELKE
Chief
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cc: