SULLIVAN & CROMWELL LLP

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Taxation of Insurance Companies

Tax Court Ruling Limits Insurance Companies' Use of the Annual-Statement Method of Accounting for U.S. Federal Tax Purposes

SUMMARY

On November 8, 2010, the U.S. Tax Court issued an opinion that limits the use of the annual statement method of accounting by insurance companies in determining their annual taxable income for U.S. federal tax purposes. In its opinion, *State Farm Mutual Automobile Insurance Co.* v. *Commissioner* (135 T.C. 26), the Tax Court ruled that amounts owed as punitive damages may not be deducted from taxable income as a loss under Code Section 832(b)(5) notwithstanding that such amounts may have been properly included as losses by the taxpayer on its annual statutory financial statements. Instead, the Court held that the annual statement method of accounting applies only to losses under the terms of an insurance contract, and not to "extracontractual" obligations, such as punitive-damages awards.

BACKGROUND

Section 832[1] provides that, for purposes of determining the gross income of insurance companies, underwriting income is "computed on the basis of the underwriting and investment exhibit of the annual statement approved by the National Association of Insurance Commissioners." This provision, and its interpretation by the courts,[2] had led some to conclude that the treatment of items of gain and loss on an insurance company's annual statement definitively determines the treatment of such items for the purposes of calculating taxable income.

The Code allows insurance companies to deduct certain losses from gross income. One such allowable deduction is provided by Section 832(b)(5), which allows a deduction for losses on insurance contracts that are outstanding at the end of a taxable year, after application of a discount factor determined under the Code.

THE TAX COURT DECISION

The question before the Tax Court was whether State Farm Mutual Automobile Insurance Company ("State Farm") was allowed to deduct as a loss under Section 832(b)(5) amounts relating to a punitive-damages judgment that had been awarded against State Farm.

A jury had awarded a judgment (the "Judgment") for both compensatory and punitive damages against State Farm for State Farm's actions relating to claims in respect of a car accident. In determining its year-end unpaid loss reserve for purposes of its annual financial statement under Illinois state regulations, State Farm included an amount reflecting both the compensatory and punitive damages. State Farm also claimed a tax deduction for such losses under Section 832(b)(5). These deductions were disallowed by the Internal Revenue Service, and State Farm filed a petition with the Tax Court disputing the disallowance.

State Farm argued that because it was required under the guidelines of the National Association of Insurance Commissioners ("NAIC") to include amounts in respect of the Judgment as loss reserves on its annual statement, it was therefore allowed under the Code to treat such amounts as deductible "losses incurred." The Tax Court, however, held that, although Section 832 explicitly incorporates the NAIC annual statement guidelines, the annual statement method of accounting applies only to losses that result from meeting a contractual obligation to cover an insured event. Punitive damages, which are extracontractual obligations that are not included in the contractual relationship between the insurer and the insured, are not deductible under the special provisions of Section 832 for "losses incurred," even if they are properly included on a taxpayer's annual statement.

In reaching its conclusion, the Tax Court distinguished the Seventh Circuit Court's 1992 decision in *Sears, Roebuck & Co.* v. *Commissioner*,[3] in which the Circuit Court applied the NAIC guidelines in deciding that certain losses were deductible by an insurance company precisely because they were properly included in the company's annual statement. The Tax Court explained that the *Sears* Court ruled in respect of *contractual* losses, and therefore held that the annual statement method of accounting may be used to determine whether or not losses are allowed. The annual statement method of accounting is not applicable, however, to an *extracontractual* loss. Accordingly, the amount and timing of any deductions are to be determined under generally applicable tax principles and not under the annual statement method of accounting.

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ENDNOTES

1 Section references are to the Internal Revenue Code of 1986, as amended (the "Code").

2 *See*, *e.g.*, *Sears, Roebuck & Co.* v. *Comm'r*, 972 F.2d 858 (7th Cir.) 1992 ("State insurance commissioners' preferences about reserves thus are not some intrusion on federal tax policy; using their annual statement is federal tax law.")

3 972 F.2d 858. State Farm's principal place of business is in Illinois, and therefore the Court of Appeals for the Seventh Circuit would normally have appellate jurisdiction over this case. The Tax Court therefore considered the *Sears* ruling because the Tax Court generally defers to the rule adopted by the Court of Appeals for the circuit to which appeal would normally lie, if that court has ruled with respect to the identical issue.

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