1971

Reinsurance -- The Industry's federal income tax problems

Francis C. Oatway

Recommended Citation
Haskins & Sells Selected Papers, 1971, p. 236-246

REINSURANCE – THE INDUSTRY'S FEDERAL INCOME TAX PROBLEMS

by Francis C. Oatway, Partner
Executive Office

Presented before the 49th International Conference of the Insurance Accounting and Statistical Association, Boston, Massachusetts – May 1971

As I reflected on recent tax developments affecting the reinsurance industry that would be of interest for discussion at this seminar, I saw what seemed to me to be a great paradox. This paradox involves a new position taken by the Internal Revenue Service, one not limited to the insurance industry, but one that ostensibly affects all taxpayers. The new position seems to be working completely at cross purposes with the thrust of Internal Revenue Service developments, both new and old, that affect the reinsurance industry. Let me explain.

AN OVERALL VIEW OF THE INDUSTRY'S PROBLEMS

The tax problems of the entire property and liability insurance industry, both primary and reinsurance, can, in my view, basically be reduced to one: A tax accounting problem. This is an area of great turbulence for all taxpayers, but it is made particularly turbulent for the insurance industry by the general lack of definition of what is or is not proper tax accounting for a property and liability insurance company.

- **Accounting Method Conformity in General** The specific Internal Revenue Service position that raises the paradox is not even a proposed regulation at this stage but rather is simply a position published through an Internal Revenue Service announcement.[1] For taxpayers generally, the Internal Revenue Service has announced an intention to pursue the objective of conforming income tax and financial statement accounting methods and techniques. The National Office has imposed a condition (when approving a request for permission to change a tax accounting method) that the proposed method be used not only for income tax purposes but also for book purposes and in the preparation of financial statements reporting the results of operations to shareholders. This is the immediate thrust of the Internal Revenue Service announcement and represents somewhat of a radical departure from prior practice. In the recent past, a similar condition has been only that the new accounting method be reflected in books and records, and even then it was conceded that in some cases a taxpayer could effectively have two sets of books. The broader objective of total conformity between tax and financial accounting is apparently to be further pursued. While the Service's announcement did indicate that further study would be required and that consideration would be given to making exceptions presumably including exceptions for industry practices, it seems clear that an increased emphasis on conformity can be expected.

- **Accounting Method Conformity for Insurers** Let me turn now not specifically to the reinsurance industry but to the property and liability industry as a whole. I think it would be fair to say that over the past several years Internal Revenue Service challenges to the tax posture of the industry have been aimed, not at encouraging conformity between annual statement reporting and income tax reporting, but rather at chipping away the industry assertion that conformity of statement reporting and tax reporting is not only desirable but mandated by the statute. As you well know, the statute defining insurance company taxable income[2] places great emphasis on the annual statement approved by the National Convention of Insurance Commissioners. The term "expenses incurred", for example, is specifically defined as meaning all expenses shown by the insurance company taxpayer on its annual statement.[3]

- **The Paradox** The paradox I see, therefore, is simply stated as this: The recently avowed objective of the Internal Revenue Service is to encourage and to insist upon conformity of financial statement reporting and tax reporting for taxpayers generally. Recent history of the Service in the examination of insurance companies has been to attack the attempt on the part of insurance companies to conform their "financial" statement reporting and income tax reporting. This, being an oversimplification is, of course, somewhat self-serving since, when we are speaking of conformity of reporting, we need to define our terms.

- **Status of the Convention Form** The conformity asserted as desirable by the property and liability insurance industry is conformity between annual statement reporting and tax reporting. The status of the annual statement or the convention blank for tax return purposes is an issue that has been argued in the courts since as early as 1935.[4] Even now it is not a totally resolved matter since a difference of opinion has been allowed to continue to exist between various Circuit Courts of Appeal. Anyone wishing to find strong language of the courts in support of an argument that the annual statement is controlling for income tax purposes can easily find such language. The Tax Court, for example, has stated that "the very terms of the Convention Form were incorporated into the statute in their own 'technical words'. Congress has taken the Convention Form as its pattern for this peculiar legislation. It should be followed precisely according to its terms and as employed, accepted and complied with throughout the United States."[5] Rather strong language, but it was later affirmed in a decision by the First Circuit Court of Appeals[6] and followed by the Fourth.[7] On the other hand, one who might wish to argue that the annual statement is not controlling for tax purposes can find similar strong language. The Ninth Circuit Court, for example, has described the convention form as "a guide, not a limitation on the statute." The court dismissed the industry argument that the annual statement was controlling as "untenable".[8]

At one point it appeared that perhaps this conflict would be resolved. An extension of time within which to file a petition for writ of certiorari was requested, but Supreme Court consideration of the matter was forestalled when, rather than have the issue faced squarely, the convention form was revised to eliminate the conflicts that had led to litigation. Current Internal Revenue Service regulations, accordingly, provide that "the underwriting and investment exhibit is presumed to reflect the true net income of the company and, insofar as it is not inconsistent with the provisions of the Code, will be recognized and used as a basis for that purpose."[9]

- **Paradox May Be More Apparent than Real** The conformity aimed for by the current Internal Revenue Service announcement is apparently conformity between financial statement reporting, presumably generally accepted accounting principles, and income tax reporting. As those of you who are familiar with the AICPA Audit Guide[10] will attest, there is a significant body of opinion holding that the gap between generally accepted accounting principles and convention form reporting is itself too wide and needs conforming or narrowing.

Perhaps then the paradox is more apparent than real. Perhaps the Internal Revenue Service challenges to industry reporting and the Audit Guide criticism of such reporting and the recommendation that it be more nearly conformed to generally accepted accounting principles, when coupled with the Internal Revenue Service's attempts to aim towards conformity, all have a common objective. In this narrow context, this objective could be reduced, for definition purposes, to an attempt to require the property and liability insurance industry to report for both financial statement and income tax purposes on a common basis, a basis which in many areas would bear no real relationship to annual statement reporting.

MAJOR AREAS OF DIFFERENCE BETWEEN ANNUAL STATEMENT AND INCOME TAX REPORTING

Before focusing on a current development affecting the reinsurance industry in particular (as to which I would like to comment at some length), perhaps it would be good to review briefly the major areas of divergence between the three kinds of reporting about which we have been speaking, for these areas of difference are the root of all current tax problems affecting the property and liability insurance industry. And, while they are basically the problems of the primary insurers, ultimately they become your problems.

- **AICPA Audit Guide** Let us just focus for a minute on three areas of difference having a significant Federal income tax impact as these areas were described by the AICPA Audit Guide:

Matching of Income and Expense
One of the financial reporting practices which insurance companies must follow is that no recognition may be given to prepaid expenses or deferred charges. All costs, such as commissions, premium taxes and other items (generally referred to as acquisition costs), in connection with writing insurance and obtaining premiums must be charged against income as they are incurred. Premiums, however, must be taken into earnings over the periods covered by the policies.

Accordingly, in a period of increasing premium volume, the results of statutory underwriting operations of a company are depressed to the extent of the expenses applicable to the increase in unearned premiums which will be reflected in income of later years. Conversely, in a period of declining premium volume statutory underwriting results are benefited by premiums taken into income whose related costs were charged against income in prior periods.[11]

Non-admitted Assets
Non-admitted assets (assets not permitted to be reported in the annual statement as available for payment of claims) are required to be excluded from the annual statement without regard to their realizable or useful value. Furthermore, some companies charge equipment, furniture and automobiles to expense when purchased rather than treating them as non-admitted assets and charging depreciation to expense.

Statutory Reserves
"Insurance companies are required to maintain loss and loss expense reserves for certain types of risks at the higher of an amount determined by the use of a statutory formula or an amount determined by the company based on adjusters' estimates case by case plus company-determined formulas for certain classes of outstanding losses. Since the company's estimates are determined in the light of particulars of individual cases, and its experience with similar claims and current trends, they generally represent a more realistic measure of the losses which will have to be met than do reserves determined by statutory formula."[12]

What all of these comments really say is that industry accounting, directed as it is to the satisfaction of regulatory requirements enacted to protect policy holders, does not even pay lip service to the broad general objectives of either generally accepted accounting principles or tax accounting principles. Whether this is a correct evaluation or not in terms of generally accepted accounting principles, it would be presumptuous of me to say. In prior years entire sessions at these IASA annual meetings have been devoted to discussions of the Audit Guide, its pros and cons, its effects and defects, and so forth. Suffice it to say for these purposes that the industry accounting practices just described do not conform to well established principles of income tax accounting.

- **Unfairness of IRS Position** Many of the tax problems currently being faced by the industry have as their genesis these just-quoted comments. I would say, nevertheless, that without regard to the merit of the Guide comments the industry's current tax problem is not a completely fair one. It was a clear objective of Congress when enacting the provisions covering the taxation of insurance companies other than life, to grant some special status to the annual statement. It would be unrealistic to assume that Congress did not recognize, at that time, that the annual statement does not pretend to have as one of its objectives an accounting objective consistent with the general objective of tax accounting methods, namely a clear reflection of income consistent with the protection of Federal revenues. To assert now that the annual statement has status only where not inconsistent with general principles of tax accounting seems to me to be a patently unfair distortion of Congressional intent.

- **Current Problems in Context** What are the current problems facing the property and liability insurance industry as a result of this failure on the part of the Internal Revenue Service to recognize the status of the annual statement? Essentially, the same problems you have heard discussed in each of the last few years. They can be broadly categorized as challenges to loss reserves and challenges to the deductibility of expenses incurred. But, in essence, what they all boil down to is the previously quoted statement in the regulations to the effect that the convention form will be followed as long as it is not inconsistent with the provisions of the Code. Under this concept, the limit of Internal Revenue Service new challenges or new developments is only in its ability to understand – or to presume to understand – insurance accounting techniques and to find areas in which such accounting techniques conflict with general principles of tax accounting. I would not even dare to suggest areas of future challenge since I would want to be the last to be blamed for calling attention to these areas. The accounting profession has suffered enough through the blame it has taken for tax controversies presumed to have resulted from the Audit Guide. These areas of vulnerability, nevertheless, do exist. There are several categories or elements of expenses incurred in the annual statement that clearly do not meet the general tax accounting test for deductibility, the so called "all events" test.

COMMISSIONS PAID ON REINSURANCE ASSUMED

Let us now turn to what is the most specific and what I judge to be the most significant recent development affecting the reinsurance industry during the past year. This was the publication late in 1970 of Revenue Ruling 70-552[13] concerning the deductibility of expenses incurred in the form of commissions paid on reinsurance assumed. On the facts of the ruling, its conclusion was a favorable one and one which, on the face of it, appears favorable to the reinsurance industry as a whole. I caution, however, that we not be misled.

- **Revenue Ruling 70-552** The ruling in question involved a stock casualty insurance company engaged in the reinsurance business. The reinsurer's business was conducted pursuant to a treaty which obligated the reinsurer to assume a stated percentage of the risk on all policies written by the ceding insurer. The reinsurer became entitled to a similar stated percentage of the gross premium collected by the ceding insurer and was committed to allow the ceding insurer a ceding commission to cover commissions paid by it and certain other acquisition costs. The form that was followed permitted the ceding insurer to deduct from gross commissions due to the reinsurer the amount of any ceding commission due.

The issue was whether or not the reinsurer could deduct as expenses incurred the ceding commission retained by the ceding insurer and, if so, when such deduction should be allowed. The issue arose because the expense was never paid but rather was netted against gross premium. The question really was whether the expense should be treated as a charge to unearned premium reserves and, accordingly, should be recognized as a deductible expense only as and when the related unearned premium was taken into income. The ruling held that, in these particular factual circumstances, the ceding commission did constitute an expense incurred in the year it was netted against gross premiums due to the reinsurer and, accordingly, did give rise to a tax deduction in that year.

- **Significance of Ruling** To you as reinsurers, this pattern should be very familiar. I understand that in virtually all pro-rata reinsurance treaties this precise form or a simple variation of it is followed. Does the Internal Revenue Service ruling, therefore, mean that commission and acquisition cost reimbursements, pursuant to such reinsurance treaties, or for that matter, even pursuant to a facultative contract following a similar form, are safely deductible and not subject to challenge? I think not.

It seems to me, when all is said and done, that what the Internal Revenue Service was really asserting, in challenging the taxpayer whose case became the subject of the published ruling, was that the form of reinsurance contract could just as easily have been arranged on a net premium basis rather than on the basis of a gross premium and a separate expense reimbursement and, therefore, the reinsurer should be viewed for tax purposes as earning a net premium only. In this event, the Internal Revenue Service would, effectively, be arguing that the form of the transaction had tax avoidance as a primary motive and, therefore, should be ignored for Federal income tax purposes. The substance, in their view, a net premium, should be allowed to control and the entire amount of this net premium should be reflected in unearned premium reserves and recognized as taxable income as the premium is earned.

I am told, and I certainly have no reason to believe otherwise, that the present form of reinsurance contracts is dictated by many other considerations than the happenstance that an acceleration of Federal income tax deduction results. In other words, it is coincidental that a mismatching of income and expense results. If this is the case, then I believe that a strong argument can be made for the proposition that the form should control in the event of any future challenge. The ruling should provide the industry with a considerable amount of comfort.

Speaking of comfort, it is of interest to note that, in the ruling, there was no suggestion that "expenses incurred", the terminology of the statute, envisions only current expenses and not also prepaid expenses. It has been the fear of many in the industry that this is the next most logical area of attack. It is also of interest to note that, in the ruling, the Internal Revenue Service, by its language, relied not only on the language of Section 832 and the regulations thereunder, but rationalized that its conclusion was not inconsistent with general principles of tax accounting. Again, our question of conformity.

- **Possible Future Problems with Ruling** Where could this ruling or the position of the Internal Revenue Service which preceded it come back to haunt us? As you well know, one of the significant functions of reinsurance is financing or unearned premium relief for the primary insurer. By statute, a direct writer must maintain a full unearned premium reserve on its writings, but is, at the same time, not allowed to take a credit for its equity in the unearned premium reserve or for its prepaid expenses. In some cases, this requirement prevents a growing company from expanding. Such a company can put itself in a position to expand only by relieving its unearned premium reserve. This can be done through reinsurance. In addition, reinsurance is often used to increase an insurance company's year-end surplus, even in a non-expansion situation, in order to reflect a better financial position. Finally, of course, reinsurance of significant parts of a company's portfolio can have significant income statement impact as well as balance sheet or surplus improvement effects.

Let us assume that a corollary benefit to this financial improvement is the creation of taxable income (normally the case) where such taxable income would be desirable for the ceding insurer. This might be the case, for example, if tax net operating losses were expiring or if the income of the insurance company could be used in consolidation to offset the loss of a fellow member of an affiliated group. I do not think it is too hard to imagine the difficulty that might be encountered in convincing the Internal Revenue Service, at the time of a challenge to the substance of the year-end reinsurance arrangement entered into for financing reasons, that the tax benefit achieved thereby was simply incidental. I am not suggesting that in any such set of circumstances the benefit to the ceding insurer and the benefit to the reinsurer would necessarily be denied or even challenged by the Internal Revenue Service. I suggest only that Revenue Ruling 70-552 covered a very narrow set of facts and should not be viewed as representing the end to all possible problems in this area.

SOME OTHER SPECIFIC PROBLEMS

The more general industry problems that have been current for the past few years continue, with few exceptions, to be current. These problems have been discussed at length in prior years and will undoubtedly be discussed at other sessions this year. I will, therefore, simply comment briefly on these.

- **Commissions** There continue to be challenges to the deductibility of commissions in certain limited sets of circumstances, generally, accrued contingent commissions resulting from arrangements whereby only a part of the total potential commission is paid initially and the balance is paid after a final amount is determined based on subsequent experience. Generally speaking, accruals of this type of commission will not meet with the general tests for tax deductibility and will, therefore, continue to be challenged. Commissions on year-end business continues to be a problem area but, as I have previously mentioned, the challenge here is not to the deductibility of prepaid commissions as much as it is to the deductibility of commissions regarded as incurred expenses but for which, in fact, no liability has yet been incurred at the year-end. Commissions on advance bookings are the prime example of this. The Internal Revenue Service does not generally suggest that if commissions on advance bookings should be denied, commissions on delayed bookings should be accrued. I, however, suggest this as a potentially significant possibility for offset.

- **Loss Reserves** In the loss reserve area there has been much discussion in prior years of the extent to which challenges are being made, generally as to statutory reserves, and the manner in which the Internal Revenue Service has been proceeding in the testing of reserves. In the brief time that I have here I will not attempt to cover this entire area. The technical advice memorandum issued by the National Office of the Internal Revenue Service in the Zurich Insurance Company case became an item of public information when it was attached as an exhibit to Zurich's petition to the Tax Court. This document has since received fairly wide industry distribution and while it has no official status as a ruling, it appears to represent the best published guidance as to the views of the Internal Revenue Service in this loss reserve area.[14]

  It is a pleasure to report that what was a troublesome issue to some companies, namely the deductibility of contested or resisted losses and losses incurred but not reported, seems to have been satisfactorily resolved by the issuance of Revenue Ruling 70-643.[15] This ruling States rather strongly the position of the Internal Revenue Service that property and liability insurance companies are entitled to deduct additions to their loss reserves for both resisted losses and losses incurred but not reported. Effectively, the ruling places these loss reserves in the same category as reserves for incurred losses. In this category they will, of course, continue to be tested for reasonableness and will be adjusted if appropriate. But no further challenge should be anticipated to the right of the insurer to deduct the reserve itself.

SUMMARY AND CONCLUSIONS

I opened my comments by saying that I thought that perhaps one of the most significant developments for the property and liability insurance industry was the announcement of the broad objective of the Internal Revenue Service to conform financial and tax accounting. While I consider that to be a truly significant development for taxpayers generally and one which will undoubtedly have some effect on your industry, I simply used that as a wedge to convey to you my feeling that the problems currently being faced and to be faced by the property and liability insurance industry are largely tax accounting problems. Certainly in resolving them one must understand insurance accounting, an understanding that the average tax advisor does not have. It is necessary, therefore, in attempting to resolve these problems to have the assistance of a true insurance accounting expert. It is no less necessary, in attempting to resolve these matters, to be sure that the problem company takes advantage of its general tax counsel, internal or external. Unless somehow or other the conflict between the Circuits on the status of the convention form is resolved favorably to the industry, the resolution of these problems lies in a sound knowledge and understanding of what is and what is not acceptable tax accounting and what relief provisions are available if forced changes in tax accounting methods are made. ●

[1] *Treasury Release IR-1125, April 14, 1971.*
[2] *Section 832, IRC.*
[3] *Section 832(b)(6), IRC.*
[4] *The Commissioner of Internal Revenue challenged the right of Pacific Employers Insurance Co. to reflect its incurred losses on the Schedule P formula basis and was upheld in its challenge by the Board of Tax Appeals. Pacific Employers Insurance Co. 36 B.T.A. 585 (1936),* aff'd, *89 F 2d 186, 37-1 USTC 9214 (CA-9).*
[5] *New Hampshire Fire Insurance Co., 2R.C. 708 (1943).*
[6] *Com. V. New Hampshire Fire Insurance Co., 146 F 2d 697, 45-1 USTC 9141 (CA-1).*
[7] *U.S. V. Fidelity and Deposit Company of Maryland, 177 F 2d 805, 49-2 USTC 9481 (CA-4).*
[8] *Pacific Employers Insurance Co. V. Commr., footnote 4, supra.*
[9] *Regulation 1.832-4(a)(2).*
[10] *Audits of Fire and Casualty Insurance Companies, American Institute of Certified Public Accountants (1966).*
[11] *Supra footnote 10, Page 61.*
[12] *Supra footnote 10, Page 63.*
[13] *1970-44 I.R.B. 18.*
[14] *Essentially the memorandum reaches three significant conclusions:*
1. Prior years' experience should be used as a basis for testing the reasonableness of reserves. However, a taxpayer may use loss run-off or development to rebut a proposed adjustment.
2. Loss reserves will be tested on a line or class of business basis and, therefore, overages and underages cannot be offset.
3. Excess reserves will continue to be allowed within percentage limitations but if adjustment is warranted, the normal allowed percentage redundancy does not constitute a flat allowance.
[15] *1970-51 I.R.B. 23, superseding G.C.M. 2318, VI-2 C.B. 80 (1927).*