

2012 FBA Insurance Tax Seminar P&C and Health Audit Update

Panelists: Steven Henson, PFTG Frontline Manager
Sharon Horn, IRS Chief Counsel, Branch 4
Joe Tedesco, XL Group

Moderator: Tracy D. Williams, Sidley Austin LLP

Overview

- Introduction to LB&I Issue Practice Groups
- Audit Issues
 - Loss Reserves
 - Life/Nonlife Consolidation
 - LAE and 404
 - Cell Companies
 - Other
- Health Insurance

LB&I Issue Practice Groups

- Pilot program operating with IPGs for change of accounting methods, deductible and capitalization expenditures, nonlife insurance, life insurance, and REITs, REMICs and RICs.
- More IPGs to come, including banking, financial instruments, etc.
- Knowledge management system intended to enhance collaboration and provide a peer network on which field examiners can rely.
- Nonlife insurance and life insurance IPGs are managed by Steve Henson and comprised of SMEs
- Communication by conference call and online network

LB&I Issue Practice Group

- Pilot IPGs have received hundreds of questions
- Significant areas of inquiries to nonlife insurance IPG
 - Captives (approx. 40%)
 - Loss Reserves (approx. 30%)
 - Health Insurance (approx. 7%)
 - Life/nonlife consolidation (approx. 6%)
 - LAE and 404 (approx. 3%)
- IPG internal website holds resources for field agents

LB&I Issue Practice Group

- Steve Henson: IPG Manager for Life, Nonlife, REITs, REMICs and RICs, and Banking
- Mary Roman: Nonlife IPG Coordinator
 - Full-time SMEs: Kate Weaver, Stuart Goldberg, Pat Ciccodicola, Yiling Cheng
- John Dunn: Acting Life IPG Coordinator
 - Full-time SME: Cheryl Reimer, Karen Suchorski
- Pearl Bassard: REITs, REMICs and RICs and Banking IPG Coordinator

Audit Issues – Loss Reserves

- Basic questions
 - calculation of reserves
 - legal issues in evaluating reserves
- Resources on IPG internal website
 - Preliminary testing tool for agents to use in identifying significant and continuing redundancies based on Schedule P data
 - Pro-forma IDRs with basic language to facilitate examining reserves

Audit Issues – Loss Reserves

- Questions for panel discussion:
 - How does the IPG expect that agents will use the testing tool and interact with the IPG on loss reserve issues?
 - What inference should be drawn where an agent gets a “positive” result on the testing tool?
 - What inference should be drawn where a reserve redundancy results from the exam team’s use of Reserve Pro?

Loss Reserves - Discussion Questions

- Does having a redundancy in hindsight cause a company's loss reserves to automatically fail the "fair and reasonable" test?
 - IRS examinations take place years after estimates of losses incurred are established and deducted
 - In hindsight, the only certainty is that the initial estimate was incorrect

Loss Reserves - Discussion Questions

- Does using conservative assumptions cause a company's loss reserves to automatically fail the "fair and reasonable" test?
 - Process of developing an estimate of ultimate losses involves actuarial judgment at every stage
 - Is the data reliable or is it distorted by short-term trends?
 - Are long-term changes adequately captured?
 - How do changes in claims management and payment practices affect the accuracy of the data?
 - How do societal changes (e.g., medical cost inflation, tort reform) affect the accuracy of the data?

Loss Reserves - Discussion Questions

- Does using “confidence intervals” cause a company’s loss reserves to automatically fail the “fair and reasonable” test?
 - Intended to capture the probability that the ultimate outcome will be below the estimate of ultimates (e.g., 65% of the time, the ultimate losses will be less than X)
 - Actuarially developed based on management’s business needs
 - May reflect varying levels of confidence (e.g., initial estimate developed at 50/50 confidence level but management selected estimate at 65% confidence level)

Loss Reserves - Discussion Questions

- Does using explicit margin in actuarial work automatically cause a company's loss reserves to automatically fail the "fair and reasonable" test?
 - Flat number or percentage of losses
 - Added by actuaries during actuarial analysis and included in amount recommended to management
 - Actuarial participation in selection of ultimate estimate
- Does a management "add-on" cause a company's loss reserves to automatically fail the "fair and reasonable" test?
 - Flat number or percentage of losses
 - Added by management after actuarial analysis is completed
 - May or may not be validated later by outside actuaries

Audit Issues – Life/nonlife consolidation

- Questions to IPG are largely focused on the use of losses, including requests for explanations of:
 - use of capital and net operating losses across subgroups
 - “bumping” rules
 - dual consolidated losses, SRLY losses
- Questions do not reflect that any particular legal issues have been surfaced
- Discussion questions:
 - Any comments on the ruling in PLR 201210015?

Audit Issues – LAE and 404

- Questions to IPG
 - What items are included in LAE?
 - How are estimates of LAE computed?
- Questions for discussion:
 - The IRS position on this issue is consistent with a larger effort by the IRS to challenge the Code's deference to Annual Statement accounting. Are other areas also being targeted?
 - How do you predict that the outcome of the State Farm appeal will affect the IRS position on this issue?

Audit Issues – Cell Companies

- Recent comments at ABA Tax Section meeting:
 - IRS attorney was quoted as saying that the IRS is looking at “offshore insurance scams” that involve “protected cell corporations.”
 - “It appears that you're one of many shareholders in the company, but it's really designed to disguise the fact that you're controlling your own funds in your own protected cell. That's really subject to abuse and we're going to be looking at this.”
- Questions for discussion
 - Does the IRS take the position that all protected cell corporations are “scams”?

Other Audit Issues

- Hedging: little current activity
 - likely due to the current Industry Issue Resolution program issue relating to the tax treatment of hedges relating to secondary guarantees of variable annuity benefits
- ECOs: little current activity
 - likely due to the pending appeal in State Farm
- Accounting: does the IPG recommend that agents attempt to reconcile GAAP/Stat/Tax information?