Time Insurance Company v. Commissioner, 86 T. C. 298 (1986)

NAIC rules for computing medical insurance claim reserves are applicable for tax purposes when the Code and regulations are silent on the matter.

Summary

Time Insurance Company challenged the IRS's disallowance of its deductions for unaccrued medical insurance claim reserves. The company used the NAIC-prescribed claim lag method to compute these reserves. The Tax Court held that Time's method was consistent with both NAIC rules and the accrual method of accounting, as the Code and regulations did not provide specific guidance on computing such reserves. The court emphasized that NAIC methods apply when there is no inconsistency with accrual accounting, upholding the company's deduction based on its established reserves.

Facts

Time Insurance Company sold life and medical reimbursement insurance across multiple states, using the claim lag method to calculate its claim reserves as required by NAIC rules and state law. The company divided its policies into categories like guaranteed renewable (GR) and optionally renewable (OR) hospital/surgical and major medical policies, as well as group policies. It assigned an 'incurred date' to claims when the insured first incurred an expense meeting the policy's deductible. Time reported these reserves on its NAIC statements, which were audited and accepted by state insurance departments. The IRS disallowed a portion of these reserves, arguing they were overstated because they included liabilities not yet 'in existence' at year-end.

Procedural History

Time Insurance Company filed its tax returns for 1972-1975, claiming deductions for increases in both accrued and unaccrued claim reserves. The IRS disallowed the unaccrued portion of these reserves, leading Time to petition the U. S. Tax Court. The court reviewed the case and upheld Time's method of reserve calculation, ruling in favor of the company's deductions.

Issue(s)

1. Whether Time Insurance Company properly computed its claim reserves for medical reimbursement policies during the years in issue.
2. Whether the IRS's disallowance of a portion of Time's deductions for claim reserves was arbitrary and unreasonable, shifting the burden of proof to the IRS.
3. If the deduction for claim reserves in 1972 is found improper, whether Time is entitled to spread forward any adjustment for that year over the 10-year period provided by section 810(d).

Holding

1. Yes, because Time’s method of computing claim reserves was consistent with NAIC rules and the accrual method of accounting, as required by section 818(a) of the Internal Revenue Code.
2. No, because the burden of proof for deductions remains with the taxpayer, and the IRS’s determination, although challenged, did not shift this burden.
3. This issue became moot as the court upheld Time’s computation of claim reserves for all years in question.

Court’s Reasoning

The Tax Court reasoned that since the Internal Revenue Code and its regulations were silent on how to compute medical insurance claim reserves, the last sentence of section 818(a) applied, allowing NAIC methods to govern. The court found Time’s claim lag method to be consistent with NAIC rules and supported by expert testimony. The court rejected the IRS’s argument that reserves must reflect only ‘existing liabilities’ at year-end, as this was inconsistent with the regulations defining ‘unpaid losses’ and ‘losses incurred. ’ The court also noted that the IRS’s proposed method of assigning incurral dates was impractical and not used by any insurer. The decision was further supported by the precedent set in Commissioner v. Standard Life & Accident Insurance Co. , where the Supreme Court upheld the use of NAIC methods in similar situations.

Practical Implications

This decision clarifies that when the Code and regulations do not specify a method for calculating reserves, NAIC rules can be used as long as they are not inconsistent with accrual accounting. This ruling impacts how insurance companies calculate and report their claim reserves for tax purposes, affirming the use of industry-standard methods like the claim lag method. It also influences legal practice by reinforcing the importance of NAIC compliance in tax litigation for insurance companies. The case has been cited in later decisions, such as those involving the computation of reserves and the application of the accrual method of accounting in the insurance industry.