OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

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

SUBJECT:

This Field Service Advice responds to your memorandum dated November 13, 1998. 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.

<u>LEGEND:</u>

Company A =
Company B =
Company C =
Company D =
Company E =
Company F =
Company G =
State =
Pool =
Date 1 =
Date 2 =
Year 1 =
Year 2 =
Year 3 =

r%	=
s%	=
t%	=
u%	=
$v	=
$w	=
$x	=
$y	=
$z	=

ISSUES:

1. Whether Company A's participation in Pool qualifies for the "mandatory pool" exception from reserve strengthening pursuant to Treas. Reg. § 1.846-3(c)(3)(ii)(A).[1]

2. If Company A's membership in Pool falls within the "mandatory pool" exception of Treas. Reg. § 1.846-3(c)(3)(ii)(A), whether Company A's method of computing the reduction to respondent's reserve strengthening adjustment for the "mandatory pool" exception is acceptable

CONCLUSIONS:

1. Pool is mandatory and, therefore, subject to the Treas. Reg. § 1.846-3(c)(3)(ii)(A) exception from reserve strengthening, if the state considers participation in a pool mandatory in order to do business in the state, even though Company A could choose which pool to join.

2. The amount of any "mandatory pool" exception reduction to respondent's adjustment for reserve strengthening should be substantiated using data obtained from Pool regarding Company A's breakdown of the loss reserves and loss payments by accident year rather than by extrapolating data from another Pool participant's report from Pool.

[1] Unless otherwise indicated, section references throughout are to the Internal Revenue Code of 1986, as amended, and the Treasury regulations promulgated thereunder, as in effect during the years at issue.

FACTS:

Company A is a diversified financial services holding company organized under the laws of State. Company A is the successor to Company B, which was also organized under the laws of State. Company B was the common parent of an affiliated group of corporations within the meaning of I.R.C. § 1504(a) which filed a consolidated federal income tax return for Year 3. Among the subsidiaries of Company B were the following property and casualty insurance companies: Company C, Company D, Company E, Company F, and Company G. These subsidiaries are collectively known as the "Pooled Companies." The Pooled Companies wrote a full line of property and casualty insurance, including workmen's compensation insurance. The Pooled Companies operated on a pooled basis under an inter-company reinsurance agreement. Under this agreement, all business written by the Pooled Companies was combined, with premiums, losses and expenses prorated to each pooled company. Each of the companies participating with Company C in the pool was a wholly-owned subsidiary of Company C. From Year 1 through Year 3, the participants in the Pooled Companies and their relative percentages of participation were:

COMPANY	PARTICIPATION
Company C	r%
Company D	s%
Company E	t%
Company F	t%
Company G	t%
TOTAL	u%

In the notice of deficiency, dated Date 1, respondent made the determination that the Pooled Companies made additions to their reserves which constituted reserve strengthening and increased Company A's taxable income for the Pooled Companies for Year 3 as follows:

COMPANY	INCREASE IN INCOME
Company C	$v
Company D	$w
Company E	$x
Company F	$x
Company G	$x
TOTAL	$y

Company agrees that a reserve strengthening adjustment is appropriate, but contends that the amount of the reserve strengthening adjustment proposed by respondent should be reduced by $z for amounts of losses reported to Company A from mandatory state and federal assigned risk pools pursuant to the “mandatory pool” exception under Treas. Reg. § 1.846-3(c)(3)(ii)(A).

Company A contends that during Year 1 and Year 2, Company C, on behalf of the Pooled Companies, was required to participate in a number of mandatory state assigned risk pools, including Pool, and that these pools fall within the "mandatory pool" exception of Treas. Reg. § 1.846-3(c)(3)(ii)(A). Company A has been unsuccessful in locating a detailed breakdown of Year 1 and Year 2 loss reserves and loss payments for these excepted pools. Some information about these pools can be found on Schedule F, Part 1A, Section 2 of Company C's NAIC Annual Statement for Year 2. In addition, Company A has submitted a breakdown of the loss reserves and loss payments by accident year reported by Pool to an unrelated property and casualty insurance company. Company A used this breakdown to extrapolate amounts attributable to Company C. Company A used the extrapolated amounts, coupled with the limited information on its Schedule F, to calculate the amount of reduction to respondent's reserve strengthening computation it contends should be made. Although Company A contends that there were several risk pools that would qualify under the "mandatory pool" exception, Company A is only claiming a reduction related to Pool since that is the only pool for which it has a comparative breakdown of loss reserves and loss payments.

LAW AND ANALYSIS:

Issue 1

This case involves the tax consequences of adjustments to a property and casualty insurance company’s unpaid loss reserves during Year 2. Property and casualty insurance companies are taxed pursuant to I.R.C. §§ 831 et seq. Under I.R.C. § 832(a), the taxable income of such a company is defined as the gross income minus allowable deductions. Section 832(c)(4) provides that these deductions include “losses incurred” as defined in section 832(b)(5).

Prior to 1986, section 832(b)(5) defined “losses incurred” as the amount of “losses paid” during the year plus the increase (or minus the decrease) in “unpaid losses.” In practice, a property and casualty insurance company would deduct the full amount of the estimated total loss in the year of the loss event even though the claim might not be paid for several years. When the claim was paid, the company would not receive any additional deduction (assuming that the payment equaled the original estimate) because the payment would be offset by a corresponding reduction in its unpaid loss reserve. Thus, pre-1986 law provided property and casualty insurance companies with an unwarranted benefit because it failed to account for the time value of money. As explained by the Senate Finance Committee:

> Unlike other taxpayers, property and casualty insurance companies are permitted to deduct losses prior to the time the loss is paid or accrued. The Committee believes that the present-law treatment of property and casualty companies thereby permits such companies to overstate the true current cost of the insured loss; the deduction for such losses is overstated by the amount by which the nominal dollar value of a loss exceeds the present value of the insurance company's liability to pay the resulting claim. * * *

S. Rep. No. 99-313, 99th Cong., 2d Sess., 1986-3 C.B. (Vol. 3) 499-500.

Congress addressed this problem by enacting I.R.C. § 846, as part of the Tax Reform Act of 1986, Pub. L. No. 99-514, § 1023, 100 Stat. 2085, 2399, 1986-3 C.B. (Vol. 1) 316. Section 846(a) provides for the discounting of unpaid losses in all lines of a company's business to account for the time value of money. At the same time it enacted section 846, Congress amended section 832(b)(5) to provide that the deduction for "losses incurred" is computed by adding to losses paid "all discounted unpaid losses (as defined in section 846) outstanding at the end of the taxable year" and deducting therefrom "all discounted unpaid losses outstanding at the end of the preceding taxable year."

Section 1023(e)(1) of the Tax Reform Act of 1986, 100 Stat. 2404, provided that the new discounting rules "shall apply to all taxable years beginning after December 31, 1986," i.e., 1987 for a calendar year taxpayer. In the absence of a relief provision, property and casualty companies would have been required to compare "old law" (undiscounted) year-end 1986 reserves with "new law" (discounted) year-end 1987 reserves, thus reducing the losses incurred deduction for 1987. Congress thus included in the 1986 legislation a transitional rule, section 1023(e)(2), which provides that for purposes of computing the losses incurred deduction for 1987, the year-end 1986 reserves would be discounted.

Absent any additional relief provision, the above transitional rule would have required property and casualty companies to take into income, in 1987, the excess of the undiscounted year-end 1986 reserves over the discounted year-end 1986 reserves. This is because the change to discounting constitutes a change of accounting method, the change engenders a double deduction for property and casualty companies, and I.R.C. § 481 requires an appropriate adjustment to prevent the taxpayer from obtaining a double deduction created by a change in accounting method. Congress, however, decided to allow the double deduction by enacting a "fresh start" provision in section 1023(e)(3)(A). Section 1023(e)(3)(A) provides as follows:

> (3) FRESH START.--

> (A) IN GENERAL.--Except as otherwise provided in this paragraph, any difference between–
>
> (i) the amount determined to be the unpaid losses and expenses unpaid for the year preceding the 1st taxable year of an insurance company beginning after December 31, 1986, determined without regard to paragraph (2) [i.e., without discounting], and
>
> (ii) such amount determined with regard to paragraph (2) [i.e., with discounting],
>
> shall not be taken into account for purposes of the Internal Revenue Code of 1986.

The double deduction provided by the fresh start provision, however, provided property and casualty companies with an incentive to increase their unpaid loss reserves during the 1986 taxable year. Congress addressed this problem in section 1023(e)(3)(B) by precluding the application of "fresh start"–and thus permitting the normal application of section 481– with respect to any "reserve strengthening" occurring in 1986. Section 1023(e)(3)(B) provides as follows:

> (B) RESERVE STRENGTHENING IN YEARS AFTER 1985.–Subparagraph (A) [the fresh start provision] shall not apply to any reserve strengthening in a taxable year beginning in 1986, and such strengthening shall be treated as occurring in the taxpayer's 1st taxable year beginning after December 31, 1986.

The Internal Revenue Service announced that it intended to issue regulations interpreting section 1023(e)(3)(B) in Notice 88-100, 1988-2 C.B. 439, and issued proposed regulations in 1991. Proposed Treas. Reg. § 1.846-3, 56 F.R. 20161 (May 2, 1991). The Treasury eventually promulgated the final regulations on September 4, 1992. Treas. Reg. § 1.846-3, T.D. 8433, 1992-2 C.B. 146. Treas. Reg. § 1.846-3(c) sets forth the rules for determining the amount of "reserve strengthening," and provides in pertinent part:

(1) In general. The amount of reserve strengthening (weakening) is the amount that is determined under paragraph (c)(2) or (3) to have been added to (subtracted from) an unpaid loss reserve in a taxable year beginning in 1986. For purposes of section 1023(e)(3)(B) of the 1986 Act, the amount of reserve strengthening (weakening) must be determined separately for each unpaid loss reserve by applying the rules of this paragraph (c). This determination is made without regard to the reasonableness of the amount of the unpaid loss reserve and without regard to the taxpayer's discretion, or lack thereof, in establishing the amount of the unpaid loss reserve . . .

* * * *

(3) Accident years before 1986--(i) In general. For each taxable year beginning in 1986, the amount or reserve strengthening (weakening) for an unpaid loss reserve for an accident year before 1986 is the amount by which the reserve at the end of that taxable year exceeds (is less than)--

(A) The reserve at the end of the immediately preceding taxable year; reduced by

(B) Claims paid and loss adjustment expenses paid (“loss payments”) in the taxable year beginning in 1986 with respect to losses that are attributable to the reserve . . . .

(ii) Exceptions. Notwithstanding paragraph (c)(3)(i) of this section, the amount of reserve strengthening (weakening) for an unpaid loss reserve for an accident year before 1986 does not include–

(A) An amount added to the reserve in a taxable year beginning in 1986 as a result of a loss reported to the taxpayer from a mandatory state or federal assigned risk pool if the amount of the loss reported is not discretionary with the taxpayer; or

(B) Payments made with respect to reinsurance assumed beginning in 1986 or amounts added to the reserve to take into account reinsurance assumed for a line of business during a taxable year beginning in 1986, but only to the extent that the amount does not exceed the amount of a hypothetical reserve for the reinsurance assumed . . . .

Treas. Reg. § 1.846-3(c).

The Supreme Court recently upheld the validity of the definition of “reserve strengthening” in Treas. Reg. § 1.846-3(c) in Atlantic Mutual Insurance Co. v. Commissioner, 118 S.Ct. 1413 (1998), aff’g. 111 F.3d 1056 (3d Cir. 1997), rev’g T.C. Memo 1996-75 (1996). Following the Supreme Court’s decision, Company A has agreed to a reserve strengthening adjustment, but contends that it qualifies for a reduction to the adjustment under the “mandatory pool” exception of Treas. Reg. § 1.846-3(c)(3)(ii)(A).

Background information on Pool submitted with the request for Field Service Advice suggests that the membership of Company A in Pool was “mandatory” under the laws of a number of states in which it did business as a condition for permission to write workers compensation insurance in those states. Our limited review of the use of “mandatory pool” in several state insurance provisions lends support to

Company A's argument that "mandatory pool" is used to describe workers' compensation risk pools in which participation is mandatory.

In Aetna Casualty & Surety Co. v. Landry Enterprises, 1995 U.S. Dist. (1995), the court described a workers' compensation reinsurance pool as an agreement among insurance companies that write workers' compensation insurance in the "voluntary" markets of several states. Each company that writes insurance in the voluntary markets must participate in the assigned risk plans of the participating states.

The National Association of Insurance Commissioners ("NAIC") also has defined the term "mandatory pool." Through the NAIC, state regulatory organizations provide the annual statement blank and uniform standards to be employed in preparing the annual statement. In 1921, Congress prescribed that, generally, the annual statement is the basis for determining the underwriting and investment income for federal income tax purposes for insurance companies. NAIC Proc. 407 (1996-1) defines voluntary pools as similar to involuntary pools except that they are not state mandated and an insurance company participate in the pool voluntarily. The 1996 NAIC Issue Paper No. 97 (Statutory Codification project issue paper) defines involuntary pools as representing a mechanism employed by states to provide insurance coverage to those with higher than average probability of loss who otherwise would be excluded from obtaining coverage. Insurance companies are generally required to participate in the underwriting results including premiums, losses, expenses, and other operations of involuntary pools, based on their proportionate share of similar business written in the state. Involuntary pools are also referred to as residual market plans, involuntary risk pools and mandatory pools.

Based on the foregoing, we conclude that Pool is "mandatory" within the meaning of the Treas. Reg. § 1.846-3(c)(3)(ii)(A) exception from reserve strengthening in each state that considers participation in a pool mandatory in order to do business in the state even though Company A could choose which pool to join.

Issue 2

As noted above, Company A is unable to provide a detailed breakdown of loss reserves and loss payment by accident year for the various mandatory pools in which it participated in Year 1 and Year 2, but has submitted a Pool breakdown reported to another company. Company A used this breakdown to extrapolate amounts attributable to the Pooled Companies. Company A then used these extrapolated amounts, coupled with the limited information on its Schedule F, to calculate the amount of reduction to respondent's reserve strengthening computation it alleges should be made.

With respect to the issue of whether the appropriate method has been employed in computing the reduction to the reserve strengthening adjustment we first note that no information has been provided as to how Company A treated this item on its books and records (financial statements) or on its annual statement. We will assume that the tax treatment is consistent with its other statements.

The legal considerations of this issue are governed by I.R.C. §§ 446 and 6001. Section 446(a) provides that taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books. Section 446(b) provides that if no method of accounting has been regularly used by the taxpayer, or is the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income. Section 6001 provides, in part, that every person liable for any tax imposed by this title, or for the collection thereof, shall keep such records, render such statements, make such returns, and comply with such rules and regulations as the Secretary may from time to time prescribe.

The amount of any “mandatory pool” exception reduction to respondent’s adjustment for reserve strengthening should be substantiated using data obtained from Pool regarding Company A’s breakdown of the loss reserves and loss payments by accident year rather than by extrapolating data from another Pool participant’s report from Pool.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

[redacted]

Please call if you have any further questions.

By: ________________________

JOEL E. HELKE
Branch Chief
Financial Institutions &
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cc: