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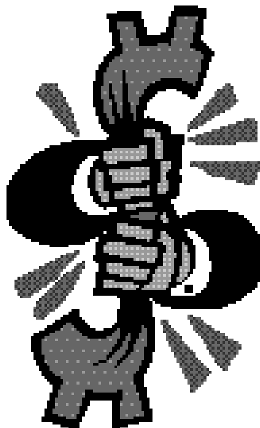
# Will Your Unpaid Loss Reserve Stand Up to IRS Scrutiny?

***by Rowen B. Bell***

Most writers of health insurance in the U.S. are taxed as "nonlife insurers" and thus fall under Section 832 of the U.S. Tax Code, which allows the insurer to deduct losses incurred on health policies in determining taxable income. According to Treasury regulations, the reserve for unpaid losses used in the calculation of losses incurred must "represent a fair and reasonable estimate of the amount the company will be required to pay."

While Section 832 specifies that the insurer's statutory filing with the NAIC shall form the basis for determining losses incurred for tax purposes, the *Hanover Insurance* (1976) case reaffirmed that the IRS can challenge the insurer's losses incurred deduction on the grounds that the statutory unpaid loss reserve does not meet the "fair and reasonable" test.



Two recent legal cases from the casualty insurance world shed significant light on the meaning of "fair and reasonable" and have interesting repercussions on actuarial practice regarding unpaid loss reserves.

### Utah Medical (1998)

Utah Medical Insurance Association is a small carrier whose only line of business is medical malpractice liability insurance and who outsources all of its actuarial services to consulting firms. At each year-end, a consulting actuary was employed to determine a range, using standard actuarial methods, for the company's unpaid loss reserves; the actuary did not make a point estimate of the reserve. Utah Medical's CFO then set the statutory reserve, and in both 1991 and 1992 he chose a figure that was within, but near the high end, of the consulting actuary's range. This statutory reserve was not adjusted by the Utah Department of Insurance during its triennial examination of Utah Medical.

The reserves established in 1991 and 1992 turned out to be overly sufficient by several million dollars. The IRS argued that this development implied that the reserves had not met the "fair and reasonable" test, and hence that Utah Medical had overstated its losses incurred deduction during those two years. Utah Medical disagreed and the ensuing case was heard by the U.S. Tax Court.

The Court ruled in favor of Utah Medical. After weighing expert actuarial testimony from both sides, the Court concluded that the range of reserve estimates established by Utah Medical's consulting actuary was reasonable. However, the IRS had argued that even if that range were found to be reasonable, the only "fair and reasonable" estimate for tax purposes was the midpoint of that range. The Court refuted this reasoning, asserting that any point within an actuarially reasonable range meets the "fair and reasonable" test. Finally, the Court stated plainly that "reserves for unpaid losses must be fair and reasonable, but are not required to be accurate based on hindsight."

### Minnesota Lawyers (2000)

Many pundits suspected that the favorable *Utah Medical* ruling might seriously impede the ability of the IRS to challenge an insurer's losses incurred deduction under the "fair and reasonable" standard. When the superficially similar *Minnesota Lawyers* case came before the U.S. Tax Court, it was widely thought that a similarly favorable ruling would result. However, as we shall see there are material differences in reserving practice between the two situations.

Like Utah Medical, Minnesota Lawyers Mutual Insurance Company is a small casualty insurer engaged in only a single line of business, namely professional liability insurance for lawyers, and having no qualified actuary on staff.

The unpaid loss reserves of Minnesota Lawyers were determined in two components: the "case reserves," and the "adverse development reserve." Case reserves were set on a claim-by-claim basis by the company's claims department; the adverse development reserve was set in aggregate by senior management and typically amounted to an additional 35-50% on top of the case reserves.

After the reserves were set, a consulting actuary was brought in to review the reserves and issue the statutory certification. The Minnesota Department of Commerce did not adjust the statutory reserves during the examination process.

In 1993, the consulting actuary determined only a point estimate for the reserve, which was less than the company's case reserves. A new consulting actuary was hired for 1994, and the new actuary determined both a point estimate and a (very wide) range for the reserve. In each of 1994 and 1995, the point estimates were higher than the company's case reserves, but lower than the total statutory reserves, which in turn were lower than the high endpoint of the actuary's range.

The actual runout for each of 1993, 1994, and 1995 showed that the case reserves by themselves were overly sufficient, and hence that the company's total statutory reserves had been highly redundant. The IRS argued that the reserves did not meet the "fair and reasonable" standard and furthermore, that the actual runout should be used to determine what the tax reserves for those years should have been.

The U.S. Tax Court ruled that Minnesota Lawyers' reserves did not meet the "fair and reasonable" test. Factors cited by the Court in arriving at a different decision in *Minnesota Lawyers* than in *Utah Medical* include the following:

- There was no evidence that Minnesota Lawyers' case reserving methodology was prone to insufficiencies, and hence there was no demonstrable need for the company to hold an adverse development reserve on top of the case reserves;

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- There were no workpapers indicating what facts were considered or analyzed by management in determining the level of the adverse development reserve;
- Minnesota Lawyers' reserves could not be said to have been determined via "consistent actuarial methods and standard actuarial loss development techniques," since the reserves were first established by non-actuaries and then only reviewed by an actuary, whereas in *Utah Medical* the statutory reserve was not set until after the consulting actuary's calculations had been performed;
- The Court could not establish whether or not the ranges recommended by the consulting actuary were reasonable, due primarily to the extreme width of those ranges (in 1995 the upper endpoint was more than twice the lower);
- The company provided no explanation of why, for the three years in question, its statutory reserves were 49%, 15%, and 37% higher respectively than the best point estimate made by its consulting actuary.

In addition, the Court refuted two other arguments raised by Minnesota Lawyers in defense of its statutory reserves:

- The Court held that an actuarial opinion that the statutory reserves "made reasonable provision" for the company's unpaid claims was not clearly intended to be equivalent to the regulatory "fair and reasonable" standard;
- The Court held that the regulator's acceptance of the company's statutory filings, without requiring an adjustment to the reserves, was a positive but not conclusive factor in assessing whether the reserves met the "fair and reasonable" test, as it was not clear that a regulator would be concerned with excessive reserves.

However, the Court did not accept the IRS stance that actual experience should be used in retrospect to establish the tax reserves for the years in question.

Instead, for 1994 and 1995, the Court found that the point estimates made at that time by the consulting actuary were "fair and reasonable," even though subsequent experience proved that those estimates were generous, and ruled that those estimates be used as the tax reserves. A similar ruling was made for 1993, but here the Court ruled that the tax reserve would be a point estimate made recently (but using only data available at the time) by an actuary testifying on behalf of the IRS, even though this estimate was actually higher than the one originally made by the company's consulting actuary.

## Conclusions

What lessons can we as health actuaries draw from these rulings in terms of assuring that the unpaid loss reserves that we set will stand up to scrutiny under the "fair and reasonable" standard for tax reserves?

- Decisions as to explicit levels of margin or conservatism added in aggregate to the reserves (akin to Minnesota Lawyers' adverse development reserve) cannot be made arbitrarily, but must instead be supportable by studies of past experience
- Neither issuance of a statutory opinion on the reserves nor acceptance of those reserves by the regulator is sufficient to ensure that the reserves are acceptable for tax purposes;
- If the actuary computes ranges of reserve estimates rather than point estimates alone, wider ranges (as in *Minnesota Lawyers*) may be more susceptible to attack than narrow ranges (as in *Utah Mutual*);
- The reserves may be vulnerable to attack if it cannot be demonstrated that the computations by which the reserves were established conform with appropriate Actuarial Standards of Practice, even in cases (as in *Minnesota Lawyers*) where a qualified actuary subsequently reviewed the reserves and performed parallel calculations using accepted actuarial methodology.

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