

P&C PERSPECTIVES

Current Issues in Property and Casualty

Internal Revenue Service: 2007 election to use company payment patterns to discount loss reserves

by Amy Angell, FCAS, MAAA

As we approach the presidential election of 2008, there is another election on the horizon that affects property and casualty insurers. Every five years, qualifying insurers have the opportunity to choose whether to use their own historical payment patterns or the industry-wide payment patterns set by the Internal Revenue Service (IRS) for the purposes of discounting loss and loss expense reserves.

Because insurance industry and company payment patterns can differ greatly, the decision to elect to use the company payment patterns can have a significant effect on taxable income—and therefore on the timing of federal income taxes.

“Companies that estimate a small but positive benefit in making the election for 2007 may have a higher benefit in 2008 to 2011, if the IRS interest rates rise.”

This overview of the election process and the IRS regulations summarizes the key variables that affect the discounting calculation and illustrates the potential benefit for a range of sample insurance companies.

IRS regulations and the election process

The discount factors determined by the IRS are a function of two variables:

- **IRS interest rate.** Each tax year, the IRS sets an interest rate to use for discounting. The IRS interest rate is based on the five-year rolling average of the monthly federal mid-term interest rate. Once set, the IRS interest rate is updated annually and remains fixed for each accident year. For accident year 2007, the IRS interest rate is 3.97%, the five-year rolling average through Dec. 31, 2006.

- **Industry payment patterns.** The IRS calculates discount factors for each annual-statement line of business using insurance industry payment patterns and the IRS interest rate. The payment patterns are defined every five years using, for each line of business, industry booked paid and ultimate loss and loss adjustment expenses. For accident years 2007 to 2011, the payment patterns are based on data from the year-end 2005 *Best's Aggregates & Averages*.

Company discount factors are a function of the IRS interest rate and the company's own payment patterns. Companies electing to use their own payment patterns must have 10 years of historical data. Because the payment patterns for accident year 2007 are based on year-end 2005 data, in order to elect to use their own payment patterns in 2007, companies must have data for accident years 1996 to 2005. Furthermore, companies making that election must use their own payment pattern for all lines for which they have 10 years of data.

Company payment patterns are calculated by line of business using the company's booked paid and ultimate loss and loss adjustment expense amounts from Schedule P, Part 1 for each line of business. The single evaluation date used to calculate the company payment pattern may contain data anomalies or unusual results (e.g., reversals in the cumulative payment pattern). The IRS regulations include rules to deal with some, but not all, potential anomalies. Also, unlike the IRS payment patterns, companies that elect to use their own payment patterns must recalculate the patterns for each accident year. Thus, future booked paid and ultimate losses and loss adjustment expenses will affect the payment patterns for discounting and could also result in anomalies.

Who?

Who benefits from this election? They may share the following characteristics:

- Stable payment patterns
- Faster payment patterns than the industry averages
- Consistent reserving practices
- Sufficient reserve volume
- Not exempt from federal income taxes

Faster payment patterns may result from a company's approach to handling and settling claims, having a lower retention than the industry average, or the regulatory climate in a particular state relative to the industry average. It all boils down to whether or not a company's payment patterns create a more advantageous environment than the industry payment patterns.

When?

Critical timeline:

- The year-end 2005 to year-end 2007 booked figures (which will determine the company payment patterns for accident years 2007, 2008, and 2009) are available now, so companies can determine in advance whether the election is likely to be beneficial.
- Companies need to make the election when they file their 2007 tax return in 2008. The filing date is mid-March. However, companies that file for an extension will file their returns in mid-September.

Companies need to work backward, depending on when they intend to file. The calculations take time, so advance preparation is in the company's best interest.

Why?

More accurately, why not? It's good practice for a company to at least review whether or not to pursue the election. The objective is to run the company to the benefit of the shareholders, which requires some scrutiny.

Company review process

The variable with the greatest uncertainty is the company payment patterns. Company payment patterns can change because of:

- **Mix of business.** If the election is estimated to be beneficial for some, but not all, lines of business, a change in the mix of business could change the overall result. Thus, the decision process should include consideration of a five-year business plan, and not just the current reserves on the books.
- **Claims-handling practices.** A company could implement a new claims-handling strategy or new claims-settlement philosophy that changes its payment patterns.
- **Data anomalies.** Because companies have to use the "single evaluation" approach to calculate their own patterns, results could change significantly from year to year because of data anomalies such as large loss settlements. To evaluate the company election, companies should review the existing payment patterns (for year-ends 2005 to 2007) to see if they are unusual or unrepresentative of the patterns expected for year-ends 2008 and 2009.

The same interest rate is used to calculate both the IRS discount factors and the company discount factors. However, to the extent that company payment patterns are faster than industry payment patterns, the use of a higher interest rate will result in a greater benefit, all other things being equal. The interest rate for 2007 is 3.97%, and the interest rate for 2008 will be 4.06%. Thus, companies that estimate a small but positive benefit in making the election for 2007 may have a higher benefit in 2008 to 2011, if the IRS interest rates rise.

The use of company discount factors will affect not only the current tax year, but also each future tax year in which the company has booked reserves for that accident year. For example, if the ultimate losses for accident year 2007 are expected to be paid out over 10 years, the company election will change the deduction for losses and loss adjustment expenses in calendar years 2007 to 2016. Companies need to estimate the present value of these differences; to do so, they need to select an interest rate to discount the projected differences. The use of a higher interest rate to perform this present-value calculation will magnify the benefit or cost.

This election needs to be made as part of each insurer's 2007 tax return. If the company election is made for tax year 2007, it will apply to the booked reserves for accident years 2007 to 2011. Making the election in 2007 will not change the discount factors used to calculate taxable income for accident years 2006 and prior.

Potential benefits

We estimated the potential benefit of making the election by constructing a model to estimate the present value of the difference between discounted incurred losses using the IRS and company payment patterns and discount factors. In the example on the following page, the company is a workers' compensation insurer who pays claims, on average, 10% faster than the industry.

Table 1

WORKERS' COMPENSATION EXAMPLE (\$ IN 000s)

	(1)	(2)	(3)	(4)	(5)	(6)
	Paid Loss and LAE		Discounted Incurred Loss and LAE		Estimated Increase / (Decrease) in Tax Deduction (4) - (3)	Estimated Change in Tax Benefit / (Cost) (5) x 35%
Calendar Year	Using IRS Pattern	Using Company Pattern	Using IRS Pattern	Using Company Pattern		
2007	19,041	20,945	89,151	92,094	2,943	1,030
2008	21,203	23,324	2,684	2,366	(318)	(111)
2009	16,906	18,596	2,045	1,627	(418)	(146)
2010	10,710	11,781	1,504	1,087	(417)	(146)
2011	7,680	8,448	1,189	728	(460)	(161)
2012	4,576	5,033	875	489	(386)	(135)
2013	2,067	2,274	561	363	(199)	(70)
2014	2,222	2,444	533	284	(249)	(87)
2015	1,115	1,226	350	222	(128)	(45)
2016	766	843	272	189	(83)	(29)
2017	766	848	242	163	(79)	(28)
2018	766	848	208	136	(72)	(25)
2019	766	848	169	108	(61)	(21)
2020	766	848	126	79	(47)	(16)
2021	766	848	75	48	(27)	(10)
2022	9,884	848	16	16	0	0
Total	100,000	100,000	100,000	100,000	(0)	(0)
					(7) Present Value at 4.0%	168
					(8) Present Value at 6.0%	234
					(9) Present Value at 8.0%	289

Table 2

RANGE OF POTENTIAL BENEFITS (\$ IN 000s)
Estimated Ultimate Losses **100,000**

Company Pattern	Interest Rate for Present Value Estimate		
	4.0%	6.0%	8.0%
10% Faster	168	234	289
20% Faster	216	306	385
10% Slower	(4)	(17)	(34)
20% Slower	(91)	(143)	(196)

Limitations

We are not experts in tax or accounting, and we are not qualified to provide tax or accounting advice. The cash-flow model shown here measures differences in discounted incurred losses by calendar year. It is beyond the scope of this discussion to comment on how making the IRS election may interact with other tax initiatives for a particular company. We recommend that any reader seek the advice of his or her own tax and accounting counsel when considering how to approach this election.

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