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ARE RESERVES FOR BAD FAITH CLAIMS DEDUCTIBLE BY A LIFE INSURANCE COMPANY?

By Peter H. Winslow

In an important decision for insurance companies, the Seventh Circuit held in *State Farm*[1] that extra-contractual obligations ("ECOs") of a property/casualty company that are claims-related compensatory damages (*e.g.*, bad faith claims) are properly included in deductible unpaid losses under I.R.C. § 832(b)(5).[2] State Farm had included a $202 million award of compensatory and punitive damages (and related interest) in its loss reserves on its annual statements and tax returns for 2001 and 2002. On audit, the IRS disallowed the loss reserve deduction arguing that the damages did not arise as claims under an insurance contract and, therefore, should be deducted on an accrual basis in the same manner as other contested liabilities. The Tax Court agreed with the IRS's position, holding that the damages were not losses incurred "on insurance contracts" as required by I.R.C. § 832(b)(5).[3]

In the Tax Court litigation, neither the parties nor the court made any distinction between compensatory ECOs and punitive damages. This situation changed on appeal in the Seventh Circuit. Several property/casualty insurance trade associations jointly filed an amicus brief with the court in which they argued that statutory accounting principles distinguish between compensatory ECOs and punitive damages. Claims-related compensatory ECOs are properly included in losses, *i.e.*, treated for accounting purposes as claims. Relying on the amicus brief, the Seventh Circuit reversed the Tax Court's decision as it related to compensatory ECOs but upheld the lower court denying a loss reserve deduction for contested punitive damages.

The Seventh Circuit's opinion has received a lot of attention because of its rejection of the IRS's position on a fundamental principle of insurance company taxation. The Internal Revenue Code provisions governing property/casualty insurance company taxation defer to NAIC accounting for computation of underwriting income. The IRS's position is that the Code's deference to NAIC accounting does not encompass the types of items that are taken into account in underwriting income for federal income tax purposes; the Code only defers to annual statement accounting once the elements of underwriting income are determined by interpreting the Code and regulations. In the case of ECOs, the IRS pursued its position arguing that NAIC accounting guidance is irrelevant and that claims-related compensatory ECOs cannot be characterized as insurance claims. The IRS contended ECOs flunk a threshold tax test for loss reserve treatment—ECOs are not losses incurred "on insurance contracts."

The Seventh Circuit rejected the IRS's narrow interpretation of the Code's deference to NAIC accounting principles. The court noted that the statute requires the use of NAIC annual statement accounting for underwriting income generally, and for unpaid losses specifically. The court concluded that, to the extent the NAIC has dictated that claims-related compensatory ECOs are required to be included in underwriting income as part of losses incurred, there is no room in the statute for the IRS to second-guess the NAIC and contend that particular classes of losses are not "on insurance contracts" within a non-NAIC tax definition imposed by I.R.C. § 832(b)(5). In other words, the deference to NAIC accounting broadly includes the measurement of underwriting income as a whole, not just the timing of particular items once the items included in underwriting income are determined by tax law.

Although *State Farm* dealt only with property/casualty insurance companies, and only with the Code provisions that govern their taxation, the Seventh Circuit's decision has potentially significant ramifications for life companies. For example, the case presents the general proposition that when deference to the NAIC is required by the Internal Revenue Code, that deference must be respected by the IRS. Thus, the court's holding calls into question whether the IRS has the authority under I.R.C. § 807(d) to require federally prescribed tax reserves of life insurance companies to be computed using any version of CRVM or CARVM that is inconsistent with NAIC guidance. In this regard, the Seventh Circuit's opinion complements the holding of the Sixth Circuit in *American Financial*[4] that similarly rejected the IRS's attempt to depart from NAIC guidance in interpreting CARVM for annuity contracts.[5]

More specifically, the *State Farm* case might support a conclusion that claims-related compensatory ECOs (*e.g.*, bad

faith claims) are deductible on a reserve basis by life insurance companies. Let's walk through the analytical steps.

Step One: Annual Statement accounting treatment for ECOs is the same for property/casualty and life companies.

Statement of Statutory Accounting Principles ("SSAP") No. 55 establishes statutory accounting principles for liabilities for unpaid claims and loss adjustment expenses not only for property/casualty insurance contracts, but also for claims and related expenses under life insurance and accident and health contracts. The general rule of SSAP No. 55 is that claims, losses and loss adjustment expenses are recognized on an estimated basis when a covered or insured loss event occurs. For life and accident and health contracts, liabilities for claims include reasonable estimates of due and unpaid claims; resisted and other claims in the course of settlement, either in the full amount of the claim or a percentage of the claim based on past experience with similar claims; and incurred but not reported claims.

In 2003, the NAIC Emerging Accounting Issues Working Group issued INT 03-17 dealing with ECOs. INT 03-17 concludes that claims-related ECOs, including bad faith losses other than punitive damages, are required to be included in losses in accordance with SSAP No. 55. By its terms, INT 03-17 applies to all lines of business, including life and accident and health insurance. Although INT 03-17 does not state the rationale for its conclusion, presumably the NAIC working group determined that the origin of the liability for ECOs is an explicit or implicit contractual duty of the insurer to settle claims in good faith, and to the extent compensatory damages arise from a breach of that duty, they are properly classified as claims arising under the insurance contract.

In summary, life insurance companies are treated just like property/casualty companies with respect to statutory accounting for ECOs; NAIC annual statement accounting requires that a liability be established for estimated potential claims-related ECOs at the time a claim is incurred. This is so even if the liability for ECOs is contested and even though the potential liability for ECOs may exceed the coverage limits in the policy.

Step Two: Tax treatment of contested claims is the same for property/casualty and life companies.

In general, I.R.C. § 811(a) places life insurance companies on an accrual method of accounting. However, I.R.C. § 811(a) also provides that:

> To the extent not inconsistent with [accrual accounting] or any other provision of this part, all such computations shall be made in a manner consistent with the manner required for purposes of the annual statement approved by the National Association of Insurance Commissioners.

This provision has been interpreted to mean that NAIC accounting rules control so long as they are not inconsistent with accrual accounting.[6] That is, where a particular item has no counterpart in accrual accounting, such as life insurance reserves, NAIC accounting standards apply.[7]

Two provisions of the Code allow for a deduction of estimated unpaid claims by life insurance companies. The first provision is I.R.C. § 805(a)(1) that provides a deduction for "All claims and benefits accrued, and all losses incurred (whether or not ascertained), during the taxable year on insurance and annuity contracts." I.R.C. § 805(a)(2) also allows a deduction for increases in reserves under I.R.C. § 807(b), which by cross-references to I.R.C. § 807(c) and 816(c)(2) includes "unpaid losses (whether or not ascertained)."[8] The regulations make it clear that the reference to "unpaid losses (whether or not ascertained)" in these sections has no counterpart in accrual accounting. After first describing "accrued" claims, Treas. Reg. § 1.809-5(a)(1) goes on to say that "losses incurred (whether or not ascertained) ... includes a reasonable estimate of the amount of the losses (based upon the facts in each case and the company's experience with similar cases) incurred but not reported by the end of the taxable year as well as losses reported but where the amount thereof cannot be ascertained by the end of the taxable year." Consequently, as a reserve item that does not depend on accrual accounting, claims (whether or not ascertained) are accounted for by life insurers in a manner consistent with NAIC statutory principles. Moreover, just as the Seventh Circuit in *State Farm* concluded that compensatory ECOs are claims "on insurance contracts" within the meaning of I.R.C. § 832(b)(5) for P/C companies, in the life insurer context, a court is equally likely to conclude that compensatory ECOs are likewise "on insurance and annuity contracts" within the meaning of I.R.C. § 805(a). In summary, it is reasonable to conclude that

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Life insurance companies are treated just like property/casualty companies with respect to statutory accounting for ECOs.

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because (1) "unpaid losses (whether or not ascertained)" for life companies are not subject to accrual accounting, (2) I.R.C. § 811(a) defers to the NAIC accounting method for this item, and (3) under INT 03-17 claims-related compensatory ECOs are included as part of claims in annual statement accounting, claims-related compensatory ECOs should be deductible on an estimated basis under I.R.C. § 805(a)(1) or (2) under the reasoning of *American Financial* and *State Farm*, at least by companies domiciled in the Sixth and Seventh Circuits.

Such a conclusion may surprise some insurance company tax practitioners, who generally are aware of important differences in the deductibility of expenses by property/casualty and life insurance companies. In particular, even though NAIC accounting principles (SSAP No. 55) require both types of insurers to report loss adjustment expenses on an estimated basis, life insurance companies are required to account for these expenses on an accrual basis at least for their life insurance lines of business.[9] A different rule applies to property/casualty companies which can include an estimate of unpaid loss adjustment expenses as part of unpaid losses under I.R.C. § 846(f)(2). However, there is an important difference between ECOs and loss adjustment expenses. The NAIC has determined in INT 03-17 that ECOs are claims and not merely costs of administering claims. As such, compensatory ECOs should be deductible by life insurance companies on an estimated basis as part of unpaid losses unless the IRS can convince another court that the Seventh Circuit was wrong in *State Farm*. However, unlike property/casualty companies, life insurers would need to bifurcate their SSAP No. 55 liability for ECO costs between compensatory damages and administrative expenses. Only the portion attributable to estimated damages would be deductible on a reserve basis for life insurance lines of business. ◂

END NOTES

1. *State Farm Mutual Automobile Ins. Co. v. Comm'r*, 698 F.3d 357 (7th Cir. 2012).
2. "I.R.C. §" refers to a section of the Internal Revenue Code of 1986, as amended.
3. *State Farm Mutual Automobile Ins. Co. v. Comm'r,* 135 T.C. 543 (2010).
4. *American Financial Group v. U.S.*, 678 F.3d 422 (6th Cir. 2012).
5. For a detailed analysis of the *American Financial* case, *see* Peter Winslow, *The Sixth Circuit Gets it Right in American Financial—an Actuarial Guideline Can Apply to Prior Contracts When the Interpretation Was a Permissible Option at the Time the Contract Was Issued*, Society of Actuaries Taxation Section, 21 *Taxing Times*, Vol. 8, Issue 3 (Oct. 2012).
6. General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, Staff of Joint Comm. on Taxation, H.R. 4170, 98th Cong., Pub. L. 98-369, at 621.
7. *Commissioner v. Standard Life and Accident Ins. Co.*, 433 U.S. 148 (1977).
8. The seemingly duplicative deductions for unpaid losses are remedied by I.R.C. § 811(c) which provides that the same item cannot be counted twice.
9. *See* Peter Winslow, *Loss Adjustment Expenses for Life Insurance Companies,* Society of Actuaries Taxation Section, T³: *Taxing Times* Tidbits, 40 *Taxing Times*, Vol. 7 Issue 3 (Sept. 2011).