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TAXATION OF PROPERTY AND CASUALTY INSURANCE COMPANIES

HEARING

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-EIGHTH CONGRESS

FIRST SESSION

JUNE 13, 1983

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CONTENTS

ADMINISTRATION WITNESSES

PUBLIC WITNESSES

ADDITIONAL INFORMATION

COMMUNICATIONS

TAXATION OF PROPERTY AND CASUALTY INSURANCE COMPANIES

MONDAY, JUNE 13, 1983

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, D.C.

The committee met, pursuant to notice, at 9:40 a.m. in room SD-215, Dirksen Building, Hon. Robert J. Dole presiding.

Present: Senator Dole (chairman of the committee).

[The press release announcing the hearing, the Joint Committee on Taxation staff report, and Chairman Dole's opening statement follow:]

[PRESS RELEASE]

SENATE COMMITTEE ON FINANCE SCHEDULES HEARING ON TAXATION OF PROPERTY AND CASUALTY INSURANCE COMPANIES

The Honorable Robert J. Dole, Chairman of the Senate Committee on Finance, today announced that the committee will hold a hearing on Monday, June 13, 1983, to examine the tax structure applicable to property and casualty insurance companies and its impact on the tax burden imposed on the property and casualty insurance industry.

The hearing will begin at 9:30 a.m. in Room SD-215 of the Dirksen Senate Office Building.

Senator Dole announced that he had invited representatives of the General Accounting Office and the Treasury Department to testify and that he also would encourage representatives of the industry and other interested parties to participate in the hearing.

"Last fall I asked the Comptroller General to begin a study of the taxation of property and casualty insurance companies to help the Finance Committee better understand the system and level of taxation imposed on various financial intermediaries. The GAO was of assistance in our review of life insurance taxation last year, and I look forward to hearing their preliminary conclusions on the taxation of property and casualty insurance companies."

Senator Dole noted, "If any efforts to raise taxes must be undertaken, the Committee should have a good idea of the tax burdens imposed on different sectors of the economy and what provisions of the Internal Revenue Code are primarily responsible for any differences in tax burden."

Dole added, "Whether or not it is determined that substantial revenue increases are warranted this year or in future years, we have a responsibility to review the tax structure periodically to determine who is, and who is not, paying a fair share of tax on his income. In March we held a hearing to review the taxation of banks, credit unions, and thrift institutions. The hearing I am announcing today will be a further effort in this review process."

Among the issues on which the committee would like to receive comment are the following:

(1) Whether certain reserves should be discounted to reflect payment of claims in furture years,

(2) Whether acquisition costs of insurance contracts should be deducted when incurred or amortized over the anticipated life of the contract,

(3) Whether the tax deferral provided for "protection against loss" accounts is justified,

(4) Whether the affiliation of property and casualty insurance companies, life insurance companies, and other unrelated businesses provides unintended opportunities for tax planning, and

(5) How "insurance" should be defined for tax purposes.

BACKGROUND ON THE TAX TREATMENT OF PROPERTY AND CASUALTY INSURANCE COMPANIES

SCHEDULED FOR A HEARING

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ON

JUNE 13, 1983

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

INTRODUCTION

The Senate Committee on Finance has scheduled a hearing on June 13, 1983, on the tax treatment of property and casualty insurance companies. This pamphlet, prepared in connection with the hearing, provides information on the property and casualty insurance industry and the taxation of such companies.

The first part of the pamphlet is general background on property and casualty insurance. Part two discusses State regulation of property and casualty insurance companies. Part three provides a description of present law tax treatment of such companies as well as a discussion of tax issues. Part four provides information and data on the various types of private property and casualty insurance. Finally, the Appendix presents statistical material on the property and casualty insurance industry.

I. BACKGROUND INFORMATION ON PROPERTY AND CASUALTY INSURANCE

The theory of insurance

The purpose of property and casualty insurance [1] (and all insurance, generally) is to pool the probable cost of the same types of risks of loss over a large number of insured persons (whether individuals or businesses). As a result, each insured person will contribute a premium payment each year to the pool, and the total annual contributions should equal the total payments for damage, plus necessary operating costs of the insurance company.

In developing its insurance pool, an insurance company will classify all the relevant possible events into categories that have as many common characteristics as can be identified. The company will identify the population that may be affected by the type of loss and determine from historical experience the proportion of the population anticipated to be affected by the loss in any annual period. Both the value of the property involved and the amount of potential damage will be estimated as part of the process. From this information, the average annual probability of the loss and the amount of the loss will be computed and an insurance premium determined to cover the estimated payments. In a perfect situation, the insured persons transfer their risks to the pool in exchange for payment of a premium. The insurance company provides a service to the insured persons in collecting, holding, investing, and disbursing payments, and ideally the company bears no financial risk.

It is important that the insurer be able to determine some pattern of experience over a large number of insured persons. In the absence of such experience, a distribution of the risks with a central tendency cannot be developed, and actuaries will not have a probability distribution on which to base a premium rate structure.

A common textbook illustration should help clarify the insurance concept. In determining the annual probability of damage to a house by fire, statistics would be collected on the incidence of fires in houses of comparable value, age, construction and location. Thus, if in a sample of 100,000 houses of comparable status 100 have burned, the probability of fire in a house is 100 divided by 100,000 or 0.1 percent. The amount of loss would be $5 billion, if the entire sample of houses (each valued at $50,000) were to be destroyed completely. However, if the 100 houses in which the fires are assumed to occur experience damage at an average cost of $20,000 to repair, the probable value of fire losses annually would be $2 million. The probability of the value of $1 of loss is $2 million divided by $5 billion or 0.04 percent. This is the equivalent of 4

[1] Under more current terminology, this may also be referred to as property and liability insurance.

cents per $100 of the cost per house to repair fire damage, or $8 for each house. Generally, an insurance company would price fire insurance for houses so that the premiums received over a five-year period would be sufficient to meet payments to insured persons and cover company costs related to this kind of insurance.

The company's objective is to estimate its payments over this period so accurately that there is an exact balance of receipts and disbursements. In that perfect case, insurance companies would be simply providing a service to the insured persons and not bearing any financial risk. Perfection, however, is not achieved, and insurance companies bear financial risks that extend into the future, because the estimates may be uncertain, new theories of liabilities may develop under the law, inflation may increase the amount of any loss, or investment earnings may fall short of expectations.

Characteristics of the industry

Property and casualty insurance companies in 1981 held more than $212 billion in assets which were invested primarily in tax-exempt and taxable bonds and common stock. Premium receipts were $93 billion in that year. Property and casualty companies directly employed 475,900 persons in 1981, about 25 percent of 1.9 million persons employed in all phases of the insurance industry.

Worldwide premium volume (outside of Eastern European Bloc countries) was about $435 billion in 1980. The United States share of the world insurance market is the greatest among all countries at 43.6 percent of the worldwide volume in 1980, which is greater than the combined premium volume of the next 8 largest insurance-writing countries.

In the United States, more than 41 percent of property and casualty insurance covers automobile liability and physical damage. A dominating portion of this insurance (82 percent) covers private passenger automobiles. Workers' compensation is the next major line of property and casualty insurance at 14.7 percent, and home and farm owners multiple peril insurance is the third largest category at 11.5 percent of the total. Other lines of property and casualty insurance include inland ocean marine coverage, commercial multiple peril, surety and fidelity, burglary and theft, crop and hail, boiler and machinery, glass, aircraft, accident and health, and liability and property damage nuclear insurance.

From 1977 to 1981, net income before taxes of the property and casualty insurance companies varied between $6.9 and $8.6 billion. Average annual rates of return in those years declined from 21.0 percent in 1977 to 11.9 percent in 1981. (The annual rates of return were calculated as net income after taxes as a percent of net worth.) During the last 10 years (1972-81), the average annual rate of return in the property and casualty industry was 13.04 percent, but the annual rates of return varied between 4.0 and 21.0 percent; the standard (i.e., average annual) deviation from the 10-year average was (plus or minus) 5.48 percent. In other industries which had higher or lower 10-year average annual rates of return, the highest standard deviation was less than 3 percent.

II. STATE REGULATION OF PROPERTY AND CASUALTY INSURANCE COMPANIES

Generally, insurance is regulated by the States to protect the public interest. The nature of insurance generally requires an advance premium payment to the insurance company for a service which is to be performed essentially in the future. It is important that the insurer be able financially to carry out its contract when a loss occurs, which involves careful scrutiny of the adequacy of premiums collected, the evaluation of assets and liabilities, and the investment of assets.

Experience has borne out the general need for regulation of insurance companies. Before the adoption of State regulatory statutes, large sums of money were lost by policyholders because of the poor business judgment or dishonesty of those in control of the companies. In other cases, competition among companies and agents drove rates (premiums) down to a level at which the company's reserves were inadequate to meet its liabilities. However, today all State legislatures have enacted insurance regulatory statutes, and each has established an Office of the Insurance Commissioner. The insurance commissioners, through their national organization, the National Association of Insurance Commissioners (NAIC), have achieved a degree of uniformity in insurance laws and regulations. State regulations are now extensive, including rules governing the establishment of new companies and the examinations for persons seeking to become insurance agents and brokers.

States also regulate premium rates and often determine how they are set. Laws require that rates be adequate, reasonable, and not unfairly discriminatory. All States, however, do not follow the same practice with respect to rate setting. Generally, State rating laws may be divided into four categories: (1) under *prior approval*, the insurance department must approve both rate level and form before any filing change or use may occur; (2) under *modified prior approval*, rate level adjustments (based on experience data) may be filed and used immediately, although more fundamental changes, in rate form, require prior approval; (3) under *file and use* rules, a company must file any new or modified rates, but the company does not have to wait for approval before putting them into effect; if a commissioner disapproves the rates within a reasonable period of time, the prior rates must be reinstated; (4) under *open competition* laws, neither rate filing nor prior approval is required; several States have adopted this procedure, and regulatory attention has turned to company solvency and equity.

Several States also regulate the type of investments that an insurance company may make in order to provide for company solvency and liquidity. In such States, a property and casualty insurance company chartered by the State is required to invest an amount equal to minimum capital requirements in Federal, State, or local government bonds, or bonds or notes secured by mortgages or deeds of trust on improved, unencumbered real estate. Asset amounts equal to 50 percent of unearned premium and unpaid loss reserves also must be invested in restricted securities of similar high quality. In such States, companies chartered by other States or foreign countries usually are required to carry investments of the same class as those required for State chartered companies.

The excess funds of every domestic company above capital stock and reserve liabilities (referred to as "surplus") may be invested in securities (described above), or in the common stock of any solvent company incorporated in the U.S., or any real estate for which there is legal authorization. Generally, not more than 10 percent of the assets may be invested in any one corporation.

Liability reserves must be established for unpaid losses and unearned premiums. Unpaid losses include provisions for claims that have been incurred but not reported, as well as for claims about which there is specific knowledge. The ultimate cost of each claim is not always known precisely, and various estimating procedures have been created to estimate the needed reserves. Unearned premiums represent the amount of premiums that has been paid or collected in advance but which are allocable to the period of protection that remains in the future. Reserves for unearned premiums are computed generally on the basis of gross premiums and do not take into account any deduction for expenses already incurred or paid. The effect of this computation is to reduce the stated amount of surplus and, thus, may limit the ability of a company to underwrite new business.

III. TAXATION OF PROPERTY AND CASUALTY INSURANCE COMPANIES

A. Overview

1. Historical background

A company whose primary and predominant business activity during the taxable year is the issuance of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies is taxed under specific provisions of the Code which are applicable solely to insurance companies. [2] Insurance companies have generally been classified into four groups for tax purposes: (1) life insurance companies; (2) mutual insurance companies other than life, and certain marine insurance companies and other than certain fire or flood insurance companies; (3) insurance companies (other than life or mutual), mutual marine insurance companies, and certain mutual fire or flood insurance companies; and (4) insurance companies that are exempt from tax under section 501(c) of the Code, such as fraternal beneficiary societies, voluntary employees' beneficiary associations, local benevolent life and mutual associations, and certain mutual insurance companies other than life or marine.

The tax provisions relating to life insurance establish an essentially free-standing set of rules for the computation of life insurance company taxable income. These provisions are beyond the scope of this discussion.[3] Likewise, tax-exempt insurance companies (category (4)), generally, will not be discussed in this pamphlet. Any further references to insurance companies in this document will be to property and casualty (nonlife) insurance companies, unless specifically stated otherwise.

Stock property and casualty insurers have been subject to virtually the same tax rules since 1921. Gross income of these companies includes underwriting income, investment income, and gains and losses (to the extent deductible by other corporations) from sales of assets. Special rules have been added defining the underwriting income of these companies. Under these rules, inclusion of income is deferred until premiums are "earned" and losses are allowed as deductions on the basis of estimates as to their occurrence and their amount.

Before 1942, most mutual property and casualty insurers were exempt from taxation. Mutual insurers that were not exempt from taxation were taxed in the same manner as corporations, with certain special deductions. From 1942 through 1962, a formula ap-

[2] Treas. Reg. § 1.801-3(a)(1) defines an insurance company.

[3] For background on the taxation of life insurance companies and their products, see Joint Committee staff pamphlet, "Background on the Taxation of Life Insurance Companies and Their Products" (JCS-11-83), May 5, 1983.

proach to the taxation of mutual insurance companies did not take underwriting income or loss into account. Generally, the tax of these companies was the higher of (1) a tax at regular corporate rates on net investment income or (2) a tax of one percent of gross investment income and net premium income reduced by tax-exempt interest and policyholder dividends. Capital gains were not included in this calculation.

Since 1963, the tax treatment of mutual insurance companies has been similar to the treatment of stock insurance companies (*i.e.*, companies listed in category (3), above) but mutual insurance companies have been allowed to defer tax on a portion of their underwriting income.

2. Stock insurance companies other than life

Stock companies are subject to tax under rules similar to those applicable to ordinary corporations, although this result is accomplished through two special provisions in the Code which override the general corporate taxation provisions.[4] The primary difference between the taxation of a property and casualty insurer and other taxpayers is in the timing of the inclusion of underwriting income and the allowance of deductions. Rather than following the generally applicable Federal tax accounting rules, the taxation of insurance companies generally follows State insurance department accounting rules.[5] Thus, the Annual Statement filed with State regulatory authorities is the governing standard for determining the timing of taxable income.

Although the courts have described property and casualty companies as accrual-method taxpayers, there are significant exceptions to the accrual rules. For example, under the usual rules, income must be accrued when all events have occurred that determine the right to income and the amount of income can reasonably be ascertained, or, if earlier, when the income is received and is subject to the recipient's control. Property and casualty insurance premiums, however, are included in income only as earned and not when payment is received. Generally, unearned premiums are those amounts which cover the cost of carrying the insurance risk for the period for which the premiums have been paid in advance. Thus, in comparison to other taxpayers, property and casualty insurers may recognize income at a later time.

Expenses are deductible by accrual method taxpayers when all events have occurred that fix the fact of liability and the amount of liability can reasonably be ascertained. Insurers, however, may deduct estimated losses and expenses on the occurrence of an insured event, even though the liability is not fixed or determinable and may be contested by the insurer. Also, whether an insured event has occurred may be estimated on the basis of the same statistical population and distribution that provides the basis for insurance. Finally, insurers are permitted to deduct acquisition expenses such as agents' commissions and premium taxes in the year

[4] I.R.C. secs. 831 and 832.

[5] Compare *Western Casualty and Surety Co.* v. *Commissioner*, 571 F.2d 514 (10th Cir. 1978), aff'g, 65 T.C. 894 (1976), and footnote 24 in *Commissioner* v. *Standard Life & Accident Insurance Co.*, 433 U.S. 148, 161 (1977).

a policy is issued rather than over the term of the policy or the expected life of the policy and renewals.[6]

3. Mutual property and casualty companies

Since 1962, the taxation of mutual property and casualty insurance companies has been similar to that of stock companies with two major distinctions. First, certain mutual companies are permitted to defer a portion of underwriting income, which is accumulated in an account called the Protection Against Loss (PAL) account. This account does not represent an actual reserve established by the company on its books or a specific allocation of assets to be held as protection against losses. Generally, these deductions do not result in a permanent deferral (see item B.4. below). Second, certain small mutuals are exempt from income tax or are taxed only on investment income.

The case law and Internal Revenue Service rulings have identified the following criteria as indicative of mutuality:

(a) there is common equitable ownership of the company by its members;

(b) the policyholders have the right to be members to the exclusion of others and to choose the management;

(c) the company's sole business purpose is to furnish insurance substantially at cost; and

(d) the members have the right to the return of premiums which are in excess of the amount needed to pay losses and expenses.[7]

Mutuals are classified into three categories depending upon the amounts of their gross receipts. Mutual companies with gross receipts not in excess of $150,000 are tax-exempt (Code sec. 501(c)(15)). Companies whose gross receipts exceed $150,000 but do not exceed $500,000 are "small mutuals" and may be taxed solely on investment income. This provision does not apply to any mutual company that elects to be taxed on total income or that has a balance in its PAL account. Additionally, small mutuals which are subject to tax because their gross receipts exceed $150,000 may claim the benefit of a special rule which phases in the regular tax on investment income as gross receipts increase from $150,000 to $250,000. Companies whose gross receipts exceed $500,000 are ordinary mutuals taxed on both investment and underwriting income.[8]

In determining the amount of gross receipts for purposes of classifying a mutual, gross premiums and gross investment income are included, but capital gains are not. Gross premiums represent the total of premiums received (including premiums received for reinsurance) without reduction for premiums paid for reinsurance ceded, return premiums, or any other similar item.

Like stock companies, ordinary mutuals generally are subject to the regular corporate income tax rates. Mutuals whose taxable income does not exceed $12,000 pay a lower tax. No tax is imposed on the first $6,000 of taxable income, and a tax of 30 percent is im-

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[6] See Rev. Rul. 70-552, 1970-2 C.B. 141, and Rev. Rul. 82-69, 1982—1 C.B. 102.

[7] Rev. Rul. 74-196, 1974-1 C.B. 140.

[8] Also, organizations called reciprocal underwriters or interinsurers generally are taxed as mutual insurance companies, subject to special rules (see Code sec. 826).

posed on the next $6,000 of taxable income. For small mutual companies which are taxable on investment income, no tax is imposed on the first $3,000 of taxable investment income, and a tax of 30 percent is imposed on taxable investment income between $3,000 and $6,000.

A small mutual may elect to be taxed on both its underwriting and investment income. This election is advantageous if the company experiences underwriting losses that could offset investment income in computing total taxable income. The election, once made, continues to apply to future years unless the Secretary of the Treasury approves a revocation upon a company's showing that continuation of the election causes an undue burden or hardship. If the mutual company's gross receipts fall below $150,000 in a future year so that the company would be exempt from tax under the rules for mutuals, the election to be taxed on both underwriting and investment income is automatically terminated.

B. Discussion of Issue Areas

1. Definition of insurance

In general

Despite the special provisions (subchapter L) for taxing insurance companies and other provisions that recognize insurance transactions, the Code does not contain a definition of "insurance." The question "what is insurance?" has been considered by several courts (including the Supreme Court), but there is still no "definitive" definition.

Under the Supreme Court decision of *Helvering* v. *LeGierse*, 312 U.S. 531 (1941), it has been commonly understood that "risk-shifting" and "risk-distribution" are essentials of a contract of insurance. Likewise, a transaction is one of insurance only if it involves an actual "insurance risk" when it is executed. The concept of risk-shifting refers to the fact that a risk of loss is shifted from the individual insured to the insurer (and the insurance pool managed by the insurer). For example, under a fire insurance policy, the property owner's risk of loss from a fire (and the resulting damage costs) is shifted from the owner to the insurance company to the extent that the insurance proceeds from the contract will reimburse the owner for that loss. The concept of risk-distribution might be considered fundamental to the very theory of insurance, which relies on the law of large numbers. That is, within a group of a large number of individual insureds who share a similar type of risk of loss, only a certain number will actually suffer the loss within any defined period of time. When a loss is suffered by any insured, each individual insured, through the payment of premiums, makes a contribution toward indemnifying the loss suffered. Despite the language in the *LeGierse* case, a more recent decision has raised the question of whether risk-shifting is still required in order to validate an insurance transaction. (See *Consumer Life Insurance Company* v. *U.S.*, 430 U.S. 725 (1977), in which the Supreme Court found that, although there was no significant risk-shifting, a transaction was valid reinsurance.)

Retroactive liability coverage

The question of what constitutes insurance may have broad practical significance in many areas. Consider the situation of retroactive liability coverage under which a policyholder obtains insurance against a particular risk after the event of the risk has occurred. When the loss event (such as a fire) has already occurred, and both parties know it has occurred, one might question whether any shifting has occurred because the risk or possibility of loss has already become a certainty. Under such retroactive liability coverage, an actual loss is being shifted rather than merely a risk of loss. The uncertainties remaining are the final determination of the size of the loss and the time of payment.

Ordinarily, the size of the loss is not an "event" that would be thought to involve an insurance risk. Focusing only on the economic realities of the transaction, the only "risk" assumed by the insurer under the retroactive contract seems to be an investment risk; that is, will the insurer earn a sufficient amount on the premium dollars charged (taking into account any tax savings generated by the transactiion) to pay the face amount of the policy some time in the future? The investment risk can be broken into two elements: (1) whether the company will earn the rate of return on the premium dollars that it anticipates; and (2) whether the company will have sufficient funds accumulated by the time it has to pay the claims. The first element of the investment risk is not unlike that assumed by a bank under any interest obligation. The second element, because it involves a timing risk, might be considered more similar to an insurable risk.

The investment risk assumed under the retroactive liability coverage might be compared to that risk assumed by a seller of a 10-year callable bond. In negotiating the price with the purchaser, the seller will take into account the rate of return for the bond and when the bond might be redeemed by the corporate issuer. Does the risk assumed by the bond seller constitute an "insurance risk?" Although investment risk has been recognized as an element of an insurance contract, the Supreme Court has said that "the assumption of an investment risk can not by itself create an insurance provision under the Federal definition."[9]

If retroactive liability coverage is insurance, the tax accounting for such a transaction can make the contract profitable. The policyholder, in a business context, is entitled to an immediate deduction for a premium, which has been discounted at interest, taking into consideration the fact that the actual claims will be paid over a long period of time. At the same time, the insurance company selling the contract recognizes the liability for the accrued claims on an undiscounted basis. Arguably, then, the transaction takes advantage of what might be viewed as a mismatching of income and deductions, as between two unrelated taxpayers and for a single taxpayer.

[9] *S.E.C. v. United Benefit Life Insurance Co.*, 387 U.S. 202, 211 (1967). Also, *Helvering v. Le-Gierse*, 312 U.S. 531, 542 (1941).

Captive Insurance Companies

The question of what is insurance also is central to an analysis of self-insurance plans and consideration of whether there can be valid insurance transactions between economically related parties. Generally, taxpayers are not allowed deductions for anticipated expenses or losses unless the liability is fixed and the amount reasonably estimated. Thus, although most types of insurance premium payments are deductible if they are incurred in connection with the taxpayer's trade or business, amounts that are added to a self-insurance fund or account are not deductible. Aside from the fact that amounts set aside as self-insurance "premiums" are not paid or incurred, self-insurance is not considered insurance because there is no economic shifting or distribution of the risk "insured." Instead of merely setting aside "premiums" within a company, a subsidiary might be formed as an insurance company to provide the insurance protection for the parent company. But such "captive insurance companies" may be viewed as highly evolved self-insurance arrangements.

Specifically, the Internal Revenue Service has ruled that the "insurance premiums" paid by a domestic corporation and its domestic subsidiaries to the parent's wholly owned foreign "insurance" subsidiary are not deductible if the "insurance" subsidiary does not also insure risks of insureds outside its own corporate family. The Service concluded that because the insureds and the "insurance" subsidiary (though separate corporate entities) represent one economic family, those who bear the ultimate economic burden of the loss are the same persons who suffer the loss. Thus, the required risk-shifting and risk-distribution of a valid insurance transaction are missing.[10] This position of the Service was favorably cited by the Ninth Circuit in *Carnation Co. v. United States.*, 640 F.2d. 1010 (9th Cir. 1981), *cert. denied*, 454 U.S. 965.

In contrast, the Service has also ruled that amounts paid by a domestic petroleum corporation to a foreign insurance company that provided insurance against certain petroleum industry risks only for its 31 unrelated shareholders and their subsidiaries and affiliates were deductible as insurance premiums. In addition to the fact that the 31 shareholders/insureds of the insurance company were unrelated, the ruling indicated that no one owned a controlling interest and no one's risk coverage could exceed 5 percent of the total risks insured. The ruling concluded that such an arrangement allowed the economic risk of loss to be shifted and distributed among the shareholders who comprised the insured group so that it constituted insurance.[11]

Although the Service has indicated what is an invalid "captive insurance arrangement" as well as what is a valid insurance arrangement, questions still remain. For example, how many unrelated shareholders/insureds are necessary in order to have sufficient risk-shifting and risk-distribution? Is the number of insureds important if the number of risk exposures is large? How much risk from unrelated insureds must a wholly owned captive insurance

[10] Rev. Rul. 77-316, 1977-2 C.B. 53.
[11] Rev. Rul 78-338, 1978-2 C.B. 107

company assume in order to provide a valid insurance arrangement in which members of its own economic family can participate? Must the premium structure charged unrelated insureds generally contribute to the funding adequacy for potential claims arising from contracts with related insureds in order for there to be the risk-shifting and risk-distribution essential for a valid insurance arrangement? Can there ever be a valid insurance arrangement between economically related parties? Whatever the rules are, do the same rules apply for reinsurance transactions between related parties? Thus far, the definition of insurance developed by the case law has not answered these questions.

Definitional problems with nontraditional "insurance" products

Finally, the definition of insurance is pertinent in areas that are outside the traditional insurance business. For example, consider the sale of "telephone maintenance insurance." For an annual fee, a company may contract to replace or repair telephone equipment that is not purchased from and serviced by the public telephone company. The risk of loss connected with a breakdown in telephone equipment is shifted from the buyer of the contract to the seller and is distributed among other buyers of similar contracts through the fee paid. Is this insurance or merely a contract to perform services? The company may be able to predict the occurrence of a certain number of repair calls per year based on its experience, and so may charge its customers accordingly. This pricing procedure is similar to the actuarial computations used by an insurance company selling traditional products. Unlike other taxpayers, insurance companies are allowed to estimate and recognize future contingent liabilities under current tax law. Should companies selling product maintenance contracts be treated as insurance companies for tax purposes? Or must an insurance company for tax purposes be licensed as such under State law? Should companies that sell nontraditional "insurance" products—such as service contracts, warranties, sureties, and tax audit insurance—be able to avail themselves of the special taxing provisions generally available to insurance companies?

2. Reserves

Property and casualty insurance companies, generally, do not maintain reserve accounts per se. However, two of the special rules relating to the computation of underwriting gain or loss for a property and casualty company have the effect of creating reserves. These are the rules relating to unearned premiums and unpaid losses.

In the computation of earned premiums, insurers deduct from gross premiums the difference between the current and prior year's unearned premiums, that is, the net unearned premiums for the current year. The Internal Revenue Service has defined unearned premiums as those amounts that cover the cost of carrying the insurance risk for the period for which the premium has been paid in advance and that are maintained for the purposes of maturing and liquidating, either by payment as they are earned or reinsurance with other companies, future unaccrued and contingent claims arising under the contract.[12]

Property and casualty insurers are permitted a deduction for losses incurred and expenses incurred during the taxable year in computing their underwriting income. Losses incurred are computed as the sum of losses paid (with appropriate adjustments for salvage and reinsurance recoverable) and the net increase (or decrease) in unpaid losses. The amount of unpaid losses which may be claimed is the amount which, at the close of the taxable year (based on the facts in each case and the company's experience in similar cases) represents a fair and reasonable estimate of the amount the company will be required to pay. The effect of this provision is to allow property and casualty insurers to claim deductions for reported losses, incurred but not reported (IBNR) losses, and resisted or contested losses.[13] A contingency reserve for events yet to occur remains nondeductible. The usual practice is for a company to determine its liability based on experience as a percentage of an element of underwriting, such as premiums in force. However, the estimates of unpaid losses must be reasonable.

The allowance of a deduction for unpaid losses of a property or liability insurer differs from the treatment of other taxpayers in two important respects. First, insurers may estimate not only the amount of liabilities they have incurred but also the existence of the liability itself. That is, the company need not know that losses have occurred with respect to any particular contract before claiming a reserve deduction based on its reasonable (generally experience-based) estimate of its liability for these losses. Second, the company's ability to deduct an unpaid loss is not diminished by its decision to contest the liability. An ordinary accrual method taxpayer, generally, may not deduct the amount of a contested liability. The net effect of these differences generally is to permit insurers to accelerate the deduction of losses claimed relative to the timing of those deductions under the generally applicable rules.

In the case of loss reserves or any accrual of liabilities far in advance of their expected satisfaction, the time value of the deduction may be significant. For example, in a theoretical world, one would want, within a single accounting period, to match perfectly the income and the deductions associated with a particular activity. The accrual method of accounting and the reserve for unpaid losses attempt to accomplish the matching. However, if the time between the recognition of the income and the actual payment of the related expenses is too long, the accrual method and the unpaid loss reserve provisions could result in an understatement of a taxpayer's economic income.

For example, assume an insurer insures a risk for which it expects to pay a claim of $150 on the fourth anniversary of the insurance contract. If the insurer wants a $10 profit after expenses of $2 on the transaction and assumes a 10-percent earnings rate in its investments, it will charge $114.50. That is $102.50 which is the present value of $150 discounted over four years at 10 percent plus

[12] Rev. Rul. 67-225, 1967-2 C.B. 238, revoked by Rev. Rul. 73-302, 1973-2 C.B. 220, with respect to retrospective rate credit reserves.

[13] Rev. Rul. 70-643, 1970-2 C.B. 141.

$12 for profit and expenses. The deduction of $150 for estimated liabilities without discounting to present values can result in a tax loss of $37.50 ($114.50 premium—$2 expenses—$150 loss reserve), assuming the loss estimate is correct. Thus, the company has economic income of $10 and a tax loss of $37.50, which will shelter the investment earnings necessary to increase the amount on hand to $150 when paid. The above discussion implies that the tax effect of reserves for unpaid losses is most dramatic (1) if the losses are not be paid in fact until a much later date, (as in the case of malpractice insurance claims) or (2) when insurance accounting rules are used to accelerate, in effect, loss deductions of other noninsurance taxpayers (see the prior discussion on retroactive liability coverage).

3. Amortization of acquisition expenses

Under present law, ordinary and necessary business expenses paid or incurred in carrying on a trade or business are deductible. However, outside the insurance area, expenditures made in acquiring or creating an asset with a useful life that extends beyond the taxable year normally must be capitalized or amortized over the useful life of the asset or a specified statutory period.

Property and casualty insurance companies use the annual statement filed with State regulatory authorities as the basis for computing the underwriting and investment components of gross income (Code sec. 832 (b)(1)(a)). State insurance departments require acquisition expenses to be charged currently against income, even though the related premium income is deferred over the policy term. These expenses of property and casualty insurers are attributable to underwriting activities and primarily include agents' commissions, but also include such items as field supervisors' costs, premium taxes, and insurance board and rate bureau costs. The Internal Revenue Service has ruled that acquisition expenses of insurance policies are deducted as incurred because this treatment is consistent with the accrual method of accounting that insurers follow.[14]

This tax treatment could be questioned if these acquisition expenses are compared to the expenses of acquiring a capital asset. Generally, acquisition expenses of a property or liability insurance contract can be attributed directly to the insurance contract to which they relate. Also, the useful life of the contract is fixed and determinable. Thus, should the entire amount of the acquisition expense of an insurance policy be deductible currently? An alternative view, however, would be that acquisition expenses of an insurance policy are related to the sale of a service rather than the sale of a contract. These "sales costs" could then be deductible currently because they do not relate to an asset having a life extending beyond the taxable year but relate instead to the present income of the company.

[14] Rev. Rul. 70-552, 1970-2 C.B. 141, and Rev. Rul. 82-69,1982-C.B. 102.

4. Protection against loss (PAL) accounts

The major distinction between the taxation of stock property and casualty companies and ordinary mutual property and casualty companies is the PAL account that is available to the mutual companies. The PAL provisions are designed to provide mutuals with protection against catastrophic losses. If a stock insurer has extraordinary losses or needs to provide for growth, it has access to the capital market. Unlike stock companies, mutuals have no stock and, thus, have no paid-in capital or shareholder surplus. Congress recognized this essential difference between stock and mutual insurers and enacted the PAL provision to alleviate this disadvantage. In the life insurance area, this distinction between stock and mutual companies led to a different conclusion, which was that stock companies need a deferral mechanism to compete effectively with mutuals because stock companies do not have access to redundant premium charges. This different conclusion may not be inconsistent; the longer term and investment features of life insurance products allow mutual life insurance companies to charge, and retain for a longer period, a proportionately larger redundant premium than is possible with short-term property and casualty coverage.

The PAL account deduction does not represent an actual reserve established by the company on its books or a specific allocation of assets to be held as protection against losses. Rather, the PAL account is a set of income tax adjustments which, in effect, accomplish a forward-averaging of underwriting income. In general, mutual companies are allowed to defer recognition of all or a portion of their underwriting income when they have taxable underwriting income. Some or all of this deferred portion is later recognized if the company had underwriting losses (which offset the income) or more than five consecutive years of underwriting gains. After an addition to the PAL account has been set aside for five years and has not been used to offset losses, the then unused balance is withdrawn from the PAL account and included in taxable income, except for a statutorily defined amount that remains as a cushion for future losses.

For the typical mutual company, the PAL account does not result in a permanent nonrecognition of the deferred income. Thus, PAL account deductions are qualitatively different from the deferral provided for under the life insurance company tax rules (the policyholder's surplus account) which is rarely recaptured.

There are three allowable additions to the PAL account that represent deductions for the current year. These three additions are amounts equal to (1) one percent of losses incurred, (2) 25 percent of underwriting gain, and (3) a further percentage of underwriting gain equal to the extent to which the percentage of premiums for concentrated windstorm, flood and similar risks during the year exceeds 40 percent of all premiums earned. The three additions to the PAL account are recorded separately because the point at which each is restored to income is based on different determinations. For purposes of the PAL additions, underwriting gain is defined as statutory underwriting income for tax purposes computed without the

PAL deduction. The one percent is calculated on losses incurred as shown in the annual statement and tax returns.

The amounts that may be deducted and added to the PAL account in a year are limited in two ways. First, the excess of any current addition over the current year's statutory underwriting gain for the year (before the PAL additions) must be subtracted. Thus, the increase in the PAL account for any year cannot exceed that year's underwriting gain. Second, current year additions are, in effect, subject to a limitation so that the PAL account may not exceed the greater of 10 percent of the total current year's earned premiums reduced by policyholder dividends or the balance in the PAL account at the end of the preceding year. Before this limitation is applied, the PAL account will be reduced by the amount of any current underwriting loss that exceeds taxable investment income and by the amount of any unused loss deduction carryovers. Also, immediately before applying the limitation, the PAL account is reduced by any amounts added to the account in the fifth preceding year if they have not been previously subtracted.

If a company fails to retain its status as a mutual, it must include in taxable income for the preceding year the entire balance in the PAL account by amending its return. In addition, a company may elect to subtract the entire PAL account and include it in income. However, this election is rarely made. The effect of the PAL account is to enlarge the available surplus of a mutual property and casualty insurance company and, thus, may be viewed as a kind of contingency reserve.

5. Consolidation of insurance companies

In general

Under present law, an affiliated group of corporations may elect to file a consolidated income tax return. An affiliated group means one or more chains of "includible corporations" connected by stock ownership with a common parent corporation, provided certain percentage of ownership tests are met. Generally, property and casualty insurance companies have always been permitted to file a consolidated return with noninsurance companies. However, prior to 1981, life insurance companies were not otherwise treated as "includible corporations" that could be consolidated with other companies, although special rules permitted two or more domestic life insurance companies to be treated as an affiliated group. Beginning in 1981, a common parent corporation could elect to treat life insurance companies as "includible corporations", subject to certain limitations. Thus, a property and casualty insurance company may now be consolidated with a life insurance company as well as noninsurance companies.

It has been suggested that the affiliation of property and casualty insurance companies, life insurance companies, and other companies may provide unintended tax benefits. Two sorts of concerns with respect to consolidation can be identified. First, some question the consolidation of income producing companies with companies that have tax losses. If, however, the activities conducted in the two businesses could be conducted in a single entity with the same aggregate tax result, then consolidation should not be objection-able. Second, some question the consolidation of companies which are permitted or required to use special accounting or tax computation rules. For example, should a company that is not eligible for reserve treatment because it has only a small amount of insurance business qualify for that treatment by segregating the insurance business into a subsidiary that can file a consolidated return with the parent? These concerns generally arise because insurance companies conduct a business that differs substantially from other companies and, thus, are taxed differently.[15]

Consolidation of property and casualty insurance companies with life insurance companies

The consolidation of property and casualty insurance companies and life insurance companies raises questions concerning the point at which, in the computation of separate taxable income, consolidation should occur. This is especially important with respect to the consolidation of life companies within the group. For example, life insurance companies are required to calculate both taxable investment income and gain or loss from operations. However, property and casualty insurance companies are not required to make this distinction in the computation of taxable income. Thus, a fundamental question in the consolidation of property and casualty insurance companies and life insurance companies is the extent to which the timing of the computation of consolidated taxable income may distort the taxable income and gain or loss from operations of life insurance companies.

Two timing rules have been suggested with respect to the consolidation of life and nonlife companies: (a) the phase-by-phase approach and (b) the bottom line approach. Under the phase-by-phase approach, the taxable investment income bases and the gain from operation bases of life companies first must be aggregated to arrive at consolidated life company amounts and then these aggregate tax bases (taxable investment income and gain from operations) are combined to arrive at a taxable income for the consolidated life companies within the group.[16] Under the bottom line approach to computing consolidated taxable income, each member of an affiliated group (whether a life or nonlife company) compute is its taxable income as if it is filing a separate return. The taxable income determined for each component member of the affiliated group is then consolidated by adding the separate company taxable income bases.[17]

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[15] Potential tax benefits are available to other includible groups of corporations in which some members of the group are provided special tax benefits that are not available to other members of the group. For example, a savings and loan association may be eligible for a bad debt deduction and consolidate with a nonfinancial institution whereas if the entity were one company, it may fail the statutory test for classification as a savings and loan association and therefore not be eligible for the bad debt deduction.

[16] The Internal Revenue Service has proposed a modified phase-by-phase approach to apply to a life insurance subgroup of a consolidation of life and nonlife companies. Under this method, consolidated amounts would be determined by aggregating separate amounts for each member in a life subgroup and a consolidated limitation would apply whenever a deduction is limited by an amount or percentage of an amount.

[17] It has been suggested that the bottom line approach presents the most consistent treatment between life and nonlife companies while creating only a minimal distortion of the life insurance company rules relating to taxable income. Proponents of this approach point out that the general rules relating to consolidation use such an approach to compute separate corporate taxable income. The Tax Equity and Fiscal Responsibility Act of 1982 contained a provision that permits life insurance companies to use the bottom line approach for a two-year period.

Intercompany reinsurance agreements

Reinsurance involves the process of providing insurance coverage to an insurer that has previously assumed a risk. Thus, in order to reduce exposure to loss for a particular risk, an insurer will use reinsurance to pass all or a portion of the risk to another insurer. Case law and Internal Revenue Service rulings relating to reinsurance have established that, in order to be effective for Federal income tax purposes, reinsurance must, in fact, involve a shifting of risk and there must be an independent business reason for the reinsurance (but see *Consumer Life Insurance Company* v. *U.S.*, 430 U.S. 725 (1977)).

Despite the requirement that reinsurance involve risk-shifting and a valid business purpose, significant tax benefits can be derived by reinsuring, because the transaction may alter the timing of income and deductions. For example, if a direct writer has an unused loss carryover that would expire in a taxable year, the direct writer may reinsure a portion of its risks. This reinsurance serves to accelerate the direct writer's income on the reinsured risks, thereby utilizing a tax benefit that would otherwise be lost.

In situations in which property and casualty insurance companies and life insurance companies are consolidated, these tax benefits may be even greater. For example, the rules relating to the consolidation of affiliated companies place two limitations on the amount of nonlife insurance company losses that can be applied against the income of the life insurance company members of the group. However, both life insurance companies and property and casualty insurance companies issue group health and accident insurance. By reinsuring in a year in which the nonlife members will have losses in excess of the limitations, the nonlife members accelerate income to offset those losses. Therefore, a property and casualty insurer could use reinsurance of certain accident and health policies effectively to pass its losses to the life insurance company notwithstanding the limitation on losses for nonlife companies that may be taken into account against life insurance taxable income.[18]

Availability of tax credits to offset the income of an affiliated company

In general, the rules relating to the consolidation of affiliated companies place two limitations on the amount of nonlife insurance company losses that may be applied against the income of life insurance company members. These limitations apply only to the amount of nonlife losses that may offset life company income. Losses incurred by the life members can offset the income of nonlife members without limitation.

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[18] Similarly, a life insurance company member of an affiliated group may reinsure accident and health insurance business with a property and casualty company to shift a deduction for retrospective rate credits to the property and casualty company. Retrospective rate credits are basically refunds for premiums previously paid, determined under a formula that considers the policyholder's loss experience. The Internal Revenue Service has taken the position that these retrospective rate credits must be treated as dividends to policyholders if they depend on the experience of the company. However, the deduction for policyholder dividends (when combined with two special deductions) for life insurance companies is subject to a limitation. No similar limitation applies to property and casualty insurance companies. Thus, the use of reinsurance can provide an opportunity for life members of an affiliated group to avoid the general limitation that may be applicable to policyholder dividends.

In addition, there is no statutory limitation on the extent to which tax credits available to one member of an affiliated group may be used to offset the tax on income of the group as a whole. Given the limitation on losses that can be used to offset life company taxable income, an argument could be made that the unlimited availability of tax credits provides an unintended tax benefit.

6. Tax-exempt investment income

As of December 31, 1981, an estimated $85.3 billion was invested by property and casualty companies in tax-exempt bonds (approximately 47 percent of their total investments). Because of this relatively large investment in tax-exempt bonds, it may be helpful, in evaluating the tax burden of property and casualty companies, to focus on how the tax rules applicable to these companies encourage such large investments.

In general, present law provides taxpayers with certain deductions from gross income. However, in cases in which taxpayers invest in tax-exempt obligations, two rules apply that may limit the otherwise allowable deductions. These rules disallow deductions relating to (1) expenses allocable to one or more classes of tax-exempt income and (2) interest on indebtedness incurred or continued to purchase or carry tax-exempt obligations.

(1) *Expenses allocable to one or more classes of exempt income.*—Generally, present law permits a deduction for any expense that is an ordinary and necessary trade or business expense or for any expense of an individual taxpayer relating to the production of income. However, no deduction is allowed for a) expenses that are allocable to one or more classes of tax-exempt income other than interest income and b) expenses of an individual taxpayer relating to the production of income that are allocable to one or more classes of of tax-exempt interest income.

Under present law, there is no similar provision that applies to expenses allocable to tax-exempt interest income of taxpayers engaged in a trade or business, including property and casualty insurance companies. Thus, property and casualty companies are permitted deductions under present law for amounts which are paid out of tax -exempt income.

(2) *Interest on indebtedness incurred or continued to purchase tax-exempt obligations.*—Present law generally allows as a deduction all interest paid or accrued within the taxable year on indebtedness. However, no deduction is allowed for interest incurred or continued to purchase or carry obligations the interest on which is wholly exempt from Federal income tax. The Internal Revenue Service and the courts have consistently interpreted the law to disallow an interest deduction only upon a showing that a taxpayer incurred or continued indebtedness for *the purpose of* acquiring or holding tax-exempt obligations. Thus, if no independent business or personal purpose exists for acquiring or continuing debt, and when there is a sufficiently direct connection between the indebtedness and the acquisition or holding of tax-exempt obligations, a deduction has been disallowed. Thus, the Congress has recognized that a taxpayer should not receive a deduction for interest that relates to a tax-exempt investment.

In practice this provision is difficult to apply for two reasons: (1) it is often difficult to trace a particular debt to the purchase or carrying of a tax-exempt bond, given the fungibility of money; and (2) there are often business reasons for acquiring a debt which make the disallowance provision inapplicable. For example, a long-standing Service position, supported by the legislative history, states that the deduction disallowance provision has no application to interest paid on indebtedness represented by deposits in banks received in the general business of banking, even though a substantial amount of these deposits are invested in tax-exempt obligations. This position apparently is premised upon the fact that the debt represented by the deposits was incurred because of the banks' obligation to accept deposits, not to acquire or purchase tax-exempt bonds. The effect of this interpretation has be to allow banks to significantly reduce their Federal income taxes.

In the case of property and casualty insurance companies investing primarily in tax-exempt obligations, it can be argued that part of the unearned premium income or estimates of unpaid losses of the company that are essentially deductible reserves are analogous to debt. For example, the deduction for estimates of unpaid losses recognizes that an insurance company has a fixed and determinable liability (debt) for the claims of policyholders. However, until a claim is actually paid, the insurer may use the amounts for investments (including tax-exempt investments).

Because property and casualty insurance companies invest substantial amounts in tax-exempt bonds, the argument can be made that at least a portion of the funds used to acquire the tax-exempt bonds comes from the companies deductible reserves. Under this analysis, some portion of the expenses of property and casualty insurance companies should be disallowed because of their investments in tax-exempt bonds.

7. Use of foreign insurance companies for additional tax benefits

Income tax

Foreign corporations generally are subject to U.S. tax only on certain U.S. source income and on income that is effectively connected with a trade or business conducted in the United States. Income that a foreign corporation receives from insurance premiums is generally subject to U.S. income tax only if it is effectively connected with the recipient's trade or business in the United States (see Rev. Rul. 80-222, 1980-1 C.B. 211). Investment income of a foreign corporation is subject to U.S. income tax if it is either (1) from U.S. sources or (2) effectively connected with a U.S. trade or business, such as investment income that a foreign corporation engaged in a U.S. business earns on premiums paid to cover U.S. risks.

Whether a foreign corporation is engaged in a U.S. trade or business in a taxable year is largely a question of fact. In general, foreign insurance companies that insure U.S. risks may be able to arrange their affairs so as not to engage in a U.S. business. A foreign corporation not engaged in U.S. business in a taxable year is not subject to U.S. income tax on underwriting income, and it is not subject to U.S. tax on foreign source investment income earned on premiums paid to cover U.S. risks in that taxable year.

Excise tax

In general, insurance or reinsurance of U.S. casualty risks by foreign insurance companies that are not subject to U.S. income tax because they are not engaged in business in the United States is subject to an excise tax. The rate of this tax is four cents on each dollar of premium for insurance, and one cent on each dollar of premium for reinsurance. Any party to the transaction is liable for payment of this tax, but in practice the tax is collected from the U.S. party that actually pays over the premiums to a foreign person. Certain U.S. income tax treaties, including those with France and the United Kingdom, waive this excise tax in certain circumstances for insurance companies resident in the treaty partner. The U.S. model treaty waives this tax also. Although the model and the French treaty do not waive the tax when the foreign insurer reinsures with a third-country insurer that is not subject to a treaty exemption, the treaty with the United Kingdom waives the tax even in that event.

Taxpayers may take the position that since the Service does not now recognize that "captive insurance companies" provide insurance protection, payments to captives are not premiums subject to the excise tax. However, taxpayers could not consistently deduct payments to a "captive insurance company" as premiums while treating the payments as exempt from the excise tax on the ground that they are not premiums. Moreover, even if these payments are not subject to the excise tax on premiums, they could be subject to U.S. income tax.

Taxation of U.S. shareholders of foreign corporations

The foreign source income of a foreign corporation that is not effectively connected with a U.S. business is generally subject to U.S. income tax only if and when it is actually remitted as a dividend to U.S. shareholders. However, under the Subpart F provisions of the Code, income from certain tax haven type activities conducted by corporations controlled by U.S. shareholders is includible in the gross income of the U.S. shareholders and currently taxed to them (subject to the foreign tax credit). The income taxed under Subpart F generally includes investment income such as dividends and interest, and income from the insurance of U.S. risks. One purpose of this rule is to prevent U.S. persons from shifting underwriting income to tax-haven subsidiaries. Income earned on premiums paid to cover U.S. risks is also currently taxable to the U.S. shareholders of a controlled foreign corporation.

In general, underwriting income of a foreign corporation from the insurance of foreign assets is not subject to U.S. taxation, either at the corporate level or the U.S. shareholder level. However, income of a controlled foreign corporation from the insurance of oil assets located without the United States is subject to current taxation under Subpart F if the controlled foreign corporation or a related party has substantial oil or gas extraction income. A U.S. corporation (or its foreign affiliates) may therefore generally insure foreign non-oil assets with a "captive insurance company" in a tax haven. Some foreign countries may allow a deduction under their income tax laws for this kind of payment.

In general, a controlled foreign corporation (one whose shareholders are subject to Subpart F) is one more than 50 percent of whose voting power is owned by "U.S. shareholders" (defined as U.S. persons owning 10 percent or more of the corporation's voting power). A special rule for insurance income expands the definition of controlled foreign corporation for Subpart F purposes to include certain foreign corporations of which more than 25 percent (rather than the standard 50 percent) of the voting power is owned by U.S. shareholders if more than 75 percent of gross premiums are attributable to U.S. risks.

If ten or fewer unrelated U.S. persons own equal voting interests in a foreign corporation 5 percent or more of whose insurance premiums received cover U.S. risks, they will be subject to Subpart F, and the Subpart F income will be includible in their gross income. Such income, however, will be foreign source income that may allow the U.S. persons to credit other foreign taxes. In general, the United States limits the foreign tax credit on the basis of total foreign source income. In some cases, a taxpayer's foreign tax credits cannot be used (and may be forever lost) if the taxpayer does not have sufficient foreign source income. Generation of foreign source income through Subpart F could enable the taxpayer to use increased foreign tax credits.

If eleven unrelated U.S. persons own equal voting in a foreign corporation, Subpart F does not apply, because there is no "U.S. shareholder" owning ten percent or more of the foreign corporation's voting power. In that case, the U.S. owners generally pay no U.S. tax on the foreign corporation's earnings unless and until it pays a dividend. When the foreign corporation pays a dividend, however, that dividend may be foreign source income that enables the shareholders to use increased foreign tax credits. Until payment of a dividend, such an insurance company located in a tax haven may be able to accumulate investment income and underwriting income free of tax (other than gross withholding or excise taxes imposed by the country of source of the income).

IV. TYPES OF PRIVATE PROPERTY AND CASUALTY INSURANCE

A. General Background

Total net premiums paid to property and casualty insurance companies have increased from about $15 billion in 1960 to almost $100 billion in 1981, an increase of more than 6-1/2 times. All kinds of property and casualty insurance is covered, and limited amounts of all accident and health insurance coverage (up to $3.6 billion in 1981) are included in these totals. Subtracting accident and health premium payments reduces the annual totals by small amounts, but the scale of increase—7 times from 1960 to 1981—remains considerable.

TOTAL NET PREMIUMS WRITTEN BY PROPERTY AND CASUALTY INSURANCE COMPANIES, 1960–81

[In millions]

Year	Accident and health	All other	Total
1960	$1,358	$13,615	$14,973
1965	1,644	18,420	20,063
1970	1,909	30,958	32,867
1975	1,820	48,146	49,967
1976	2,120	58,693	60,813
1977	2,317	70,080	72,397
1978	2,628	79,062	81,690
1979	3,179	86,943	90,123
1980	3,291	92,389	95,569
1981	3,585	95,690	99,276

Source: "Insurance Facts," 1982–83 edition.

The percentage distribution among the major lines of property and casualty insurance in 1972 and 1981 is shown in the next table. Two categories of auto insurance predominate, exceeding 40 percent in both years, even though the percentage of auto liability insurance declined by 1981. The absolute amount of premiums paid increased during that period, as can be seen in the preceding table. Major proportionate increases in coverage have taken place in workers' compensation and home and farm owners multiple peril policies.

PERCENTAGE DISTRIBUTION OF MAJOR INSURANCE LINES [1] 1972 and 1981

Line	Percent of all lines	
	1981	1972
Auto liability [2]	24.6	29.6
Auto physical damage [2]	16.9	16.8
Workers' compensation	14.7	10.7
Homeowners/farmowners multiple peril	11.5	8.8
Other liability (includes medical malpractice)	7.4	6.7
Commercial multiple peril	6.9	5.4
Fire and allied	4.9	8.9
All other	13.1	13.1
Total	100.0	100.0

[1] Excludes Lloyd's organizations.

[2] Includes commercial and private passenger autos because 1972 data cannot be disaggregated. Between 1973 and 1981 private passenger auto liability decreased from 22.7 to 19.8 percent and commercial auto liability from 5.5 to 4.8 percent. Private passenger auto physical damage increased from 14 to 14.2 percent and commercial auto physical damage from 2.6 to 2.7 percent.

Source: Calculated from Best's Aggregates and Averages, 1982, by American Insurance Association

B. Fire Insurance

The standard fire insurance policy generally provides insurance against direct loss by fire and lightning. In addition, the insured may obtain protection against loss of income while damage is being repaired, extra expenses involved in getting a business back in operation after a fire, and the cost of housing a family after its house has burned. Fire insurance companies also provide protection against such perils as earthquake, explosion, riot, rain and smoke among other perils, in the same insurance contract.

Amounts paid (i.e., premiums written) for fire and allied insurance are shown in the following table. Amounts paid doubled between 1960 and 1981.

PREMIUMS WRITTEN FOR FIRE AND ALLIED INSURANCE, 1960–81

[In millions]

Year	Fire	Allied—Lines [1]
1960	$1,667	$739
1965	1,548	667
1970	2,199	948
1975	2,510	1,181
1976	2,811	1,291
1977	2,993	1,422
1978	3,223	1,462

PREMIUMS WRITTEN FOR FIRE AND ALLIED INSURANCE, 1960-81—Continued

[In millions]

Year	Fire	Allied—Lines [1]
1979	3,247	1,534
1980	3,210	1,574
1981	3,193	1,624

[1] Covers a wide variety of perils, including windstorm, riot, explosion, sprinkler leakage, water damage and earthquakes.

Source: "Insurance Facts," 1982-83 edition.

C. Ocean and Inland Marine Insurance

Marine insurance is the oldest branch of the insurance business. While there is a great variety of marine insurance coverages, a common factor embodied in each is that property covered under marine insurance involves an element of transportation, or, at least, that the property is capable of being transported. Ocean or wet marine insurance primarily is concerned with water-borne commerce, and inland or dry marine insurance covers transportation and related risks on land.

Ocean navigation and trade involves three major interests: the cargo, the hull, and the freight, i.e., the costs charged or incurred for transporting the cargo in the hull from place to place. Inland marine insurance is an extension from ocean marine insurance to cover the shipment for the entire voyage from the shipper to the addressee. Forms of inland transportation cover railroad, airplane, coastwise steamer, motor transport, parcel post, registered mail and first class mail. In addition to transportation forms, inland marine insurance also covers bridges and tunnels as well as personal effects, personal property, jewelry, furs, fine arts and many others. The amounts paid for insurance coverage (premiums written) has increased sixfold from 1960 to 1981, from $381 million to $2.4 billion.

PREMIUMS WRITTEN FOR ISLAND AND OCEAN MARINE INSURANCE, 1960-81

[In millions]

Year	Inland Marine	Ocean Marine
1960	$381	$230
1965	489	262
1970	81	465
1975	1,266	861
1977	1,584	953
1978	1,867	1,000

PREMIUMS WRITTEN FOR ISLAND AND OCEAN MARINE INSURANCE, 1960–81—CONTINUED

[In millions]

Year	Inland Marine	Ocean Marine
1979	2,061	1,009
1980	2,291	1,065
1981	2,428	1127

Source: "Insurance Facts," 1982-83 edition.

The growth in ocean marine insurance during the same period has been almost as great as for inland marine insurance, or from $230 million in 1960 to $1.1 billion in 1981. The growth reflects increased international trade as well as growth in ownership of pleasure craft along coastal and inland waterways.

D. Casualty Insurance

General casualty insurance

Casualty insurance is based on the law of negligence, under which everyone is obligated to be so careful that no member of the public is caused to suffer bodily injury or property damage (which includes loss of income). Liability insurance coverage extends to the payment of damages that arise from civil liabilities. Most business policies are restricted to bodily injury and property damage caused by accident. Personal liability insurance provides protection for the insured against liability that may be incurred in personal activities, as distinguished from business activity.

Business and professional persons tend now to purchase general liability insurance. Sharp increases in the number of lawsuits and the average size of claims in recent years, particularly against physicians, other professional people, and product manufacturers have generated interest in general liability insurance. Liability coverage is included in both commercial and homeowners package (or umbrella) policies. The table below shows general liability premiums written for the past two decades. Medical malpractice premiums have been included in the totals, to permit valid historical comparisons even though also shown separately below.

PREMIUMS WRITTEN FOR GENERAL LIABILITY INSURANCE, 1960-81

[In millions]

Year	Amounts
1960	$963
1965	1,137
1970	2,140
1975	3,981
1977	6,794
1978	7,706
1979	7,817
1980	7,690

Year	Amounts
1981	7,385

Source: "Insurance Facts," 1982-83 edition.

Medical malpractice insurance

A proliferation of insurance claims and lawsuits against hospitals, doctors and other medical practitioners has generated a heavy demand for medical malpractice insurance in recent years. Medical malpractice premiums written increased by 4.9 percent from 1980 to 1981, and by 49 percent from 1975 to 1981.

PREMIUMS WRITTEN FOR MEDICAL MALPRACTICE, 1975-81

[In millions]

Year	Amounts
1975	$895
1976	1,133
1977	1,194
1978	1,216
1979	1,204
1980	1,276
1981	1,338

Source: "Insurance Facts," 1982-83 edition.

Automobile insurance

Personal injury and property damage involving automobiles generate large economic losses, often beyond the personal ability of drivers and owners to cover. Insurance protection for others is generalized throughout the country. In some States, minimum coverage through insurance or some other form of security is mandatory, and bad risks (i.e., drivers with a high probability of recurrent accidents) often are covered through special arrangements.

The tables below provide information on the amount of premiums written (i.e., amounts paid for insurance coverage) for both auto liability insurance and auto physical damage insurance.

PREMIUMS WRITTEN FOR AUTO LIABILITY INSURANCE, 1956–81

[In millions]

Year	All autos
1956	$2,684
1960	3,883
1965	5,424
1970	8,958

	Private Passengers [1]	Commercials [1]
1972	$9,070	$2,306
1975	10,775	2,539
1976	12,899	3,152
1977	14,998	3,830
1978	16,048	4,335
1979	17,385	4,717

	Private Passengers [1]	Commercials [1]
1980	18,590	4,729
1981	19,650	4,745

PREMIUMS WRITTEN FOR AUTO PHYSICAL DAMAGE INSURANCE 1956–81

[In millions]

Year	All autos
1956	$1,613
1960	1,994
1965	2,861
1970	4,824

	Private Passenger [1]	Commercial [1]
1972	$5,502	$1,052
1975	6,386	1,237
1976	7,987	1,578
1977	9,582	1,939
1978	10,541	2,294
1979	11,909	2,628
1980	13,086	2,747
1981	14,034	2,714

[1] Totals were not broken into these categories prior to 1972.

Source: "Insurance Facts," 1982-83 edition.

There are many other types of property or casualty insurance written to protect businesses and individuals. The kinds of coverage provided include business interruption insurance, personal business interruption insurance, boiler and other pressure vessels and associated piping, machinery, glass, surety bonding, crime (burglary, kidnap, ransom—for example), title insurance and commercial credit insurance. Each of these groups also include detailed variations that are made available to suit the insured person's requirements. There also is insurance against losses resulting from nuclear accidents. Table 5 in the Appendix shows the amounts of premiums paid for many of these individual types of insurance, 1978-1981.

E. Workers' Compensation

Workers' compensation is a form of social insurance although it is coverage provided to a private employer for compensation of employees who are injured on the job. In contrast, almost all other forms of social insurance are offered by the Federal Government.

The responsibility of an employer for the safety and well-being of its employees while at work has well-established legal precedents. Presently, all States have workers' compensation laws.

Under workers' compensation, an injured employee is guaranteed the payment of a level of benefits. Payment is prompt and does not involve litigation. The employer is able to estimate in advance the probable costs of injury to the workforce while at work. Generally, four types of benefits may be provided under workers' compensation: medical (including also surgical, nursing and hospital benefits, income replacement, death and survivor's benefits), and rehabilitation.

The amount of premiums paid (written) for workers' compensation from 1960-1981 is shown below. This premium volume has increased tenfold over that period and has quadrupled since 1970.

PREMIUMS WRITTEN FOR WORKERS' COMPENSATION INSURANCE, 1960-81

[In millions]

Year	Amounts
1960	$1,419
1965	2,042
1970	3,492
1975	6,186
1977	9,261
1978	11,300
1979	13,164
1980	14,238
1981	14,616

Source: "Insurance Facts," 1982-83 edition.

APPENDIX

STATISTICAL MATERIAL RELATING TO THE PROPERTY AND CASUALTY INSURANCE INDUSTRY

The five tables in this Appendix provide some general information about the property and casualty insurance industry and some comparisons of this industry with other industries.

Assets and premiums of property, casualty and life insurance companies

In table 1, assets and premium receipts of life and property and casualty companies in 1977 through 1981 are shown. Generally, both types of insurance companies receive close to the same amounts in premium receipts but life insurance company assets are two and one-half times as large as those of property and casualty companies.

Table 1.—Comparison of Assets and Premium Receipts of Property and Casualty and Life Insurance Companies, 1977-81

[In billions of dollars]

Year	Assets		Premium receipts	
	Property and casualty	Life	Property and casualty	Life
1977	126.6	351.7	72.4	72.3
1978	149.1	389.9	81.7	78.8
1979	174.2	432.3	90.1	84.9
1980	197.7	479.2	95.6	94.2
1981	212.3	525.8	99.3	107.7

Source: "Insurance Facts," 1982-83 edition; "Statistical Profile of the Casualty Insurance Industry;" 1983; "Life Insurance Fact Book," 1982.

Income of property and casualty insurers

Operating, investment, and combined income of property and casualty companies is presented in table 2 for selected years from 1957 through 1981. Combined income and investment income in those years have been positive. Underwriting often has been a net loss but has been offset by investment income to produce positive combined income.

Table 2.—Income of Property and Casualty Insurers, Selected Years, 1957–1987

[In millions of dollars]

Year	Gross underwriting gain or loss	Policyholder dividends	Net underwriting gain or loss	Investment income	Combined income, before taxes
1957	−130	279	−409	580	171
1960	462	313	150	768	918
1965	−352	357	−710	1,132	422
1970	78	504	−426	2,005	1,579
1975	−3,594	633	−4,227	4,150	77
1976	−1,559	630	−2,189	4,806	2,617
1977	1,926	815	1,112	5,816	6,928
1978	2,548	1,252	1,296	7,290	8,586
1979	24	1,324	−1,301	9,279	7,978
1980	−1,712	1,622	−3,334	11,063	7,730
1981	−4,464	1,824	−6,288	13,248	6,961

Source: "Insurance Facts," 1982-83 edition.

Rates of return of property and casualty insurers and certain other industries

Average annual rates of return of the property and casualty insurance industry and several other industries are shown in table 3. The data cover each year in the period from 1972 through 1981, and the table also shows the average rate of return and standard deviation for 3 ten-year periods: 1972-1981; 1962-1971; and 1952-1961. The standard deviations of the property and casualty insurance industry are greater than those for any other industry group shown in the table and the average rates of return are lower for 10-year periods.

Table 3.—Average Annual Rates Return: Net Income After Taxes as Percent of Net Worth, Selected Industries, 1972–81

Year	Property and casualty insurance	Public utilities	Commercial banks	Services	Manufacturing	All industries
1972	13.7	10.3	10.5	12.1	12.1	10.5
1973	9.4	10.6	11.0	12.9	14.9	12.0
1974	5.9	10.4	10.7	13.5	15.2	12.5
1975	4.0	11.0	10.3	15.0	12.6	11.5
1976	11.3	11.5	11.5	18.1	15.0	13.3
1977	21.0	12.1	11.8	18.3	14.8	13.8
1978	20.9	12.1	12.9	19.2	16.0	14.6
1979	17.8	13.0	13.9	19.1	18.3	16.4
1980	14.5	12.6	13.7	19.2	16.4	14.9
1981	11.9	13.8	15.4	20.9	15.5	14.5
Mean: 1972–81	13.04	11.74	12.17	16.83	15.08	13.4
(Std. deviation)	(5.48)	(1.22)	(1.63)	(2.98)	(1.68)	(1.70)
Mean: 1962–71	4.95	10.59	9.41	13.06	12.24	10.01
(Std. deviation)	(2.57)	(0.32)	(0.70)	(2.36)	(1.3)	(0.7)
Mean: 1952–61	5.35	9.63	8.62	11.04	12.08	10.14
(Std. deviation)	(1.88)	(0.33)	(0.89)	(1.32)	(1.58)	(1.01)

Source: "Insurance Facts," 1982–83 edition.

Investments of property and casualty insurance companies

The distribution of assets among general types of investments by companies in the property and casualty industry are shown in table 4 for three selected years. Tax-exempt bonds, taxable bonds, and common stock, in that order, have been the major forms of investment.

Table 4.—Distribution of Invested Assets of property and Casualty Companies December 31, 1975, 1978, and 1981

[Amounts in millions of dollars]

Type of investment	1975		1978		1981	
	Amount	Percent	Amount	Percent	Amount	Percent
Tax-exempt bonds	33,397	42	63,487	49	85,335	47
Taxable bonds	19,648	25	35,498	27	45,122	25
Common stock	20,220	25	20,876	16	32,540	18
Preferred stock	3,039	4	4,511	4	8,645	5
Mortgages and real estate	1,770	2	2,174	2	4,004	2
Other	1,971	2	3,012	2	4,456	3
Total	80,044	100	129,559	100	180,102	100

Source: "Statistical Profile of Casualty Insurance Industry," April 1983.

Premiums paid for different types of property and casualty insurance

The amounts of premiums paid (written premiums) for 20 different lines of property and casualty insurance in 1978, 1979, 1980 and 1981 are shown in table 5. The list is virtually all-inclusive.

TABLE 5.—PREMIUMS PAID FOR DIFFERENT TYPES OF PROPERTY AND CASUALTY INSURANCE, 1978–81

[In millions of dollars]

Type of insurance	1978	1979	1980	1981
Automobile:				
Liability:				
Personal	16,048	17,385	18,590	19,650
Commercial	4,335	4,717	4,729	4,745
Property:				
Personal	10,541	11,909	13,086	14,034
Commercial	2,294	2,628	2,747	2,714
Multiple perils:				
Homeowners	7,792	8,792	9,821	10,780
Commercial	5,830	6,667	6,885	6,870
Farmowners	434	519	555	620
Fire insurance and allied lines	4,675	4,781	4,784	4,817
Burglary and theft	133	140	136	128
Inland marine	1,867	2,061	2,291	2,428
Ocean marine	1,000	1,009	1,065	1,127
Glass	35	33	32	31
General liability (nonauto)	7,706	7,817	7,690	7,385
Medical malpractice	1,216	1,204	1,276	1,338
Workers' compensation	11,300	13,164	14,238	14,616
Surety and fidelity	1,076	1,155	1,248	1,351
Boiler and machinery	256	283	293	298
Crop-hail	351	396	417	504
Nuclear:				
Liability	19	20	23	28
Property	31	40	61	74

Source: "Insurance Facts," 1982–83 edition.

Statement of Senator Dole: Hearings on Taxation of Property and Casualty Insurance Companies

I am very pleased to welcome you to these hearings on the taxation of property and casualty insurance companies.

PURPOSE OF THESE HEARINGS

Before we begin, I would like to take a moment to emphasize the purpose of these hearings. We have no specific tax or policy that we plan to impose on property and casualty insurers. However, we have a responsibility to review the tax burden of various industries to make sure that no one industry is bearing too great or too small a share of the corporate tax burden. This March we held a hearing on the taxation of banks and other savings institutions. At that time, I indicated my interest in reviewing the taxation of their financial intermediaries. This hearing on property and casualty insurance companies is the second installment in our review process.

As I am sure everyone is all too aware, the Congress also has an obligation to act to reduce the projected Federal budget deficit. Although it is my stated view that proposals to reduce the 1984 deficit should be based on spending reductions and not on tax increases, the Finance Committee must be prepared to find equitable methods to raise new revenue if needed. Furthermore, I believe that when the Congress determines that additional funds are needed to support a desirable program or policy, we, in turn, must reexamine our present tax expenditures and revise if appropriate. Finally, although activity in Congress is focused on the fiscal year 1984 budget, it is necessary to review our general tax policies and plan policies for the future.

OTHER HEARINGS THIS MONTH

The property and casualty insurance industry is not alone in giving us the benefit of its thoughts on how our Nation's tax laws can be improved. The Finance Committee has scheduled several hearings this month on various spending program and revenue issues. On Wednesday and Thursday we will be holding hearings on the Administration's spending reduction proposals. Next week we will hold hearings on the Administration's spending reduction proposals. Next week we will hold hearings on the Administration's spending reduction proposals. Next week we will hold hearings on the Administration's proposal to cap the amount of employer-provided medical care that may be excluded from an employee's income, and we will also review the present tax treatment of statutory and nonstatutory fringe benefits. We are also holding hearings on possible tax compliance measures next week, and on June 28 and 29 we plan to review Federal tax expenditures.

FOCUS OF THESE HEARINGS

Last fall I asked the Comptroller General to begin a study of the property and casualty insurance industry to help this committee better understand the purpose and the effect of our tax laws on this industry and the people they serve. At that time, I expressed a hope that the GAO would be able to examine a number of areas—the size and structure of the industry; the appropriate methods of determining reserve liabilities for tax purposes; and the impact of changing economic conditions and new product trends on the industry.

One trend in which we are particularly interested is the interrelationship of life insurance companies with property and casualty insurers since any additional review of the life insurance company provisions, some of which expire at the end of this year, should not occur in a vacuum. It appears that some products—such as accident and health insurance, and annuities—are sold or reinsured by both companies and it is difficult in some cases to differentiate between these companies. Another trend that has been in the news in connection with Baldwin-United is the purchase and use of insurance companies by large conglomerates.

A review of these issues is a tall order, and although the GAO report is not final, I understand that Mr. Havens intends to address some of these issues today—particularly the determination of reserves and accounting for expenses. I am looking forward to hearing from all our witnesses on these questions. I suspect that you may not all agree with one another, but I thank you in advance for taking the time to talk with us today.

The CHAIRMAN. Let me first say that we are pleased to have our witnesses here this morning, and I assume other members will be coming and going as we proceed with these hearings.

Before we begin, I would like to take a moment to emphasize the purpose of these hearings. I would say at the outset, we have no specific tax or policy that we plan to impose on property and casualty insurers. However, we do have a responsibility to review the tax burden of various industries to make certain that no one industry is bearing too great or too small a share of the corporate tax burden.

This March we held a hearing on the taxation of banks and other savings institutions. At that time I indicated my interest in reviewing the taxation of other financial intermediaries. This hearing on property and casualty insurance companies is a second installment in our review process.

I am certain everyone is all too aware that the Congress also has an obligation to act to reduce the projected Federal budget deficit, and although it is my view that the proposals to reduce the 1984 deficit should be based on spending reductions and not on tax increases, the Finance Committee must be prepared to find equitable methods to raise new revenue if needed.

Furthermore, I believe that when the Congress determines that additional funds are needed to support a desirable program or policy, we in turn must reexamine our present tax expenditures and revise them if appropriate.

Finally, although activity in Congress is focused on the fiscal year 1984 budget, it is necessary to review our general tax policies and plan policies for the future as well.

The property and casualty insurance industry is not alone in giving us the benefit of its thoughts on how our Nation's tax laws can be improved. The Finance Committee has scheduled several hearings this month on various spending programs and revenue issues. On Wednesday and Thursday we will be holding hearings on the administration's spending reduction proposals. Next week we will hold hearings on the administration's proposal to cap the amount of employer-provided medical care that may be excluded from an employee's income. We will also review the present tax treatment of statutory and nonstatutory fringe benefits.

We are also holding hearings on possible tax compliance measures next week, and on June 28 and 29 we plan to review Federal tax expenditures or tax preferences.

Last fall I asked the Comptroller General to begin a study of the property and casualty insurance industry to help the committee better understand the purpose and effect of our tax laws on this industry and the people they serve. At that time I expressly hoped that GAO would be able to examine a number of areas: the size and structure of the industry, the appropriate method of determining reserve liabilities for tax purposes, and the impact of changing economic conditions and new product trends on the industry.

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Another trend has been in the news in connection with Baldwin United and the purchase and use of insurance companies by large conglomerates. So I just suggest that we are going to try to carry out our responsibility. While we are debating whether or not we should cap the third year of the tax cut or repeal the third year of the tax cut or repeal indexing, it seems to this Senator that before we do that we ought to make certain that we have taken a look at tax preferences, that we have taken a look at compliance, to make certain that those who owe taxes and are not paying taxes have an opportunity to do so before we take away tax reductions for real taxpayers; and second, that we go back, as we do on the spending side, and take a look at some of the tax preferences to see whether or not there may be some need for revision, maybe some areas of expansion, some areas of tightening up some of those provisions.

I would suggest to the witnesses, particularly if no one else is here but me, if you can summarize your statements it would be particularly helpful. I can read maybe more quickly myself than you can read it to me. If you could summarize your statements, we will have some time for questions.

Our first witness this morning will be Hon. John E. Chapoton, Assistant Secretary for Tax Policy, Department of Treasury.

STATEMENT OF HON. JOHN E. CHAPOTON, ASSISTANT SECRETARY FOR TAX POLICY, DEPARTMENT OF THE TREASURY

Mr. CHAPOTON. Good morning, Mr. Chairman. I am pleased to have the opportunity to present the Treasury Department's views on the taxation of property and casualty companies. As you mentioned, a review has been going on of the taxation of life insurance companies.

Like a life insurance company, property and casualty companies serve essentially two functions: First, it acts as a pooler of risks, and from that activity it makes an underwriting profit.

Second, it acts as a financial intermediary. There is a time lag between the collection of premiums and the payment of claims. During that time period, the premiums are held for the benefit of policyholders and for the benefit of the company. They are invested in financial instruments. Some of the investment income accrues to the benefit of the policyholders, as it enables the company to charge a lower premium, and the remainder accrues to the benefit of the property or casualty company.

The taxation of insurance companies is governed by subchapter L of the Internal Revenue Code. Different rules apply depending on whether the company is classified as a life insurance company or not, and I will not go into those now, but the distinctions between the two made in the Code are rather arbitrarily based upon the reserves which are considered life reserves or not life reserves. But the taxation is considerably different depending upon whether they are classified as a life company or not.

Property and casualty companies, though, unlike life companies, are taxed under a statutory scheme which is similar to that applicable to other corporations. But there are some special and very important provisions which are inconsistent with the rules of taxation generally applicable to business taxpayers.

The most important of these is that a property or casualty company is allowed to estimate and deduct currently the full amount of expenses that it expects to pay in the future, whereas a normal business corporation not engaged in the insurance business may not deduct an expense until it has been paid or accrued.

There are, and we list in the testimony, four separate issues which we consider timing issues. We think these are the major issues presented by the taxation of nonlife companies. And then we list five other issues other than timing issues, some of which are not very significant. But we are listing all of the problems we see in the taxation, or the potential problems we see in the taxation, of property and casualty companies.

The most important, though, are the timing issues. Most of these, the first three on our list, stem from the fact that the taxable income of a nonlife company is determined in accordance with the computation of income required for regulatory purposes by the National Association of Insurance Commissioners.

The purpose of that measure of income is to protect the interest of policyholders by insuring that the company has sufficient assets to pay claims under the policies it has issued. This conservative approach tends to understate income and overstate expenses. Even though companies are required to use these conservative accounting practices for State regulatory purposes and are currently allowed to use them for Federal income tax purposes, we do not think this is necessarily appropriate for determining the timing and measure of income and expenses for tax purposes.

Let me just mention a couple of the timing issues that we see as the most significant. The first is the exclusion from current gross income of a portion of premiums described as unearned premiums. Under the exclusion of unearned premiums, premium payments allocable to insurance coverage for periods subsequent to the close of the taxable year are not included in taxable income. Taxpayers normally allocate premiums over the entire period of the policy's coverage on a pro rata basis. We question this rule for deferral of tax on a portion of the premiums.

The exclusion of current receipts from gross income is in conflict with general tax accounting principles. Normally a cash or accrual basis taxpayer who receives a payment for a service to be rendered in some future year without restriction upon its use or disposition generally must include the amount received in income, even though he receives it before it is earned.

Now, there are statutory exceptions to that rule, but we are concerned that the exclusion of unearned income may permit a mismatching of income and deductions, since a disproportionate amount of the corresponding expenses may be incurred in the first year upon the issuance of the contract, and when you defer a major portion of the income the mismatching occurs.

Moreover, even if it is decided that the companies should be permitted to exclude a portion of the unearned premiums from income, we believe the method of spreading it pro rata over the life of the policy is incorrect. The proper measure, if one tried to equate the current earned premium with the coverage provided, would allocate a larger portion of the actual premium payment to the earlier period and a smaller portion to the later period.

The seriousness of the problem from the deferral of unearned premiums of course depends on the length of time beyond the close of the taxable year to which the premium payment relates.

The second timing issue and the only one I will cover in any detail, and it is most significant, is the reserve for unpaid losses. A property casualty company is allowed a deduction for losses incurred. They may deduct currently their estimate of unpaid losses, even though the losses have not yet accrued under traditional accounting rules.

Unpaid losses include both amounts that will be paid in connection with claims filed during the year and on amounts relating to claims expected to arise from events occurring during the taxable year, but have not yet been reported to the company. The amount of the deduction for the future claim is not discounted to reflect the fact that it will not be paid until some time in the future.

Allowing a deduction for unpaid losses effectively permits property and casualty companies to deduct larger deductions than are necessary to pay these future expenses. This can result in a serious distortion of the timing of an insurance company's income. I think an example is helpful there.

Suppose an insurance company sells a group of liability insurance policies during the taxable year and it estimates at the end of the year that it eventually will have to pay out $1,000 with respect to events that occurred during the taxable year and covered by these policies. The payment of the claims will be made over a period of years. But for purposes of this example, assume that all the payments would be made at the end of 5 years for simplicity purposes.

The company might charge a premium for that coverage of $900, which it would invest for the 5-year period pending payment of the claims. If the investor premiums earned an after-tax rate of return of 6 percent, by the time the claims are paid at the end of 5 years they would have earned $304 of investment income. Thus, at the end of the 5-year period it would have a profit of $204.

For State regulatory purposes, the company is required to establish a loss reserve at the outset, in the first year, of $1,000. Since the premiums only totaled $900, it shows a $100 loss for regulatory purposes during the first year. The investment income is reported over the period it is earned.

For Federal tax purposes, since the code follows the regulatory rule, a $100 loss is reported in the first year, even though we know we know there will be an overall profit on the insurance.

In calculating the premium the company charges, of course, it will take into account the investment income it will earn until the claims are paid, and in the facts that I have given, a $1,000 claim paid 5 years hence, the company could calculate that it would need a premium of only $750 as the discounted value of the future $1,000 payment and any premium received in excess of $750 would represent an immediate profit.

Thus, by charging a $900 premium in our example the company would have realized an underwriting profit, an immediate underwriting profit of $150. As I pointed out, it will have an overall profit at the end of 5 years of $204, so in both cases it will recognize eventually income of $204.

The only difference is the timing of income recognition. Under current law it would have a loss initially, income from the investment income later, and at the end of 5 years it would have recognized a net $204, but the timing would have been far different than if it had to recognize underwriting income in the first year. And we think a serious distortion arises as a result of this timing difference.

This is not merely a technical accounting issue. The benefits can be extraordinary. Consider an insurance company that admits it is liable on a $100,000 claim of an accident victim. Assume that it can earn an after-tax return of 9 percent and that it pays tax at a 46-percent marginal rate on its last dollar of income.

It would be economically better off to pay the injured party $50,000 today and $1 million in 10 years than paying him $100,000 now. In fact, it would be still better off if it increased the final lump sum payment to $2 million or more.

This consequence results from the fact that the company gets an immediate tax savings of 46 percent of the future payment which it may invest. As long as you pick a period of time far enough out in the future so that the tax benefit from the deduction now will grow to an amount in excess of the future amount paid, the company has an incentive, as silly as it might sound, to make the future payment larger rather than smaller.

We think that the rule that allows the company to get an undiscounted deduction of estimated future claims is a serious flaw in the system, and it causes problems in general. It is difficult to audit and evaluate the various procedures employed by the companies. These rules effectively permit the taxpayers to deduct currently amounts that are properly allocable to future periods, thereby sheltering other income that would otherwise be taxed in the initial year.

This unsound result occurs whenever a taxpayer takes a full deduction for future expenses, whether or not the expense has technically accrued. Any time you do not discount a current deduction for a future expense, you run into this problem to some extent.

Allowing insurance companies a full deduction for losses to be paid in the future may allow taxpayers other than insurance companies to effectively accelerate deductions for their future losses through the provision of insurance to cover such losses. One prominent example of this is so-called retroactive insurance, which purports to provide insurance coverage for a loss known to have already occurred prior to entering into the contract.

It has been reported in the press that a well-known hotel had a fire in which numerous guests were killed or injured. After the fire the hotel's owners sought insurance to pay a portion of the claims when they were finally settled. The premium charged, which was a small fraction of the amount virtually certain to be paid under the policy, reflected the discounted value of the estimated future liability, increased by a loading charge.

The premium also, of course, took into account the tax benefits claimed by the insurer, and the premium paid presumably was claimed as a current business deduction by the policyholder. The potential use of insurance for similar purposes is also illustrated by the fact that in recent years insurance has been sold to protect against product warranty claims and other nontraditional risks.

We think that the tax law should not create an excessive incentive to have risks transferred to an insurance company. Current tax law is far from neutral.

There are a couple of approaches that we could follow in dealing with this problem, Mr. Chairman. One would be to simply defer the deduction until the company actually pays the claim in the later year. That is in effect putting them on a cash flow basis.

Another would be to discount the current deduction for the future claims. There are problems in both. If you deferred the deduction until the amount was paid, that could cause serious transitional problems of solvency of some of the companies because they have been operating under the present system.

The present value approach would cause other problems. Estimate of future claims would be required and it would be necessary to select an appropriate discount rate, and it would be necessary to determine when the claim would be paid in the future, which does not have to be determined now. But it would not be an easy determination, we suspect.

Notwithstanding these problems, we are hopeful that the changes can be made to minimize the distortions inherent in the current rules while avoiding undue adverse consequences to taxpayers. We would like to work with the committee and the committee staff toward this end, and we do look for and expect cooperation from the insurance industry in undertaking an evaluation of this problem and how it might be protected.

Mr. Chairman, I cover several other points in my testimony, but I think that is by far the most significant aspect of this testimony. I think I will stop there and see if you have any questions.

[The prepared statement of Hon. John E. Chapoton follows:]

22-734 O—83——4

For Release Upon Delivery
Expected at 9:30 a.m. EDT
June 13, 1983

STATEMENT OF
THE HONORABLE JOHN E. CHAPOTON
ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE
SENATE COMMITTEE ON FINANCE

Mr. Chairman and Members of the Committee:

I am pleased to have this opportunity to present the views of the Treasury Department on the taxation of property and casualty insurance companies. As we stated in our testimony regarding the taxation of depository institutions before this Committee in March of this year, a review of the taxation of all types of organizations which function exclusively or partially as financial institutions is appropriate at this time in light of the increasing competition among them. An examination of the tax treatment of property and casualty insurance companies is particularly important in light of the current reexamination of the taxation of life insurance companies, since both types of insurance companies engage in some of the same lines of business. The tax law should tax the income from a line of business in the same way irrespective of the type of company that conducts the business.

BACKGROUND

General Description of Property and Casualty Insurance Companies and Products

Insurance (other than life, accident, and health insurance) may be generally classified as either property insurance or casualty or liability insurance. Property insurance is "first party" insurance: it provides indemnification to the policyholder for insured property that is damaged or destroyed. Examples of property insurance include fire insurance, and automobile collision insurance.

Liability insurance provides protection against liabilities imposed on the policyholder as a result of injuries to third persons or damage to their property. Examples include malpractice insurance and automobile liability insurance. Often, a single policy will provide both property and liability protection.

Like a life insurance company, a property and casualty insurance company serves essentially two functions from which it may derive a profit. First, it acts as a pooler of risks, collecting premiums from its policyholders and paying out claims to those policyholders who suffer losses. The profit earned by an insurance company in its role as a pooler of risks is referred to as underwriting profit.

Second, a property/casualty insurance company also operates as a financial intermediary. There is a time lag between the collection of premiums and the payment of claims. During this time, the company holds the premiums for the benefit of its policyholders and invest most of these funds in financial instruments. Some of the investment income earned may accrue to the benefit of the policyholders as it enables the company to charge a lower nominal premium. Any investment earnings which are not passed through to the policyholders constitute the investment income of the insurance company.

Statutory Scheme for Taxation

The taxation of insurance companies is governed by Subchapter L of the Internal Revenue Code. Different rules apply depending on whether an insurance company is classified as a life insurance company or not. The Internal Revenue Code attempts to make this classification based on the predominant character of the company's business: if the majority of the company's reserves are "life insurance reserves," the company is taxed as a life insurance company. Thus, a life insurance company may sell a substantial amount of property and casualty insurance while a property and casualty insurance company may sell a substantial amount of life insurance. The distinction between life and non-life companies is also obscured by the fact that reserves on certain types of accident and health insurance policies sold by life insurance companies are treated as life insurance reserves for purposes of determining whether the company will be taxed as a life insurance company.

Unlike life insurance companies, property and casualty insurance companies are taxed under a statutory scheme which is similar to that applicable to other corporations.

However, several special code provisions apply to these types of insurance companies. In several important respects these provisions are inconsistent with rules of taxation generally applicable to business taxpayers, including:

- a property/casualty insurance company is allowed to estimate and deduct currently the full amount of certain expenses that it expects to pay in the future; corporations not engaged in the insurance business may not deduct an expense until it has been paid or accrued;

- certain mutual property/casualty insurance companies are not taxed currently on a portion of their underwriting income; all income earned by other corporations is generally taxed equally irrespective of the activity that generated the income.

Several other provisions applicable to property and casualty insurance companies may also distort the timing of the recognition of income and expenses. Moreover, provisions governing such items as the treatment of policyholder dividends and tax-exempt interest may be viewed as inconsistent with the tax treatment of comparable items for other business taxpayers.

ISSUES RELATING TO THE PROPER MEASUREMENT OF ECONOMIC INCOME OF PROPERTY AND CASUALTY INSURANCE COMPANIES

Overview

Most of the major issues relating to the proper measurement of the economic income of an insurance company1/ involve the existing tax rules that govern the timing of income and deduction items of these companies. These issues may be stated briefly as follows:

Timing Issues

- Should a portion of gross income from premiums be deferred to the extent the premiums are not "earned" in the year received?

1/ Unless otherwise indicated, the term "insurance company" will be used to refer to a non-life insurance company, governed by part II or III of subchapter L.

- Should an insurance company be allowed to deduct additions to a reserve established for state regulatory purposes to provide for the payment of future claims? If so, should they be allowed to deduct amounts that are larger than the amounts needed to provide for the payment of those claims in future years?

- Should the costs incurred in selling and issuing insurance contracts be amortized over the anticipated life of an insurance contract?

- Is the tax deferral provided by the "protection against loss" account justified?

<u>Other Issues</u>

- Should a mutual insurance company be allowed to deduct all dividends paid to their policyholders?

- Do the current rules applicable to non-life insurance companies produce appropriate results when the company invests in obligations the interest on which is exempt from taxation?

- Are special tax provisions needed for small mutual insurance companies?

- Should the consolidated return provisions applicable to insurance companies be changed?

- Is a definition of "insurance" needed for tax purposes?

The first three of the timing issues stem from the fact that the taxable income of an insurance company is determined in accordance with the computation of income required for regulatory purposes by the National Association of Insurance Commissioners ("NAIC"). This measure of income is often referred to as NAIC annual statement income. These accounting rules do not provide an accurate measure of income. Rather, they are intended to protect the interests of the policyholders by insuring that the company has sufficient assets to pay claims under the policies it has issued. For this reason, the annual statement uses conservative accounting practices that tend to understate income and overstate expenses. Even though insurance companies are allowed to use these conservative accounting practices for tax purposes under current law, this is not necessarily appropriate for determining the timing and measure of income and expenses for tax purposes.

A separate discussion of each of the issues follows.

Timing Issues

1. Exclusion from Gross Income of Unearned Premiums. Under current law, the only premiums included in gross income of an insurance company are "premiums earned on insurance contracts during the taxable year."2/ This phrase excludes "unearned premiums," which are premium payments allocable to insurance coverage for periods subsequent to the close of the taxable year. In computing unearned premiums, taxpayers most frequently allocate the premium over the entire period of coverage on a pro rata basis. We question the current rules governing unearned permiums.

The exclusion from gross income of unearned premiums is in conflict with general tax accounting principles. A cash or accrual basis taxpayer who receives a payment for a service to be rendered in some future year without restriction upon its use and disposition generally must include the amount received in income even though it was received before it was earned.3/ The fact that future events may create an obligation to repay a portion of the amount received typically does not justify the deferral of taxation.4/ We recognize that Congress has created other similar statutory exceptions to this rule.5/ However, we are concerned that the exclusion from gross income of unearned premiums may permit a mismatching of income and deductions, since a disproportionate amount of the corresponding expenses may be incurred upon the issuance of the contract.

Moreover, even if it is decided that insurance companies should be permitted to continue to exclude their unearned premiums from gross income, we believe that the method generally used by taxpayers to compute unearned premiums results in a deferral of an excessive portion of the premiums paid. Currently, taxpayers treat premiums as if they will be earned on a pro rata basis. Since the unearned premium will

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2/ Section 832(b)(3) of the Internal Revenue Code.

3/ Schlude v. Commissioner, 378 U.S. 128 (1963); American Automobile Assoc. v. U.S. 367 U.S. 687 (1961).

4/ A.M. Brown v. Helvering, 291 U.S. 193, 199 (1934).

5/ See, e.g., Section 455 of the Internal Revenue Code. (relating to prepaid subscription income) be invested to earn interest, the proper measure of unearned premiums would allocate a larger portion of the actual premium payment to earlier periods and a smaller portion to later periods. The seriousness of this problem depends on the length of time beyond the close of a taxable year to which the premium payment relates.

2. <u>Reserve for Unpaid Losses</u>. An insurance company is allowed a deduction for "losses incurred" during the year. All taxpayers are, of course, entitled to deduct losses incurred in their trades or businesses. However, insurance companies are allowed to deduct as losses amounts not deductible by most other taxpayers. In particular, they may deduct currently their estimate of "unpaid losses" even though such losses have not yet accrued under traditional tax accounting rules. Unpaid losses include both amounts that will be paid in connection with claims filed with the company during the taxable year and amounts which relate to claims expected to arise from events occuring during the taxable year that have not been reported to the company. The deduction for these claims is not discounted to reflect the fact that they will not be paid until some time in the future.

Allowing such a deduction for unpaid losses effectively permits taxpayers to deduct larger deductions than are necessary to pay the future expenses. This result can produce a serious distortion of the timing of an insurance company's income. A simplified example may help illustrate the problem.

Suppose an insurance company, X, sells a group of liability insurance policies during the taxable year. The company estimates that eventually it will have to pay out $1,000 with respect to events that occurred during the taxable year and that are covered by these policies. Payment of these claims would usually be made over a period of years. For purposes of this example, however, assume that all claims will be paid out precisely five years after the close of the taxable year. X charges a premium for the insurance coverage provided of $900 which it invests pending the payment of claims. If the invested premiums earn an after tax rate of return of 6 percent, by the time the claims are paid the company will have earned $304 of investment income. Thus, at the end of the five year period, taking into account the claims paid of $1,000, there remains a profit of $204.

For state regulatory purposes, the insurance company would establish a loss reserve on these policies at the end of the first taxable year of $1,000. Since premiums totalled only $900, the company would report a loss of $100 for regulatory purposes during the first year. The investment income would be reported as income when earned.

Under current tax laws, the company's taxable income is computed by reference to the income reported for state regulatory purposes. Thus, for tax purposes X also has a loss of $100 in the first year, even though it will have income of $304 over the next five years, yielding on overall net profit of $204. Of course X knows that while premiums are being held for payment of claims in later years, they will earn investment income. In calculating the premium it must charge, X will take into account the investment income that it will earn until the claims are paid. For example, X may calculate that, in order to cover the $1,000 of anticipated claims, it needs a premium of only $750 as this is the discounted value of its obligation to pay the claims in the future. Any premium received in excess of $750 would represent an immediate profit.

By charging a premium of $900 X will have realized an underwriting gain of $150. As shown above, X will have an overall profit of $204 if the total claims are paid exactly as expected. Of the $1,000 in claims, $750 is paid out of premiums received while $250 is paid out of investment income. Thus, X also has $54 of investment income. Since X may report a loss of $100 in the initial year and $304 of investment income spread out over five years, it is much better off under present law than it would be if it were required to report income of $150 in the first year and $54 of investment profit spread out over the next five years. It is important to recognize that in either case, X will realize income of $204. The only difference is in the timing of income recognition. The timing, and taxation of X's income is seriously distorted if X is taxed as if it had a $100 loss in the initial year.

This example may appear to raise only highly technical accounting issues. However, the benefits can be extraordinary. Considor an insurance company that admits that it is liable on a $100,000 claim of an accident victim. Assuming that it can earn an after-tax return of nine percent and that it pays tax at a 46 percent rate on its marginal taxable income, it would be economically better off if it paid the injured party $50,000 today and $1,000,000 in ten years. In fact, it would be still better off if it increased the final lump sum payment to $2,000,000 or more. This consequence results from the fact that the company gets an immediate tax savings of 46 percent of the future payment which may be invested.

We believe that the current tax rules which permit insurance companies to deduct the undiscounted estimate of their future claims are seriously flawed. First, allowing deductions based on estimates of future claims encourages taxpayers to adopt procedures for making estimates that tend to overstate the amount of claims which actually will be paid. It is difficult to audit and evaluate the various procedures employed by individual companies. Second, and more significant, these rules effectively permit these taxpayers to deduct currently amounts that are properly allocable to future periods, thereby sheltering other income that otherwise would be taxed currently. This is roughly equivalent to allowing the investment income earned on the portion of the premium amount set aside to pay claims to build up free from tax.6/ This unsound result occurs whenever a taxpayer takes a full deduction for future expenses, whether or not the expense has technically accrued.

Moreover, allowing insurance companies a full deduction for losses to be paid in the future may allow taxpayers other than insurance companies to effectively accelerate deductions for their future losses through the purchase of insurance to cover such losses. One example of this is so-called "retroactive insurance," which purports to provide insurance coverage for a loss known to have occurred prior to entering into the contract. It has been reported in the press that a well known hotel had a fire in which numerous guests were either killed or injured. After the fire, the hotel's owners sought "insurance" to pay a portion of the claims when they were finally settled. The premium charged (which was a small

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6/ The deduction for undiscounted, unpaid losses may be particularly troublesome when coupled with the exclusion from gross income of unearned premiums. This interaction is clearest in the case of title insurance companies. Since these companies insure against title defects which have already occurred (if they exist at all), losses of a title insurance company are treated as incurred but not reported in the year in which the policy is issued. However, state insurance regulators require title insurance companies to set aside a portion of premiums received to cover claims in future years. Title insurance companies claim that additions to this reserve should be treated as unearned premiums. At least one court decision has upheld this treatment. Early v. Lawyer's Title Insurance Co., 132 F.2d 42 (4th Cir. 1942). The net result is that title insurance companies take deductions for undiscounted future liabilities before they are paid and before the corresponding income item is fully taken into account.

fraction of the amount virtually certain to be paid under the policy) reflected the discounted value of the estimated future liability, increased by a loading charge. The premium also took into account the tax benefits claimed by the insurer, i.e., the unpaid loss deduction equal to the undiscounted value of the estimated future liability. The premium paid presumably was claimed as a current business deduction by the policyholder. The potential use of insurance for similar purposes is also illustrated by the fact that in recent years, "insurance" has been sold to "protect" against product warranty claims and other nontraditional risks.

We believe that the tax laws should not create an excessive incentive to have risks transferred to an insurance company. Current law is far from neutral in this regard.

In devising an acceptable set of tax rules for accounting for claims to be paid in the future, at least two alternative approaches might be considered. One method would be to defer the deduction until the insurance company actually pays the claims. Another would be to limit the deduction for unpaid losses to the discounted present value of the future claims. As the attached analysis demonstrates, these alternative approaches produce results that are economically equivalent.

We recognize that both approaches may cause practical problems. Some taxpayers have claimed that deferring deductions until claims are paid may cause certain insurance companies to encounter transitional problems relating to the state regulatory authorities' measure of solvency. Use of the alternative "present value" deduction approach would cause other problems. Estimates of future claims would still be required, and it would be necessary to select an appropriate discount rate.

Notwithstanding these problems, we are hopeful that changes can be made that minimize the distortions inherent in the current rules while avoiding undue adverse consequences to taxpayers. In working toward such a solution, we would be happy to work with the Committee and its staff. Moreover, we hope that the insurance industry will cooperate in this endeavor to produce fair yet practical tax rules.

3. Timing of Deduction for Selling Expenses. Insurance companies are allowed to deduct currently the expenses (principally sales commissions) incurred in connection with the issuance of new insurance policies. A current deduction is allowed even in cases where a multi-year policy is

involved. Since an insurance policy is likely to be renewed in subsequent years, the costs incurred in selling the original policy relate in part to the original premium and in part to renewal premiums paid in later years. Under strict tax accounting principles, which would require that income and deductions be matched precisely, an appropriate portion of the selling expenses would be capitalized and written off over the life of the policy and its expected renewals.

Treasury does not believe that it is necessary to revise this long-standing practice at the present time.

4. Protection Against Loss ("PAL") Account. Most mutual property and casualty insurance companies are allowed deductions for net contributions to a Protection Against Loss ("PAL") account. The function of a PAL account is to defer tax on a portion of the company's underwriting income. These benefits are allowed in addition to permitting these companies a full deduction for estimates of future losses. These accounts are not required by state regulatory authorities.

The statutory scheme for accounting for a PAL account is somewhat complicated. For present purposes, it is sufficient to note that a deduction is generally allowed for contributions to the account in an amount equal to 1 percent of the losses (both known and estimated) incurred during the taxable year plus 25 percent of the underwriting gain for the taxable year. Companies which have a high percentage of risks relating to windstorms, hail, flood, earthquakes or similar hazards may defer a larger percentage of their underwriting income.

The portion of the deferred income representing 1 percent of losses incurred and one-half of the deduction for 25 percent of underwriting income is brought back into income after, at most, a 5-year deferral period. The remaining amount continues to be deferred indefinitely, until the company has underwriting losses.

The provision for PAL accounts was added to the Code by the Revenue Act of 1962. The stated rationale for the provision was that it would allow a mutual insurance company to retain a portion of the tax on its underwriting income as a cushion against extraordinary losses. Allegedly, this was to put a mutual on a par with a stock insurance company, which "can pay extraordinary losses not only out of its accumulated profits but out of its paid-in capital.7/

Treasury seriously questions the need for an income deferral provision for mutual insurance companies such as the Protection Against Loss account. The fact that these accounts are not required by state regulatory authorities indicates that they are not necessary in order to provide for the financial solvency of the companies. Moreover, the provisions relating to the carryback and carryover of unused loss deductions (analogous to the net operating loss deduction) would seem to provide ample long-term protection against extraordinary underwriting losses. This is especially so in light of the extension in 1981 of the loss carryover period to 15 years.

Other Issues

1. Deduction for Policyholder Dividends. In general, non-life insurance companies are allowed to deduct "dividends and similar distributions paid or declared to policyholders in their capacity as such."8/ This deduction primarily benefits mutual insurance companies. The rationale for this deduction, as well as the corresponding deduction for policyholder dividends paid by life insurance companies, is that the amount paid or credited simply represents a refund of an excess premium.

To the extent that a policyholder dividend in fact represents a "price adjustment," it is properly deductible, at least to the extent that the premium received was included in income. However, amounts paid out as policyholder dividends do not consist entirely of price adjustments. The policyholders of a mutual insurance company are also its owners, and a portion of their premium payments represents

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7/ H.R. Report No. 1447, 87th Cong., 2d Sess., on the Revenue Act of 1962, P.L. 87-834, 1963-2 C.B. 402, 442. Curiously, this justification for a PAL account for mutual insurance companies is exactly contrary to the arguments made in 1959 for special provisions applicable primarily to stock life insurance companies. These provisions, including the deferral of one-half of underwriting profits, were enacted on the ground that, unlike mutual companies, stock life insurance companies could not raise additional capital by charging redundant premiums which could later be refunded in the form of policyholder dividends.

8/ Sections 832(c)(11), 822(e).

their contribution to the capital of the company. Similarly, a portion of each policyholder dividend should be viewed as a distribution of a dividend or a return of equity to a stockholder. In any event, the insurance company should not be permitted to deduct the entire amount paid out as policyholder dividends.

The tax laws governing life insurance companies recognize these principles. For this reason, mutual life insurance companies may deduct policyholder dividends only to a limited extent. In testimony before the Subcommittee on Select Revenue Measures of the House Ways and Means Committee given May 10, 1983, we stated that mutual life insurance companies should be treated like other business entities; since mutual policyholders also act as owners of the business no deduction should be allowed for the portion of a policyholder dividend which represents a return on equity. This applies with equal force to non-life insurance companies organized as mutual entities. Moreover, the maintenance of different rules for the two types of insurance companies would continue to place pressure on life insurance companies to attempt to be reclassified as non-life companies in order to avoid the limitation on policyholder dividends.

As our earlier testimony on life insurance companies pointed out, it is difficult to measure that portion of the policyholder dividend which should be nondeductible. As in the case of a mutual life insurance company, one possible method of measurement would be to compute the capital of the mutual non-life company and impute a return on this capital. Deductions would be permitted only for amounts distributed in excess of this imputed return.

The question of how to treat policyholder dividends is also important from the standpoint of the policyholders. While a price reduction should be taxable to a policyholder only if the policyholder took a deduction for the full premium when paid, any return to a policyholder in his role as equity owner is investment income. The present system fails to impose any tax upon amounts received by a policyholder in his role as an equity owner of the company. The benefit of this exclusion should be considered in determining a fair treatment of policyholder dividends, whether it is taken into account in computing the deductions available to the company or in computing the income of the policyholders.

2. <u>Tax-Exempt Interest</u>. An insurance company (other than a life insurance company) includes tax-exempt income in gross income and is allowed a deduction in an equal amount.

A property/casualty insurer may properly be viewed as a financial intermediary which borrows money from its policyholders. This is so because the policyholder pays premiums to the insurance company prior to the time at which these funds are needed to pay the claims to which they relate. Economically, this borrowed amount is credited with interest, and a portion of the borrowed amounts are used to purchase or carry tax-exempt obligations. In general taxpayers are not permitted to deduct interest on funds borrowed to acquire or carry tax-exempt obligations. Yet the insurance company's deduction relating to amounts used to purchase or carry tax-exempt obligations is not reduced.

The analysis of insurance premiums as a deposit which is credited with interest was discussed earlier in our analysis of reserves. As stated in that earlier analysis, the premium can be divided into a "true" net premium, which equals the present value of the anticipated claims, amounts necessary to pay expenses and a profit. Since the net premium would not be needed to pay claims until some time in the future, it can be invested to earn interest. Both the insurance company and the policyholders recognize this fact, and it will be reflected in the agreement between the parties.9/

The precise manner in which the expected investment return will be reflected will vary from contract to contract. Frequently, it will be reflected in the premium rates established. This is evidenced by the fact that in most years in which interest rates are high the premiums charged to policyholders are less than the level of anticipated claims. In other types of contracts the expected investment return is explicitly stated. For example, many business insurance contracts are "experience rated." Under this type contract, the policyholder will pay a premium which will be refunded to the extent that the premium paid plus interest credited on available funds exceeds the claims paid plus a specified charge imposed by the insurance company.

9/ The policyholder receives an investment return in the nature of interest that is effectively credited to the policyholder during the period that the premiums are held pending the payment of claims. The policyholder is not taxed on this return. Whether or not there is a tax benefit to the policyholder depends on whether an offsetting deduction would be available to the policyholder for the constructive payment of additional premiums.

In either case, the insurance company is effectively borrowing money from its policyholders upon which interest is credited. Effectively, that interest is deducted from the insurance company's taxable income as is the case with other financial intermediaries when the borrowed funds are invested in tax-exempt securities. The insurance company still receives, in effect, a full deduction for interest paid to policyholders.

Other non-bank corporations must reduce their deduction for interest on borrowed funds that are invested in tax-exempt securities. The failure to reduce the deductions allocable to the tax-exempt interest gives insurance companies a tremendous incentive to invest in tax-exempt obligations. This allows insurance companies to reduce considerably their effective tax burden. It should be noted that this incentive does not exist for life insurance companies, although it does exist for commercial banks. This problem merits a careful reexamination. It should be noted that any changes to the rules concerning the deduction for unpaid losses may have an impact upon this analysis.

3. Special Provisions for Small Mutual Insurance Companies. The Code contains a number of special provisions for small mutual insurance companies. First, mutual insurance companies with total receipts of $150,000 or less are completely exempt from tax. Those with receipts of more than $150,000 but not in excess of $500,000 are subject to tax only on their investment income unless they elect to be taxed on total income (which would be advantageous if they had underwriting losses). In order to avoid a "notch" at $150,000, taxability is phased in gradually from receipts of $150,000 (tax-exempt) to receipts of $250,000 (fully taxable). Also, the first $3,000 of investment income is exempt from tax. Finally, companies having gross receipts of less than $1,100,000 are allowed a special deduction against underwriting income. The amount of this deduction is $6,000 for a company with gross receipts of $500,000 or less and the deduction phases out gradually for gross receipts between $500,000 and $1,100,000.

The Code contains numerous provisions of general applicability that tend to lessen the tax burden of small business. We question why additional provisions are necessary for small mutual insurance companies. With respect to the specific provisions now in the Code, we question the basis and the necessity for drawing distinctions between investment income and underwriting income. Such distinctions add complexity to the Code and may put pressure on an insurance company to attempt to recharacterize its income for tax purposes. Accordingly, if special provisions for small insurance companies are retained, Treasury suggests that consideration be given to replacing the special provisions which distinguish between investment and underwriting income with provisions of more general applicability.

4. Consolidated Return Issues. Insurance companies, like other corporations, are permitted to file consolidated returns with other members of an affiliated group. In certain circumstances, the right to file a consolidated return may be subject to abuse, particularly when more than one insurance company join in the filing of the consolidated return, and one of the companies is taxed as a life insurance company. For example, a life insurance company and a non-life insurance company may structure their combined affairs so as to give the life insurance company an inflated underwriting income while the non-life insurance company has an artificial underwriting loss. Although the combined operation would produce a taxable profit if the business were operated in a single business entity, a substantial current tax loss may result if the business is conducted in separate entities. This result comes about since under current law, only one-half of the underwriting income of a life insurance company is subject to current tax. When a consolidated return is filed, the artificially created loss can be used to offset other income within the consolidated group.

One method used by taxpayers to generate these types of artificial tax losses was through the use of reinsurance arrangements. Under these complex arrangements, insurance companies would "carve up" the anticipated income and expenses allocable to a group of insurance contracts among different companies. This carving up produced underwriting income for one company and substantial losses for others. Because of the substantial potential for abuse inherent in these arrangements, Congress enacted section 818(g) in the Tax Equity and Fiscal Responsibility Act of 1982. This provision authorizes the Internal Revenue Service to reallocate tax attributes among related parties in these types of arrangements. We strongly support this provision.

However, we are concerned that other methods may be used to produce comparable tax results. For this reason, we could not support at this time a liberalization of the current limitations on the ability of life insurance companies and non-life insurance companies to file consolidated returns. Of course, our concerns would be lessened if the tax rules applicable to these separate types of companies were made consistent.

5. Definition of Insurance. The definition of insurance for tax purposes is important primarily because of the generous tax treatment given to insurance companies, most notably the deduction for unpaid losses. As noted above, an insurance company may pass through the benefits of this deduction to its policyholders, effectively allowing them to accelerate deductions through the purchase of insurance. Taxpayers have gone to extreme lengths in the hope of obtaining these benefits.

Questions have been raised whether the claimed tax treatment of "retroactive insurance" is supportable under current law. Notwithstanding the uncertain tax status of certain of these arrangements, Treasury is concerned that analogous arrangements could have a very large adverse revenue impact if anyone faced with a large future liability, whether virtually certain or estimated, could obtain the economic benefits of a full deduction for estimates of future liabilities. These forms of "insurance" would become far less attractive (and less of a revenue concern) if the deduction for unpaid losses were eliminated or discounted to a fair approximation of present value.

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Appendix

Analysis of Alternative Tax Treatments Of Deferred Expenses

I. Nature of the problem

It is frequently the case that a current exchange of goods and services entails completion of a future action by the seller. When that future action requires the expenditure of resources by the seller, the question arises as to whether those expenditures should be taken into account in determining the seller's current year pre-tax or taxable income. The correct answer to this question is a rule which ensures that the amount deducted by the seller reflects no more than the resource cost of completing the transaction. The purpose of this Appendix is to demonstrate that a rule which requires that the seller include in his gross income for the current year the entire proceeds of his sale while deferring to the later year the deduction of the associated expense generally produces the correct result. The analysis also demonstrates that the correct result is obtained if the current deduction is limited to the present value of the future expense. The analysis also identifies the error implicit in the current rule that permits an insurance company to currently deduct the future cost.

The exposition following includes: first, a description of the determination of the price to be charged absent the influence of income taxation; second, a measure of the seller's income in the year a sale is made which requires a future year expenditure; third, a demonstration that a rule that would defer the deduction for future expenses would not affect the current year price charged; and finally, an identification of the logical error in the formulation of the current rule under which the seller's current year taxable income is measured as the sales price less the future cost of completing the transaction.

II. Determining the current year price to be charged a buyer of goods or services when the seller becomes obligated to incur a future expense.

If all an insurance company must do in connection with its insurance policies is to issue the policy and pay claims in the current year, the price charged would have to be sufficient to cover all the related expenses: wages of employees, the cost of materials consumed, the amount of the claims to be paid and a gross return to the company sufficient to cover depreciation of its equipment and to provide a return to its creditors and equity owners. Since the price to cover all these costs of production multiplied by the quantity of policies sold is reported by the company as "gross income," the company is allowed to deduct the wages paid and the cost of materials used up, since these elements of gross income are allocable to those productive agents. The company is similarly permitted to deduct depreciation costs to determine pre-tax income. After the insurance company deducts the interest paid creditors--their share of the pre-tax income from capital employed in the company--the residual is the pre-tax income of equity owners. Taxation affects the cost of operating an insurance company only to the extent it affects the cost of wages or materials or the pre-tax rates of return of creditors and equity owners. So long as costs incurred are appropriately measured and allowed as deductions to the company, the income taxation of insurance companies, <u>per se</u>, does not affect the price of insurance.

Now suppose that, in addition to incurring these current costs, the insurance company must also pay claims at some point in the future. Clearly, an additional cost to the company has been imposed. This future claims expense can be isolated in determinating its effect on the price of insurance. Let us symbolize the cost to be charged insurance buyers for this service as P_1, the subscript indicating that it is a price to be charged in year #1, when the policy is sold.

If we symbolize the future outlay as O_n, the subscript indicating the year when the outlay will be made, then the only other determinant of P_1 is the discount rate by which the current year charge can be related to the future outlay. Let us call this discount rate, which is the opportunity cost of shifting payment obligations over time, r. Then ignoring taxation,

$$P_1 = O_n \ (1+r)^{-(n-1)}. \tag{1}$$

That is where O_n = \$100, n=7 and r=0.12, P_1 = \$100$(1.12)^{-6}$ = \$50.66. The insurance company would have to charge the buyer at least \$50.66 in year #1 so that, 6 years later, he would have accumulated \$100 with which to cover the claims costs (in year #7). From the buyer's point of view, he would pay no more than \$50.66 in year #1 for he could take that capital sum and accumulate it over 6 years to \$100 and, himself, requite the claims cost of \$100.

III. The seller's income.

Suppose that the cost assumption of the above example hold. What is the measure of the insurance company's income in year #1 when it receives the \$50.66? Obviously, with respect to the \$50.66 received, it is zero: It has simultaneously received a market payment of \$50.66 but incurred an obligation to cover a future expense the <u>present</u>

value of which is exactly equal to \$50.66. Therefore, for financial statement purposes, the receipt of the \$50.66 has no effect on the company's income statement; but it will have a balance sheet effect. On the balance sheet, the \$50.66 will be an increase in assets (earning 12 percent, by assumption) offset by the recognition that there is a future \$100 obligation, less a "discount" of \$49.34, which represents the 6-year cumulation of earnings of the \$50.66. With each passing year, the insurance company will record interest income and a corresponding decline in the "discount" associated with the year #7 claims oblgiation. If it does not in fact accumulate among its assets the interest earned, when the \$100 outlay is made the insurance company will suffer a \$49.34 decline in net worth.

IV. Introducing income taxation.

In order to simplify exposition, we shall now assume the r in equation (1) represents an after-tax rate of return to capital employed in the enterprise. There are two income tax formulations for the treatment of P_1 that will give the same result as equation (1): deferral of the deduction for the expense and another rule which applies the result in III, above, namely, that there is zero pre-tax income in year #1.

First, we rewrite equation (1) to introduce an income tax levied at rate m. If T_1 = tax due in period #1 and T_n the tax due in period n,

$$P_1 - T_1 = (O_n + T_n)(1+r)^{-(n-1)} \tag{2}$$

Symbolically, equation (2) simply says that P_1, less tax due when it is received, must be equal to the future outlay, plus tax due, when the outlay is made in year n, all discounted to the present.

If a deduction were not allowed for the future expense until it is paid, then P_1 would be taxed as received and a deduction of O_n would be allowed in year n,

$$T_1 = mP_1 \tag{3a}$$

$$T_n = -mO_n. \tag{4a}$$

If equations (3a) and (4a) are substituted in equation (2), the result is:

$$P_1(1-m)=O_n(1-m)(1+r)^{-(n-1)},$$

which, of course, is exactly the same as equation (1) after cancelling the (1-m). Applying this rule to the factual assumptions specified above, produces a P_1 = \$50.66, and if we take m = 0.40, \$20.26 will be paid in tax (T_1=\$50.66 x 0.40) leaving the insurance company a capital fund of \$30.40 which will accumulate to \$60 in year #7, at which time the company will receive a refund of \$40 (T_7 = -\$100 x 0.40) enabling him to cover the $100 year #7 cost.

Of course, if the taxpayer is allowed a $50.66 deduction in year #1 against his P_1 = $50.66 to signify his lack of economic income in that year and is not allowed to take a deduction when the expense is incurred in year #7, T_7=0, the same result is achieved. Neither rule causes an alteration in the charge for insurance. But note that, in order to apply the latter rule, the present value of the future cost must be determined, and this requires estimation of a discount rate. In contrast, the rule which taxes P_1 and refunds with respect to O_n operates only with actual transactional data and requires no discounting.

V. The effect of erroneously permitting the current deductibility of future (undiscounted) costs.

Suppose we define P_1 to be the year #1 charge for future costs to be incurred by the seller under a tax rule that will permit the amount of the future outlay, O_n, to be currently deducted. Then,

$$T_1 = m(P_1 - O_n) \tag{3b}$$
$$T_n = O, \tag{4b}$$

and substituting these in equation (2) and simplifying, we obtain

$$P_1 = O_n[(1+r)^{-(n-1)} - m]/(1-m). \tag{4}$$

In contrast with P_1 as determined by deferring the deduction for the expense, this rule makes P_1 a function of the tax rate m. In general, for all tax rates greater than zero P_1'/P_1, the difference being a tax subsidy to benefit the cause of the deferred expense; it results from the deduction of an undiscounted amount O_n, in year #1, and the subsidy increases with the taxpayer's marginal rate.

For example, continuing to use the example in which $50.66 is the true charge for future claims a buyer of insurance should pay, allowing current expensing of $100 would result in the following:

Insurance Company's tax rate	P_1 Buyer's Insurance charge	Subsidy ($50.66 - $P_1'^1$)
0.20	$38.33	12.33
0.40	17.77	32.89
0.46	8.64	42.02

The CHAIRMAN. What we will do, Mr. Chapoton, as we generally do, is to make your entire statement part of the record.

I was interested in your statement. Have you been working directly with the industry to go over some of these problems?

Mr. CHAPOTON. Yes. We have had meetings with representatives of the companies. I think, quite frankly, a lot more has to be done. We do need further meetings.

The CHAIRMAN. It is my hope that as we get into some of these areas that properly should be addressed, that we can do it on that kind of a basis. We were somewhat successful last year working with life insurance companies, though I must say we ended up with less revenues than we thought, but that happens from time to time, nearly every time. [Laughter.]

But at least there was cooperation and willingness to help on the part of the industry. And we certainly do not have any enemies list or hit list, but we do believe we have an obligation to try to make the system fair. And if in fact there are some areas that ought to be tightened up, we ought to have the cooperation of those, without doing themselves in, to help us in that area.

Otherwise, we may be doing some things that we may not totally understand. We will be looking to Treasury and the industry, as well as the Government Accounting Office representatives, who also have looked into some of these areas.

I think you have touched on the points that I was going to ask you about. In fact, your example I think may have taken care of the question I have.

When you talk about discounting reserves and the value of money, is not the issue simply that if you do not have to pay a claim until a future time you can invest the premium, as you pointed out, and earn interest until the claim has to be paid?

Mr. CHAPOTON. Right.

The CHAIRMAN. Now, whether that is something that we might want to address—and I am also aware of the fact that the Treasury has opposed deducting expected mine reclamation expenses up front on an undiscounted basis because of this same problem.

Now, is there any reason to have any different treatment for this industry?

Mr. CHAPOTON. As an initial matter, I see no reason for a difference. Simply stated, the effect is that the amount set aside in the reserve is larger than the amount necessary to pay the future claim. The problem does arise in several contexts.

In the property and casualty insurance area, of course, it is now in the statute. In the other, in the mine reclamation expenditure, the attempt initially was to say that this is an amount that has properly accrued under present tax rules without special statutory provision. Now the effort is to do it through a statutory change. We have got a problem there, and you are correct, we have the same problem with the statutory provision for insurance companies.

The CHAIRMAN. As I understand it, even though you may support certain changes, you are not yet ready to make any recommendations?

Mr. CHAPOTON. No, sir, we are not prepared to make a recommendation. As I pointed out, dealing with that problem alone is difficult. You have to know the discount rate and you have to know when the future claims are going to be paid. It is something we need to work on further.

The CHAIRMAN. As everyone knows, the budget marathon is still in progress. It seems to me that whatever happens it will not make much difference, because there is not much hope in either the House or the Senate budget resolutions; very little on the spending side, but a lot on the tax side.

I do not want this committee to have to raise taxes so somebody else can spend the money. So we hope that we will have a balanced package. I am not very optimistic about that, but I think it is fair to say that either capping the third year or delaying the third year is not going to happen. The President either has the votes going in or he has the votes to sustain any veto if it were capped, or whatever.

And if we are asked in this committee to come up with, $9 billion next year, as in the Senate budget resolution, or $30 billion as in the House resolution, we are going to have to scramble pretty hard, and I assume we will have to get some of the other people to chip in to take care of the bankers' problems since they cannot afford to implement withholding. I am certain other groups would like to pick up the tab for them, and that is another $2 or $3 billion.

So we are looking at maybe $12 or $15 billion of additional revenues in fiscal year 1984. I would hope that those who may be here today will understand our problem and try to work with us. We do not want to go out and punish anyone, but I do not know how we are going to raise $15 billion in fiscal 1984.

Do you have any other ideas on how to raise $15 billion?

Mr. CHAPOTON. Not at the moment, Mr. Chairman.

The CHAIRMAN. It may be that we will not have to do that. But, if we are concerned about the deficits, as I assume we should be, then what we are trying to do is prepare for whatever the budget conference may ultimately do, otherwise we are going to find ourselves in September with no budget resolution or maybe finally getting a budget resolution and the fiscal year starting October 1, which does not give our committee much time.

That is another reason we are having these hearings at this time, so that at least we will be prepared, that is also the reason we are having all the other hearings. I do not want anyone to feel that we are looking just at property and casualty companies and not pretty much across the board.

We will have other questions as we continue to work on this package.

Thank you.

Mr. CHAPOTON. Thank you, Mr. Chairman.

The CHAIRMAN. We next have a panel of witnesses: Harry Havens, Assistant Comptroller General, accompanied by Craig Simmons, Acting Associate Director of Program and Economic Analysis, and Natwar M. Gandhi, Senior Evaluator, General Accounting Office.

You may proceed in any way you wish and your statement will be made a part of the record. We appreciate your testimony and your study over the past several months.

STATEMENT OF HARRY HAVENS, ASSISTANT COMPTROLLER GENERAL, ACCOMPANIED BY CRAIG SIMMONS, ACTING ASSOCIATE DIRECTOR OF PROGRAM AND ECONOMIC ANALYSIS, AND NATWAR M. GANDHI, SENIOR EVALUATOR, GENERAL ACCOUNTING OFFICE

Mr. HAVENS. Thank you very much, Mr. Chairman. We are pleased to be here and to share the preliminary results of our work.

The CHAIRMAN. There are some chairs down front. I hate to have people stand when there are seats available.

Mr. HAVENS. In the interest of time, I think I would simply summarize the points that we make in the formal statement.

First of all, on the loss reserve deduction, we share the views of the Treasury that deducting the gross amount on an undiscounted basis is a significant violation of economic income as a basis for taxation. We believe that discounting is an appropriate way to move in that direction, at least based on the work we have done to date.

The second point is on the subject of allocation of acquisition costs. We believe again that there is a significant violation of economic income which results in an inappropriate deferral of tax liability resulting from the expensing in the current year of costs associated with income to be accrued in the subsequent year.

Finally, on the protection against loss account with respect to mutual companies, here again we think there is a questionable deduction associated with this arrangement. The original justification for it, we believe, is clearly flawed in conceptual terms.

Those are the main points that we talk about in the statement. Changing each of these, all other things being equal, would yield additional revenue. But I want to make one very significant caveat about the estimates of additional revenue that we reflect in our statement. These assume that the companies involved take no other actions to shelter income in other ways.

Insurance companies, in the way they invest their reserves, have a great deal of flexibility in sheltering income, through the acquisition of additional tax exempt bonds, for example, or further investments in securities of domestic corporations, for which the dividends are largely excluded from income. So while we have numbers in our statement, we do have a caveat about the reliability of them as a basis for assuming that you will solve your $30 billion problem through this particular avenue.

I think that summarizes the main points of the statement, Mr. Chairman. We would be happy to respond to any questions.

[The prepared statement of Mr. Havens follows:]

U. S. GENERAL ACCOUNTING OFFICE

WASHINGTON, D. C. 20548

FOR RELEASE ON DELIVERY
Expected at 9:30 A.M. EDT
Monday, June 13, 1983

STATEMENT OF

HARRY S. HAVENS

ASSISTANT COMPTROLLER GENERAL FOR PROGRAM EVALUATION

BEFORE THE

SENATE FINANCE COMMITTEE

ON

TAXATION OF THE U. S. PROPERTY/CASUALTY INSURANCE INDUSTRY

Mr. Chairman and Members of the Committee:

We are pleased to be here today to discuss our ongoing work on tax policy issues pertaining to the property/casualty insurance industry. Our preliminary work has focused on the issue of economic income. In this connection we found three areas where tax code treatment differs in important ways from the concept of economic income. The ultimate result is that because of the definition of taxable income that is currently used, the tax burden of property/casualty companies is lower than it otherwise would be.

Specifically, it is our view that the present definition of losses incurred is inappropriate for tax purposes; that costs related to the acquisition of insurance contracts should be allocated to conform more closely to economic income; and that the protection against loss account is not achieving its intended purpose. I will address each of these issues in turn.

The Loss Reserve Deduction

Basically, taxable income is defined as gross income less the expenses of doing business. The sum of investment and underwriting income of property/casualty companies is reduced by deductions for administrative expenses and for losses incurred, as well as by exclusions for tax-exempt interest and for dividends. Losses incurred include those actually paid during the tax year and also the annual change in reserves for future loss payments.

Loss reserves usually grow from year-to-year because of the real and inflation-related growth in business activity, and because of changes in the mix of business. More insurance is being written in workers compensation and in third party liability lines that involve claims that are paid out over a considerable period of time. Relatively less insurance is being written in property damage lines where claims are settled comparatively quickly. Insurance lines involving long payment tails increased from about 47 percent of the total business written in 1972 to about 51 percent in 1981. This results in an estimated claims payment stream that extends further into the future.

Clearly, loss reserves are needed to ensure that a company has adequate funds to pay future claims, and just as clearly such reserves and reserve additions should not be taxed. However, current practice overstates the amounts that must be set aside to satisfy future claims. This is because amounts ultimately needed should be reduced by the investment income that will be earned on the reserves between the time they are set aside and the time they are paid out. In other words, reserves for estimated loss payments should be discounted to take into consideration the time value of money. Permitting companies to deduct the change in loss reserves on an undiscounted basis understates economic income.

Some have argued that discounting reserves which are uncertain in amount risks taxing income which may be needed in subsequent periods if reserves were underestimated. This ignores the fact that reserve estimates are made annually, and any errors in one year will be corrected in a subsequent year. It also must be realized that the uncertainty associated with the reserve estimation process exists regardless of whether the reserves are discounted.

We estimated discounted loss reserve levels and the additional tax revenue that would have resulted had this practice been followed. Our estimates, at varying discount rates, are presented in table 1 accompanying my statement. It is our view that the appropriate discount rate for a company should reflect its expected earnings rate on its invested assets. For example, had this rate been six percent in 1981, and had it been used to discount reserves for all companies, the deduction taken would have been reduced by about $1.5 billion, and tax revenues would have been greater by about $675 million.

I would like to sound one cautionary note about these estimates of additional tax revenues. To the extent that the discounting procedure increases tax burdens, companies might seek ways to further shelter investment income and thereby mitigate any increase in taxes. This could be done through increasing holdings of tax-exempt securities or equity securities of domestic corporations.

In the case of tax-exempt securities, when their yield exceeds 54 percent of yields on taxable securities, it may be prudent for companies to invest in tax-exempts. As of April of this year, the ratio of tax-exempt to taxable yields was about 79 percent. In view of this, there appears to be ample leeway for companies to increase investment in tax-exempts beyond their current share of admitted assets. Data on the tax status of investment income is shown in table 2.

Allocation of Acquisition Costs

A second income measurement issue is the proper allocation of business expenses related to the acquisition of new and renewal contracts. Currently, National Association of Insurance Commissioners (NAIC) accounting practice, which is incorporated into the Code, permits the immediate expensing of acquisition costs, such as agents' commissions and brokerage fees. This practice is consistent with neither generally accepted accounting principles nor with the concept of economic income. Expenses should be allocated over the same periods in which the corresponding income is recognized.

We believe the Code's reliance on NAIC statutory accounting practices for measuring taxable income is misplaced. If acquisition expenses were allocated as revenue is recognized then taxable income would increase. Table 3 displays the additional tax revenues which would have accrued for the years 1980 through 1982 if this change had been made and everything else had remained the same. Note, for example, that if acquisition costs had been allocated in 1981, we estimate that the additional tax revenues would have been approximately $186 million.

Protection Against Loss Account

We also have under review the rationale for and revenue implications of the protection against loss (PAL) account established for the benefit of mutual companies in the Revenue Act of 1962. The PAL account is solely a tax form account and is not a statutory or financial accounting requirement.

Essentially, the PAL account operates to defer taxes on a portion of an insurer's income. A mutual company makes additions to the account based on the size of its incurred losses and underwriting income. These additions, subject to certain statutory limitations, are deductions against current period underwriting gains.

Apparently the rationale for establishing the PAL account for mutuals was concern over their lack of access to capital markets in the event that they sustained a catastrophic loss. There are at least two flaws in this rationale.

In the first place, if an extraordinary catastrophic loss were to occur that was not sufficiently covered by policyholder surplus and reinsurance, the account does not necessarily assure the company's ability to satisfy its contract obligations. This is because there is no requirement that the deferral or the tax reduction be earmarked for this purpose.

Second, the basic rationale of access to capital markets is questionable. The argument assumes that stock companies, if faced with a catastrophic loss, could issue securities in the capital market to obtain funds whereas mutuals cannot. If a stock company were to suffer a catastrophic loss exceeding its recoverable reinsurance and its policyholder surplus, it seems unlikely it could successfully offer securities in the capital market.

Our review of the tax policy issues pertaining to the industry is continuing. In addition to the issues I have discussed, we are studying the unintended tax planning opportunities provided by affiliation of property/casualty companies, life companies, and other unrelated businesses, and how insurance should be defined for tax purposes. These and other related issues will be discussed in our forthcoming report.

This concludes my prepared statement. We would be happy to respond to your questions at this time.

TABLE 1

Estimates of Additional Revenues for the Property/Casualty Insurance Industry From Discounting Reserves For Calendar Years 1980-1982
($000,000 omitted)

	1980			1981			1982 1/		
	Earning Rates			Earning Rates			Earning Rates		
	5 Percent	6 Percent	7 Percent	5 Percent	6 Percent	7 Percent	5 Percent	6 Percent	7 Percent
1. Undiscounted Loss Reserve Deduction	$11,338	$11,338	$11,338	$9,970	$9,970	$9,970	$7,578	$7,578	$7,578
2. Discounted Loss Reserve Deduction	9,774	9,513	9,268	8,718	8,503	8,305	6,524	6,378	6,245
3. Decrease in Reserve Deduction (line 1 minus line 2)	$ 1,564	$1,825	$2,070	$1,252	$1,467	$1,665	$1,054	$1,200	$1,333
4. Additional Taxes (.46 x line 3)	$ 720	$ 840	$ 953	$ 576	$ 675	$ 766	$ 485	$ 552	$ 613

1/Estimates developed by GAO from unpublished preliminary Best's data.

Source: Best's Aggregate and Averages Property/Casualty, various years, also Best's Casualty Loss Reserve Development, various years, A.M. Best Company, Oldwick, New Jersey.

ATTACHMENT

TABLE 2

Property/Casualty Companies' Share of Tax-Exempt Securities Held by the Public and Share of Companies' Admitted Assets and Amount of Tax-Exempt Income for Calendar Years 1975-81
($000,000 omitted)

	Percent of Publicly Held Tax-Exempt Securities	Tax-Exempts as a Percent of Admitted Assets	Tax Exempt Income	Gross Investment Income	Dividends Excluded	Exempt Income to Gross Income (Percent)	Dividends Excluded to Gross Income (Percent)	Total Exempt and Excluded to Gross Income (Percent)
1975	14.9%	34.1%	$1,730	$3,347	$1,082	51.7%	32.3%	84.0 %
1976	16.2	33.6	1,951	3,857	1,025	50.6	26.5	77.1
1977	18.8	39.2	2,411	6,230	1,326	38.7	21.3	60.0
1978	21.6	42.6	3,148	7,750	1,438	40.6	18.5	59.1
1979	22.7	42.3	3,937	9,787	2,278	40.2	23.3	63.5
1980	22.7	41.2	4,669	11.667	2,531	40.0	21.7	61.7
1981	21.7	40.2	5,415	13,938	2,622	38.9	18.8	57.7

Source: Best's Aggregate and Averages, A.M. Best Company, Oldwick, New Jersey, various years.

Flows of Funds, Federal Reserve Board, Washington, D.C. for share of publicly held state and municipal obligations.

Note: Property/casualty companies include stock, mutual, and reciprocal type organizations. The industry total reported by A.M. Best represents 95-98 percent of the industry's admitted assets. Prior to 1974, companies did not separately report tax-exempt interest income to state insurance commissions. Dividend exclusion is estimated as 85 percent of dividends received from domestic corporations and 100 percent of dividends received from affiliated companies.

ATTACHMENT

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TABLE 3

Forecast of Additional Revenues
By Allocating Acquisition Expenses
Property/Casualty Insurance Industry
For Calendar Years 1980-1982
($000,000 omitted)

	1980	1981	1982 1/
1. Acquisition Expenses Deducted (on a non-allocated basis)	$15,954	$16,784	$17,607
2. Acquisition Expenses Deductible (on an allocated basis)	15,158	16,380	17,280
Additional Revenues:			
3. Additions to Taxable Income (line 1 minus line 2)	$796	$404	$ 327
4. Additional Taxes (.46 x line 3)	$366	$186	$150

1/1982 acquisition expenses rely on forecasted values of net premiums written and estimates of acquisition costs by business line.

Source: Best's Aggregate and Averages, Property/Casualty, A.M. Best Company, Oldwick, New Jersey, various years. Forecasts of net premiums written for 1982 and acquisition expenses, on an allocated basis, are GAO estimates.

The CHAIRMAN. Well, in March we held hearings on the taxation of banks and other savings institutions, and credit unions which are tax exempt. We heard, or at least we were told, that several large banks had tax rates between—effective tax rates between 2 and 3 percent.

Could you tell us what the effective tax rates of a representative group of property and casualty insurance companies would be?

Mr. HAVENS. Well, the group that we studied, which represents the largest in total volume by a very large margin, had effective tax rates on a fairly simple-minded basis of about 15 percent in 1977. It has declined to about 1 percent in 1981, sir.

The CHAIRMAN. One percent?

Mr. HAVENS. Yes.

The CHAIRMAN. What is the reason for the decline?

Mr. HAVENS. A combination of factors: The exclusion of income through the tax exempt bonds and the deductibility of domestic corporation dividends, and some fairly heavy taxable underwriting losses in recent years, which has resulted in a combination of a fairly low taxable income under present statutes.

The CHAIRMAN. Well, that is probably in line with my next question. As we have heard from some of our friends in the industry, the property and casualty insurance industry, they argue that they are losing money; that is the reason that they produce less tax revenues for the Federal Government.

Would that be a fair statement? If they have had large losses, I assume that might be partly true. And second, does it address the question of the effective tax rate on economic income? I think that is the broader and possibly more important question.

Mr. HAVENS. From the standpoint of economic income, the income of the company resulting from interest on tax exempt bonds is economic income, for example. It is exempt from taxation for reasons having nothing to do with the insurance companies themselves. But it does have the effect of producing substantially lower taxable income.

So I suspect—I would have to defer to my colleagues here as to the details, but I suspect if you compare taxable income for the major companies with the income they report to their stockholders or policyholders, that there would be some fairly significant differences, particularly over a period of time. There were some fairly heavy underwriting losses in more recent years, but over a period of time the differences would be fairly significant.

The CHAIRMAN. Would either one of your colleagues like to elaborate further on that?

Mr. GANDHI. I would generally suggest that what Mr. Havens has said in this regard is correct. I would simply add this much: There has been a concern about whether the losses suffered by the industry are truly economic losses or primarily tax losses, and exclusion of the investment income from the tax base has been the principal reason why the tax rates are so low. And such exclusion occurs because, as Mr. Havens suggested, of the buying of the tax exempt securities.

The CHAIRMAN. I think you may have set it out in your statement and it will be made a part of the record, but have you estimated the additional revenues this discounting is likely to produce?

Mr. HAVENS. Yes. If you refer to table 1 attached to the statement, the results of shifting to a discounting of reserves basis would, all other things being equal, yield additional taxes in the range of half a billion to a billion dollars, depending upon which discount rate is assumed and depending upon which year we are talking about. We have numbers related to 1980, 1981, and 1982.

But again I want to mention the caveat that I commented on, that given the opportunity of insurance companies to shelter income in other ways, through shifting into additional tax exempt financing of their investment reserves, one cannot count on these amounts to show up in the tax revenues of the United States.

The CHAIRMAN. Well, the argument is made that one reason that they should not discount is because of the uncertainty of the estimates of loss reserves. Are you adding to the risk to the company that they will not have adequate income to meet future loss payments if you started discounting?

Mr. HAVENS. We think not, Mr. Chairman. The reserves are recalculated annually by the firms' actuaries. If an error were made and the future losses or future payouts, claims, were underestimated in 1 year, there would be sufficient opportunity in subsequent years, particularly from the long-tail policies which are the ones really at issue here, to recapture any underestimate by adjusting the estimate for reserves in future years. So there is plenty of time for those, where the discounting would have the greatest effect.

The CHAIRMAN. I would like to ask a question about the National Association of Insurance Commissioners' statutory accounting. And again, I read your statement and it seems to me that you imply that the NAIC statutory accounting rules are flawed.

Are you proposing any change in the NAIC accounting rules, and if so what effect would these changes have on the way companies file their annual reports with the State insurance commissions?

Mr. HAVENS. We are not proposing that the NAIC rules be changed. We are observing that the objectives of the NAIC are to assure the safety and soundness of the firms, to protect the policyholders. It is quite appropriate for them to be very conservative in their approach to estimating required reserves.

We think that is a very different issue from defining what should be considered taxable income, economic income, for purposes of the Internal Revenue Code. This is where we think the inherent conservatism of the NAIC approach, which is appropriate for its purposes, need not be continued. So we do not propose changing the NAIC. We do propose, or suggest that you consider the opportunity to change the Internal Revenue Code.

The CHAIRMAN. You have given us a couple of ideas on ways of reducing taxes, available to insurance companies to reduce tax on their income. Do you give sort of a complete list of ways that can be done in your prepared amendment?

Mr. HAVENS. Well, we focus on those that they have used predominantly in the past, which is the tax exempt securities market and the securities market for domestic corporations, for which approximately 85 percent of the dividends are excluded from tax.

I would not want to pretend that I know every way that a company can find to shelter its income from tax. I am sure there are many others. These are the two that the industry has tended to use most extensively in the past.

The CHAIRMAN. I have just been reading this new book called "The Invisible Bankers, Everything the Insurance Industry Never Wanted You to Know." I do not know if you have had a chance to review that.

Mr. HAVENS. I have not, sir.

The CHAIRMAN. I am only on page 60. I got to the salaries part and that seemed kind of interesting. I have not gone beyond that yet. I thought I would show that to Senator Jackson. [Laughter.]

Do you know approximately what percentage of the assets of property and casualty insurers are invested in tax exempts?

Mr. HAVENS. Yes. I believe that appears on a table, table 2 attached to the statement. Tax exempt holdings represented 34 percent in 1975, rising to a peak of 42.6 percent in 1978, and currently at about 40.2 percent of their admitted assets.

The CHAIRMAN. Let us just assume that changes. If changes were made in the tax treatment of insurers with respect to tax exempt issues, do you have any conclusions on how this might affect the tax exempt bond market?

Mr. HAVENS. Well, considering that the property and casualty companies hold approximately 20 percent of tax exempt securities in the market, if it were altered in such a way as to cause the P and C firms to change their investment pattern away from tax exempts it could be a very serious blow to the tax exempt market.

The CHAIRMAN. You are not suggesting that be done, as I understand it?

Mr. HAVENS. No, sir.

The CHAIRMAN. And in your investigation did you determine or did you make an effort to determine whether State regulation differs for mutuals and stock companies?

Mr. HAVENS. To the best of my knowledge, we have not looked at that issue, no, sir.

The CHAIRMAN. You also indicate in your statement that insurance lines involving long-tail payments increased to 51 percent in 1982. Do you know what specific lines of insurance are generally involved in long-tail payments?

Mr. HAVENS. Those tend to be third party liability lines and workers compensation lines. For example, in health insurance or medical malpractice insurance, you may well be paying out for a very extended period of time with respect to any claim that is made in any particular year. So it is primarily in the third party liability and workers compensation lines.

The CHAIRMAN. As I understand it, you are not yet ready to publish any final report. In other words, you are still in the process of looking at certain areas. When is it probable that that report will be available to the committee?

Mr. HAVENS. We expect that to be ready for publication in the fall, sir.

The CHAIRMAN. That would be early fall, hopefully?

Mr. HAVENS. I think we are talking about October at this point. We would be pleased to keep you and the committee staff apprised of the results as we proceed, so that you need not wait entirely until the report comes out to have the information that we have available.

The CHAIRMAN. That would be helpful. Again, I am not suggesting what we may or may not do, but I am suggesting that our responsibilities are going to come fairly quickly if in fact there is a budget resolution.

And obviously, we are given numbers in the budget resolution, not specific programs. But again, as I have said, with certain things off-limits, that the President would veto or that would never be changed in the first place, plus I think the general obligation we have to make certain we level out the playing field for tax purposes, the sooner we have information from you the better.

Mr. HAVENS. We will be happy to share any information we acquire as rapidly as we have it. If your schedule requires you to act, we will give you whatever information we have at the point where you need it, sir.

The CHAIRMAN. In this particular study, have you had the opportunity to visit with a number of insurance people?

Mr. HAVENS. We have had very extensive contact with the insurance industry at all levels and in all dimensions. So we have had very good cooperation from them with respect to information.

The CHAIRMAN. So you think you have a pretty good balanced view of what the industry does?

Mr. HAVENS. We believe so. I would not want to guarantee that the industry will always agree with the conclusions we reach based on that information, but we have had a good exchange of information, yes, sir.

The CHAIRMAN. Well, they are going to be testifying next. Maybe if they agree with you we can shorten the hearing. [Laughter.]

Mr. HAVENS. That would be very nice, sir.

The CHAIRMAN. I am wondering if it might be possible—I know you have other obligations—if you could just maybe remain for a while——

Mr. HAVENS. Certainly.

The CHAIRMAN [continuing]. While we hear the other witnesses. It may be material that you have already gone over, but it might be helpful. We thank you very much and we will be in touch as we proceed.

Mr. HAVENS. Thank you, sir.

The CHAIRMAN. We now have a panel consisting of: Lawrence Jones, president, American Insurance Association; Thomas Thornbury, chairman of the committee on taxation, American Insurance Association; Harold C. McCarthy, president of the Meridian Mutual Insurance Co. of Indianapolis, Ind, and a member of the board of governors, National Association of Independent Insurers; Ralph Milo, chairman of the Federal tax committee, National Association of Independent Insurers, Washington, D.C.

I assume that you have some order in which you wish to proceed, and if it is satisfactory with you we can include your entire statements, unless they are too voluminous.

Mr. JONES. We would like to include all of our statements in, Senator.

The CHAIRMAN. The statements will be made a part of the record.

Mr. JONES. Maybe join the next panel with us?

The CHAIRMAN. Oh, sure. We thought there would be too many witnesses to fit in one panel, but if you can find space please feel free to include Andre Maisonpierre and Michael Cuddy of the Alliance of American Insurers and Coopers & Lybrand.

You may proceed.

STATEMENT OF T. LAWRENCE JONES, PRESIDENT, AMERICAN INSURANCE ASSOCIATION

Mr. JONES. Senator, I am Lawrence Jones, president of the American Insurance Association. With me is Tom Thornbury.

As you see, the panel consists of the four national insurance trade associations. These associations represent 90 percent of the industry. We have taken your admonition about no duplication very seriously, so we have divided up the five issues that you have identified in your call for a hearing. One person will speak about each topic, but he speaks for all four groups. We went over the testimony and we all verify that he speaks for all of us.

You also asked for information about the industry. We put together and have submitted to you a statistical profile of the industry. We hope that it provides you with all the information that you might want to know.

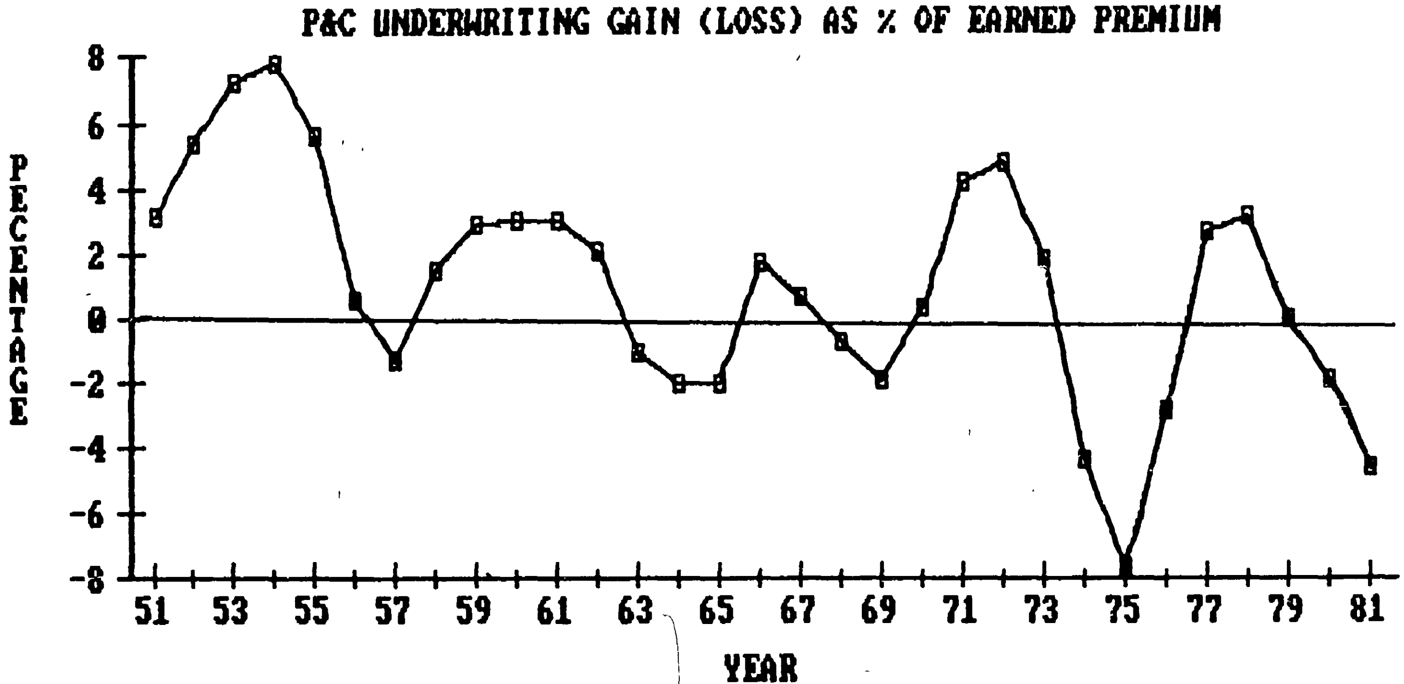
The CHAIRMAN. That will not be made a part of the hearing record, but it will be made available to the committee.

[The statistical profile is in the official committee records.]

Mr. JONES. Available to you and the GAO and the Treasury, sir.

My assignment is to cover that, or the most relevant points. We would only like to bring out four major points that are characteristic of the industry that are relevant to your hearings. Two of the charts in the statistical profile have been reproduced here, and we would like to call your attention to those.

[See chart and tables attached.]



P&C UNDERWRITING GAIN (LOSS) AS % OF EARNED PREMIUM
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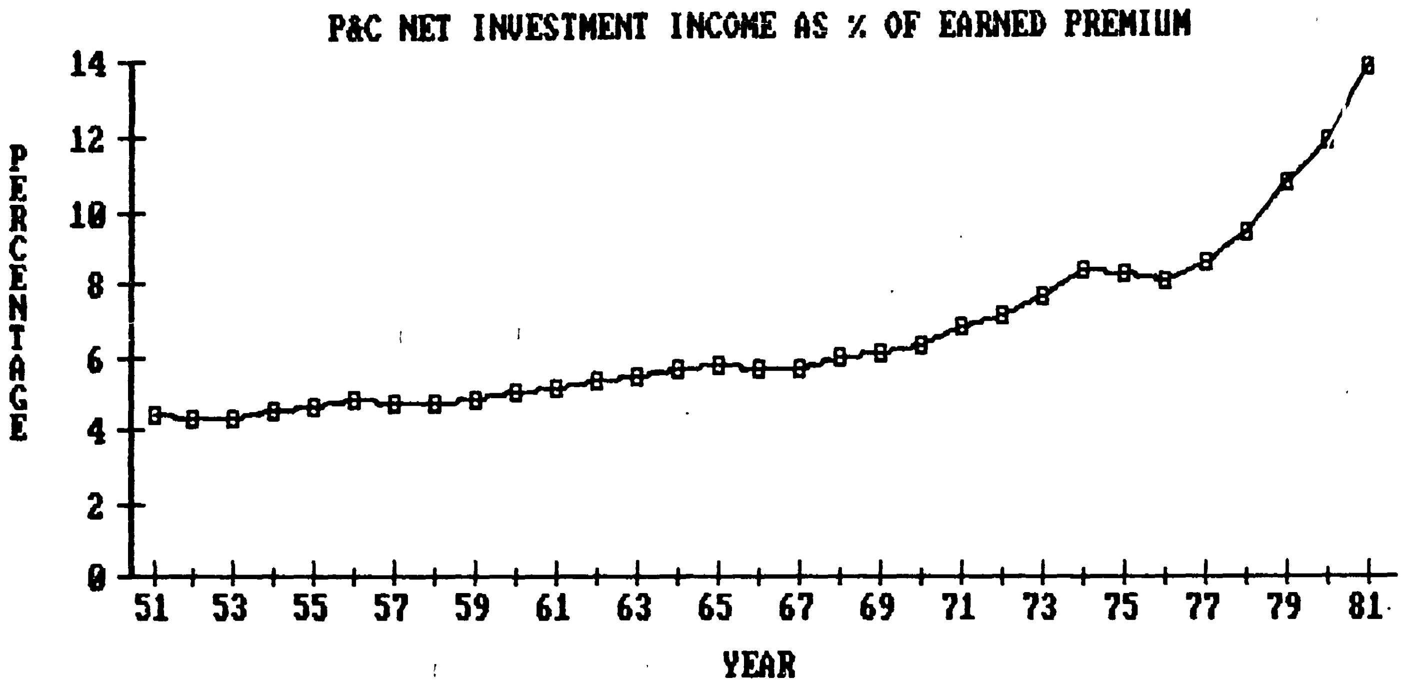
YEAR


P&C NET INVESTMENT INCOME AS % OF EARNED PREMIUM
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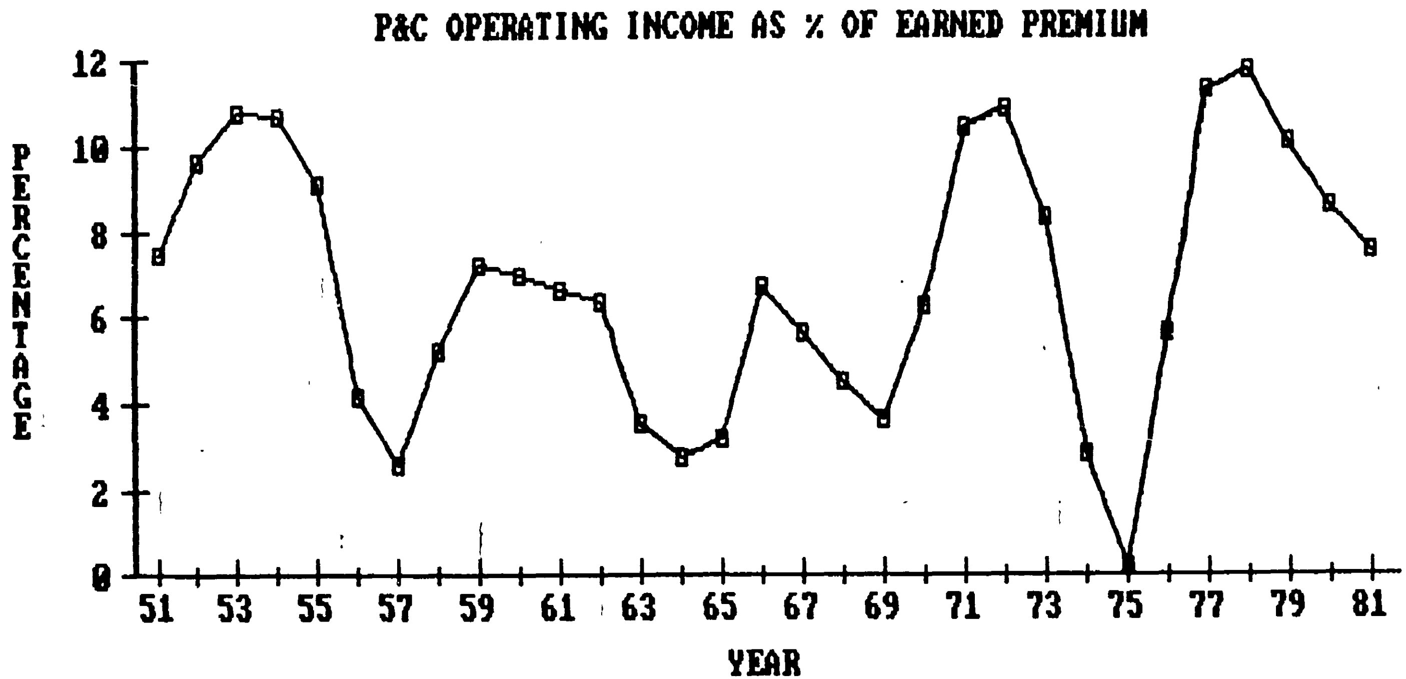
P&C OPERATING INCOME AS % OF EARNED PREMIUM
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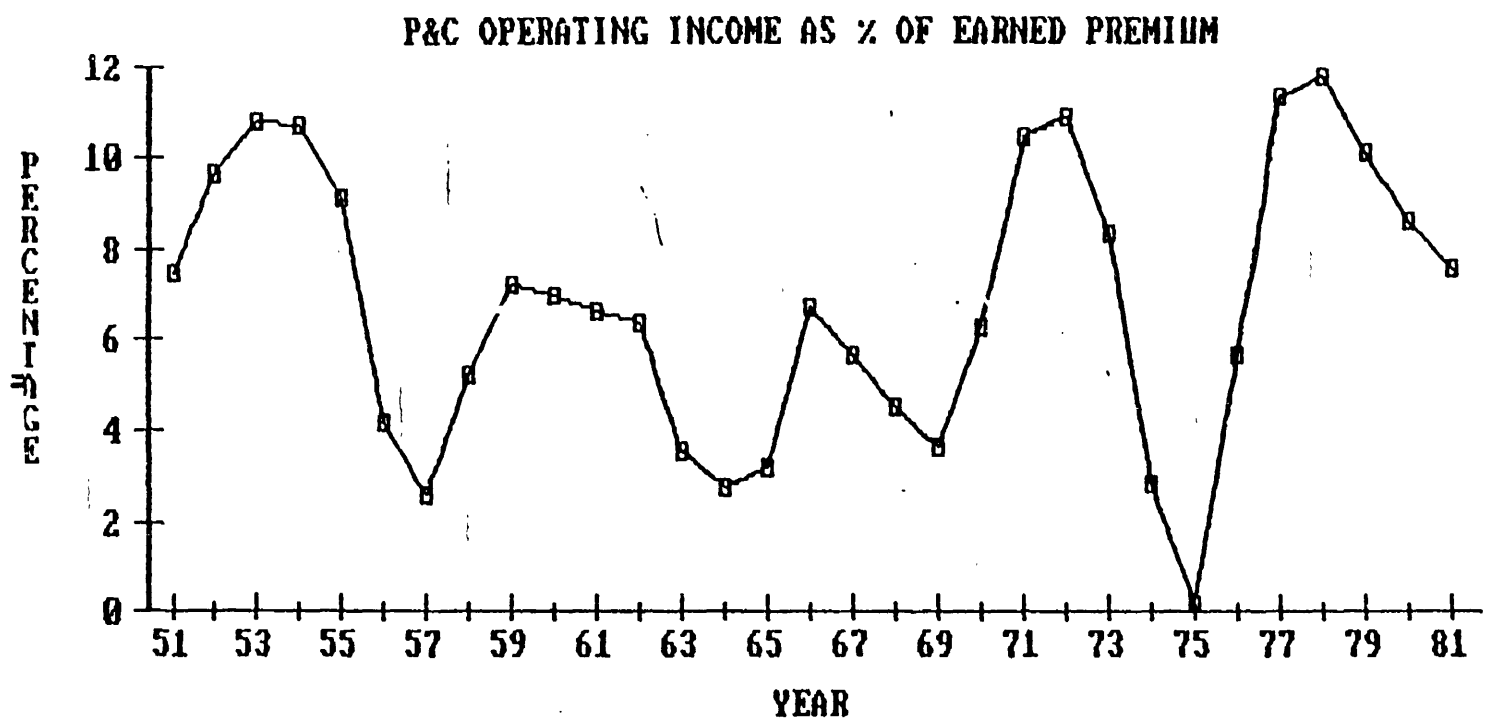
P&C OPERATING INCOME AS % OF EARNED PREMIUM
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CHART 3

TABLE 3

INVESTMENT, UNDERWRITING, AND OPERATING INCOME
PROPERTY/LIABILITY INSURANCE INDUSTRY
1951-1982

Year	Investment Income to Premiums Earned %	Adjusted Underwriting Gain or Loss %	Operating Income to Premiums Earned %
1951	4.40	+3.07	7.47
1952	4.27	+5.45	9.72
1953	4.25	+6.59	10.84
1954	4.52	+6.19	10.71
1955	4.69	+4.43	9.12
1956	4.85	- .69	4.16
1957	4.83	-2.25	2.58
1958	4.82	+ .39	5.21
1959	4.91	-2.28	7.19
1960	5.10	+1.87	6.97
1961	5.18	+1.45	6.63
1962	5.35	+ .98	6.33
1963	5.51	-1.99	3.52
1964	5.70	-2.95	2.75
1965	5.77	-2.57	3.20
1966	5.65	+1.04	6.69
1967	5.72	- .11	5.61
1968	5.99	-1.44	4.55
1969	6.08	-2.44	3.64
1970	6.34	- .11	6.23
1971	6.82	+3.66	10.48
1972	7.09	+3.84	10.93
1973	7.57	+ .80	8.37
1974	8.25	-5.43	2.82
1975	8.16	-7.92	.24
1976	8.04	-2.39	5.65
1977	8.45	+2.86	11.31
1978	9.26	+2.56	11.82
1979	10.68	- .60	10.08
1980	11.80	-3.13	8.67
1981	13.59	-6.01	7.58
1982E	14.69	-9.61	5.08

Source: Best's Insurance Management Reports. January 4, 1982, and A. M. Best Company for 1981 actual and 1982 estimate.

Notes: Adjusted underwriting gain or loss equals 100 less the combined ratio after dividends to policyholders.

Operating income equals underwriting gain or loss plus investment income.

The values for 1982 are estimates.

Irving H. Plotkin 3/31/83

Arthur D. Little, Inc.

TABLE 4

RETURNS AFTER TAX ON NET WORTH
1966-1980

Year	Non-Insurance Industry 50th Percentile	Insurance Industry Rate of Return[1]
1980	16.3%	13.8%
1979	17.3	16.4
1978	15.9	18.0
1977	15.0	18.5
1976	14.4	10.3
1975	12.0	3.6
1974	13.8	5.7
1973	12.9	11.5
1972	11.3	12.9
1971	10.4	13.1
1970	10.7	8.9
1969	12.4	7.9
1968	14.0	6.5
1967	14.0	6.7
1966	15.1	8.8
15 YEAR AVERAGE	13.7%	10.8%

[1]Excludes unrealized capital gains and losses.

Source: Comparative Profits: Joint Industry Task Force on Profitability, February, 1982.

The first one, closest to you, shows the underwriting gain or loss as a percentage of the earned premium over the last 30 years from 1951 to 1981. The dark green section of the lines above the zeroes shows underwriting gain. The light green portion of the line below the base line shows the underwriting losses.

The chart shows that the operating income, measured as a percentage of earned premiums, has varied greatly. It has been extremely volatile over the last 30 years, and this variation has been particularly pronounced in the last 12 years.

The major point we would like to make is that the industry is highly competitive. It is characterized by a large number of companies and ease of entry. The business is easily portable and subject to competition from overseas insurers. It is regulated by the states, and we have very strict regulation of operations and investments.

Casualty losses can be very dramatic. They are affectively economic cycles, storm cycles, so that our underwriting results vary greatly. The amount of claims payments and the time of occurrence is unknown to us when we write the policy. The industry has produced, as I have pointed out, this very volatile earning record and performance record over time, which makes it difficult for us to look ahead, and causes us to be cautious in our estimates of necessary reserves.

I would like to give the rest of my time to Mr. Thornbury.

The CHAIRMAN. You have all the time you need. We are not going to try to limit you.

STATEMENT OF THOMAS G. THORNBURY, CHAIRMAN, COMMITTEE ON TAXATION, AMERICAN INSURANCE ASSOCIATION

Mr. THORNBURY. My name is Thomas G. Thornbury. I am chairman of the taxation committee of the American Insurance Association.

My particular assignment is to deal with issue No. 4, the issue of affiliations. I understand that you include in your approach to this issue both consolidation of tax returns and reinsurance transactions. I will address my remarks to both.

Current rules provide for election to consolidate tax returns of property and casualty companies with 80-percent ownership related noninsurance companies. This area of consolidation has been available since 1941. It is entirely logical to permit property casualty tax returns to be consolidated with returns of other affiliated companies.

From a tax viewpoint, they are very much alike. As Mr. Chapoton indicated, their tax formulas are very similar. They are taxed on total income. The need to have property/casualty operations in a separate corporate entity is dictated by State regulatory considerations, not by tax considerations.

The prohibition against consolidation of life insurance companies and mutual casualty insurance companies was repealed in 1976, to take effect with the 1981 tax year. Beginning with taxable year 1981 and later, life companies may elect to file on a consolidated basis with other types of corporations, including casualty insurers. The Treasury did not object to that amendment.

We believe that permitting consolidation among companies which are part of an integrated business unit is sound and equitable tax policy. All four industry associations represented on this panel support retention of the right to consolidate tax returns of property/casualty companies with tax returns of their affiliates, both life and noninsurance companies.

On the reinsurance side, property/casualty companies reinsure insurance risks to arrange for sharing of the underwriting risks. Since the ability to undertake underwriting risks is a function of available surplus, large or severe risks must be shared if an individual company is to avoid losses of overwhelming size from a single occurrence.

The capacity of the industry to take underwriting risks is enhanced by reinsurance. The tax aspects of a reinsurance transaction, as any insurance transaction, should follow the risk assumed and the assets which are involved. As a consequence, we see nothing in the reinsurance area which warrants a change of present rules. There is no situation of which we are aware that is comparable to the modified coinsurance situation with which you dealt last year.

We believe that the Internal Revenue Service already has effective weapons to deal with any reinsurance transaction among affiliates that might have tax advantages to the contracting parties.

Section 482 of the Internal Revenue Code gives to the Government authority to reallocate income and deductions to prevent evasion or avoidance of tax or to clearly reflect income. Further, if acquisition is involved, section 269 of the Internal Revenue Code gives authority to recast the transaction. The parties must have significant nontax reasons for a transaction to withstand attack under these sections. If there are significant nontax reasons for a transaction, there is no reason why the tax law should not recognize the transaction. We feel that no remedial action is necessary in this area.

In summary, we believe that the existing provisions regarding consolidation and reinsurance are quite adequate. Thank you.

[The prepared statement of Mr. Jones and Mr. Thornbury follows:]

AMERICAN INSURANCE ASSOCIATION

1025 Connecticut Ave., N.W.
Washington, D.C. 20036
(202) 293-3010

STATEMENT ON BEHALF OF
AMERICAN INSURANCE ASSOCIATION
BEFORE A HEARING OF THE
SENATE FINANCE COMMITTEE
ON
CASUALTY INSURANCE COMPANY TAXATION
JUNE 13, 1983

PRESENTED BY
T. LAWRENCE JONES, PRESIDENT
AMERICAN INSURANCE ASSOCIATION
AND
THOMAS G. THORNBURY
CHAIRMAN, COMMITTEE ON TAXATION

SUMMARY

- While the insurance industry is often viewed by the public as a single entity, the two branches-casualty and life-cover different types of risks. In life insurance, the amount of the payment is prescribed; only the time of death is uncertain. Casualty losses, however, are uncertain in both time of occurrence and amount.

- Because of the nature of the risks insured and the high level of competition, the casualty industry has always exhibited extreme volatility. In the last 12 years the industry has experienced the two worst underwriting periods in its history, and it is not certain when the industry will emerge from its current underwriting slump. In the last 8 years, the volatility of operating income has intensified, varying from .24% of earned premiums in 1975 to 11.82% in 1978.

- Sound tax policy requires that a deduction be permitted for loss reserves. These amounts represent expenses of an insurance company. As the Tax Court noted in <u>Bituminous Casualty Co.</u>, "If premiums were taxed as received and deductions allowed only later as they became fixed, the result would be to tax very large sums of money as income when, in fact, those amounts will never really become income because they will have to be paid out to policyholders and other claimants."

- Casualty insurance reserves are not discounted under current law. Unlike ordinary life insurance where reserves are now discounted, casualty insurance risks are uncertain in both time of occurrence and amount. Predicting casualty losses involves a far greater degree of difficulty than establishing life reserves.

- Neither the National Association of Insurance Commissioners nor two professional groups which are considering the discounting of reserves, the American Academy of Actuaries and the AICPA, have recommended discounting. For the tax law to adopt discounting in advance of the NAIC would be unsound. It would, in effect, impose a tax on amounts insurers are required to hold for payment of claims.

- Under statutory accounting procedures, acquisition expenses are deducted in the year in which they are incurred in order to measure accurately the amounts available to insurers to pay claims. The industry uses primarily one year contracts.

- Stock casualty insurance companies have been permitted to file consolidated returns with all eligible corporations since 1941. Permitting all types of corporations to file consolidated returns is sound tax policy and should not be altered. Current law provides the IRS sufficient means to deal with tax motivated acquisitions (§269) or overreaching within affiliated groups (§482).

- The broad definition of insurance in <u>Helvering</u> v. <u>LeGierse</u> is adequate and workable as a general standard. This general rule permits courts to review a wide range of transactions and to develop standards appropriate to specific cases.

I am T. Lawrence Jones, President of the American Insurance Association. With me is Thomas G. Thornbury, Director of Taxes for the Hartford Insurance Group and Chairman of the American Insurance Association's Committee on Taxation. I want to thank you for the opportunity to appear before you today.

The American Insurance Association is a trade association representing 164 casualty insurance companies predominantly organized as stock companies. Our member companies had a total premium volume in 1981 of $28.8 billion, or 29% of the $98.3 billion of the direct premiums written. AIA member companies' assets in 1981 totaled $81.4 billion or 40% of the industry's $212.3 billion assets in 1981. Our member companies write all types of personal and commercial coverage.

This hearing is one of a series examining the taxation of financial institutions. The review began with the "Stopgap" amendments to the Life Company Tax Act in TEFRA, and continued with a hearing in March on the taxation of banks and other depository institutions. Today's hearing does not proceed from any clearly identified need to amend the statute, like the modified coinsurance transactions which led to "Stopgap" last year. On the contrary, the hearing and the request for a study by the General Accounting Office were prompted by general questions raised about the casualty companies' tax structure in the course of the TEFRA amendments.

AN INDUSTRY PROFILE

While the insurance industry is often viewed by the public as a single entity, the two branches---casualty and life---cover different types of risks and by law and custom are organized into separate corporations. If the two industries appear similar to the casual observer, it is clear from even a cursory review of the types of risks covered and the volatile underwriting record of casualty companies that assumptions about the life insurance industry can not be applied to the casualty insurance industry without examination. We believe that a better understanding of the industry's operations will help to explain differences between the taxation of insurance companies and all other industries, as well as differences in the taxation of casualty and life insurance companies.

Casualty insurance companies provide protection against the risk of financial loss to businesses and individuals. One widely accepted classification divides casualty coverages into loss or damage to property (fire, automobile physical damage and homeowners' multi-peril), liability to third parties (auto liability, products liability and medical malpractice), loss of earning power and compensation for future expenses (business interruption and automobile no-fault), suretyship (fidelity and construction bonds), and health insurance. Of all these lines, only health insurance may be written by life insurance companies.

The life insurance product and the casualty insurance product involve materially different risks. In ordinary life insurance, the amount of the payment is prescribed by the face value of the policy: only the time of death is uncertain. In contrast, the losses covered by casualty insurance are uncertain in both time of occurrence and amount. Casualty losses can be both dramatic and extensive, as in the devastation resulting from a Gulf Coast hurricane or the sinking of an offshore oil rig. The nature of the policy is different, too, in that casualty insurance generally is short-term and does not involve an investment element while life insurance policies typically are long-term and may involve an investment element.

Historically, the industry has been regulated by the states. When the Supreme Court's decision in United States v. Southeastern Underwriters Association, 322 U.S. 533 (1944) extended Congress's authority under the Commerce Clause to insurance, Congress declared in the McCarran Ferguson Act, 15 U.S.C. 1011 et seq that "the continued regulation and taxation by several states of the business of insurance is in the public interest." State insurance laws govern the management, investment, sales and claims practices of the companies in the interest of ensuring equitable procedures and financial stability. They also establish rates for certain lines, notably automobile and homeowners in personal lines and workers' compensation and medical malpractice in commercial lines. State departments, working through the National Association of Insurance Commissioners (NAIC), an organization that includes the Commissioner in ever state, have obtained a high degree of uniformity in their laws and regulations. The NAIC has traditionally provided a forum in which the states can discuss and examine new matters and co-ordinate changes in laws which may be needed.

Studies of competition in the insurance industry by the U.S. Department of Justice, state insurance regulators in New York, and Virginia, and the National Association of Insurance Commissioners have shown that there is a high degree of competition within the industry.* A 1977 study of the industry by the Antitrust Division of the Justice Department concluded

> ... The property-liability insurance business in most lines is favorably structured for price competition, with a large number of firms selling essentially identical services.

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* Monitoring Competition: A Means of Regulating the Property and Liability Insurance Business, NAIC, May, 1974.

The Public Interest Now in Property and Liability Insurance Regulation, State of New York Insurance Department, January, 1969.

Competition in Property and Liability Insurance in New York State, State of New York Insurance Department, 1973.

Cartels vs. Competition: A Critique of Insurance Price Regulation, State of New York Insurance Department, 1975.

The Open Rating Law and Property Liability Insurance, State of New York Insurance Department, 1977.

The Pricing and Marketing of Insurance, Task Force on Antitrust Immunities, U.S. Department of Justice, Jan., 1977.

Competition in the Property and Casualty Industry: An Evaluation of Alternative Methods of Rate Regulation, Virginia Bureau of Insurance, Jan., 1978.

Jaskow, "Cartels, Competition and Regulation in the Property-Liability Insurance Industry," Bell Journal of Economics and Management Science, Autumn, 1973.

SEC Institutional Investor Study Report, 1971, v.2 at 786.

> moderate levels of concentration relative to other industries, ease of entry, the absence of significant economies of scale, and a relatively simple and short-term contract.
>
> The Pricing and Marketing of Insurance, Task Force on Antitrust Immunities, U.S. Department of Justice, January, 1977, at 4.

This highly competitive environment includes not only domestic companies but foreign insurers, many of whom have a pricing advantage because they operate under less burdensome taxes and regulation.

In recent years the industry has been adversely affected by the slowing demand in automobile and home sales, as well as the decline in capital spending and employment in the economy. Self-insurance plans and captives have made significant inroads into commercial business. Premium growth--the industry's measure of sales--has slowed from 12.8% in 1978 to 5.1% (Table 1).* Adjusted for inflation, the annual growth rate has deteriorated from 5.1% in 1978 to 3.2% in 1982.

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* Information about the industry's operations is provided in greater detail in the Statistical Profile of the Casualty Insurance Industry, prepared by the American Insurance Association's Department of Policy Development and Research.

TABLE 1
SIZE OF CASUALTY INDUSTRY
1977 - 1982
(in 000)

Year	Written Premiums[1]	Annual Growth Rate	Real Written Premiums[2]	Annual Growth Rate
1982[P]	$104,320,000	5.1%	$49,022,556	- 3.2%
1981	99,275,575	3.9	50,624,974	- 6.4
1980	95,579,549	6.0	54,085,313	- 2.9
1979	90,122,619	10.3	55,700,011	4.9
1978	81,689,931	12.8	53,114,389	5.1
1977	72,396,929	--	50,521,234	--
1977-1982	$543,373,803	7.5%	$313,068,477	- .6%

[1]Totals may differ from those shown or used in other tables in this profile because of differences in number of companies represented.

[2]In constant 1972 dollars. Deflated by the Implicit Price Deflator for GNP by Major Type of Products, Services Component.

[P]Preliminary.

Source: Best's Aggregates and Averages, 1982.

The 1970's saw the beginnings of substantial changes in a number of casualty lines. Changes in the tort law, mandated benefit modifications, and the movement to a more litigious society have created unanticipated liabilities. Casualty insurers writing products liability or medical malpractice, to name only two examples, have experienced rapid escalation in the severity as well as the frequency of their losses. During the ten year period 1972 to 1981 the "other liability" line of business (which included products liability and medical malpractice) lost almost nine cents for every dollar of earned premium, and was instrumental in causing the casualty industry to lose one cent on every dollar of earned premium over the same period (Table 2).

Because of the nature of risks insured, the industry has always exhibited extreme volatility, as is attested by the underwriting experience of the last thirty years (Chart 1). During that time underwriting income as a percentage of earned premiums had ranged from 7.8% in 1954 to -7.6% in 1975. Just in the last twelve years the industry has experienced the two worst underwriting periods in its history, and it is not certain when the industry will emerge from its current underwriting slump.

Casualty insurers have traditionally invested in publicly held securities in order to have sufficient flexibility to meet changing investment objectives. Marketable securities, which accounted for 95% of their portfolios in 1981, permit insurers to liquidate investments quickly when faced by sudden cash demands from catastrophic losses. During profitable periods of the underwriting cycle, insurers have invested in government

TABLE 2

UNDERWRITING RESULTS

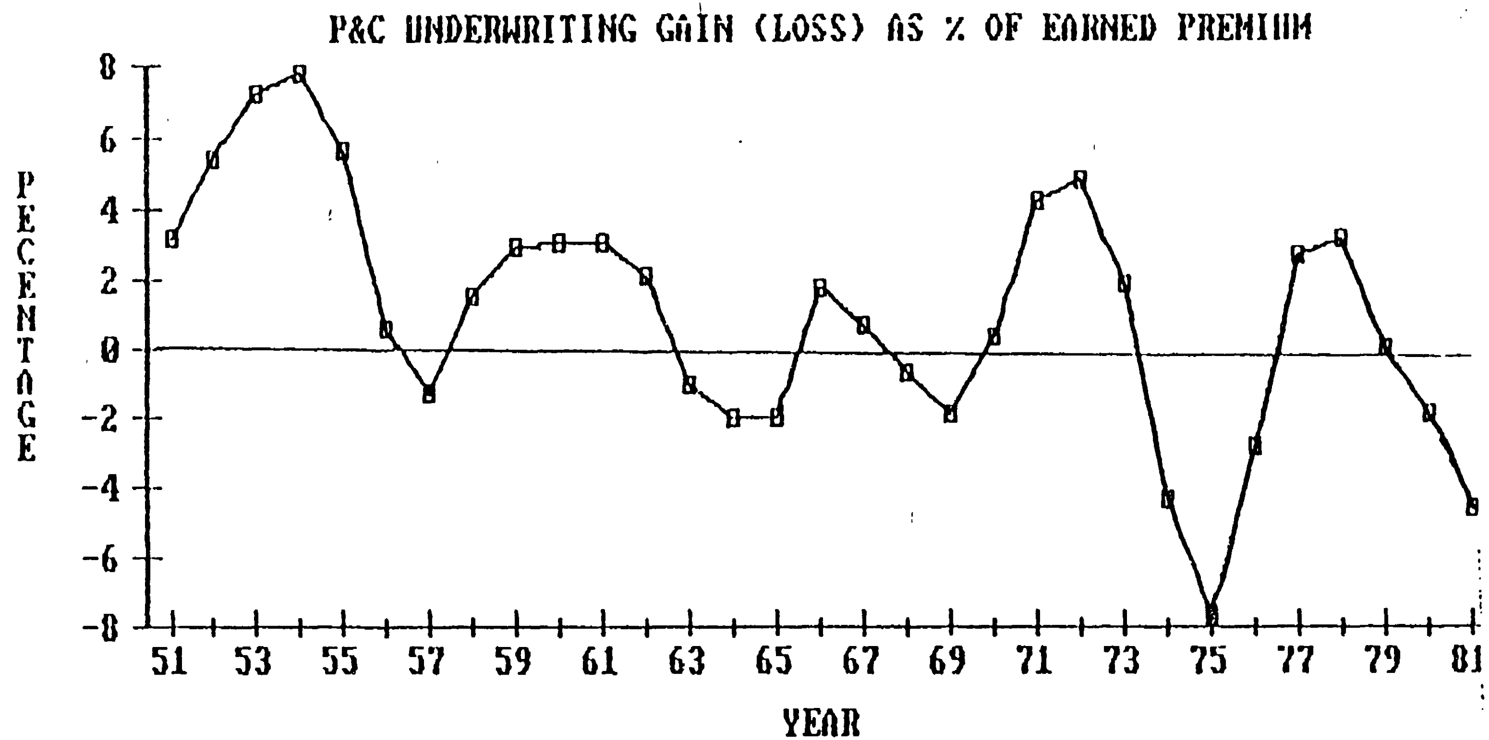
MAJOR INSURANCE LINES

1981 and 1972-1981

Lines	Percent of Premium Earned 1981	1972 to 1981
Workers' Compensation	5.6%	1.5%
Fire and Allied	3.6	7.7
Auto Physical Damage[1]	.8	1.4
Homeowners/Farmowners Multiple Peril	- 3.0	- 1.4
Commercial Multiple Peril	- 6.9	3.9
Auto Liability[1]	-11.0	- 3.7
Other Liability (incluces medical malpractice)	-18.7	- 8.9
All Insurance Lines	- 4.7%	- 1.0%

[1]Between 1973 and 1981 the underwriting profit and loss rate for private passenger auto liability was -3.3%: for commercial auto liability, -7.0%: for private passenger auto physical damage, .3%: and for commercial auto physical damage, 3.4%.

Source: Best's Aggregates and Averages, 1973 to 1982.



P&C UNDERWRITING GAIN (LOSS) AS % OF EARNED PREMIUM
PECENTAGE
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-8
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YEAR

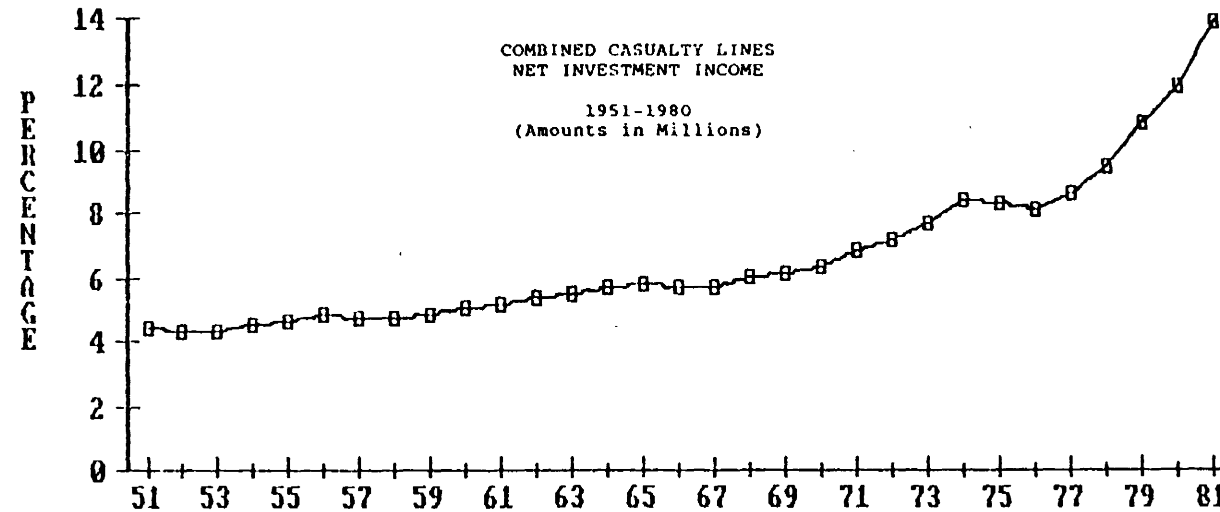
CHART 1

securities, which accounted for 45% of their investments in 1981. With the widespread underwriting losses of the past two years, however, insurers have sought corporate securities with a higher yield.

Although investment income has shown a steady increase (Chart 2), it has only served to dampen, not eliminate, the effect of large underwriting losses. Over the last eight years the volatility of operating income has intensified, in a notable break from the experience of the previous twenty-four years (Chart 3 & Table 3). Operating income has varied from .24% of earned premiums in 1975 to 11.82% of earned premiums in 1978. Moreover, the prevailing high interest rates between 1979 and 1982 were not sufficient to prevent a sharp decline in operating income. With the recent decline in interest rates there is concern that investment income will not provide sufficient coverage for companies' growing underwriting losses and that serious operating losses may occur. Under these conditions, it is not surprising that casualty insurance industry's rate of return between 1966 and 1980 was below the average return for all other industries (Table 4).

CHART 2

P&C NET INVESTMENT INCOME AS % OF EARNED PREMIUM



		Net Investment Income	% of Earned Premium
Total:	1951-1960	$ 4,998.2	4.7
	1961-1970	12,302.1	5.8
	1971-1980	53,622.8	9.1
TOTAL		70,923.1	7.8
1981		13,248.0	13.6

Source: Best's Review, January, 1982; Net Investment Income (excluding any realized and unrealized Capital Gains or Losses), before federal income taxes.

STATEMENT OF RALPH MILO, CHAIRMAN, FEDERAL TAX COMMITTEE, NATIONAL ASSOCIATION OF INDEPENDENT INSURERS, ACCOMPANIED BY HAROLD C. MC CARTHY, PRESIDENT, MERIDIAN MUTUAL INSURANCE CO.

Mr. MILO. Good morning, Mr. Chairman.

I am Ralph Milo, chairman of the Federal tax committee of the National Association of Independent Insurers. In my testimony, I will focus on the question you raised concerning whether certain reserves should be discounted.

The question of discounting loss reserves involves a very basic tax issue. The critical question is, would it be proper to include in current income and subject to tax now an estimate of investment income that may or may not be earned in the future?

In analyzing this issue, it is necessary to bear in mind the role of the property and casualty insurer and the nature of its reserves. An illustration might be helpful. Let us assume that on January 1, the company collects premiums of $1 million from all its policyholders. At the end of the year, the premium has been fully earned, and accordingly is included in income.

However, let us also assume that on December 21, a policyholder factory burned down, resulting in an insured economic loss of $1 million. At yearend, the loss has not been paid, but it is owed to the policyholder. This is clearly different from a loss reclamation expense, where the economic loss has not occurred, while insurance involves an economic loss that has occurred to the system, and only then is a loss reserve provided.

The $1 million of assets in my example held by the insurer represents a pool of funds which will be paid to the policyholders and claimants. As such, the insurer has no rights to these assets, and cannot use any portion of them to pay expenses, taxes, or pay dividends to stockholders.

The law requires that the portion of assets held by the insurer which will be paid to the policyholders and claimants be designated for that purpose. The assets held for that purpose are measured by the reserve and the company has an immediate right to and dominion over only the excess of those assets over the reserve.

From this excess, expenses, dividends, and taxes are paid. Some investment income may or may not be earned in the future on those assets belonging to policyholders. As it is earned, it will be included in income. The net effect of discounting is to somehow approximate the present value of the investment income that may be realized in the future from these assets.

Assuming this value is approximated to be $100,000, the $1 million reserve is reduced by that amount. At the end of the year, the insurer would include in income the $1 million of premium offset now by a discounted reserve of $900,000, resulting in current taxable income of $100,000. But what did this mathematical exercise accomplish?

The company, after discounting, has no more rights to the $1 million of policyholder and claimant assets than it had without discounting. It can guess on what it may earn in the future from these assets, but now it has nothing, and that is discounting, an elaborate facade to tax now what is not there but may be there in the future.

This $100,000 of income represents solely an expectancy that investment income will be earned in the future, and only in the future may $100,000 of assets be available. If the $100,000 is taxed currently, the assets necessary to fund the tax liability must come from the insurer's capital and surplus, and may eventually render it insolvent unless writings are suspended.

This acceleration of tax on income which might be earned in the future will have three serious consequences: Immediately reduce and eventually eliminate the ability of small and medium-sized companies to write business because of surplus constraints; increase the flow of premium dollars for United States risks to overseas insurers that are taxed under different tax principles; result in endless controversies between insurers and the IRS as to the appropriate portfolio rate, reinvestment rate, loss payment patterns, and a host of other hypothetical and speculative assumptions which will be ultimately resolved in court.

Present rules, both tax and nontax, are based on the legal requirement that the money owed to policyholders and claimants must continue to be held, that is, reserved for their account, until it is clearly no longer needed, and it becomes income to the company only when assets released from these reserves are made available to the company. Any erosion of this principle will seriously undermine financial integrity of insurers and jeopardize the resources not only of the companies but millions of policyholders and claimants.

Thank you.

Mr. McCarthy. Mr. Chairman, I am Harold McCarthy, speaking on behalf of the National Association of Independent Insurers, and these other trade associations which, as we have said, represent 90 percent of the property and casualty premiums written.

I call to your attention facts which we believe your committee should take into account in making any decisions about the taxation of our industry.

On the level of public policy, which all of us know is both impacted and implemented by the tax laws, we believe the committee should be aware of these vital facts. First, our industry is fiercely competitive. Therefore, any increased taxes will be translated almost immediately into higher premiums for our policyholders. This will mean that many individuals and businesses now receiving insurance protection will no longer be able to afford that protection.

Second, our policyholders consist of individuals, farmers, and businesses, large and small. These policyholders are entitled to know that we are financially sound. A key element in assuring financial soundness is the century-old system of statutory accounting employed in our industry. The current tax laws properly take this system into account. We urge this committee not to undermine this system, since to do so would pose a substantial threat to the solvency of our industry.

Third, property and casualty insurance coverages can readily be written by either domestic or overseas insurers. It is essential that the tax laws not operate so as to put the domestic insurance industry at a competitive disadvantage vis-a-vis overseas insurers. The current tax laws allow domestic insurers to compete with overseas insurers.

Finally, we are not financial institutions, as many have characterized us. Policyholders do not use us as depositories for purposes of accumulating savings as they do with banks, other financial institutions, and life insurance companies. Our function is solely to insure against losses. Current tax laws properly recognize that vital distinctions exist between us and financial institutions.

In summary, we believe the present tax laws operate in a fair and sensible manner to promote sound public policy goals with respect to our industry and the policyholders we serve.

[The prepared statement of Mr. Milo and Mr. McCarthy follows:]

STATEMENT OF
THE NATIONAL ASSOCIATION OF INDEPENDENT INSURERS

Description of NAII

The National Association of Independent Insurers (NAII) is a voluntary, non-profit trade association of property and casualty companies and an approved statistical-advisory organization. It was founded in 1945, following the enactment of the McCarran-Ferguson Act, which confirmed the propriety of state regulation of insurance.

NAII's founders sought enactment of state legislation permitting independence in pricing and policy forms, in the belief that vigorous competition would provide the insurance-buying public with the broadest protection at the lowest price. The soundness of that purpose is demonstrated by the fact that the Association has grown from the 21 charter members with a premium volume of $90 million to a membership of more than 500 companies with a premium volume of $26.5 billion in 1982. NAII represents companies of all types of corporate structure, ranging in size from one-state writers to large multi-state companies. This large and diverse membership provides a strong voice representing the broadest range of views on major issues.

Inflation and the Insurance Business

Over the last decade, rampant inflation has radically changed the property and casualty insurance business. A number of statistical changes in which the Committee has expressed interest -- such as changes in so-called "effective tax rates" -- are directly attributable to operating changes brought about by inflation. Inflation has also created a number of distortions in life insurance operations, as you are already aware, but casualty insurance is substantially different from life insurance, and the inflation-induced changes are substantially different.

In property and casualty insurance, policyholders in effect contribute premiums to a pool to pay for economic losses sustained by individual policyholders and for the costs of administering the pool. The premiums are invested during the period between their receipt and their payout, and the income from those investments is also applied to the payment of losses, if needed. The premiums and investment income not needed for the payment of losses and expenses are released to the insuring entity as its profit, but only when it is clear that they will not be needed. Generally, most of the premiums (in recent years, all of the premiums) are used to pay losses and expenses, so that all but a small fraction of the total cash flows are flows for the account of policyholders rather than for the account of the insuring entity itself. The insuring entity thus operates under concepts very much like those applicable to a trustee.

Under these circumstances, the amount of premiums required to be collected is directly affected by the amount of the investment income which will be earned on the premiums before they are required to be paid out. If there is low investment income, premiums must be higher; if there is high investment income, competition will force premiums lower.

Ten years ago, before inflation exploded, premiums were sufficient in most casualty companies to cover all of the losses and all of the cost of administering the losses. In technical terms, the percentage which losses and expenses are of premiums is known as the "combined ratio." A combined ratio of 100% means that premiums are sufficient to cover losses and expenses exactly. A combined ratio of less than 100% means that the amount of premiums is somewhat greater than the amount of losses and loss expenses, which means, in turn, that a part of the premiums themselves and all of the investment income on the premiums are left to compensate the insurance company for other costs, including the cost of supplying additional capital.

There is nothing magical, of course, about whether premiums alone cover all, not quite all, or more than all of the losses and expenses. Managements set premiums (unless constrained by state regulatory agencies) at a level such that the premiums, when added to earnings on the premiums, will cover losses and expenses and provide a reasonable return on investment. Vigorous competition among thousands of underwriting entities ensures that premium prices will be kept at a level sufficient to pay expenses and provide a reasonable return, but no more.

There may be no other industry in which the results of an intensely competitive marketplace have been so visible. NAII owes its creation and much of its subsequent success to its crusade in the 1940s and '50s to change regulatory practices so that individual companies could price their premiums competitively, based on their own costs. Our largest members today owe their market positions to the existence of a highly competitive marketplace in which they won market share by cutting costs, and then charging the most attractive (i.e., lowest possible) premiums. And many of our smaller members owe their ability to break into the business and become successful to that same thing -- the ability to price compete.

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Virulent inflation has had two major effects on this competitive process and on pricing, in particular.

The first effect has been with respect to losses, which have steadily grown larger and less predictable with inflation. Losses have inflated significantly faster than prices generally, which has tended to make premiums chronically insufficient.

The second effect of inflation has been that earnings from invested premiums have become a radically larger portion of income. Double digit inflation brought double digit interest rates. That may at first blush seem an advantage to the industry, but it was not. The radical increase in interest rates caused a massive decrease in the value of asset portfolios invested earlier at lower interest rates. If the entire industry were required tomorrow to pay all of the casualty losses for which it is now liable, an alarmingly large number of companies would have sustained such large losses in investment portfolio values that they would be unable to do so.

What happened as investment yields escalated was that price competition on premiums grew much fiercer. Companies could write new business at lower premiums if they could invest the new premium dollar at 15% rather than at 5%. And they did. In the highly competitive marketplace the percentage of losses and expenses covered by the premium itself was driven downward. Combined ratios rose dramatically -- from an industry average of 96.2% in 1972 to an estimated 109.6% in 1982. It is hard to imagine a more dramatic illustration of the competitive marketplace at work. Increases in investment yields were passed through swiftly to policyholders in the form of lesser premiums, even in the face of a weakened financial structure caused by declines in asset values created by the same inflation which created the higher yields.

This history is written plainly in the numbers. It illustrates a principle which is important for the Committee to understand as it approaches a review of the taxation of the insurance function. The principle is this: any increased costs imposed by general changes in taxes will, like any other general cost changes, be translated almost immediately into higher premium prices. If there are tax changes that impose costs retroactively, there may be a one-time loss to the entity administering the insurance, and ill-considered changes could cause that one-time loss to be large and devastating. But, prospectively, increased tax costs will be passed through to premiums as swiftly and as surely as changes in investment yields have been passed through in this inflationary period. Thus, changes in the nominal tax burden of insurance companies will be changes in the real tax burdens of individual policyholders.

Effective Tax Rates

As the Treasury Department has repeatedly reminded the Congress, computations of so-called "effective tax rates" often rest on faulty arithmetic and, even when correct, are largely useless in determining questions of what is "equitable" and who bears the actual economic burden of taxes. Recently, some persons have used such numbers to suggest that the system for taxing casualty companies is flawed. It is true that the dollar amount of taxes remitted by casualty insuring entities has fallen in recent years. This, too, is almost entirely the result of the way that inflation has changed the nature of the business.

The decline in tax payments is entirely attributable to the fact that, while casualty companies have always kept a large part of their investments in state and municipal bonds, inflation has caused an increasingly larger percentage of their incomes to come from that source. That fact has not resulted in a revenue loss to the Treasury. On the contrary, in the system as a whole it has, if anything, produced a revenue increase, a more equitable distribution of the total tax burden and lower financing costs for state and municipal governments.

A significant part of the insurance management function is the investment of premiums during the period between their receipt and their disbursement. For decades, a large part of those investments has been state and municipal bonds, the yield on which is tax-exempt. The proportion of exempt bonds in the total portfolio is higher for casualty companies than for many other taxable investors because the practicalities of insurance regulation require casualty companies to keep a major portion of their portfolios in bonds, as distinguished from other investments offering a higher but less certain yield potential. Although no firm figures are available as to the total amount of exempt securities outstanding or who holds them, it is generally believed that property and casualty insurance companies constitute the second largest non-individual market for state and municipal obligations.

The taxable income of casualty insurance companies consists basically of two components: "underwriting income" and "investment income." Underwriting income is the excess of premiums over losses and expenses. Investment income is self-explanatory. As a large segment of total investment income has traditionally consisted of exempt income from state and municipal bonds, only a fraction of the investment income component has been taxable. In earlier years, however, when premiums alone were more than sufficient to cover losses and expenses, there was a significant amount of underwriting income, all of which was taxable. As inflation has driven premiums down and investment yields up, underwriting income has been eliminated in most companies while investment income has grown. But, since underwriting income was taxable while investment income was in significant degree exempt, the total tax bill has dropped.

It is important to emphasize that a reduction in taxes remitted by a company does not make the company wealthier or more profitable when, as here, the reduction is passed through to policyholders in the form of lesser premium and there is, in addition, a massive loss in portfolio values.*

The drop in tax liabilities of insuring entities brought about in this way by inflation would, at first blush, suggest an accompanying drop in revenue to the Treasury. But there has in fact been no such drop in total revenues. On the contrary, the extensive

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*In the case of many bond holdings, the rise in interest rates caused total investment return on the holding actually to be negative, i.e., the resulting drop in portfolio value was greater than the gross coupon income.

holdings of exempt securities by casualty insurers has probably produced a net revenue gain to the U.S. Treasury as well as a cost savings to state and local treasuries.

What has happened is that the lesser tax payments of casualty insurers has been offset by greater tax payments by others, while the drop in tax payments of casualty insurers has been passed through to policyholders in the form of lower premiums. If casualty insurance companies had been forbidden to invest in state and munic- ipal securities, their after-tax investment income would be less and the competitive marketplace would have caused premiums to be priced higher.

The revenue loss to the Treasury from tax-exempt securities is a loss from the very <u>existence</u> of those securities, not from the manner in which they are held.* <u>Whoever</u> holds them, they will produce a stream of income which is exempt from tax, which will substitute for some other stream of income that would be taxable and which will, as a result, produce a revenue loss to the Treasury. The fact that they are held by casualty insurance companies rather than by wealthy individuals actually produces a revenue gain (or more correctly, a smaller revenue loss) because casualty insurance companies are taxed at a maximum marginal rate of 46% while top

*Most of that revenue loss redounds to the benefit of states and municipalities in the form of lower borrowing costs, but a part of it is siphoned off to investors who are in high marginal tax brackets. For example, if a municipal bond yields 7% while a taxable bond yields 10%, the municipality has a 3% saving in borrowing costs, but a 50% taxpayer would also end up with a 2% greater after-tax yield, i.e., the difference between 7% and 5%, after tax.

bracket individuals are taxed at 50%. Moreover, from an equity point of view, it is better to have them held by casualty companies as the benefits of the exemption that accrue to holders (as distinguished from those that accrue to state and local issuers) will flow through to ordinary policyholders in the form of lower premiums, which is obviously preferable to concentrating all those benefits on high bracket individuals.

In the case of any exempt security, a part of the investors' yield comes in the form of cash interest payments and a part comes in the form of tax benefits, i.e., exemption. As a result, the cash yield on state and municipal securities is less than the cash yield on comparable taxable securities. That results in lower borrowing for state and municipal governments. But the fact that a part of the real return consists of tax exemption (so that the cash component of the yield is less) means that state and municipal obligations are not purchased by taxpayers who cannot use the exemption benefit. Taxpayers who cannot use the exemption benefit because they are already exempt or because in their hands it is not available will simply buy fully taxable obligations which pay a higher taxable cash yield. Tax-exempt institutions, such as colleges and pension funds, for example, do not buy exempt securities because they must take a part of the return in the form of exemption and exemption is of no use to them.

So, too, if state and municipal bonds were taxable in the hands of casualty companies, casualty companies would simply not own them, as higher paying taxable bonds would be a better investment.

That is already the case with life insurance companies, which are, in effect, partially taxable on tax-exempt bonds and therefore generally do not buy them.

If the government had over the last ten years discouraged the holding of state and local securities by casualty companies in order to make casualty companies send in more dollars of tax, other taxpayers would have sent in less tax. The market for the sale of such securities would have contracted and state and local governments would have had to pay higher interest rates to sell their bonds. That would not only have increased the cost of state and local financing but would have increased the tax benefits for high bracket taxpayers holding the bonds. Meanwhile, the Treasury's revenue loss on the bonds actually outstanding would increase because a higher yielding stream of income would be exempt in the hands of other taxpayers. Only if the higher borrowing costs had caused state and municipal governments to issue fewer bonds would there have been any offset to that larger revenue loss.

Thus, as in many other cases, first blush impressions are misleading. When the entire process is analyzed and all of the moving parts are identified, it becomes apparent that, given the fact that we have tax exemption for state and local bonds, the drop in the taxes of casualty companies reflects an optimum (i.e., from the Treasury's point of view, the "least bad") operation of the exemption privilege utilized by state and local government issuers.

In summary, the so-called "effective tax rates" of casualty companies have declined because casualty companies have always held a substantial part of their investments in tax-exempts and because inflation has caused an increasing percentage of the companies' income to come from that source. The Treasury is no worse off, because the bonds would be held by someone, and is better off than if they had been held by individuals in higher brackets. And a larger share of the benefit of tax exemption is flowing through to ordinary policyholders and a lesser share to high bracket individuals.

If Congress is genuinely concerned about reducing the revenue loss from state and local obligations, its only real option is to restrict the amount of such obligations that are issued, instead of permitting them to expand. Tax rules which only cause the ownership of such obligations to be shifted may make it harder for the man in the street to tell which shell the pea is under, but will, in reality, only make matters worse for everyone except high bracket taxpayers.

The Nature of Insurance and of Property and Casualty Insurance in Particular

In order to understand insurance taxation one must understand the special nature of insurance underwriting.

Insurance is an institution to permit the pooling of funds by policyholders in order to share risk. Over the years a variety of entity arrangements -- partnerships, stock corporations, mutual companies, reciprocals, pools, etc. -- have emerged to receive, hold and administer the pool funds. But the essential nature of the function has remained the same in each case.

Casualty insurance is fundamentally different from life insurance. In casualty insurance the risk shared by pooling relates to economic loss currently sustained.

Life insurance is likewise a pooling device for risk sharing. But the risk relates primarily to a saving purpose, rather than to loss compensation. The holder of a life policy desires to save some specified amount for some future event. The most common event is death, but it may also be such events as retirement or attaining college age. The risk to be shared is that the policyholder will not live long enough (mortality) or stay well enough (morbidity) to put away the desired amount.

While the purposes -- loss compensation and saving -- are different, the essential concept in both cases is that the pool is held and nurtured as an asset belonging to the policyholders who have paid into it. Assets are released from the policyholder pool and become "income" to the administering entity, i.e., the "company," only when it is clear that they are no longer needed to satisfy the policyholder's claims. The mechanism for determining when assets are no longer needed is "reserving," which is carried out under explicit, well-developed rules, regulated and closely scrutinized by state regulatory agencies. Premiums paid go into the pool in the first instance and earnings on those premiums go into the pool to the extent they are determined to be needed under the reserving mechanism.

Further, companies are required by state regulators to maintain prescribed levels of "capital and surplus" as a cushion against inadequacies that may develop in the pool. If the reserving mechanism determines at any time that the pool is deficient, the "company" is required to transfer additional amounts from its own "capital" and "surplus," i.e., from amounts originally paid in by its owners ("capital") and from amounts previously determined [illegible] not needed and thus released from the pool ("surplus").

Tax rules follow these general concepts. To the extent premiums and income from investing premiums are needed for policyholder purposes, they must be set aside in the pool for those purposes. To that extent they have not yet inured to the company's benefit, the company is not yet better off, and, accordingly, it has no taxable income. When it is clear that they are no longer needed and they are released to the company, they become taxable income to it, but not before.

Specifically, premiums that relate to future periods ("unearned premiums") are still needed and are not subject to tax until "earned." Premiums that relate to the current or prior periods (i.e., "earned premiums") are still needed to the extent required to take care of losses that have already occurred and, to that extent, are not included in income. That is a proper result for two reasons: because there is no reason to tax amounts which the policyholders have set aside to pay out on their own behalf, and because real economic losses have already occurred. In practice, all or all but a small fraction of earned premiums are used to pay losses that have already occurred at the time the premiums are earned, and are, accordingly, never released to the company's own account. However, to the extent [illegible] premiums earned at the end of any accounting period exceed the losses that have actually occurred, the excess is taxable.

Investment income involves somewhat different considerations because, unlike premiums, it is not simply a transfer from the policyholder to be used for particular purposes, but is an amount of newly earned income. Investment income is accordingly taxed currently, as earned. However, to the extent that premiums are insufficient and investment income is needed to offset losses that have actually occurred, the investment income is offset by the excess of losses over earned premiums.

It is important to keep in mind throughout that the only losses which are taken into account in determining the amounts of premium or investment income which are "needed" and must be retained in the pool are losses from events that have actually already occurred, as distinguished from losses from events which may occur at some future date. Thus the term "reserve" in this casualty loss context does not include provision for future events, although in other contexts, including life insurance, the term is often used to describe a present provision for a future event.

Committee Questions

Against the foregoing background, we have the following comments on questions raised by the Committee's notice of hearing:

1. Should casualty reserves be discounted to reflect payment of claims in future years?

"Discounting" of casualty loss reserves would be entirely inappropriate because the reserves represent economic losses that have already occurred.* The economic loss is "now," aggregate income in the tax system has in reality been reduced, and the deduction should likewise be now, just as if there had been a payment. (In this context a loss in value is the economic equivalent of a payment; or, more precisely, payment is simply one way in which the payor sustains a loss in value of his assets.) If the loss were reduced by some "discount" factor, the effect would be to collapse and tax immediately the stream of investment income that will be realized in the future.

Assume, for example, that a policyholder, P, insures machinery with insurer, Y, for a premium of $100 and that a new machine of P's with a value and cost of $100 is destroyed in an accident. Absent insurance, P would report $100 less taxable income as a result of the accident, i.e., would have an immediate loss deduction of $100. However, since insurance has shifted the loss to Y, it is Y, not P, that reduces income by $100, which it does by establishing a "loss reserve" of $100. The consequence of the accident to the Treasury is the same, whether or not there is insurance -- the loss has reduced revenues by the amount of tax that P would have paid on $100 of income. (There is no disadvantage to the Treasury even if Y takes the shifted loss in a higher tax bracket than P, because $100 of premium income as well as $100 of loss has been shifted into that higher bracket.)

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*The situation is different in the case of life insurance, as there is no economic loss to reduce aggregate income, now or later. See discussion below.

How quickly Y sends P the check for $100 will make a difference to Y and P. However, it should be of no concern to the Treasury which party has the use of the $100. Whether the $100 is held by Y or by P, it will be earning income and the income, as earned, will be subject to tax and will produce revenue for the Treasury.

Discounting would, however, produce a substantially different result depending on which party had the use of the money. If, on the one hand, Y pays P the $100 immediately, the "discount" would be zero, there would be no tax to Y or P at that point, P would have the use of the $100 and the income from investing it would be taxed when earned, and not in advance. But, if it takes one year for Y to process the claim and send P a check for $100, the result would be very different. If the $100 can earn at the rate of 10%, or $10 a year, the reserve for the real loss of $100 would be "discounted" at 10% for one year, and would be reduced to $90.91. Y would then have taxable income of $9.09 (i.e., $100 of premium less $90.91 of discounted "loss"), and, after tax, would have less than $100 to invest. The income earned on the amount invested over the one-year period would be sheltered from tax because the "discount" would diminish to zero by the end of the next year, producing an additional deduction of $9.09 after one year. From this it is apparent that the effect of "discounting" the $100 reserve is to subject to tax <u>immediately</u> the present value of investing the $100 at 10% for one year in the future, and to exclude from tax the same amount of investment income (on $100, reduced by the tax) which is earned in the future.

Obviously, there can be no justification for the Treasury's collecting a heavier tax if the loss is reimbursed one year later than if it is reimbursed immediately. The total amount of income in the system is the same in either case, and the income from investing the $100 should, in both cases, be taxed only when earned.

Thus, the discounting of casualty loss reserves would create major distortions in the taxation of economic income: a true economic loss would not be deductible in full at the time the loss occurred; the full deduction would depend on the fortuitous timing of the transfer from the pooled funds to the policyholder; income to be earned in the future would be taxed prior to the time it is earned; and there would be a significant difference between the treatment of losses which are paid relatively quickly and those which are paid after some delay.*

The magnitude of the distortion would be substantial, and the practical consequences would be serious.

One consequence of the unjustified tax liabilities that would be caused by discounting would be to seriously disadvantage

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*"Discounting" this kind of "reserve" is not only conceptually incorrect but would produce comparable major distortions in many other kinds of business. Take, for example, the case of traveler's checks: Customer, C, buys $1,000 of checks from X, uses $800 of the checks over the next 6 months and forgets to cash in the balance until a year and a half later. X records a receipt of $1,000 and a liability of $1,000 and reports no income. But X knows from experience that it will have the use of the funds, on average, for 6 months and at 10% the discounted value of the liability would be $952. If the liability is to be discounted, X would have income of $48 immediately on issuing the checks, representing the present value of the income X will earn in the future from investing the portion of the $1,000 which remains from time to time uncashed. That is an obviously unsound result, and it is clearly not the law. The same problem would be present in all non-interest bearing checking accounts.

the domestic insurance industry in its competition with foreign insurers. Insurance is a highly portable international business. No large plant or equipment is necessary. Marketing can be done through independent brokers and agents. A very substantial amount of the insurance of United States risks can be and already is placed across national borders with insurers operating under more favorable tax regimes. The discounting of reserves and its accelerated taxation of future income would substantially increase the cost of domestic insurance and disadvantage domestic insurers in their already fierce competition with foreign insurers.

Second, the discounting of loss reserves for tax purposes would be a nightmare to administer. For financial purposes, accountants could doubtless agree on a variety of estimating procedures as they need not arrive at a precise number, but only a band of "materiality." But for tax purposes a single number is required. The determination of the proper amount of loss reserves has been a perennial source of misunderstanding and controversy between the IRS and insurance companies, as the IRS has found that evaluation of the complex actuarial procedures and judgments actually used by the companies in arriving at loss reserve estimates are beyond the resources of the IRS. Discounting would also require the determination of a proper discount rate (which would never be clear cut and would always be changing) and of the estimated future payment schedule of the losses (which would necessarily be judgments, based on an array of statistical data). Endless controversy would be the sure result.

Third, and, perhaps most important, discounting strikes at the primary objective of all operating and accounting procedures for casualty insurance: financial integrity and meticulous responsibility to the policyholders, whose money it really is that the companies are receiving, reserving and disbursing. In the abstract, discounting for tax purposes need not dictate discounting for financial or regulatory purposes. But, in practice, tax accounting rules create irresistible pressure for other rules to follow and establish conceptual approaches that take root in other fields where they do not belong. Present rules, both tax and non-tax, are based on the understanding that the money paid in by the policyholders must continue to be held, i.e., "reserved," for their account until it is clearly no longer needed; and that it becomes income or surplus to the company only when released from those reserves. The applicable legal rules are categorical that the insurer must hold aside for the policyholders the funds required to pay the losses that have occurred and may not hold aside a lesser amount on the theory that there will be investment income in the future to make up the difference. Whether and when there is income depends for tax purposes, as for other purposes, upon the real nature of the underlying relationship, and for more than 60 years the tax law has explicitly rested on the relationship described. Any erosion of the principle that policyholder funds are held for policyholders until no longer needed will seriously undermine financial integrity and jeopardize the resources not of the companies, but of millions of policyholders.

Difference from Life Insurance

None of the foregoing analysis applies to life insurance, where entirely different factors are involved. The life policyholder typically makes periodic premium payments, which, when compounded at some rate of interest for a number of years, will add up to the face value. The interest compounded for the policyholder's account is excluded entirely from tax, although it is in fact income in the tax system as a whole, not offset by losses of any kind. It would be possible -- and easier for the layman to understand -- simply to compute the compounded interest element each accounting period and exclude it from taxable income. However, for simplicity in dealing with policies in bulk and to facilitate periodic adjustments in the interest assumptions, that is not done. Instead the insurer takes the target savings amount (face amount) and subtracts from it future premiums scheduled to be paid, plus estimated future investment income to be earned on accumulated balances. That is done by solving mathematically for the number which, when augmented by the future premiums and investment income, will equal the face amount. Mathematically that technique is known as "discounting" the face amount -- i.e., determining the amount which is required now in order to grow to equal the face amount at some future date, assuming some specified interest rate. It is a mathematical shortcut to back out the investment income already compounded on the amounts deposited by the policyholder, so that the amounts can be set aside, relieved from tax, and accumulated for the policyholder.

None of that is involved in casualty insurance, as the casualty policyholder is not entering into a saving transaction and is not entitled to have interest compounded, tax free, on his account. The casualty policyholder is entitled only to have his economic losses paid, and it is the loss, not an investment computation, that determines the amount he is entitled to have set aside. The amounts so set aside produce no tax, not because they are specially exempt, but because they are offset by real, economic losses.

2. Should acquisition costs of insurance contracts be deducted when incurred or amortized over the anticipated life of the contract?

The present treatment is correct.

The term "acquisition costs" is somewhat misleading. As noted above, an insurance company serves as an administrator of a pool of funds held for the account of policyholders. "Acquisition costs" merely represent certain costs of administering the pool. In this respect, the "acquisition costs" are similar to the payroll and other expenses incurred by a bank in collecting and administering its customers' deposits.

The misconception surrounding the term "acquisition costs" is compounded by the fact that, in the insurance industry, the bulk of such costs is paid in the form of "commissions." Both terms have the flavor of some kind of asset acquisition. But they are in truth simply another expense of administering assets which essentially belong to policyholders.

Accordingly, it would be inappropriate to capitalize "acquisition costs." This has long been recognized by the states which require such costs to be expensed because they do not represent an asset of continuing value.

3. Is the tax deferral provided for "protection against loss" accounts justified?

Yes.

Mutual property and casualty insurance companies are allowed a special deduction for amounts added to their protection against loss ("PAL") accounts. The purpose of this deduction is suggested by the name of the PAL account: to provide mutual companies with a cushion from which extraordinary losses can be paid.

The reason for the PAL deduction relates to the nature of mutual insurance companies. Unlike stock insurance companies, mutual companies generally lack access to outside capital infusion and must rely, for a safety cushion, on the accumulation of funds which would otherwise be returned to policyholders. This accumulation thus serves the same purpose as the capital of stock companies. The deferral of the tax on such an accumulation compensates mutual companies for the lack of capital and access to capital, and it is an important tool for eliminating or diminishing any competitive advantage which stock companies might enjoy as a result of their capital and capital raising potential.

NAII surveys of its member companies show that the PAL deduction has served the purpose for which it was intended. More importantly, the PAL deduction has allowed many smaller companies which have suffered underwriting losses in recent years to remain afloat.

Finally, it should be noted that the deferral provided by the deduction for additions to the PAL account is not permanent. The deferral is generally limited to five years and is often substantially shorter. The underwriting losses experienced by the insurance industry in recent years have eliminated many mutual companies' PAL accounts and threaten to negate the needed relief provided by the PAL deduction.

4. Does the affiliation of property and casualty insurance companies, life insurance companies, and other unrelated businesses provide unintended opportunities for tax planning?

No.

The purpose of consolidated returns is to tax related corporate entities as a unit. This was made clear in the following excerpt from a report of the House Ways and Means Committee which at one time considered abolishing consolidated returns:

> Your committee considered at length the question of abolishing the consolidated return. Our subcommittee originally recommended this action. The Treasury believed this policy undesirable. The Treasury pointed out that the one way to secure a correct statement of income from affiliated corporations is to require a consolidated return, with all intercompany transactions eliminated. Otherwise, profits and losses may be shifted from one wholly owned subsidiary to another, and their separate statements of income do not present an accurate picture of the earnings of the group as a whole. For all practical purposes the various subsidiaries, though technically distinct entities, are actually branches or departments of one enterprise. For these reasons, consolidated statements of income have been the rule for ordinary business purposes, and for 16 years, the income tax law has provided for consolidated returns. The administration of the income tax law is simpler with the consolidated

> return since it conforms to ordinary business practice; enables the Treasury to deal with a single taxpayer instead of many subsidiaries; and eliminates the necessity of examining the bona fides of thousands of intercompany transactions.
>
> Consequently, after careful consideration of the question, the committee decided that it would be undesirable to abolish the consolidated return at this time. (Report No. 704 on the Revenue Bill of 1934, House Committee on Ways and Means, 73rd Cong., 2d Sess., Feb. 12, 1934.)

The goals Congress sought to achieve in permitting the filing of consolidated returns apply with equal force in the context of property and casualty insurers.

The consolidated return privilege allows an economic unit to be treated in the same manner for federal income tax purposes whether the unit decides to do business as one large corporation with multiple divisions or as several smaller corporations. For non-tax reasons related primarily to the state regulation of the insurance industry, most economic units which contain an insurance "division" utilize a separate corporation for their insurance business. The consolidated return looks through the form of this arrangement and taxes the economic unit according to its substance.

We submit that there can be no unintended benefits from taxing an economic arrangement according to its substance. As indicated in the above quotation, the provision for consolidated returns gives effect to the substance. It allows the income of one enterprise or economic unit to be correctly and accurately determined and prevents the manipulation of income through the shifting of profits and losses between related entities which would otherwise file separate returns.*

5. <u>How should "insurance" be defined for tax purposes?</u>

Present definitions appear adequate.

The definition of insurance has been the subject of numerous court cases, in both the federal tax and the state and federal regulatory areas. The consensus of the case law is that insurance involves an arrangement with elements of risk shifting and risk distribution.

The case by case analysis of various arrangements appears to have produced reasonable and workable results. We are not aware of abuses that are not adequately dealt with by the principles of current case law. If the Committee believes there are such, NAII would be glad to work with the Committee staff in analyzing what is involved and in proposing solutions, if required.

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*During Congressional consideration of the Tax Reform Act of 1976, NAII opposed initial proposals to permit life insurance companies to file consolidated returns with their non-life insurance company affiliates. However, Congress enacted a compromise provision which allows limited consolidation and which was designed to eliminate the abuses about which we expressed concern. NAII supports the present provisions governing consolidation of life and non-life insurance companies.

STATEMENT OF ANDRE MAISONPIERRE, SENIOR VICE PRESIDENT, ALLIANCE OF AMERICAN INSURERS

Mr. MAISONPIERRE. Thank you, Mr. Chairman.

My name is Andre Maisonpierre, and I am a senior vice president of the Alliance of American Insurers.

My comments address the treatment of acquisition costs. For tax as well as other purposes, our financial data relevant to acquisition costs of property and casualty insurance are derived from their convention statements. The convention statement financial data is concerned with determining whether the insurer has sufficient assets to pay its liabilities at any point in time.

Amortizing acquisition expenses defeats this principle, since many acquisition expenses must be paid whether the insurer ever earns the premiums generated by those expenses. Property and casualty insurance companies use many sales approaches to acquire premiums. These in turn generate a variety of expenses such as salaries, advertising, and mailing costs, or commissions.

Regardless of the sales mechanism, all companies incur substantial sales-related expenses in the form of salary paid to their employees. For those companies who sell insurance to their own employees, sales expenses consist almost entirely of salary and fringe benefits. These expenses are incurred regardless of how much insurance is sold by the salesperson to whom the salary is paid.

Companies using independent agents also incur substantial direct sales costs, since agents must be supervised and serviced by company employees who are, of course, on salary. Thus, the large portion of property and casualty insurance sales expenses consist of salary paid company employees. These costs cannot be matched against specific insurance contracts, nor are they subject to refund if those contracts are canceled at midpoint.

Direct mail and advertising expenses are other costs incurred by property casualty insurers which do not bear any direct relationship with premiums collected nor which can be matched with any insurance contract. Incidentally, there are many companies which depend almost exclusively on direct mail as their primary sales outlet.

Clearly, there would be no way to amortize any of these expenses except perhaps by way of formula. It is not realistic, however, to expect that in practice such a formula approach would work, since insurance, insurance contracts, and insurance products continuously undergo changes. To require amortization of sales expenses would place onerous and costly accounting burdens on the companies. These, of course, would be passed on to the insuring public.

Furthermore, such procedures would raise many serious conflicts between the companies and the Internal Revenue Service, and of course there would be little, if any, additional revenue for the Government, since the change would only affect the timing of the tax payment, nor that insurance contracts are for relatively short periods, in personal lines, generally speaking, 1 year or less; commercial lines seldom more than 1 year.

It is ironic that at a time when tax simplification is generating strong support, consideration could be given to greatly complicating the tax and accounting structures of property and casualty insurers.

The final observation: Property and casualty insurance companies' sales expenses are treated today for tax purposes in ways quite similar to other businesses' analogous sales costs. Such expenses are allowed to be deducted on a cash basis, expensing them immediately.

In conclusion, Mr. Chairman, we believe that the present tax treatment of sales expenses incurred by property and casualty insurers is sound. It enhances the regulatory objective of solvency. It does not materially diminish the company's tax liabilities. It is simple, and minimizes the potentials for conflict between the Government and the taxpayers. It taxes acquisition expenses of property and casualty companies as similar expenses are generally treated in other industries.

Thank you very much.

[The prepared statement of Mr. Maisonpierre follows:]

TESTIMONY OF THE ALLIANCE OF AMERICAN INSURERS

My name is Andre Maisonpierre. I am Senior Vice President of the Alliance of American Insurers, a national association representing 160 property and casualty insurance companies providing insurance protection in all fifty states and the District of Columbia.

Mr. Chairman, we appreciate the opportunity to comment on the taxation of property and casualty insurance companies.

There is a great deal of similarity in the ways property and casualty insurers, on one hand, and other business activities, on the other are taxed. The major difference in their tax treatment lies in the method used to recognize the insurance companies' income and expenses. This results from the fact that the taxes paid by property and casualty insurers are based upon information determined from the data contained in the Convention Statement filed with state insurance commissioners. The Convention Statement prescribes the use of statutory accounting principles. These principles provide a uniform accounting system to measure the results of operations of insurance companies. These principles are based on the theory of liquidation. Thus, if a company were to go out of business at any one time, there would be sufficient funds available to pay the losses incurred by the company as well as to meet all other obligations which might have been incurred at the time of liquidation.

The use of statutory accounting principles allows insurance regulators, business and consumers the opportunity to evaluate the ability of a property and casualty insurance company to respond to obligations assumed under contracts of insurance. In other words, the solvency of companies can best be measured if the companies are required to develop their public financial data based on statutory accounting.

The importance of basing property and casualty insurance companies' tax obligations on the data contained in the Convention Statement has been recognized by Congress and others for the past 60 years. Obviously, the application of ordinary accounting principles would seriously distort income when applied to property and casualty insurance companies. This distortion derives from the fact that in general commerce expenses preceed income; a manufacturer must incur the cost of manufacturing his product before he gets paid for it. However, in the property and casualty insurance industry the reverse is true. The policyholder pays the insurance company in advance and the insurance company's costs, which are primarily the payment of claims and the expenses related thereto, come afterwards. If the premiums were to be taxed as received and deductions allowed only as they become fixed, the result improperly would be to distort property and casualty insurance tax liability. How -- ? By taxing very large sums that will never become income because they, in reality, will have to be paid out in settlement of claims, for expenses of settling those claims and for other operating expenses.

The potential consequences of a change in the ground rules under which property and casualty insurance companies are taxed would be to severely impair their financial resources, and thus the capacity to write insurance. This would have a major adverse impact upon the availability of insurance to the public as well as on the price of insurance.

The wisdom of integrating sound tax policy into public policy is not limited to the field of property and casualty insurance. It is a principle which has been widely adopted in business taxation. Note, for instance, the special depletion tax allowance to encourage greater investment in energy exploration; or the accelerated depreciation tables to support capital investment in the new equipment needed to modernize our industrial complex.

The integration of public and tax policies for insurance purposes presents a problem which does not usually apply to other business or industries. Insurance is, as you are aware, regulated by the states under congressional authority. As a result, public policy objectives, on one hand and tax policies, on the other are set by two distinct government entities. It is a tribute to the concept of federalism that this Committee and Congress have, for better than half a century, recognized the need to support the public policy goals set by state government with respect to insurance regulation.

The protection of insurance policyholders and claimants against insurance company insolvencies is by far the overriding concern of state insurance regulation. This conforms to the objectives of federal administrators having responsibility for the regulation of other financial institutions since they too have identified solvency as the primary consideration.

The major tool presently at the disposal of state insurance regulators and consumers which can be relied upon to ascertain the financial position of individual insurance companies is the Convention Statement filed by each company in all the states in which they are licensed to do business. A great deal of the data submitted by individual companies is computerized, analyzed and information derived from these reports receive wide distribution among all insurance commissioners. Companies which may show signs of financial weakness are thus identified and as a result of this early warning system insurance company insolvencies are minimized.

To the extent that federal tax policy would require the use of different and conflicting financial data by property and casualty insurers, there would ensue serious implications for the integrity of the Convention Statement. Policyholders would receive different signals from different government agencies. Regulation for solvency would be compromised and the insured public would lose the sense of security it now has in the protection provided by the industry.

It is within this general framework which we will comment on the specific issues suggested by the Committee.

THE DISCOUNTING OF LOSS RESERVES

Reserves for losses and loss adjustment expenses generally comprise the largest single liability in a property and casualty insurance company's statement. Since adequate reserving for future payments is so crucial to a company's financial integrity, any change of the present system is bound to have serious repercussions.

Property and casualty loss reserves represent the incurred losses for which a company must respond as a result of the obligations assumed under contract to pay to or on behalf of policyholders losses which have actually occurred under the contract. When an obligation under an insurance contract results a company must identify sufficient funds for payment of the losses even though the payment may not take place until some future date. It must be kept in mind that the event giving rise to the ultimate payment of the loss has occurred. Thus if a company were to liquidate at any one time there would be sufficient funds available to pay all losses incurred by that company, at time of liquidation, under present and past insurance contracts.

Loss reserves present a "moving target." As new losses arise additional reserves are posted. As claims are settled, reserves are reduced. As conditions require, each individual claim reserve may be revised upward or downward.

Obviously, many claims are settled within a relatively short time from the date of accident. There are, however, other claims which, because of the nature of the obligation or the circumstances surrounding the claim, ultimate payment of the loss may not take place until substantial time has elapsed between date of accident and date of reporting. In addition, property and casualty insurers must post adequate loss reserves in the anticipation of claims which may not as yet have been reported but where experience tells a company claims will be filed.

For instance, a great majority of the claims arising out of homeowners policies -- household fires or damages arising out of windstorms -- are paid relatively promptly after the loss has occurred. Workers' compensation insurance coverage on the other hand gives rise to considerable delay between the date of accident and the date of final payment since a company's obligation to the injured person is an ongoing obligation which lasts until medical care has ceased, the injured has returned to work, or a final determination of the extent of permanent disability has been rendered. Likewise, many product liability and malpractice liability claims result in extensive gaps between date of accidents or date of reporting of accidents until date of payments because of the complex litigation issues which may be involved and the delays resulting from court backlogs.

The greater the gap between the date of ultimate payment on a claim, the more complex becomes the issue of proper evaluation of the reserve. Loss payments are subject to many influences -- the effects of inflation, changes in jury attitudes and sometimes changes in the law. Since historically all of these factors have had the tendency to increase ultimate claims cost, companies have had to struggle to keep reserves at adequate levels.

It has been estimated, for instance, that for calendar year 1982, General Liability Loss Reserves are deficient by $1.2 billion or 10.4 percent of outstanding general liability reserves and that for 1982, Workers' Compensation Loss Reserves are deficient by $1.7 billion or 9.7 percent of outstanding workers' compensation reserves.*

In fact, the single greatest concern of insurance regulators with respect to the financial position of property and casualty insurers has been adequacy of reserves.

The adequacy of company reserves can also be affected by the emergence of claims for occurrences which arose during the policy period years after the date of expiration of a policy. For example, the flood of claims resulting from asbestos exposures were never contemplated at the time the policies were issued nor were they anticipated at the time the insurance contracts expired. Companies insuring policyholders involved in the processing or sale of asbestos were seriously under reserved until the magnitude of the anticipated exposure became clear.

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* Best's Insurance Management Reports Property/Casualty. May 2, 1983

Inadequacy in loss reserving is an unintended situation but, one which can create serious financial dislocation for a company. For instance, the magnitude of the asbestos problem may cause serious financial difficulties for a broad segment of the property and casualty insurance business in the years to come.

The direct effect of discounting of loss reserves would be to require property and casualty insurance companies to fund loss reserves out of funds used to gauge the total premium income companies may have. These funds, generally called surplus, are essential to assure the solvency of companies. Insurance regulators require that a minimum ratio be kept between premium income and the surplus held by each company. When a company's ratio falls below the minimum, the company is required to reduce its sale of insurance. A major reduction in surplus would result in the immediate reduction in the amount of coverage made available by the companies. A major change in the tax law which would lead to a diminution in the property and casualty insurance company's surplus would result in an immediate reduction in the amount of insurance coverage made available by the companies. This would have a chilling effect on industry, commerce and consumers as restriction in the sale of insurance would limit insurance availability in the market place.

Discounting of loss reserves for tax purposes has many adverse affects.

- It would force property and casualty insurers in the position of being perpetually under-reserved.
- It would strike at the stability and responsiveness of the insurance contract.

- It would affect the reliability of property and casualty insurance; and
- It would jeopardize the ability of the industry to pay incurred losses.

Additionally, one should not underestimate the technical complexities likely to be involved in discounting.

Discounting adds an entirely new dimension to the already difficult job of adequate reserving. Not only would companies be required, as they must today, to determine how much to reserve for, but the timing of the loss payments would become crucial. If payments on losses come due before expected, there will not have been sufficient income earned on the discounted reserves to be adequate to pay the losses.

Another technical problem associated with discounting is the rate of discount to be applied. Different companies have different investment strategies and portfolios. Lines of insurance and pricing strategy do, to a large degree, determine the nature of a company's investments -- hence a return on that company's investment. A uniform discount rate would be quite detrimental to the industry's need for investment diversification.

How would a fair discount rate be established, considering that incurred losses may not be paid ten or more years after emerging? This is particularly true if interest rates continue to gyrate as they have done over the recent past. Such swings in future interest rates would create great uncertainties and would substantially increase the riskiness of the property and casualty insurance business.

In a way, discounting bears many of the complexities associated with the indexing of benefit payments. Such indexing has found its way in a number of workers' compensation laws. It requires that current benefits be increased to reflect changes in the cost of living. Indexing has been a particularly onerous provision of the current federal Longshoremen's and Harbor Workers' Compensation Act since this workers' compensation law provides for no maximum on the amount by which current benefit payments may be increased. This provision, which was enacted in 1972, is a major reason for workers' compensation insurers having withdrawn from writing this federal workers' compensation coverage. There is no way under such circumstances that a company can accurately price either potential losses or premiums in an open-ended environment. Likewise, property and casualty insurance companies would be very insecure if they had to rely on future unrealized and uncertain investment income to pay incurred losses. Incidentally, the indexing of benefits is generally recognized as one of the most significant villains associated with the near bankruptcy of our social security system. Experience with indexing under various federal benefit programs should tell us that discounting of loss reserves could bring about disastrous results to property and casualty insurers and to their public -- especially those who are insured.

It stands to reason that if loss reserves had to be discounted for tax purposes, a certain portion of the company's investment income would need to be exempt from federal taxes. Barring this treatment, companies would find it difficult to accumulate sufficient funds through investment income to discharge their loss obligations. This would be in line with present tax treatment affecting life insurance companies.

Let there be no mistake about it. Forcing property and casualty insurance companies to discount loss reserves for tax purposes would generate extremely high internal accounting costs. The more complex and refine the discounting procedures, the higher those costs would be. These costs, obviously, will end up as higher insurance costs for business and individual policyholders. We question whether it makes good sense to structure a tax procedure which generates substantial internal costs solely for the purpose of taxation. There are better ways to utilize financial resources.

A final caution. Property and casualty insurers must compete in a global economy. Today a growing amount of property and casualty insurance business is placed directly overseas, all over the world. Discounting loss reserves for tax purposes will increase the operating costs for U.S. insurers, not the foreign competition. The result will be an expansion of the penetration by foreign insurers of the American property and casualty insurance market. There will not only be a loss of markets for American insurers but a flight of capital abroad as American industry exports premium dollars in efforts to secure lower cost insurance coverage. In fact, it is likely that American insurers may themselves be forced to support this exportation of capital by reinsuring long term losses overseas where reserves do not have to be discounted for tax purposes. Foreign competition can be just as destructive of the American property and casualty insurance business as it has been of the American automotive and steel industries. We do not believe that such extensive reliance of foreign insurance is desirable as a matter of national policy.

The discounting of loss reserves would be both complex and administratively very costly to both government and the companies. It is questionable whether it would raise any appreciable revenue. It would certainly restrict insurance capacity, thus possibly affecting the nation's economic growth. It will increase insurance premiums since policyholders would no longer benefit from investment income in ratemaking. It might threaten the American property and casualty insurance business with unfair foreign competition. Most of all, discounting carries with it all the potential for undermining the stability of the property and casualty insurance business.

THE TREATMENT OF ACQUISITION COSTS

For tax as well as other purposes all financial data relevant to acquisition costs of property and casualty insurers are derived from their Convention Statements. The importance of the Convention Statement information as the most accurate measurement of a company's solvency has already been discussed. Let me again stress that Convention Statement financial data is concerned with determining whether an insurer has sufficient assets to pay its liabilities at any point in time. Amortizing acquisition expenses defeats this principle since many acquisition expenses must be paid regardless of whether the insurer ever earns the premiums those expenses are matched with. Unearned premiums, afterall, are required to be repaid in mid-term when policies are cancelled by either party.

Requiring the amortization of acquisition expenses for tax purposes, furthermore, creates complication which may not be all that apparent to those who are not familar with the merchandising of property and casualty insurance products.

Property and casualty insurance is marketed in a variety of ways. The most commonly used ones are the agency distribution system, the direct sales system, the advertising and mail system and the brokerage system. Some companies limit themselves to one marketing approach. Others may utilize a combination. Here is the way each operates.

With the agency system, a company has a contract with one or more agents to represent that company within a certain territory. The agent is paid a commission generally based on the amount of insurance produced and on the experience which the company has had on the business produced by that agent.

With the salaried employees sale system, the largest part of a company employee sales personnel renumeration consists of a salary paid by the company. Some companies might also provide additional compensation in the form of commission to salaried employees. In addition, sales employees receive various fringe benefits -- health insurance, pension benefits, vacation, etc. to which other company employees are entitled.

The direct mail system is based generally on a combination of direct mailing and mass advertising. Companies utilizing this approach have few or no salespersons. Applications for insurance received in the mail are usually processed directly by line underwriters.

The insurance broker receives his payment for services performed not from the insurance company but from the policyholder from whom he secures insurance. Companies working through brokers do not generally incur direct acquisition costs. Obviously, the premium paid by the policyholder reflects the fact that the policyholder will incur costs to the broker who is, in fact, the policyholder's agent.

If, for tax purposes, property and casualty insurers would be required to spread acquisition costs over the anticipated life of the insurance contract, first one would need to know what is meant by "acquisition cost." One should note that many sales expenses incurred by a company are not recoverable by the company even if contracts of insurance are cancelled in mid-term. Clearly all salary and fringe benefits paid to company sales employees represent final payment. The same applies to sales expenses associated with advertising and direct mail campaigns. Further, these sales expenses cannot be attributed or matched to any particular insurance policies or contracts.

It could be argued that salaries, advertising and other direct sales expenses incurred by property and casualty insurers which cannot be matched to any specific insurance policy could, for tax purposes, be amortized by way of formula. We do not believe, however, that this would work out in practice. Insurance is not static. Companies make changes in their policies, including changes involving contract durations. In fact, contract duration varies both by contract and by lines of insurance. Companies constantly develop new products. Whatever formula would be established for amortization purposes would bo very sensitive to these changes.

What would result is clear. Not only would such requirements impose onerous and costly accounting burdens on those companies which have adopted certain marketing strategies but they would create untold conflicts between individual companies and the Internal Revenue Service with respect to the appropriateness of the formula used. Also, it must be emphasized that such a change would not, in the long run, create additional tax liabilities or provide additional tax revenue for the government. All that the change would accomplish would be to speed up the company's tax liability. It is ironic that at a time when tax simplification is generating strong support consideration could be given to greatly complicating the tax and accounting structure of property and casualty insurers.

The complex accounting procedures which would be imposed on property and casualty insurers if forced to spread acquisition costs over the lifetime of the insurance contracts would also affect companies which rely principally on agents as their production outlets. Agency activities are controlled and supervised by company salaried employees. The agents are dependent on a variety of services from the companies with whom they have contracts and those services are generated by employees who also are on salary. Would there be a requirement that their salaries also be spread? If so, what base would be used for such amortization of expenses?

If, on the other hand, the spreading of acquisition costs of insurance contracts over the anticipated life of the contract were limited to those expenses which can be directly attributable to specific insurance policies then, companies depending on agents as their principal marketing outlets would be placed at a disadvantage. They would have to spread their sales expenses. Others would not. We do not believe that the tax code should be an instrument which favors certain competing companies within an industry. The code should be, to the extent possible, competitively neutral.

Consumers greatly benefit from the variety of distribution systems used by property and casualty insurers. There are literally millions of policies bought each year by both individuals and businesses. The variety of sales network used by individual insurers enhances competition within the industry, provides a broad range of services to policyholders, and allows for a distribution of the product which could not be achieved were it not for the variety of approaches utilized.

On the other hand, requiring that all acquisition costs, including cost of advertising, salaries, etc., be spread over the anticipated life of insurance contracts would create untold accounting nightmares for all companies. Such a program would invite costly and prolonged conflicts between the companies and the Internal Revenue Service. It would not, in the long run, generate additional income for the government.

It should be noted that property and casualty insurance company sales expenses are treated, today, for tax purposes, in ways quite similar to other businesses sales costs. Generally, business may deduct these costs in the year in which they are incurred, even though some of the expenses are generated to support income which will be recognized in some later years.

Thus, for example:

- Leasing, banking and savings and loan industries are allowed to deduct expenses analoguous to insurers acquisition expenses on a cash basis, expensing them immediately.
- Expenses generated in connection with most construction contracts may be deducted in those years in which they are incurred.*

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* An exception applies to contracts whose completion dates extend many years in the future. Note, however, that property and casualty insurance contracts are generally of relatively short duration.

Accordingly, we believe that the present tax treatment of acquisition costs of insurance contracts is sound. It enhances the regulatory objective of solvency. It does not materially diminish the company's tax liabilities. It is simple and minimizes the potentials for conflicts between the government and the tax payers. Furthermore, it taxes acquisition expenses of property and casualty insurance companies, as similar expenses are generally treated in other industries.

PROTECTION AGAINST LOSS ACCOUNTS (PAL)

In 1962, Congress authorized mutual property and casualty insurance companies (and reciprocal companies) to establish Protection Against Loss Accounts (PAL). The law allows the companies to defer federal income tax on certain amounts each year and to place these funds in an earmarked account, the PAL account. If these sums are not used by the companies to pay unanticipated losses, within a certain time frame, they must be added to current income and be subject to tax in the year they are subtracted from the PAL account. The amount added to a company's PAL account must come from the company's underwriting income, not investment income.

The rationale which led Congress to establish the PAL account some 20 years ago continues to be present today.

As already stated, all property and casualty insurance companies must have surplus funds available in order to be allowed to write insurance. These funds are needed to pay unanticipated losses. A company's growth in the marketplace may be limited by the amount of surplus funds it has available.

Stock insurers have three sources from which to generate their surplus funds -- underwriting income, investment income and the capital market. Mutuals, being owned solely by their policyholders, traditionally have had only two sources from which to generate the necessary surplus funds -- premium income and investment income.

Insurance regulators properly limit the amount of insurance which any insurance company may underwrite by the size of the company's surplus account. Thus, if a company's account remains static a company cannot grow. If the account is reduced regulators may require, as a condition to continue to do business that the company reduces its insurance activities.

Consequently the surplus account performs two functions.

- It is a necessity for a company to pay unanticipated catastrophic losses.
- It is needed to support a company's premium base.

It was the intent of Congress in 1962 when it authorized the PAL account to provide mutuals with a substitute source from which to sustain growth of the company as well as to provide policyholder protection in case of unanticipaged catastrophic losses.

The PAL account was not, however, a "freebee.: At the time, Congress was completely rewriting the tax code for mutual insurance companies, and was removing the tax advantages which those companies had traditionally enjoyed.

Thus the PAL account was a quid pro quo.

Today, the PAL account is still the only source of capital mutuals have as a substitute to the stock company's availability to sell stocks and bonds. It remains essential to provide for future growth and as protection against catastrophes. Given the highly cyclical nature of the property and casualty insurance industry, PAL enables mutual companies to build surplus in years with underwriting gains so that it may protect policyholders in time of underwriting losses.

The possibility of a catastrophic loss is considerably greater today than 20 years ago. Property values have increased; there is much greater concentration of insured property than was the case then. The need for capital after a catastrophe is greater today than it ever was.

The PAL account is especially important for small mutual insurers, many of which may concentrate on one line of insurance or several closely related lines in a small geographical area. The yearly underwriting results of these companies can be very vulnerable to natural catastrophes. Since property and casualty insurers are not allowed deductions for catastrophic loss reserves, the PAL account provides those companies with a necessary means to build surplus during good years in order to protect policyholders in the years when massive losses occur.

The importance of PAL to the smaller companies cannot be overlooked. These companies, and there are literally hundreds of them, provide very essential services to a large number of policyholders. The elimination or cut back of PAL would severely hamper their ability to stay in business.

THE AFFILIATION OF PROPERTY AND CASUALTY INSURANCE COMPANIES, LIFE INSURANCE COMPANIES AND OTHER UNRELATED BUSINESSES

In 1976, the Alliance was strongly opposed to the legislation which was pending before this Committee to allow life insurance companies to file consolidated returns with their non-life insurance affiliates. Our companies believed that such consolidations would give rise to serious anti-competitive results, primarily benefiting the large life insurance companies. Uncontrolled consolidation could well have led to a federal government subsidy of the expansion or entry by those companies in property and casualty insurance by the operation of the tax laws. Alliance companies believe in competition. But for competition to work, it must be fair and all competitors must be subject to equal treatment under the law.

The initial legislation considered by this Committee would have allowed the expansion of life insurance companies investments in property and casualty insurance to come, in large part, from dollars which would have been paid out in taxes.

A compromise which Congress enacted appeared to us, at that time, to be fair. It allowed for some consolidation but the intention was to discourage acquisition or investment into property and casualty business by life insurance companies for tax motivated purposes.

Since consolidation would be delayed for five years, the Treasury Department delayed a promulgation of regulations under which consolidation could take place until the fall of 1982. Filings for 1981 were the first returns under which companies could avail themselves of the law enacted in 1976.

We are suggesting that the existing law be allowed to mature and that it be reviewed by Congress no earlier than five years after consolidation became effective.

With respect to the consolidation of property and casualty insurance companies and other unrelated business, it is our impression that <u>all</u> non-life insurance companies, whether they are insurers or not, are treated similarly for consolidation purposes by the Code. There does not appear to be any legal advantages given to property and casualty insurers. The cyclical nature of the property and casualty insurance business may make it possible for non-insurers to offset property and casualty losses against their gains. This, however, is an advantage available to any company consolidating with a company in a cyclical industry.

We believe that the existing tax code contains sufficient safeguards to prevent tax motivated affiliation and does not require any change.

DEFINITION OF INSURANCE

Those sections of the Code which pertain to property and casualty insurance do not deal with insurance as such but with insurance companies. In other words, the incidence of tax is imposed not on the insured but rather upon the income of the company providing the protection.

To define insurance for tax or any other purposes would be self defeating. New products and new mechanisms constantly emerge as marketplace needs are met.

Over the years, the judiciary has dealt with the definition of insurance. The courts continue to do so today. We believe that to the extent a specific property and casualty insurance company's activity falls outside the business of insurance, as defined by the courts, the Internal Revenue Service has sufficient flexibility to challenge the activity. We see no compelling reason to define property and casualty insurance transactions. Such a move could well result in stifling the ability of the companies to meet policyholders needs. Further, it would require constant legislative revisions as the need for changes in insurance protection arises.

CONCLUSION

In conclusion, Mr. Chairman, we believe that it is essential to continue the integration of federal tax laws applicable to property and casualty insurance company into the broad public policy objectives relating to the regulation of the property and casualty insurance industry. Property and casualty insurance has become a fundamental need for commerce as well as individual's peace of mind. The solvency of the industry must be protected.

The property and casualty insurance industry is today undergoing serious financial strains. Insurance rates for commercial insurance are universally recognized as being grossly inadequate. The inadequacy is caused, in part, by the inadequate loss reserve position which is due to factors described in this statement.

Any change in the federal tax code which would force an illusion of profitability by switching liabilities into assets would have catastrophic consequences not only for the property and casualty insurance business but for business, commerce, and consumers alike.

We urge you to consider these factors as you examine the federal treatment of property and casualty insurance taxation.

STATEMENT OF MICHAEL CUDDY, PARTNER, COOPERS & LYBRAND, ON BEHALF OF THE NATIONAL ASSOCIATION OF MUTUAL INSURANCE COMPANIES

Mr. CUDDY. Good morning, Mr. Chairman.

My name is Michael Cuddy, and I am here as spokesman for the National Association of Mutual Insurance Companies, an association of nearly 1,200 members that represents most of the small mutual companies in the United States.

I have been left with the final two issues, the protection against loss account and the question of what is insurance. As for the protection against loss account, I want to focus on the way the question is posed in your press release, because it gives us two key clues to the issue before this committee.

Protection against loss account. We tend to call it the PAL account, but when we focus on the words and the name, protection against loss, we have a clear meaning of the original intention of why it was added to the law in 1962.

Second, the word deferral is in the question, so everybody is aware that we are not dealing with a permanent savings of any kind. Quite to the contrary, we are dealing with an account that has ins and outs, and in the long run does not amount to any permanent tax savings.

The protection against loss account was made part of the law in the Revenue Act of 1962, at the time that mutuals were subject to tax on overall income for the first time. The specific reasons for including section 824 in the Code was a recognition by Congress that mutuals, since they are owned by their policyholders, are not in a position to raise capital from the outside in most cases.

As a consequence, the protection against loss account is devised as a way of creating temporarily additional surplus which could be used to pay losses over time.

As I have said, the account works through a mechanism of an addition which constitutes a deduction in a given year when there are underwriting profits, and these amounts are subtracted in later years when the company incurs losses. It is fair to say that with a limited exception, as I have already said, there are no permanent tax savings from this account.

In talking to our members, we have found that they believe that this account is very important to their operation. Keeping in mind that we are dealing in many cases with small mutuals who insure farms and rural communities, where insurance is not available on a large scale, it is the experience of these companies that the PAL account has enabled them to write insurance in these areas and cover unusual losses as they arise.

The next issue that I want to address is the one of what is insurance, and I think it is fair to say that we can make this the easiest issue to be addressed or the most difficult. It is a pure factual question, and I must say that I surprised myself in looking at the material we accumulated. The decisions and the rulings over the last 40 years indicate clearly that the courts and especially the Treasury have had little difficulty dealing with this issue.

The leading case of *LeGierse* which is relied on in most situations to apply the right result to a set of facts where the court or the IRS may decide that there is not insurance, but there is another type of financial transaction. It is interesting to note that in the captive area, which has gotten a lot of publicity as being a type of noninsurance, that the Internal Revenue Service, in published and private rulings, has been able to find the existence of insurance even where an insurance company is wholly owned by one of the insureds, the test being whether there are outside insureds included in the body of the insureds.

So, it seems to me that against this background of the courts and the Treasury being able to, in my view, adequately address the issue of when we have insurance and when we do not, that legislation would not be an appropriate solution to whatever abuses may be perceived.

Thank you.

The CHAIRMAN. I would like to ask Mr. Cuddy a couple of questions and then maybe direct some questions to others. You have just covered what we ought to consider as insurance. You indicate in your testimony that you believe that retrospectively rated policies, under which refunds are made for a company's favorable loss experience, should be considered insurance.

What about policies issued after a loss event has occurred? Should they be considered insurance, and is there a significant percentage of these policies in the market today?

Mr. CUDDY. In answering the last question first, I have no information that there is a significant amount of these policies in the market, No. 1.

No. 2——

The CHAIRMAN. Should they be considered insurance?

Mr. CUDDY. No. 2, I think that they could be, if one takes the view that insurance constitutes two elements: an event and an amount. And if the amount remains unknown, even though the event has taken place, I think it can be argued that there is insurance. And I think this is an issue that the courts and the Treasury are well able to deal with if they think it is a problem.

The CHAIRMAN. We also have a Congress.

Mr. CUDDY. I understand that, Senator.

The CHAIRMAN. We do not do much, but——

Mr. CUDDY. It just seems to me, based on the precedents that I am familiar with, that that may be a better way of dealing with it.

The CHAIRMAN. What you really have is sort of an extended warranty, just like on an automobile or a toaster—well, I should not use toaster; other appliances.

Mr. JONES. Senator, I want to say, it is insurance. It can only occur in a market where there are a great number of claims, a very large amount in question, and there is risk-spreading among insurers. The companies that have taken that on after the event are taking on the risk that funds will not be sufficient to pay the amount.

There will be a number of claims and so there is both a spreading of risk, the fact of spreading a risk among companies, and a distribution of risk. They have taken on both the pooling of it and the distribution of it.

The CHAIRMAN. Well, I guess the next question would be, what is an insurance? I guess everything but bail bonds under Mr. Cuddy's definition, would be insurance.

Mr. CUDDY. Well, as we point out in our statement, that was held by the courts not to be insurance.

The CHAIRMAN. Everything else is? Everything else would be, every other product would be?

Mr. CUDDY. I cannot go that far. I would not make that statement.

The CHAIRMAN. The GAO indicated when they were here and in their testimony—and in fact they are still here—that discounting reserves would not be a company's risk, because the reserves are recalculated annually. Would someone like to address that question?

Mr. MILO. I am not sure exactly what they meant by that. It does not reduce the company's risk exposure. Insurers review reserves annually, but I am not sure that is relevant.

Mr. CUDDY. If I may on that, it is fair to say that you can review the reserves annually, but you may not in a given year be able to pick up a trend. There are many companies that it has taken years to discover trends, and the fact is that they have been working with bad assumptions and data and have come up short. So although it is possible going from year to year to pick up shortfalls, that is not necessarily the case in all situations.

Mr. JONES. Senator, there is one aspect of the GAO's testimony on that that I think might have left a false impression. They indicated that by discounting reserves they could generate a half a billion to a billion dollars in taxable income. In no way can that be done over a short period of time.

As Mr Chapoton of the Treasury Department said, this is merely a matter of timing, and they may increase tax revenues by accelerating the taxing of income that had not been earned, which is the reason for our objection. Although discounting may increase current taxable income, it will not change in any way the ultimate taxable income of the company.

It will not be a revenue raiser. All you are doing is advancing anticipated income into current taxes, and there will be adjustment later that will level that out. So the Government will only accelerate, but would not collect any greater taxes than they would over a period of time. It is not a revenue raiser.

The CHAIRMAN. While we are on that area, do you have a chart on investment income? You have other income other than gain or losses from premiums.

Mr. JONES. Yes, sir. It is in the "Statistical Profile," but we did not magnify it here or put it in a chart form. It is a pretty consistent line, but increasing greatly in the last 5 years.

The CHAIRMAN. Profit or loss?

Mr. JONES. In profit.

The CHAIRMAN. That made a nice chart. I do not know why we did not——

Mr. JONES. Because it is so steady——

The CHAIRMAN. That is right, we would not want a balanced picture up here.

That looks pretty good. It looks a lot better than these other charts.

Mr. JONES. This one over here incorporates investment income, dividends, interest.

The CHAIRMAN. That is operating income?

Mr. JONES. That is operating income. Investment income is reflected in the chart showing operating results completely.

The CHAIRMAN. I cannot see the last couple of years. What happened in 1975?

Mr. JONES. We thought that was a disaster. We made an operating income of one-fourth of 1 percent. Investments went down. We had a disastrous underwriting loss. What produced it was the accumulation of inflation that occurred after wage and price controls were removed, and our reports on economic trends could not keep up.

That is really what happened in that 1974–1975 period. There was not a quick enough adjustment, because we operate on our losses as reported, and our losses had a lag in coming in. But if you remember, it was also an economically depressed period.

The CHAIRMAN. Last year it was brought to our attention that a major life insurance company in New York wanted to be taxed as a property and casualty company. Would that be because so they could pay more taxes?

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Mr. THORNBURY. No, I do not think so, Senator. There are different perceptions among the industry as to who pays more taxes and who pays less taxes.

The CHAIRMAN. In some cases it is hard to tell who pays less.

Mr. THORNBURY. There were companies on both sides of the discussion last year, if you will recall.

The CHAIRMAN. I assume they would pay less tax. Maybe there are other reasons other than taxes. But again, I am not promoting this book, but I am reading about this little company that owns 200 office buildings, 500 industrial buildings, 75 hotels, 50 shopping centers, 55 residential buildings, and 600,000 acres of farmland. That is just one. It seems like they must be making a little profit.

Mr. JONES. They evidently would rather do that than buy tax exempt municipal bonds.

The CHAIRMAN. I think there are some other examples of that in there, but I have not finished the book.

Mr. Thornbury, one feature of TEFRA life insurance rules is the safe harbor percentage of so-called excess interest paid to policyholders which is deductible to a life insurance company. Stock life insurance companies wanted 100-percent deductibility for these interest payments, but Congress merely allowed the companies to litigate the issue.

Could not a company avoid this issue and get 100-percent deductibility by selling so-called universal life insurance in a property and casualty insurance company or subsidiary?

Mr. THORNBURY. It would certainly appear that any property/casualty company offering that product would have more certainty in being able to deduct all of their customer payments. But being a property/casualty company is not in all cases an improvement over being a life insurance company from the taxable income viewpoint. You may be more certain of being able to deduct your excess interest payments, but the very issuance of universal life policies in a nonlife company would tend to move your life insurance reserves upward toward the 50-percent test that will bring it back into the life insurance company rules.

Second, when you move from life insurance rules to nonlife insurance rules and back, there are some consequences with respect to the deferred taxation accounts that the life insurance company has.

Finally, a property/casualty company is not able to get the same kind of reserve treatment that a life insurance company has. If a life insurance company has preliminary term reserves, then it may elect to have those treated as net level reserves. It is a mixed bag.

The CHAIRMAN. When you talk about losses, are you talking about economic or tax losses? What do you tell your shareholders in your annual report, that you are losing money?

Mr. MILO. There would be an underwriting loss and you would have underwriting losses. Those underwriting losses are offset by investment income, which a significant portion is tax exempt. But for both taxes and for financial statements reported to stockholders, it would show an underwriting loss.

The CHAIRMAN. But do you believe that property and casualty companies should pay taxes?

Mr. MILO. To the extent that they have taxable income, certainly. In the last 3 years what has happened in the industry has been, an insurance company is going to try to reach a certain return on investment, and with the actual investment income increasing and inflation increasing by a greater amount, it serves to reduce the amount of premiums, resulting in underwriting losses which, offset by investment income, produces a rate of return which was marginally acceptable to the industry.

And what had happened in the last 3 years, the mix of the income, underwriting going down and tax exempts, investment income going up, caused the industry to reduce its tax substantially. But it was not the industry attempting to reduce its tax; it was the interplay of the inflation, spiraling inflation causing underwriting losses, being made up by investment income which was tax exempt, basically tax exempt.

But with the spiraling inflation, which hopefully now is at rest and hopefully interest rates will come down, I think that definitely the industry will be paying a tax, as it had in the previous years.

The CHAIRMAN. Suppose we did impose a requirement imposing discounting reserves, say, at any one of the three levels suggested by GAO. How would this affect the premium prices?

Mr. MILO. Senator, they would have to increase, the premium prices, and basically the reason why is because if the insurer collected $1,000 and he reserved $1,000 because a series of economic losses had occurred and now there was an economic loss to the system, then the $1,000 of premium would be offset by the $1,000 loss reserve. The insurer has no right to the $1,000. He cannot use it for any purpose.

Therefore, if it is subject to discounting, then even though he collected $1,000 and has losses of $1,000 and that particular transaction resulted in nothing, the insurer would have to come up with tax money. And since the transaction did not produce any revenue or any assets which it can utilize, it would have to dip into its surplus, and to the extent it depletes surplus it would go out and borrow to the extent it is allowed to.

All that is going to cause significant expenses to the insurers, which would have to be passed back to policyholders.

The CHAIRMAN. I guess my question is, if that is the case is it not better to have the customer pay the real cost, rather than the Federal Government subsidizing it?

Mr. MILO. Well, I do not know where the real costs are, the real cost being——

The CHAIRMAN. You say it is going to increase the premium. But if it is good policy to discount reserves and you cannot do it only because it might raise the price of the premium, then the argument is, why should the Government through some tax policy that is not very good subsidize the premium? That is an area we will be looking at.

Mr. THORNBURY. Senator, I do not think the Government is subsidizing the premium. If we are talking here about the investment in tax exempts, investment in tax exempts will be made by other parties if not by this insurance company.

The CHAIRMAN. We are talking about discounting of reserves.

Mr. THORNBURY. But that ties in with the investment in tax exempts. The company is getting a different net tax result only because of the interplay between those.

Mr. MILO. Senator, if I could just expand upon that, assuming that a loss does occur and assuming that that particular loss is paid immediately by the insurer, then the policyholder has an amount, let us say $1,000, and he would invest that $1,000 and that $1,000 would earn income which would be taxed when earned, and the policyholder would pay that amount.

If the insurer, however, does not pay out the loss yet because it has not been completely settled, then he would hold the $1,000. And as that income is earned he would be included in income. There is no subsidy involved in that. The system remains the same if the loss is paid immediately or if it is paid later on. There is no subsidy as far as we can see with regard to that issue.

Mr. CUDDY. I think there is another side to that, also. That has to do with the body of insureds, because if premiums are increased as a result of steps to change the formula then the insurers will be getting a larger tax deduction, reducing their own tax liability. So that is the other side of the coin, it seems to me.

The CHAIRMAN. I appreciate that. You know more about it than I do, I understand that. But we are going to try to learn a little more.

It is my understanding that the States do not levy income taxes on insurance companies. They rather have opted for a flat excise tax on premiums, as well as various licensing and other fees. What about some method like that at the Federal level, with that premium tax? Would that have any great appeal?

Mr. THORNBURY. Senator, there are now pending in at least 12 States proposals for increasing the premium taxes. And further, I would note that a number of States do impose income taxes on insurance companies.

The CHAIRMAN. How many States? Well, we can find that out for the record.

Mr. THORNBURY. I do not have the number at hand here.

The CHAIRMAN. The question is, what would you think of that at the Federal level? Maybe we could avoid all these complicated provisions—someone complained about making this complicated. Maybe this would uncomplicate it, so it would be a flat premium tax. There are a lot of people who are for a flat tax.

Mr. CUDDY. I guess one thing that could be said about that is that you would then distinguish insurance companies from other corporate taxpayers, and I do not know whether that could be justified.

The CHAIRMAN. There are some who say there is a distinction now.

Mr. CUDDY. There is a distinction only in the tax accounting method. There is no other distinction. I mean, every other provision of the Internal Revenue Code applies to insurance companies, for the most part. So I think they are corporations, they are taxed as corporations, and I do not think that the premium tax is consistent with that.

The CHAIRMAN. Well, put me down as undecided on that one.

Mr. JONES. Let me say that the most severe problem with the premium tax approach is that it would encourage self-insurance, which is growing among large commercial risks. I think you would have to address the problem of making it an equal burden between the insurance companies and those that chose to carry their own risks. Otherwise it would be very damaging to the insurance industry.

The CHAIRMAN. I am not sure who mentioned foreign insurance and that maybe discounting might cause a competitive disadvantage. I believe, Mr. Milo, you did?

Mr. MILO. Yes, Senator.

The CHAIRMAN. How would such a rule affect current competition among U.S. insurers? Would it have any impact?

Mr. MILO. Yes. To the extent that what discounting actually does is to tax now what may be earned in the future—just as an example, it is like someone buying a series E bond and paying $50 now and then in 5 years it will mature, let us say, $75. In the year purchased he should include in income now the $25 that he is going to get in year 5. Effectively that is what discounting does, is to tax now what you expect in the future.

Well, the other insurers overseas are not taxed on that basis. They are taxed on the basis as we are currently taxed, and that is that you take a deduction when you experience an economic loss in the year. You deduct the entire economic loss. Thus, to the extent that overseas companies are taxed under this environment, and insurance being very portable, to the extent that in that country an insurer would not be currently taxed on its future investment income, then it could take this business and not be penalized. U.S. insurers taking this business would be penalized because they would have to then provide a tax on income which they have not earned yet.

The CHAIRMAN. Go ahead.

Mr. JONES. What I was going to point out, Senator, is that the GAO suggested that it might be advantageous to a company to anticipate higher losses than really exist. I want to say that there is very strict internal discipline in this system that keeps that from happening.

Companies really do try their best to get an accurate appraisal of their unpaid losses. If they make them too high, they show a poor performance compared to other companies. There is a management consulting firm that surveys 19 large companies and 8 direct writers and compiles the average of reserves and then shows whether various companies are above or below that average. So there is a discipline within the industry giving companies an initiative to perform well as compared to their peers.

Also, a company which used only its own experience in setting rates would rise losing some market share.

On the other hand, if a company underestimates losses too much, it may seem that it is turning in a good performance now, but there has to be an adjustment and the regulators may force it. Best's, the rating organization of insurance companies, may force it. Periodically you see that a company has to explain their poor results this year because they had to strengthen their reserves. It is clear that there is an internal discipline in the reserving process.

The companies are not going to set aside more than they have to. It is a competitive market, and they stay as close as they can to that mark.

Mr. MAISONPIERRE. Mr. Chairman, the inadequacy of reserves is one of the regulators' greatest concerns, and in fact in management it is a serious concern. In spite of the high attention given to the reserving, sources outside of the insurance business estimate that in the so-called long lines there is considerable under-reserving by the industry and not over-reserving, as GAO might believe.

I believe in workers compensation about 10 percent under-reserving, and about the same amount for general liability. The tendency is for the industry to be in fact under-reserved.

The CHAIRMAN. Are a lot of corporations acquiring insurance companies? We have heard about Baldwin United and MGIC; is that happening in other areas? Do you see other corporations moving in and acquiring insurance companies? And if so, why would they be doing that?

Mr. THORNBURY. There have for some years been a number of insurance companies who were owned by noninsurance companies. Both U.S. and foreign companies have invested in the U.S. insurance industry. To the extent that the companies are in periods of their economic cycle where they have net underwriting losses and investment income is not sufficient on a taxable basis to offset those underwriting losses, the consolidation of those companies would produce some tax shelter to their owners, but they also represent a cash flow from those owners if the owners are giving current tax benefit for any of those losses.

The CHAIRMAN. Right, so the deductions would be available to the parent company.

Mr. THORNBURY. Under consolidation, yes.

Mr. JONES. Senator, acquisition began about 1969. We find ourselves vulnerable and are concerned about it because of the volatility of our earnings. Our stocks sell at an average of six or seven times earnings, whereas generally in the market stocks sell on the average of 13 times earnings. So, companies found that they could offer an exchange of stock that appeared attractive to our stock companies. Of course, this does not apply to the mutuals. Companies that acquired insurers were the ones that could take advantage of the cyclical nature of the business.

In other words, they could make a profit overall despite the cyclical nature of the business, and thus maintain the values of their stocks in the market.

The CHAIRMAN. Well, I want to thank everyone on the panel very much. As I indicated at the outset, we are going to be looking at a lot of areas and a lot of groups to see whether or not changes should be made. I do not have any prejudgments, but we also have some responsibilities, as you have, and we may have to revisit this area. As I would summarize your testimony, you are all in agreement that we should do nothing. That would not take any 5-minute statement. But I do not see any area about which you indicate GAO or Treasury or anyone else should have any legitimate concern.

Again, we have to make judgments, too. If we are asked to come up with $10 billion or $12 billion by a mandate by Congress, I assume that you would be willing to help us in that regard, although perhaps not all of it.

Mr. THORNBURY. Senator, if you decide that there are some proposals that you wish to obtain some reactions on, we would like the opportunity of a hearing at that time.

The CHAIRMAN. We will give you time for reaction before the fact, hopefully.

Mr. JONES. Senator, you asked us not to duplicate, and I think it worked out pretty well from our point of view, too. It imposed a certain amount of discipline on what we had to say. We got together, and it was our effort.

The CHAIRMAN. I appreciate that, and I will make it clear that the entire statements will be made a part of the record, and in the event there are supplemental views you would like to add based on GAO testimony, or any of the questions posed, that will be made a part of the record. The hearing record will be kept open for a period of a couple of weeks, and it will be printed and available to anyone, any panelist or anyone else in the audience.

I assume that, in fact, as the GAO progresses, they will be meeting with you. If you represent 90 percent of the industry, we certainly want to keep in touch. Thank you.

Our final panel is John Byrne, chairman and chief executive officer of GEICO, and Roger Joslin, vice president and treasurer of State Farm Mutual. Again, I would say for the record that your entire statements will be made a part of the hearing record. I do not know who wishes to proceed first. In the order I called? Mr. Byrne?

STATEMENT OF JOHN J. BYRNE, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, GEICO, INC.

Mr. BYRNE. Thank you, Senator.

My name is Jack Byrne. I am chairman of the Government Employees Insurance Co. We are a local company, medium-sized property casualty company. Today we are a healthy company. We are a heavy taxpayer. Seven years ago we were on the brink of insolvency, and that is what I would like to talk with you about today. We did not go under by the skin of our teeth, but my main point is, had we been using a system of reserves which had been promulgated here by the GAO and Treasury, we would indeed be insolvent today.

Let me say, I support the positions of the industry panel, and I would just like to underline two of those points. The first point is the extremely adverse impact of the discounting of property and casualty insurance company loss reserves and the erroneous conception that property and casualty insurance companies are financial intermediaries that should be considered as part of the test of financial intermediaries.

Historically, most property and casualty insurance company reserves have not been adequate. Primarily they have not been adequate because of inflation. I base this statement upon my 25 years of managing in the insurance industry, and on my training as an actuary. Discounting of loss reserves will exacerbate this already substantial problem of inadequacy to the great detriment of the property and casualty industry and to the great detriment of the public.

In 1976, 7 years ago, I assumed the general management responsibilities at GEICO. At that time, GEICO's statutory capital and surplus had dropped suddenly from $142 million to $20 million, and we were losing $2 million a week. So, at that rate of financial loss, our survival was measured in days, not weeks or months, but literally days. At that time, we had 2½ million policyholders, and 9,000 employees, and none of us cared to measure the financial and people impact of GEICO becoming insolvent.

The property and casualty insurance industry is highly volatile. As your staff report that came out Saturday—Friday, the report of the Joint Committee on Taxation, as it shows on page 34, we are not a very profitable industry. Over the last 10, 20, and 30 years, we have made returns on capital far below the rest of America's business. Your staff also points out that we are a very volatile industry. Our reported earnings jump all over the place, and right now this is not a very good time for our industry.

It is a cyclical industry. Losses are extremely difficult to predict with great precision, and at the same time the pricing mechanisms are closely regulated. Surges in losses, whether from natural causes or from spiraling inflation, take their inevitable toll, and clearly these events outrace the ability of property and casualty companies to obtain increases in premium.

Therefore, a property casualty insurance company can suddenly find itself going from what looks like a successful record to a suddenly very unsuccessful record, and that is exactly what happened to us at GEICO.

The CHAIRMAN. Were there not other factors? You did not charge enough for your premiums, I think was one of the problems.

Mr. BYRNE. Yes, sir. Good for you. That is exactly right. However, the reserves, being so inadequate, hid that from view for a very precious 9 or 12 months, and this kind of crack the whip thing can happen very quickly in the casualty property business, and that 12 months—that is a little overstatement—maybe 9 months, hidden from view because of the reserve side of the problem, prevented the action that was necessary, and that is why it got in such a terrible crack so fast.

The CHAIRMAN. I remember I followed that carefully. This was a big story, as you know, in this town for months and months.

Mr. BYRNE. It was very uncomfortable for those of us who were living through it.

The CHAIRMAN. You have done a good job, too.

Mr. BYRNE. Thank you.

What protection do we have? Well, we have two protections, that our loss reserves are adequate, and that we have enough capital and surplus. Now, is it easy and comfortable to establish reserves? Let me assure you that it is not. In this staff report on page 14, they talk about the way we do it. It brings to mind serious questions in my mind whether they even realize—the people who wrote the report even realize how we do it. They talk about simple relationships to premiums, and that is not the way our actuaries try to set reserves at all.

There is one way to try to do it right, and the only way I know is to follow the rules of statutory accounting. They are monitored by the accountants as some of the industry witnesses have said earlier. There are strong attempts at discipline within the industry. GEICO squeaked through, thanks to the help from many, many quarters, and today, we are a healthy company, we are a good employer, and we are a heavy taxpayer. Had we been required to discount those reserves, we would have fallen over the brink, and we would today be insolvent. It is as simple as that.

So, as you consider the suggestions for discounting reserves, I would ask you to keep in mind the direct results that would have flowed had we become insolvent. Two and a half million policyholders, 9,000 employees, $700 million of liabilities would have been thrown upon the State regulators to try to work out somehow, and over 20,000 investors would have lost hundreds of millions of dollars.

I cannot urge you in strong enough terms to not fall prey to such proposals.

I know my time is up. I would like to make one more point—two more points. In the GAO tables submitted this morning, they talk about the four or five—excuse me. You asked a question, what kind of revenues might flow, and they pointed to table 3 in their submitted testimony. Let me just assure you, do not count on that $500 million of revenue flowing. It will not flow for reasons that are not taken into account in the table.

My last point is on the commentators on level playing field and financial intermediation, and my point is simply that we should not be considered in the same terms as the life insurance company and the banks. The written statement of the industry makes this point. I would like to just underline it. Life insurance companies are essentially a savings concept. Property and casualty companies are essentially temporary pools of capital that are there for the single purpose of sharing the casualty property pool.

Likewise with banks. They are lenders and borrowers and savers, provide savings mechanisms. We have none of that. So please consider the property casualty industry, which is not doing well these days, by any measure—return on capital by your own staff measures, et cetera—please consider the property casualty industry on its own measures, and do not—be very cautious of analogies that relate us to the banking industry or the life insurance industry.

Thank you, sir.

[The prepared statement of Mr. Byrne follows.]

PREPARED STATEMENT OF JOHN J. BYRNE

INTRODUCTION

My name is John J. Byrne, and I am Chairman and Chief Executive Officer of Government Employees Insurance Company (GEICO), Geico Plaza, Washington, D. C. 20076. I am accompanied by Edward N. Delaney, Zuckert, Scoutt, Rasenberger, Delaney and Johnson, Washington, D. C., our counsel in this matter.

We appreciate the opportunity to participate in the hearings of the Committee on Finance covering a subject that is so critical to the future of GEICO.

It is important, we believe, for you to be aware of GEICO, its place in the property and casualty insurance industry, and its recent financial experiences.

GEICO is a local company, that is, it is local to Washington, D. C. It is a medium-sized property and casualty insurance company, and less than eight years ago, it teetered on the brink of financial insolvency.

NATIONAL ASSOCIATION OF INDEPENDENT INSURERS

I appear today only in my capacity of Chairman and Chief Executive Officer of GEICO. But among my functions and responsibilities are service as a member of the Board of Governors of the National Association of Independent Insurers (NAII), and as a member of that Association's Tax Steering Committee. During the preceding panel, you heard from Harold C. McCarthy speaking on behalf of Lowel R. Beck, President of NAII, and

Ralph Milo speaking on behalf of NAII's Tax Committee.

I fully support their testimony, the written statement submitted by NAII, and the testimony of the other members of that panel. I want to emphasize two very important matters, i.e., the extremely adverse impact of the discounting of property and casualty insurance companies' loss reserves, and the erroneous conception that property and casualty insurance companies are "financial institutions" in the sense of life insurance companies and banks.

DISCOUNTING OF PROPERTY AND CASUALTY INSURANCE COMPANY LOSS RESERVES

It is a fact, that historically most property and casualty insurance companies' reserves have not been adequate because of inflation. I base this statement upon my twenty-five years of management responsibilities in the insurance industry, and my education and training as an actuary. Discounting of loss reserves will exacerbate this already substantial problem to the great detriment of property and casualty insurance companies, and more importantly, to the detriment of the public.

You may say that is a gross exaggeration by a representative of the property and casualty insurance industry who has a vested interest in protecting a policy, statutory accounting, that is outdated and outmoded. Let me assure you it is not an exaggeration; it is a fact that you and we must face.

In 1976, less than eight years ago, I assumed the chief management and operating responsibilities at GEICO. At that time, GEICO's statutory capital had plummetted from $142,000,000 to $25,000,000. GEICO was incurring a financial loss of about $2,000,000 every week.

At that rate of financial loss, GEICO's financial survival was measured in days -- not months, not weeks -- but days.

At that time, GEICO had 2,500,000 policyholders, and about 9,000 employees.

None of us cared to measure the financial and people impact of GEICO becoming insolvent.

The property and casualty insurance industry is highly volatile. It is cyclical. Losses are extremely difficult to predict with great precision. At the same time, its pricing mechanism is closely regulated. Increases in charges for our products -- premiums for policies -- cannot be made out-of-hand.

Surges in losses, whether from natural causes or man made, and spiralling or raging inflation, take their inevitable toll. Clearly, these events outrace the ability of property and casualty companies to obtain increases in premiums. Therefore, a property and casualty insurance company can, almost overnight, incur substantial underwriting losses. This was GEICO's problem.

What protection does such a company have for its policyholders?

Loss reserves, and its statutory capital.

Is it easy or comfortable to establish reserves? Let me assure you that my experience teaches me it is not.

How then do we assure adequate reserves? Let me tell you that the only way I know to assure adequate reserves is to follow the rules of statutory accounting. This, in conjunction with an effective monitoring system -- the monitoring undertaken by the National Association of Insurance Commissioners -- is the only effective way to assure reserves adequate to the financial demands of a highly volatile industry in inflationary times.

GEICO squeaked through! Today we are a healthy company, and a good employer.

If GEICO had been required to discount its reserves in 1975, I can assure you that GEICO would have fallen over the brink and into insolvency. Let me also say, discounting of reserves for purposes of the determination of the industries' federal income tax liability will inevitably result in discounting of such reserves for general business purposes. This will jeopardize our ability to meet our fiduciary responsibilities to our insureds, which are our primary obligations.

As you consider suggestions for discounting reserves, keep in mind the direct results that would have flowed had GEICO become insolvent:

(1) 2,500,000 policyholders, individuals and businesses looking to GEICO for protection against losses, would have been stranded;

(2) approximately 9,000 employees would have lost their jobs;

(3) $700,000,000 of claim liability would have been shifted to state regulators to resolve; and

(4) investors would have lost hundreds of millions of dollars.

We paid a heavy price for the lack of adequate reserves, but we did squeak through. Discounting reserves raises the very real possibility of more occurrences such as faced GEICO. As important, and as NAII has said, discounting strikes at the heart of all operating and accounting procedures of the property and casualty insurance industry, that is, at the financial integrity and responsibility of the insurers to their policyholders, whose money the companies receive, reserve and disburse.

I cannot urge you in strong enough terms -- do not fall prey to such proposals.

PROPERTY AND CASUALTY INSURANCE COMPANIES ARE NOT FINANCIAL INSTITUTIONS IN THE SENSE OF LIFE INSURANCE COMPANIES AND BANKS

Recently, some commentators have been saying that the concept of a "level playing field" requires that property and casualty insurance companies be considered in the same terms as life insurance companies and banks. That is clearly wrong.

The written statement of NAII submitted for these hearings points out vividly, and correctly, that life insurance companies and property and casualty insurance companies, have very few common aspects. Life insurance is essentially a savings concept. Property and casualty insurance companies are essentially pools of capital to share risk of loss -- not savings institutions.

Similarly, banks and property and casualty insurance companies share few common business attributes, and their reasons for existence have nothing in common.

Banks are providers of funds to their customers through the lending process, and offer saving opportunities to other customers. Property and casualty insurance companies do not do that. They are temporary pools of capital collected for the sole purpose of risk sharing.

Property and casualty insurance companies do not share "a playing field" with banks and life insurance companies. While it is fully appropriate for this Committee to review the property and casualty insurance industry, it is totally inappropriate to consider this industry in relation to the life insurance or the banking industry.

The CHAIRMAN. Thank you.
Mr. Joslin.

STATEMENT OF ROGER JOSLIN, VICE PRESIDENT AND TREASURER, STATE FARM MUTUAL AUTOMOBILE INSURANCE CO.

Mr. JOSLIN. Mr. Chairman, my name is Roger Joslin. I am vice president and treasurer of State Farm Mutual Automobile Insurance Co., Bloomington, Ill. We are well known as an independent voice in the insurance industry. We communicate with the trade associations, but we are not represented by them.

I have submitted a formal statement for the record. We point out that we emphasize two significant factors in there, that accounting changes—significant accounting changes in the tax law would not be good for the Government or for the insurance industry. We also believe that there are adequate tools to deal with abuses. However, we stand ready to work with you and your staff on any perceived or actual abuses that you find as far as the tax laws and the insurance industry might be related.

Property and casualty insurance, as other people have said, is a unique business. We set our prices well before our major costs are established. Losses, of course, are our major cost. Our loss experience is difficult to predict. It is cyclical. The tax laws and the unique accounting methods applied to the insurance business take into account those factors.

Tax equity and fairness should be carefully guarded in this industry, as in others. Similarly situated taxpayers should pay the same tax and tax determination should be capable of being made with certainty and predictability. Unintended benefits and manipulation of the system should be prevented. We agree with that. Any tax changes should be grounded in tax and social policy principles, and should not be adopted simply to meet predetermined revenue targets.

The NAIC (National Association of Insurance Commissioners) statutory accounting rules are good and satisfactory. Any change in the area of acquisition costs would bring forth a small revenue gain and create a lot of disruption. We sometimes listen too much to the theoreticians. Requiring an industry to capitalize its selling and promotional expenses really would be a deviation from traditional tax policy, and we do not feel that we ought to be singled out in that regard.

In the area of discounting of loss reserves, there is a twofold problem. One is economic. As other speakers have said, the whole concept of discounting calls forth into the current year estimates of future years' investment income. Administratively, though, I think it would be a nightmare. The biggest single problem that we run into in the Internal Revenue Service examination of insurance companies is the dispute over the level of loss reserves. We are only dealing with the question of the ultimate payout in those examinations today. We add the pattern of payout and the appropriate discount rate. We are expanding geometrically the complications that we are going to have to deal with.

Also, we hope you recognize and continue to recognize the unique circumstances of the mutual property casualty insurance companies.

Finally, we want to emphasize that we have no sympathy for financial transactions under the insurance umbrella that have little or no economic significance while providing large tax benefits. To the extent that problems exist, and if current weapons are not sufficient, we certainly support carefully drafted changes in the tax law.

The Government should be able to unravel insurance wash sales and to deal with situations where related parties move money or paper from one pocket to another without affecting—other than their tax liabilities—any financial realities, so we stand ready to work with you and your staff in any way possible.

[The prepared statement of Mr. Joslin follows:]

STATEMENT
OF
ROGER JOSLIN
VICE PRESIDENT AND TREASURER
OF
STATE FARM MUTUAL AUTOMOBILE INSURANCE COMPANY
BEFORE THE
SENATE FINANCE COMMITTEE

June 13, 1983

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE: My name is Roger Joslin, and I am Vice President and Treasurer of State Farm Mutual Automobile Insurance Company.

I am pleased to have the opportunity to appear before this Committee. State Farm Mutual has been a national leader in the property and casualty insurance industry for many years, and we wish to offer our cooperation and assistance to the Committee in this very significant undertaking.

As you begin this review of the Federal tax structure applicable to property and casualty insurance companies, you should not underestimate the complexity and difficulty of the task you are embarking upon. Our industry is in many ways unique: it is highly competitive, closely regulated and very diverse in its structure. Further, property and casualty insurance

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plays a significant economic and social role in the life of the nation. All these characteristics must be taken into account in formulating the applicable tax policy.

In the body of my statement, I will (1) briefly review the nature of the property and casualty insurance industry and State Farm Mutual's place in it; (2) suggest important factual and policy considerations relevant to the Committee's work; (3) describe the varying historical approaches that have been taken to taxation of property and casualty insurance companies; and, finally (4) address issues raised by the Committee.

The State Farm Mutual Group of Companies

State Farm Mutual Automobile Insurance Company, the parent company of our group, is a "mutual" property and casualty insurance company. The other major insurance companies in our group, while organized as stock companies, are wholly owned subsidiaries of the parent company.

The State Farm Mutual group of companies is essentially a "pure" insurance group, *i.e.*, we have no significant business operations other than insurance. The State Farm Mutual Group primarily writes personal lines of insurance and insurance for small businesses. These lines include automobile, homeowners, commercial multi-peril, accident and health, and life insurance.

Each of the State Farm Mutual affiliated insurance companies files its own Federal income tax return and pays its own Federal income taxes.

The Property and Casualty Insurance Industry Generally

It is important to understand the diversity of the property and casualty insurance industry. It is comprised of both mutual and stock insurance companies. Stock insurance companies, like other businesses conducted in the corporate form, are owned by shareholders who commit their capital to the enterprise and expect a dividend return on their equity investment. Mutual companies are owned by the policyholders who purchase insurance from the company.

Although it is difficult to determine exactly, we estimate that there are now more than 2,700 property and casualty insurance companies operating in the United States, of which over 1,500 are mutual companies. The mutual companies range in size from relatively small township and county companies to large national organizations like State Farm Mutual. Stock companies also vary greatly in their size and characteristics.

The amount of property and casualty insurance premiums paid each year by the American public is quite large. According to Best's Review, about $100 billion in premiums were paid in 1982. We estimate that the stock companies write approximately three-quarters of these premiums, and mutuals about one-quarter.

In recent years, the industry as a whole has experienced substantial losses from its underwriting activities, although investment income and capital gains have more than offset losses from underwriting.

In the context of the industry as a whole, and the historical period in which we now operate, State Farm Mutual is somewhat unusual. We have earned a profit on our insurance underwriting activities, in addition to the income from our investments. We have paid substantial amounts of Federal income taxes.

As we see it, an essential element of tax policy must be to fairly and equitably distribute within the business community and the nation at large the necessary Federal tax burden. We willingly accept paying a reasonable level of taxes, but we consider it crucial that all property and casualty insurers share fairly in the Federal tax burden on our industry.

Important Factual and Policy Considerations in
<u>Review of Property and Casualty Insurance Taxation</u>

No major tax changes have taken place with respect to our industry since the Revenue Act of 1962. Since 1962, the total amount of premiums written has increased dramatically, and the size and character of insurers have changed as well. The nature and amount of insured property and casualty risks in America has also changed significantly in 20 years, as obviously have investment conditions and practices. As this Committee knows all too well, the size, significance and complexity of the Federal tax system have also increased; and the pressures on that system to collect huge amounts of revenue have never been greater. In short, the facts and circumstances and the policy considerations relevant to this area have changed dramatically.

In light of these changed conditions, we believe the Committee, the Treasury and GAO should adhere to a common base of factual understanding and a common set of policy principles in evaluating property and casualty taxation and making any judgments as to possible changes. With the purpose of aiding this endeavor, we suggest that these considerations should at a minimum include the following:

1. Property and casualty insurance is a unique business from a tax perspective. Unlike manufacturing, the price of our service is set well before our most significant cost (i.e., claims) is known. Unlike life insurance, where future claims can be predicted relatively accurately based on life expectancy, our loss experience is highly variable and is much more difficult to predict. The tax law has recognized our uniqueness and has in the past adopted rules to reflect appropriately our characteristics.

2. Property and casualty insurance serves essential economic and social purposes in our society and is subject to intense public pressures and demands. Tax changes which affect our industry could possibly have significant societal impacts. Insurance must be widely available at reasonable costs.

3. The property and casualty insurance industry historically has been regulated at the state level. This responsibility rests in a Commissioner of Insurance in each of the 50 states and the District of Columbia. These Commissioners pool their expertise through the National Association of Insurance Commissioners ("NAIC").

The major responsibility of the state Commissioners is to insure the financial solvency of insurers: they need to safeguard policyholders and assure that claims are paid. Thus, Federal tax changes must continue to be in harmony with state regulatory objectives.

4. The property and casualty insurance industry is by far the major source of investment funds for bonds issued by state and local governments. Tax changes that affect the industry's investment posture could affect its role as a major support of the financial structure of state and local governments.

5. The property and casualty industry is highly competitive. Any tax regime must strive toward being neutral in its impact on the various segments of the industry. This principle is particularly important in our industry because of the desirability of encouraging a competitive climate. Competition produces economic and social benefits for the public. Efficiency and profitability must not be penalized; neither large companies operating nationally nor small companies serving local communities should be unduly burdened.

6. Mutual companies are significantly different from stock companies: mutuals do not have shareholders'

equity and cannot easily gain access to the capital markets. By virtue of their form of organization, mutuals provide an important barometer of the health of the industry from a "pure" insurance standpoint. Congress has traditionally recognized and taken account of these important distinctions, and it must continue to do so.

7. Tax equity and fairness should be guarded carefully in this industry, as in others. Similarly situated taxpayers should pay the same tax, and tax determinations should be capable of being made with certainty and predictability. Unintended benefits and manipulation of the system should be prevented.

8. Any tax changes should be grounded in tax and social policy principles, and <u>should</u> <u>not</u> be adopted simply to meet pre-determined revenue targets.

History of Federal Taxation of
<u>Property and Casualty Insurance Companies</u>

With the foregoing factual and policy considerations in mind, it is helpful to review the several different approaches to property and casualty taxation which Congress has adopted in prior years. Each of these approaches undoubtedly has both merits and demerits, which should be evaluated in considering changes for the future.

A. Taxation of Stock Companies

The current system of taxing stock companies is derived from the Revenue Act of 1921. These provisions have not been substantially changed since 1921. The most significant aspect of the historic and current tax regime is the principle that income and expenses for tax purposes are to be accounted for on the basis of the annual statement approved by the state regulatory Commissioners through NAIC. This statement is required to be filed by all insurance companies (both stocks and mutuals) each year. The tax law thus achieves general conformity between tax accounting and state regulatory and financial accounting.

B. Mutual Companies

Prior to 1942, mutual property and casualty insurance companies were generally exempt by statute from Federal tax. If a mutual company failed to qualify for the exemption, specific allowances recognizing their mutual organization and exposure to loss generally reduced their tax liability to very low levels.

Under the Revenue Act of 1942, mutual companies became subject to Federal income taxation under whichever of two alternative formulas resulted in a higher tax. Under one formula the company was taxed at the ordinary corporate tax rates on its net taxable investment income. Under the second formula the company was subject to a tax of 1% on the combined amount of its gross taxable investment income plus its net premium income, minus dividends to policyholders. Based on the conditions at this time, this act resulted in essentially an exemption of tax on underwriting income. By the same token, however, underwriting losses were not allowed to be taken into account to reduce taxable investment income.

In 1962, after the prior system had been in place for 20 years and after the matter had been studied for about three years, Congress determined to abandon the alternative formula approach. Instead, a mutual company was to be taxed in all cases on its combined investment and underwriting income. The Revenue Act of 1962 taxed the income of mutual companies in substantially the same manner as the income of stock companies -- i.e., based on the NAIC annual accounting statement -- but with one major difference: mutual companies were permitted a deduction for annual additions to a "protection against loss" or "PAL" account. As will be discussed later, the PAL account was enacted in order to take account of the fundamental difference in the organizational characteristics of stock and mutual companies.

The current system of mutual company taxation is substantially the same as that enacted in 1962.

Specific Issues Raised by the Committee

On the basis of the foregoing background and important factual and policy considerations, I would like to address issues raised by the Committee.

1. Acquisition Costs

Under the NAIC regulatory accounting rules, the cost of writing or acquiring an insurance contract is deductible in the year paid or incurred by the insurer. Acquisition costs are defined as those costs incurred by an insurance company for the production of business. The NAIC rules provide specific guidelines for identifying such costs.

Generally accepted accounting principles (GAAP) require acquisition costs to be recorded as prepaid expenses and subsequently charged to expense as premium income is earned. All property and casualty insurance companies keep their primary books of account in accordance with NAIC rules, rather than GAAP. Only those companies subject to Securities and Exchange Commission oversight of their reports to stockholders are required to convert their accounts to GAAP.

Under general income tax principles, expenses incurred in the acquisition of an asset generally are considered to be capital expenses and are to be recovered over the useful life of the capital asset. The general rule attempts to match the timing of an expense deduction with the receipt of income produced by that expense. However, Congress has seen fit to enact numerous exceptions to this general rule, such as the immediate expensing of research and development expenses, the accelerated cost recovery system for capital property, immediate write-off of intangible drilling costs, percentage depletion of minerals, five year amortization of new business start up expenses and many others. Indeed, the exceptional situations appear to be more numerous than those covered by the general rule.

Property and casualty insurance contracts generally are short term, 12 months or less. Any mismatch of income and expense caused by the NAIC treatment is limited by the contract term. The issue, as we see it, is whether the apparent benefits of any changes intended to reach a more precise matching would outweigh the considerable costs and uncertainties that would be involved.

Deferral and amortization of acquisition costs for Federal income tax purposes would be a major departure from the NAIC rules. It could lead to confusion and controversy in the property and casualty insurance context by requiring the development of a set of new and unfamiliar accounting rules. Even new tax rules based on GAAP would be difficult for companies to implement, since most do not follow GAAP. Given the diversity of insurance company situations, such tax rules would not be likely to produce more precise income measurement in an administrably feasible fashion looking at the industry as a whole.

Finally, we doubt that any alleged "overstatement" of current deductions would be significant in relation to the deductions that will be allowed in any event. It is unlikely that significant revenue gains will be achieved from any changes in this area, particularly when offset by the increased administrative costs that would inevitably be incurred.

2. Discounting of Reserves

In the majority of cases that arise in State Farm Mutual's lines of insurance, a policyholder will incur a loss, make a claim and receive payment of that claim, all within a few months. The bulk of our losses are incurred and paid within two taxable years.

Under the NAIC accounting rules, a deduction is allowed for paid losses, and for a fair and reasonable estimate of amounts to be paid in the future for losses which have occurred. Under the NAIC rules, the liability for incurred but unpaid losses is not discounted to present value. (There is a very limited exception for worker's compensation claims in some states.)

There are serious difficulties of both a practical and policy nature with proposals for a new tax accounting system which would require the discounting of reserves on incurred but unpaid losses. First, there are multiple uncertainties in discounting. The individual insurer would be required to estimate three factors: (1) the amounts that will actually be paid, (2) when they will be paid, and (3) an appropriate discount rate to be applied to accurately reflect future investment returns. Extensive reliance on such difficult estimates will drastically reduce the certainty and predicability of computing the insurer's tax liability. Subjective judgments may lead to manipulation and compound existing disputes with the Internal Revenue Service. Similarly situated taxpayers will wind up paying very different tax liabilities based on their approach to estimating and the ability of the Internal Revenue Service to enforce compliance. The uniformity of treatment presently achieved by following NAIC rules will be lost.

Second, because it would be clearly inappropriate to discount reserves for short term claims, introduction of a discounting system for longer term claims would inject into the system a complexity which would not appear warranted by the circumstances.

Third, it is important to appreciate that discounting has <u>not</u> been adopted by the accounting profession with respect to unpaid property and casualty insurance claims. The discounting issue has been under study by NAIC, the Financial Accounting Standards Board, and the American Institute of Certified Public Accountants. <u>None</u> of these experts has taken the position that reserves for unpaid losses must be discounted.

Discounting of loss reserves would be based on the idea that the "true" cost of an incurred but unpaid liability is equal to (i) the actual out-of-pocket cost of paying the liability, less (ii) the portion of that cost which it is estimated that the insurer can earn on its investments prior to the payment. Discounting would not match actual premium income with actual expense, but rather would match actual income with estimated expense net of an estimate of anticipated future income. Thus, discounting may actually distort proper reflection of current income, by in effect recognizing as today's taxable underwriting income an estimate of tomorrow's anticipated but not yet earned investment income.

Finally, we would point out that in all events, discounting would constitute a major change in tax policy, possibly with far-reaching implications outside the area of loss reserves of property and casualty insurance companies. For example, if future payments of expenses are to be discounted, should not future income streams, which are now generally accrued at the full face amounts, also be discounted? The concept of discounting in the fullness of time might well cost, rather than gain, the Treasury significant revenues.

3. PAL Account

In each of the several different taxing structures for property and casualty insurance adopted in the past, Congress has given recognition in one fashion or another to the different characteristics of stocks and mutuals. In 1962, the protection against loss, or "PAL," account was introduced for just this reason.

The PAL account is not a tax exemption: rather, it is a limited deferral mechanism. Its primary justification is to give recognition to the mutual company's lack of access to the capital market for funds with which to pay losses. In 1962, this Committee described the need for the PAL account as follows:

> "While a stock insurance company can pay extraordinary losses not only out of its accumulated profits but out of its paid-in capital, a mutual insurance company can pay extraordinary losses only out of retained underwriting income. As a result, a mutual ordinarily retains a portion of its underwriting income each year for this purpose: the remainder is paid to its policyholders as policy dividends. This accumulated underwriting income constitutes its reserve out of which insurance losses can be paid, and the existence of such reserves is an important protection to the mutual policyholders.
>
> "Under the law up to this time, no income taxes have been paid on this retained underwriting income, except

> (since 1941) to the extent the excess of the alternative 1-percent tax over the tax on investment income in effect taxed part (all, or more than all) of the underwriting income. Similarly, underwriting losses may not reduce the tax on investment income. Under the President's proposal, underwriting gains would have been fully taxed as realized. Under the provisions of this bill, however, these mutual fire and casualty companies will be permitted to set aside a portion of each year's underwriting gain in a special account for protection against losses. This amount will be available to meet certain losses for 5 years, after which most of any remaining portion will be included in taxable income of the sixth year." Sen. Rep. No. 1881, 87th Cong., 2d Sess. (1962), at page 55.

The PAL account addresses significant needs for mutual organizations, and any proposals for change must be carefully constructed to take account of these needs.

4. The Definition of Insurance

The concept of property and casualty insurance is well understood. The business of property and casualty insurance companies is spreading the risks of loss based on the law of large numbers. In the ordinary course, there is no difficulty in determining that a contract that spreads a risk of future loss is an insurance contract. We assume, therefore, that the Committee is concerned with the use of questionable "insurance" or "reinsurance" contracts to obtain unwarranted tax benefits.

When dealing with complex issues, the correct answer often becomes more clearly visible once the question is properly phrased. Perhaps this question should be restated to read: "What tax treatment should be afforded financial transactions in the nature of true insurance, entered into by and with true insurance companies?"

The answer then may be found in general tax principles which have been developed to limit manipulative attempts to achieve tax benefits based on legal form rather than economic substance. If the rules already in place do not assure tax equity and fair competition, we would support carefully crafted mechanisms to deny tax benefits for transactions where the economic reality is something other than a legitimate insurance arrangement.

Conclusion

Mr. Chairman, the State Farm Mutual Group pledges our cooperation and assistance as the Committee proceeds with its task. Careful and thoughtful work needs to be done. We know this Committee and the Congress, together with the Treasury and the GAO, will carry out their responsibilities wisely and prudently.

Thank you, Mr. Chairman, for the opportunity you have given me to represent State Farm Mutual here today.

National Association of Independent Insurers

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Tania Demchuk
PUBLIC AFFAIRS SPECIALIST

For Release: June 13, 1983

PRESS RELEASE

Contact: Tania Demchuk
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Washington, D.C. June 13 -- Despite a decline in the effective tax rate for property/liability insurers - as claimed by the General Accounting Office - insurance companies' extensive holdings of exempt securities has produced a net revenue gain for the U.S. Treasury, a significant cost savings for state and local treasuries, and lower premiums for insurance policyholders.

These points were underscored today by the National Association of Independent Insurers (NAII) following the GAO's testimony at a hearing of the Senate Committee on Finance.

Ralph Milo, chairman of NAII's Federal Tax Committee, attributed the GAO's reported decline in the effective tax rate for casualty insurers to severe inflationary pressures of recent years. He explained that high inflation in the price of goods and services paid for by insurers produced unprecedented, sustained underwriting losses which offset insurers' income from other sources and thus reduced their tax liabilities.

"Nevertheless," Milo said, "this drop in tax liabilities does not suggest an accompanying drop in revenue to the Treasury. On the contrary, the fact that most tax-exempt securities are held by casualty insurance companies rather than by wealthy individuals actually produces a revenue gain, or smaller revenue loss, because casualty insurance companies are taxed at a maximum marginal rate of 46 percent, while top-bracket individuals are taxed at 50 per cent."

(more)

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If, over the last 10 years, the government had discouraged the holding of state and local securities by casualty companies in order to make casualty insurers send in more dollars of tax, Milo said, other taxpayers would have sent in less tax.

"The market for the sale of such securities would have contracted," he said, "and state and local governments would have had to pay higher interest rates to sell their bonds. That not only would have increased the cost of state and local financing, but would have increased the tax benefits for high-bracket taxpayers holding the bonds.

"Meanwhile, the Treasury's revenue loss on the bonds actually outstanding would increase, because a higher yielding stream of income would be exempt in the hands of other taxpayers. Only if the higher borrowing costs had caused state and local governments to issue fewer bonds would there have been any offset to that larger revenue loss."

Milo also pointed out that "it is better to have tax exempt securities held by casualty companies, because the benefits of the exemption flow through to ordinary policyholders in the form of lower premiums, which obviously is preferable to concentrating all the benefits on high-bracket individuals."

"If casualty insurance companies had been forbidden to invest in state and municipal securities," Milo said, "their after-tax investment income would have been less, and the competitive marketplace would have caused premiums to be priced higher."

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For Release: June 13, 1983

PRESS RELEASE

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WASHINGTON, D.C., June 13 -- Any change in the current tax structure that increased the tax burden on property/liability insurers would lead to higher premiums for policyholders, jeopardize the financial solvency of the industry, and put U.S. insurers at a competitive disadvantage with foreign companies.

This was the assertion made today at a hearing of the Senate Finance Committee by a panel of four property and casualty insurance trade associations - the National Association of Independent Insurers, the Alliance of American Insurers, the American Insurance Association, and the National Association of Mutual Insurance Companies.

Testifying for the industry panel, which represents more than 90 per cent of the total property and casualty insurance coverage written in the U.S., Harold C. McCarthy, president and chief executive officer of Meridian Mutual Insurance Company, and a member of the NAII Board of Governors, urged the committee to take several public policy considerations into account before making any decisions involving taxation of the insurance industry.

First among them, he said is the competitive nature of the insurance industry. "Because our industry is fiercely competitive, any increased taxes will be translated almost immediately into higher premiums for our policyholders. This would mean that many individuals and businesses will no longer be able to afford the insurance protection they currently receive."

Secondly, McCarthy said, policyholders are entitled to know that insurers are financially sound, and the century-old system of accounting employed in the industry is a key element in assessing financial soundness.

"Current tax laws properly take this system into account, and to undermine the system would pose a substantial threat to the solvency of our industry," McCarthy warned.

The industry spokesman also urged the committee to consider the fact that property and casualty insurance coverages can readily be written by either domestic or foreign insurers, and he noted that current tax laws allow domestic insurers "to compete with foreign insurers." The NAII cautioned against enacting tax laws that would put the domestic insurance industry at a competitive disadvantage with foreign insurers.

"Finally, we are not financial institutions, as many have characterized us," McCarthy observed. "Policyholders do not use us as depositories for purposes of accumulating savings, but solely to insure themselves against risks. Current tax laws properly recognize that vital distinctions exist between insurance companies and financial institutions."

Also testifying for the NAII was Ralph Milo, chairman of the NAII Federal Tax Committee. Milo addressed the Senate committee's question on whether casualty reserves should be discounted to reflect payment of claims in future years.

"Discounting would be entirely inappropriate because the reserves represent economic losses that have already occurred," he said. "The discounting of casualty loss reserves would create major distortions in the taxation of economic income."

Such distortions would occur, Milo explained, because a true economic loss would not be deductible in full at the time the loss occurred; the full deduction would depend on the fortuitous timing of the transfer from the pooled funds to the policyholders; income to be earned in the future would be taxed prior to the time it is earned; and there would be a significant difference between the treatment of losses which are paid relatively quickly and those which are paid after some delay.

The NAII pointed out three serious consequences of the unjustified tax liabilities that would be caused by discounting. One consequence would be to seriously disadvantage the domestic insurance industry in its competition with foreign insurers.

"A very substantial amount of the insurance of United States risks can be and already is placed across national borders with insurers operating under more favorable tax regimes. The discounting of reserves and its accelerated taxation of future income would substantially increase the cost of domestic insurance, disadvantaging domestic insurers in their already fierce competition with foreign insurers.

Second, discounting would be a nightmare to administer, according to Milo. "Endless controversy would be the sure result."

Milo said discounting of loss reserves for tax purposes would require the determination of the proper amount of loss reserves (a perennial source of misunderstanding and controversy between the IRS and insurance companies); the determination of a proper discount rate (which would never be clear cut and always be changing); and the determination of the estimated future payment schedule of the losses (which would necessarily be judgments, based on an array of statistical data).

"Third, and perhaps most important, discounting strikes at the primary objective of all operating and accounting procedures for casualty insurance: financial integrity and meticulous responsibility to the policyholders, whose money it really is that the companies are receiving, reserving and disbursing," Milo said.

Present rules, both tax and non-tax, he added, are based on the legal requirement that the money paid in by the policyholders must continue to be held, i.e., "reserved," for their account until it is clearly no longer needed; and that it becomes income or surplus to the company only when released from those reserves.

"Any erosion of this requirement will seriously undermine financial integrity and jeopardize the resources not of the companies, but millions of policyholders," Milo said.

Statement on Behalf of the National Association of Mutual Insurance Companies (NAMIC)

Prepared by Gerald I. Lenrow
and Michael J. Cuddy
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Testimony will be presented by Michael J. Cuddy and NAMIC General Counsel Robert J. Spolyar

SUMMARY OF POINTS INCLUDED IN STATEMENT

For the reasons stated in the following statement we believe that:

(1) Since the answer to the question of "What is insurance?" depends on the facts and circumstances of each particular situation, it will be difficult, if not impossible, to legislate a definition which is more adequate than existing precedents.

(2) The PAL account was enacted as a tax deferral mechanism because Congress believed that mutual insurance companies needed an additional "reserve" for the payment of extraordinary losses. Unlike their stock company counterparts, mutuals do not generally have access to equity markets. Thus the PAL account was provided as "an important protection to the mutual policyholder". It has served this purpose over the past 20 years.

Other reasons for creating the PAL account also still exist. Many of the small and medium sized mutuals, 100 years of age and more underwrite by law in small geographic areas, and therefore, the loss from a single catastrophic event could greatly damage the company's ability to operate and pay losses. Moreover, the PAL account allows mutual insurance companies to increase surplus and write additional insurance that it would otherwise be unable to write. This benefits the consumer, especially at times when insurance coverage is difficult to obtain except from these local mutuals. The need for additional surplus by these companies is real since these companies tend to stabilize insurance availability particularly in rural areas. Thus the PAL account should be retained.

INTRODUCTION:

The National Association of Mutual Insurance Companies (NAMIC) is made up of over 1,170 member companies, the vast majority of which write farm property and casualty risks. About two-thirds of these companies are quite small and rural in orientation. The age of many of these companies exceeds 100 years. They are spread throughout forty-one states and, being mutual in nature, comprise the original consumer movement. Among the remaining one-third of our membership, many of the companies are large and write property and casualty coverages of all types. They range down in size from the very largest to moderate sized companies.

The Association, which was founded in 1895, is headquartered in Indianapolis, Indiana. Its President is Harold W. Walters and its General Counsel and Legislative Vice President is Robert J. Spolyar. Washington Counsel is Collier, Shannon, Rill and Scott, 1055 Thomas Jefferson Street N.W., Washington, D.C.

In an April 29, 1983 Press Release, the Honorable Robert J. Dole, Chairman of the Senate Committee on Finance, announced that the Committee would hold hearings on Monday, June 13, 1983 to examine the tax structure applicable to property and casualty insurance companies.

Our statement discusses in detail two of the issues that the Committee will address and to which we will submit oral testimony at the June 13, 1983 hearings:

(1) How "insurance" should be defined for tax purposes,

(2) Whether the tax deferral provided for protection against loss accounts is justified.

In light of Senator Dole's request that those with similar views should appoint a spokesperson to represent them so as not to duplicate testimony, we have not briefed the following three points since we believe others will adequately address them:

(1) Whether certain reserves should be discounted to reflect payment of claims in future years.

(2) Whether acquisition costs of insurance contracts should be deducted when incurred or amortized over the anticipated life of the contract.

(3) Whether the affiliation of property and casualty insurance companies, life insurance companies, and other unrelated businesses provides unintended opportunities for tax planning.

QUESTION I: HOW INSURANCE SHOULD BE DEFINED FOR TAX PURPOSES

Over time commentators have offered many definitions of insurance. However, most of these definitions, are rather broad and do not define the term with any degree of exclusivity, indicating the difficulty in arriving at a definition which will encompass all situations not to mention changes in the concept of insurance.

In Couch, Second Edition, "Cyclopedia of Insurance Law" (1959 edition with 1982 supplement) at page 28, Section 1.2, insurance is defined as follows:

> "Insurance, or as it is sometimes called, assurance, is a contract by which one party, for a consideration, which is usually paid in money either in one sum or at different times during the continuance of the risk promises to make a certain payment of money upon the destruction or injury of something in which the other party has an interest."

Both a definition and an excellent statement of the problem are contained in American Jurisprudence 2d Section 1 at Vol. 43, pages 73-75:

> "There are a great number of definitions of the term insurance under the common law as well as under the statutes of many states. Necessarily, in defining insurance in a single sentence, only the most general terms can be used, and any general <u>definition must be extended to cover the ever changing phases in which the subject is presented to the public</u>. ... The authoritiies are substantially agreed that insurance may be defined as an agreement by which one person for a consideration promises to pay money or its equivalent, or to perform some act of value to another on the destruction, death, loss or injury of someone or something by specified perils. (Emphasis supplied)
>
> ... "as a general matter... the essential feature of policies of insurance at the present time is substantially that of indemnity to the insured... Insurance has consequently been defined, by statute in some jurisdictions, as a contract whereby one undertakes to indemnify another against loss, damage, or liability arising from an unknown or contingent event. It has likewise been defined as a contract whereby one party agrees to wholly or partially indemnify another for loss or damage which he may suffer from a specified peril... The concept of insurance has been said to involve some investment risk-taking on the part of the insurer and to involve a guaranty that at least some fraction of the benefits will be payable in fixed amounts."

An excellent description of the issues raised by the question in a Federal income tax setting is contained in a May 5, 1983 Joint Committee on Taxation background paper on the taxation of life insurance companies and their products, prepared for the use of the Committee on Ways and Means. In the document the following statement is made:

> "Although the Code defines life insurance reserves, it does not define insurance reserves. Rather, the definition of insurance reserves must be discerned from case law and can require consideration of the fundamental question: What is insurance? Although this question has been considered by several courts (including the Supreme Court), there is still no 'definitive' definition. Compare Helvering v. LeGierse, 312 U.S. 531 (1941) and Consumer Life Insurance Co. v. United States, 430 U.S. 725 (1975)." sic (1977).

> "When a company assumes only the risk of paying a guaranteed amount, that is, it assumes only an investment risk, does the contract involve insurance which would cause such funds to be set aside in an 'insurance reserve'? Certain court cases have held that the assumption of a mere investment risk does not constitute insurance, because an investment risk is not an insurance risk. Although the assumption of such an investment is akin to the type of risk assumed by many banks, the court cases are far from definitive."

As footnote 11 at the bottom of page 41 makes clear, the issue of what is insurance is not confined to life insurance.

> "The question of what constitutes insurance may have a broad practical significance in areas other than life insurance. For example, this question is central in the fact situation of retroactive insurance under which a policyholder obtains insurance against a particular risk after the event of the risk has occurred. If it is insurance, the tax accounting for such a transaction may make the contract profitable: the policyholder may be entitled to an immediate deduction for a premium, which has been discounted at interest, taking into the

consideration the fact that the actual claims will be paid over a long period of time; at the same time, the insurance company selling the contract recognizes the liability for the accrued claims on an undiscounted basis. Thus, the transaction apparently takes advantage of what might be viewed as a mismatching of income and deductions, as between two unrelated taxpayers.

The question of what is insurance, also, is pertinent in certain areas which are outside the traditional commercial insurance business. For example, in the area of sureties and warranties, there is an argument that such contracts constitute insurance and companies issuing such contracts should be taxed as insurance companies, able to avail themselves of certain special and advantageous accounting provisions available only to insurance companies.

Finally, the question is central for any analysis of self-insurance plans and consideration of whether there can be valid insurance transactions between economically related parties, specifically, the captive insurance area."

There follows an analysis of significant cases and rulings of the past 40 years which we believe constitutes a satisfactory framework for answering the question of "What is insurance?" for tax purposes.

How Insurance Has Been Defined for Tax Purposes

The Supreme Court decision in Le Gierse, 41-1 USTC 10,029 (1940) rev'g, 1940-1 USTC 9332 (CA-2, 1940) and 39 BTA 1134 (1939) is the precedent most commonly cited by the courts and Service as authority for the principle that insurance requires the transfer of an economic risk of loss and the distribution of such risk. Le Gierse was specifically addressed to the liability for estate taxes on what the taxpayer claimed were insurance proceeds. The court ruled that the proceeds were not insurance payments since the insurance company had assumed no risk of loss in its contracts with the deceased.

Simultaneous to purchasing the policy, the deceased who was eighty years old had made full prepayment for an annuity. The very high risk usually assumed from insuring one so old was negated by the strong probability of a minimal liability for annuity payments. The fact that the life policy was in customary form did not persuade the court that it represented insurance. Thus, a recurrent doctrine of tax law was applied, substance controls over form, and under the particular circumstances of this case insurance was not present because taking the two policies together the company assumed no economic risk.

In contrast was the decision in Commissioner v. Treganowan, 50-1 USTC 10,770 (2nd Cir. 1950), rev'g 13 TC 159 1949. In that case, the question raised was whether proceeds received by the estate of the decedent constituted taxable life insurance proceeds. The decedent had been a member of the New York Stock Exchange. Members were required to pay an amount to the trustee of a gratuity fund upon admission and upon the death of any member. The money was paid out to designated beneficiaries of the member upon his demise. The Court ruled that the payment was insurance because the risk of the member's premature death was shifted to the other members.

In Steere Tank Lines, Inc., 1978-2 USTC 9605 (5th Cir. 1978), aff'g 76-2 USTC 9526 (D.C. Texas, 1976) the Fifth Circuit

Court of Appeals sustained the IRS's position that deposits into an account established to demonstrate the taxpayer's capacity to satisfy anticipated accident claims were not deductible as premiums paid for insurance. Rather the deposits were determined to be additions to a self-insurance reserve for contingencies. The court concluded that insurance did not exist since no risk of loss was shifted from the taxpayer to the administrator of the fund.

Steere, an oil shipping company, was required by Federal and state regulatory authorities to file evidence that it could make restitution for accidents in operating motor vehicles. It did so in the form of a surety bond. Steere argued that its arrangement with the surety constituted insurance in the form of a retrospectively rated policy.

Steere was obligated to maintain a deposit account at a minimum level equal to total claims. The surety was liable to pay losses that exceeded the deposit, but it had the right of indemnification against Steere. Thus, as the court observed: "The terms of the agreement are such that, effectively, the only risk Tri-State (surety) has is if Steere becomes insolvent." Deposits that were not used to pay claims after six years (statute of limitations for tort actions) were refundable to Steere in full. Steere also had the obligation to defend the surety in the event of a lawsuit and to carry excess coverage. For a case which arguably viewed insolvency as an insurance risk see the

22-734 O—83——14

Supreme Court's decision in Consumer Life Insurance Co., 1977-1 USTC 9364 (S.CT. 1977) aff'g 75-2 USTC 9776 (Ct. Cl. 1975).

The taxpayer in Steere relied on Weber Paper Co., 1963-2 USTC 9630 (1963), aff'g 62-1 USTC 9423 (D. Mo. 1962), as support that its program represented risk shifting. However, the Steere court distinguished the facts of Weber and concluded that Weber was not controlling. In Weber, several businesses located in an area vulnerable to floods organized an interinsurance plan financed by the policyholders. Similar to Steere, commercial carriers in Weber concluded that the flood risk was uninsurable. Significantly, and the basis of the taxpayer's reliance on Weber, was the fact that the participants in Weber could withdraw their participation and be refunded a maximum of 99% of their premium contributions. However, as the Steere court noted in distinguishing Weber, the amount of a participant's refund on his withdrawal depended on the experience of other members as reflected in the operating results of the insurer.

In Weber the participants' agreement provided that:

> "Our Attorney shall debit our Catastrophe Loss Account with our pro rata share of the payment of adjusted flood losses incurred by such similarly classified subscribers in the event flood loss or damage should occur within the policy coverage of such subscribers..."

Thus, the Steere court concluded that in Weber, a participant's payments would be used to pay losses of other insureds. This is risk shifting and risk distribution, the critical indicia of insurance which was absent in Steere. It is noteworthy that there was a finding of insurance in Weber although no insurance company was in the picture.

The government's argument in Steere paralleled that of Revenue Ruling 60-275, 1960-2 C.B. 43 which on Weber type facts held that a "refund" provision destroyed risk shifting where insureds were located in the same locality. In the event of flood, it was likely that each insured would suffer a simultaneous loss. Because each participant was underinsured, these facts indicated to the Service that reimbursement for claims would be from the insured's own funds. In the ruling the Service indicates that distribution of risk is a key element of the risk shifting requirement. It stated:

> "Since the eventual classification of the taxpayer with other member subscribers of the exchange will be limited to specific groups within the same flood district, each facing similar flood hazards, there is little likelihood that there could be a real sharing of the risks, because the occurrence of a major flood probably would affect all properties in a particular flood basin."

Another example of where insureds' losses have effected only their separate interest, and therefore, no risk of loss has been shifted is contained in Revenue Ruling 67-206, 1967-1 C.B. 179. In that ruling a group of attorneys formed a fund to provide title insurance for clients. The attorneys also intended the fund to provide protection against malpractice claims. Each attorney's interest in the fund was earmarked into separate accounts which recorded his contributions and losses. The ruling states that:

> "The fact that their interest in the Fund is reduced pro tanto for losses, for which they are civilly liable, indicates that the members do not receive protection in an insurance sense."

In essence where each participant's interest in the fund is immune from the loss experience of other members, there is no shifting and sharing of a risk of loss.

In a technical advice (LTR 7908003) the Service considered the applicability of the Section 4371 excise tax to the transfer of historical loss reserves. In that ruling, a domestic insurer reinsured some of its insurance risks and historical reserves for incurred but unpaid losses that related to the portion of the policies transferred to a foreign insurer related to the policyholder. The IRS stated that a premium is the consideration paid for insurance protection against a risk uncertain as to occurrence or time of occurrence. Thus it was held that the consideration for the transfer of historical reserves was intended merely to liquidate established claims the amount of which was known. In the Service's view this constituted only an assumption of the administrative functions of processing and paying the claims and not an insurance risk. It should be not be inferred from this ruling that if the amount of the exposure is unknown insurance does not exist.

Risk Shifting Where Insured has Ownership Interest in Insurer

Perhaps the arena where the issue of what is insurance has most frequently arisen in recent years is where the insured has an ownership interest in the insurer. In Revenue Ruling 77-316 the IRS held that a contract with a wholly-owned offshore captive did not constitute insurance since there was no shifting of risk outside the economic family. Subsequently Revenue Ruling 78-277 and LTR Ruling 7904047 held that no excise tax was due on "premiums" paid to a captive even though in the latter case the captive received 3% of its premiums from outside sources because the transaction did not constitute insurance.

On the other hand, the Service has ruled that insurance may exist in a captive setting. For example, in Revenue Ruling 78-338 an offshore insurer organized by a domestic oil producer to insure oil industry risks was found to be issuing insurance, where there were 31 unrelated shareholder-insureds, none of whom were controlling shareholders, and each of whom contributed no more than 5% of the total risks.

The first judicial views on the question appeared in Carnation Company v. Commissioner, 81-1 USTC 9263 (9th Cir 1981), aff'g 71 TC 400 (1978). In Carnation the Court held that a domestic corporation could not deduct insurance premium payments to an unrelated insurance company where the unrelated company had agreed pursuant to a reinsurance agreement to pass on the risk to the corporation's foreign subsidiary. In Carnation the foreign subsidiary only insured the risks of its parent and other related companies. Carnation also agreed to capitalize the insurance subsidiary for an additional amount of approximately $3 million. Citing LeGierse, the Court held that taken together with the reinsurance agreement they counteracted each other. Thus, no risk shifting or risk distribution occurred.

Certain rulings and regulations can be read as indicating that insurance may exist between an insured and a wholly-owned captive insurer if the captive issues insurance policies to other unrelated parties. For example, the Department of Labor class exemption from the ERISA rules provides that insurance of pension funds with a related domestic insurer does not violate the prohibited transaction rules if more than 50% of the insurer's premiums were derived from unrelated insureds. Treasury Regulation Section 1.105-11(b)(1)(iii) which deals with the problem of determining when a medical reimbursement plan is self-insured, adopts a similar position. The regulation provides that:

> "A plan underwritten by a policy of insurance issued by a captive insurance company is not considered self-insured for purposes of this section if for the plan year the premiums paid by companies unrelated to the captive insurance company equal or exceed 50% of total premiums received and the policy of insurance is similar to policies sold to such unrelated companies."

In two 1981 private letter rulings the IRS approved deductions for insurance premiums paid by a cooperative organization and one of its members to its wholly owned subsidiary.

The premiums received from unrelated insurers (members of the cooperative) exceeded 50% of all premiums received.

In LTR ruling 8111087 an offshore captive subsidiary was owned by a cooperative organization whose members were independent retailers. For several years, the cooperative had been helping its members obtain property/liability coverage and had obtained similar coverage for its own employees with an independent carrier. To save on insurance costs, it organized its own offshore captive and encouraged its members to insure with the captive. It placed its own product liability coverage directly with the captive and indirectly placed its workers' compensation and auto liability coverages through a fronting company. No one policyholder would receive more than 5% of the captive's total coverage.

In its ruling, the IRS allowed deductions for the premiums paid both directly and indirectly to the captive. The IRS reasoned that although the cooperative provided 100% of the captive's capital, the requisite risk shifting and risk distribution had occurred since a solvent insurer pays claims out of total premium and investment income and surplus rather than out of capital. Therefore, according to the IRS rationale, the risks were distributed to other policyholders and necessarily shifted to those other policyholders Thus, the transactions between the cooperative and its captive are a valid insurance arrangement because more than half of the captive's premiums came from unrelated parties, that is, members of the cooperative outside "the economic family." To the same effect see LTR 8111101. For a case finding insurance to exist where unrelated risks were less than 50%, see Theodore v. Commissioner, 38 TC 1011 (1962).

In LTR Ruling 8250021 the IRS reiterated that risk distribution and risk shifting take place between a body of insureds, rather than between insured and insurer. Thus, the fact that an insured is also the sole owner of a captive insurance company does not bar the deduction of premiums it pays to the captive as long as the captive writes sufficient outside risks. The question was viewed as factual and the case was returned to the District Director for a final determination. The Service subsequently announced that it would ordinarily no longer issue advance rulings as to whether the requisite risk shifting and risk distribution exist to qualify a captive as an insurance company. Rev. Proc. 82-41 1982-30, IRB 17.

Retrospectively Rated Policies

A common practice of some insurance companies is to return part of an insured's premiums if the company has favorable loss experience. These rating mechanisms are a better reflection of an individual insured's record than class rating.

Individual experience rating programs can be beneficial in several respects. They produce fairness, by securing an equitable participation by each insured in the losses and expenses incurred by all insureds as evidenced by the company's experience. Therefore, individual experience rating does not detract from the risk sharing indicia of insurance, but in fact assists it by promoting genuine sharing. It was never contemplated that insurance should operate as a penalty to those who diligently manage their loss vulnerability. Individual experience rating also benefits the public by providing the motivation for loss prevention. The public is certainly better served by preventing accidents than simply providing compensation to the injured, often after protracted court dispute. These retrospective rated policies have been recognized as legitimate insurance transactions where the insurer's assumption of risk includes reasonable maximum and minimum premiums.

The taxpayer in Steere had maintained that its contract was a retrospectively rated policy, since its deposits were refundable after its experience for a period was determined. The court disagreed that Steere's contract was one of insurance. This should not be interpreted as a judicial rejection of the retrospective rated policy. See for example Bituminous Casualty Corporation v. Commissioner, 57 TC 58 (1971), acq. 1973-2 CB 1. Two points should be noted: 1) Individual experience rating plans such as retrospective rated policies are designed to reward insureds who have favorable experience. Steere was uninsurable due to its poor accident record. 2) Steere was the only participant in its program. Its premiums would be used only to pay its own losses, and its losses were not compensated by contributions of other members. In distinguishing this fact from the favorable holding of Weber, Steere observed: "In Weber, a subscriber's premium payment would be used to pay flood losses suffered by other subscribers. Thus, there was an element of risk shifting to the insurer, which in turn distributed that risk of loss among all subscribers."

It therefore should be evident that an individual experience rating plan whether prospective (lower or higher renewal rates) or retrospective (rebate of prior payments) still should allow a deduction for premiums, where there is no exact identity of the premiums paid by an insured with the reimbursement of its losses. This can be accomplished by structuring the retrospective rated policy, or renewal rates, with reasonable minimum and maximum parameters, beyond which increases or reductions may not exceed.

For example, in Revenue Ruling 83-66, IRB 1983-16, 9 the Service decided that medical malpractice reserve premiums, subject to retrospective rate credit refund clauses, were currently deductible in full. In reaching its decision, the Service concluded that the requisite risk shifting and risk distribution existed to support a premium expense deduction.

Also in LTR ruling 8248022 a retrospective premium contract provided that the premium paid by the policyholder could not be less than the minimum retrospective premium nor greater than the maximum retrospective premium both of which were stated in the policy. The Service ruled that the company assumed a meaningful amount of insurance risk.

On the other hand, in LTR ruling 8251008, the Service analyzed a medical reimbursement plan underwritten by an insurance company and ruled that the premium charged represented the actual benefits paid, and therefore, the employer was paying its own claims. Thus insurance was not present. However, for premiums paid for benefits to be paid above a certain limit there existed insurance. Above this limit the Service held that the exposure of the carrier relative to the additional premium was sufficient to create the requisite risk shifting and made the excess of loss feature of the plan insurance for tax purposes.

Risk Assumption Which Is Not Insurance

The application of the insurance criteria is less clear, notably in decisions determing that bail bondsmen are not insurers. In Revenue Ruling 68-101, 1968-1 C.B. 319 the Service concluded that bail bond arrangements do not shift the risk of any monetary loss from the state or accused to the company. The accused's duty to appear for trial remains even if bail is forfeited, and the state's interest is not satisfied by forefeiture of bail. The Service determined that forefeiture of bail is a penalty for the bondsman's failure to perform services, i.e., to present the accused for trial. It is not a payment to reimburse the State for an economic loss but rather serves as a penalty for the surety's failure to perform his obligation. Similarly, in

Allied Fidelity, 78-1 USTC 9325 (CA-7, 1978) aff'g 66 TC 1068 (1976) the court agreed with the Service's position that the writing of bail contracts are not contracts of insurance for federal income tax purposes even though the company may be subjected to state insurance laws because of such activity. The court stated that bail bond contracts were more in the nature of a service agreement or a loan. To the same effect see Surety Insurance Co. of California v. Commissioner, 39 TCM 1220 T.M. Memo 1980-70.

Definition of an Insurance Company

Not only has the definition of insurance been left to the courts and the Treasury, but so has the definition of what is an insurance company. The Treasury's response has long been a regulation definition (see Treas. Reg. Section 1.801-3):

> "The term 'insurance company' means a company whose primary and predominate business activity during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies. Thus, though its name, charter powers, and subjection to State insurance laws are significant in determining the business which a company is authorized and intends to carry on, it is the character of the business actually done in the taxable year which determines whether a company is taxable as an insurance company under the Internal Revenue Code."

This definition is necessarily so general that court or ruling elaboration is required in most cases. (See for example - Cardinal Life Ins. Co., 70-1 USTC 9398 (5th Cir. 1970), rev'g and rem'g 69-1 USTC 9391 (D.C. Tex. 1969); Industrial Life Ins. Co., 73-1 USTC 9533 (4th Cir. 1973), cert. denied, 414 U.S. 1143 (1974), cases dealing with the predominant issues).

At the same time it may be necessary to decide whether a given activity is insurance before ever reaching the "predominant" question. Perhaps this suggests that the regulation definition as a practical matter serves little, if any, purpose.

Conclusion

While the general nature of insurance may be stated, it simply defies specific definition with any degree of certainty. As the above cases and rulings demonstrate the answer to the question of "what is insurance" has been addressed on the particular facts and circumstances of a given case over many years while insurance products were keeping pace with changing times. During this period certain guidelines and parameters have evolved as to what is insurance. These guidelines remain for those developing new insurance products. It is submitted that the Treasury has sufficient precedents to address any abusive situation it uncovers and that legislation on the question of what is insurance is not needed.

QUESTION 2: WHETHER THE TAX DEFERRAL PROVIDED FOR 'PROTECTION AGAINST LOSS' ACCOUNTS IS JUSTIFIED."

Background

The primary difference between the taxation of stock property and liability companies and mutual property and liability companies is the protection against loss account (PAL) afforded mutual companies under Code Section 824. This provision was added to the Code by the Revenue Act of 1962 as part of a new taxing formula for mutuals. Prior to 1963, mutuals were taxed under a special formula which did not take underwriting income or loss into account. As a consequence of the 1962 amendments they became subject to tax on underwriting income as well. In making this change, Congress recognized the special characteristics of mutuals and the PAL account is evidence of this recognition.

Mutuals are owned by their policyholders rather than stockholders. As a consequence of their structure mutuals lack the ability to raise capital. This makes them more vulnerable to insolvency. Because of this difficulty in raising capital and vulnerability to insolvency Congress in 1962 provided a special tax deferral account for mutuals, the PAL.

Congress recognized that:

"While a stock company can pay extraordinary losses not only out of its accumulated profits, but also out of its paid in capital, a mutual insurance company

> can pay extraordinary losses only out of retained underwriting income. As a result, a mutual ordinarily retains a portion of its underwriting income each year for this purpose; the remainder is paid to its policyholders as policy dividends. This accumulated underwriting income constitutes its reserve out of which insurance losses can be paid and the existence of such reserves is an important protection to the mutual policyholders." Senate Finance Committee Report Page 55.

There are three allowable additions to the PAL account which represent deductions for the current year. These three deductions are amounts equal to: (1) one percent of losses incurred; (2) 25 percent of underwriting gain; (3) a further percentage of underwriting gain, to the extent the percentage of premiums for concentrated windstorm and similar risks during the year exceeds 40 percent of all premiums.

At the same time, the Code sets forth five separate provisions for making annual subtractions from the PAL account which become inclusions in taxable income. They are:

1. The excess of the current year's PAL account additions over the current year's underwriting gain.

2. The current year's loss calculated as the excess of the underwriting and investment loss over the underwriting and investment income.

3. The amount of unused loss carryover that is carried from another year to the current year.

4. The amounts recorded in the PAL account reflecting additions from the fifth preceding year that have not been absorbed by losses or otherwise taken into taxable income. However, one-half of the fifth preceding year's addition of 25 percent of underwriting gain may remain deferred until absorbed by losses, under this provision.

5. The balance in the PAL account at the end of the year is reduced to the greater of 10 percent of the net earned premiums, less dividends to policyholders, or the prior year's closing balance in the PAL.

All subtractions are computed after the company has made its additions for the current year. Subtractions from the PAL account will never exceed the balances in the account as there cannot be a negative PAL balance. Before a mutual can have an unused loss deduction for the year, its entire balance in the PAL must be absorbed, or restored to income. Subtractions under (1), (2), and (3) above are computed on a first-in, first-out basis for amounts added during the preceding five years, and then subtracted from remaining additions of years earlier than the five immediately preceding years.

Statements prepared by both the Senate Finance Committee and the Ways and Means Committee on the 1962 Revenue Act indicate the intent behind the PAL account. Prior to 1962 mutuals were not subject to tax on their underwriting income. While a portion of this income was generally paid out as a policyholder dividend, a reserve was established to provide for extraordinary losses.

The 1962 Act imposed a tax on ordinary mutual's underwriting profit. Thus, the reserve retained from underwriting profit would be reduced by the applicable federal tax rate. In order to assure the continuing protection of the policyholder Congress devised the PAL account. In devising the PAL account Congress attempted to put mutuals on a somewhat equal footing as stock companies which can "pay extraordinary losses not only out of its accumulated profits but out of its paid-in-capital." Congress recognized that if mutuals did not have an additional source out of which losses could be paid they would be competitively disadvantaged. This is because a greater amount of reserve would have to be retained by the mutuals, and therefore, either higher rates would have to be charged or smaller policyholders dividends paid.

It is suggested that the reasons for the PAL Account are as important today as in 1962. The PAL is of greatest importance to the small and medium sized mutuals operating in rural and less populated areas. These companies are often the only source of easily available insurance coverage in rural areas since the larger companies tend to write business in these areas on a non-recurring basis. In addition these smaller sized companies tend to be legally restricted to underwriting business in a small geographic area. Thus, there is less chance to spread the risk of loss from a catastrophic event which may occur and affect the geographic area.

A further point which must be made is that the PAL Account allows mutuals to write additional business. This is because the account increases the company's surplus. Insurance companies underwritings are limited to a multiple of surplus (usually 3 to 1). Moreover, this additional underwriting capacity has the potential of increasing surplus so that even when the PAL account is reduced during certain points in the underwriting cycle surplus will have been increased over a period of time through utilization of the PAL account. This additional capacity allows these companies to grow with the result that more taxes may be paid over a period of time than would be the case if the companies did not have this ability to expand their underwriting.

Due to the present underwriting cycle many companies currently have eliminated any balance in their PAL account from prior years. In these cases the losses incurred have been reduced for tax purposes by the amount previously accumulated in the PAL account. Thus, the Treasury has received the taxes which it would have received had there been no PAL account. The only difference the PAL account has made is that it has deferred the payment of the tax to a later year. The PAL has in this recent period of large underwriting losses proved to be a stabilizing influence on insurance markets because it has enabled companies to build up their surplus to pay off these losses.

A survey conducted by our Association indicates that the PAL is very important to the members of our organization. Approximately 60 percent of the members responding so indicated. One of the responding companies stated the following:

> "The original intent of the PAL account was to provide retention of capital for a mutual insurance company. Even today it is important because the availability of capital is not available in the public markets. PAL smooths out 3-5 year underwriting cycles and provides a cushion for catastrophic loss years and most definitely should be retained for these reasons."

Conclusion

The need for the PAL account remains. As was the case in 1962, mutual companies do not have access to equity capital markets. To the extent a mutual must retain reserves for losses, less can be paid in the way of policyholder dividends and more must be charged for insurance protection. Thus, if stocks and mutuals are taxed the same mutuals will be at a competitive disadvantage. The PAL account lessens this disadvantage.

Moreover, as Congress recognized in 1962 the PAL is merely a tax deferral account it does not reduce the tax on a mutuals income. "Eventually these companies will pay tax on their total income, but the tax deferral formula of the bill gives recognition to the mutuals' lack of access to the capital market for funds with which to pay losses."

It appears that the same factors which warranted the creation of the PAL Account in 1962 still exist today. For these reasons, it is respectfully submitted that the PAL account should be retained.

The CHAIRMAN. I appreciate that. We are not certain what the revenue requirements of the budget resolution may be, but we are certain that we need to reduce the deficits, and the Senate did adopt a budget resolution which did contain $9 billion in revenue in 1984. I did not vote for it, but 51 members did. However, we are only voting for numbers in the budget resolution. That is an indication that at least a majority of the Members of the Senate are looking at revenues. Unfortunately, they are not looking much at spending reductions. But we have to be prepared for whatever may happen in the budget battle, and that is why we are trying to get a leg up, at least as far as some hearings are concerned.

Now, State Farm, I believe, has been profitable in recent years, despite some adverse experience in the industry. As I understand it, on both the underwriting as well as the investment side, you have shown a profit over the past years. Is that correct?

Mr. JOSLIN. Yes; we have. In the last couple of years, we have shown really no underwriting profit, no taxable underwriting profit nor statutory underwriting profit, but in the last 10 years, yes, we have shown underwriting profit.

The CHAIRMAN. You did not have the same difficulty others had in 1975?

Mr. JOSLIN. We are not immune from what happens in the country, in the industry. I think the cycles may not move quite as vigorously from top to bottom as far as we are concerned.

The CHAIRMAN. Now, I do not recall which witness indicated that we probably should not consider property and casualty companies as financial intermediaries, but I think the record would indicate that the property and casualty industry had $6.3 billion in investment income in 1981, so that we must at least focus on that aspect of it.

Mr. JOSLIN. I think the real issue is that we are not in the business of collecting money for deposits, and things of that nature—investment contracts, that type of thing.

Mr. BYRNE. I hate to argue that that $6.3 billion is incidental, $6.3 billion of income, tax-exempt income, but I would argue that that is incidental to our purpose, and in the numbers we work in, it is somewhat incidental, but the main point I was trying to make was that the basic economics of our business, because we are not people who hold out a savings device and then relend the money, that causes the basic economics of our business to be quite different than those of the life insurance industry or the commercial banks. Our tax laws are nowhere near as complicated, et cetera, and I would just hope we do not get swept into that.

Senator, while I have the microphone, I should have elaborated on one answer to a question of yours. You asked me, was not part of our problem premiums, and that certainly was true. In about half of the States, we could not raise our premium rates because of the State regulation approach to it, so that was half of the problem with premiums.

The CHAIRMAN. I was not suggesting that it was the fault of management necessarily, because I think you did have a problem, but as I recall, that was one of the reasons for the difficulties.

Well, this will conclude phase 2 of our continuing efforts to take a look at different segments of our economy, different industries, to determine if in fact there should be any change in the Tax Code as it relates to particular industries. We will be working with GAO. We appreciate your willingness to cooperate, and we will probably be seeing you again. Thank you very much.

[Whereupon, at 11:35 a.m., the committee was adjourned, to reconvene at the call of the Chair.]

[By direction of the chairman, the following communications were made a part of the hearing record:]

STATEMENT ON BEHALF OF CHUBB & SON, INC., AMERICAN INTERNATIONAL GROUP, THE CONTINENTAL CORP., HOME INSURANCE CO., AND ALLSTATE INSURANCE CO.

At the hearing held on June 13, 1983, by the Committee on Finance on the taxation of property and casualty ("P&C") insurance companies, written and oral statements were presented on behalf of the Department of the Treasury and the General Accounting Office. Those statements suggested that consideration be given to a requirement that P&C insurers discount their unpaid losses for federal income tax purposes. The statement on behalf of the Department of the Treasury described a method purportedly used by P&C insurers to determine the amount of premiums to be charged for the insurance coverage issued by them. This memorandum is intended to demonstrate that the described method is not used by P&C insurers and to suggest some of the practical problems that would arise were discounting of unpaid losses required.

The written and oral statements presented by John E. Chapoton, Esq., Assistant Secretary for Tax Policy, Department of the Treasury, assume that P&C insurers, like life insurers, compute the premiums they will charge to cover expected losses at amounts which aggregate less than those expected losses. In both statements, he described a simplified example in which P&C insurance company X writes a group of liability policies during the taxable year on which X estimates that it will have to pay $1,000 because of losses that occur during that year. For purposes of the example, it was arbitrarily assumed that all of these losses would be paid at the end of the fifth succeeding year. The example states that X charges $900 as the premium on this group of policies.

As a result of the facts assumed in the example, X would report an underwriting loss of $100 in the year in which the policy was written. The loss would be computed according to the method of accounting required of the insurer by state regulatory authorities and followed under the provisions of section 832 of the Internal Revenue Code (the "Code").

The Assistant Secretary's example clearly recognizes that a P&C insurer's estimate of the amounts that it will have to pay on losses incurred by its policyholders relates to losses incurred in the current year rather than, as in the case of "valuation reserves" of life insurers, to losses that will not occur until future years. In acknowledging the vast oversimplification represented by the assumption that X will pay all of its losses at a fixed future date, the example also recognizes that a P&C insurer pays its losses in a continuous stream on dates which it cannot foresee when it writes its policies.

However, the Assistant Secretary's written submission states that "[i]n calculating the premium it must charge, X will take into account the investment income that it will earn until the claims are paid." This version of the manner in which premiums are determined by P&C insurers is simply at odds with reality. In actual fact, the process used to determine the amount to be charged for premiums, i.e., rating, may be described as follows.

In general, for personal lines of business, i.e., homeowners and personal automobile, rates by type of coverage must be filed in each state in which the insurer proposes to use the rate. The rate must be supported by statistics showing the portion of the premium to be used to pay expenses by type and the ultimate amount of losses expected to be paid without regard to the time when those losses will in fact be paid. In some states the rate may be used immediately subject to subsequent disapproval of the regulatory authority. In others it cannot be used until actually approved. The rate filing, once approved or not disapproved, must be used for any business covered by the filing until a new rate filing is made and, in those states where necessary, approved.

The state requirements for rate filings on commercial lines of business and particularly on multi-state risks vary from non-existent to substantially the same as those for personal lines. In addition, many states periodically audit rating practices on all lines of business to insure compliance with rate filings and sound rating practices. This audit is separate from the periodic examination of the financial condition of insurers.

The objective of rating, all things being equal, is to earn a reasonable underwriting profit. For this purpose an underwriting profit is the amount of premiums earned less losses and expenses incurred, the definition of gross income from underwriting contained in section 832 of the Code.

As in any industry in which competition is severe, all things seldom are equal. Old rate filings, which were adequate when filed, may become inadequate due to inflation, new loss frequency and severity patterns, etc. Competition may prevent the filing of new rates to correct the emergent inadequacy or the regulatory authority may fail to approve or may disapprove the new filing. The old rates, therefore, must continue to be used or the insurer must discontinue writing the business covered by the old rate filing if it wishes to avoid underwriting losses. Barring exceptional losses, marketing considerations usually make the latter alternative unattractive.

It should be clear from the above and from the requirements of statutory accounting that rates cannot be based on discounting of losses to be paid in years subsequent to the year of loss occurrence. To do so would produce inadequate rates which ultimately would impair the surplus of the insurer using them. Therefore, the example discussed by the Assistant Secretary, under which the insurer would intentionally seek an underwriting loss of at least $100 for each $900 of premium income, does not accord with economic reality.

The example might apply in the case of so-called "retroactive insurance." Later in his statement the Assistant Secretary referred to the well-publicized instance of a hotel which purchased this type of coverage following a 1980 fire which claimed 84 lives and left 700 people injured. The publicity given to this situation in itself demonstrates that it represents an isolated phenomenon far removed from the mainstream of the P&C insurance industry. Moreover, recent articles have indicated that the hotel has settled all of the hundreds of lawsuits arising from the fire and that, even after taking investment income into account, the insurers which wrote the coverage will as a group suffer a net loss.

No insurer can set rates that ignore the fact that in any given year losses will be paid, whatever the type of coverage, on losses occurring in that year. In fact, it is not unusual for losses to be paid even before the premium has been remitted to the insurer by the agent or broker collecting the premium on behalf of the insurer from the insured. Obviously, to discount premiums for these losses would be a mistake.

Presumably, discounting would apply only to the net amount of unpaid losses used in the determination of losses incurred. These unpaid losses are determined net of reinsurance recoverable by the insurer. In almost every case the insurer does not recover the reinsurer's portion of a loss until after the insurer has paid the loss. In many cases the lapse in time between payment of the loss by the insurer and recovery from the reinsurer is of sufficient duration to substantially distort any discount factor that might be applied to the net unpaid loss.

The example contained in the Assistant Secretary's written statement assumes that an unpaid loss today that is not paid for five years will be paid at the same amount five years from now as it would be if paid today. While this assumption is valid for a loss under a life insurance policy, where the face amount of the policy, and only that amount, will be paid, it is not valid for a loss payable under a P&C insurance policy. Most losses paid by P&C insurers are not equal to the face amount of the policy. This result arises from the fact that a loss under P&C insurance is measured by damage, a concept foreign to life insurance.

Where there is a substantial interval between the date of the incident giving rise to a loss and the date of payment of that loss, factors come into play that almost always result in an increase in value of the loss, particularly in those cases where the loss involves a liability of the insured to a third party. An examination of original accident year estimates of unpaid losses against the amounts ultimately paid in the so-called "long tail lines" will make this fact clear. If this fact were taken into account in the example used by the Assistant Secretary, the ultimate amounts paid on the losses of $1,000 could be expected to exceed the original estimates.

Thus, if premiums were priced in the manner suggested by the Assistant Secretary's example, the ultimate loss from underwriting would not be $100, but some figure in excess of this amount due to the pressures of inflation, changes in jury verdicts, changes in court decisions as to liability, etc. If the impact of these factors applied at the same pre-tax rate as the pre-tax discount factor, say 10%, used in the example, then the insurer could be expected to pay not $1,000 but $1,611. The underwriting loss of $711 would exceed the assumed investment income of $304.

One of the problems with the example posed by the Assistant Secretary is that it assumes that by reason of the pricing of the P&C premium factor for losses, a P&C insurer will always report an underwriting loss in the year in which the policy is written. In fact, as previously described, it is the objective of rate filings to secure an underwriting profit. This objective may not always be obtainable, due to political, economic, competitive and similar reasons or because of unforeseen natural catastrophes, such as hurricanes, tornadoes and earthquakes.

Nevertheless, it is erroneous to assume, as the Assistant Secretary seems to have done, that a P&C insurer will always report a statutory and taxable underwriting loss on its policies due to the losses incurred under such policies exceeding the loss-factor built into the premium charge. If the example were correct, it is inconceivable that P&C insurers would ever report an underwriting profit for federal income tax purposes. Yet the P&C industry on a cyclical basis does just that. Historically, the P&C industry has been subject to a cycle in which years of ascending underwriting profit are followed by years of descending underwriting profit or underwriting losses. Although the current trough of the underwriting cycle has lasted longer than in previous cycles, the P&C industry will ultimately head into the upward phase of the cycle and again report an underwriting profit, even though this would be impossible if the Assistant Secretary's assumption as to the pricing mechanism of the P&C industry were accurate.

The impracticality of requiring P&C insurers to discount their unpaid losses becomes obvious upon analysis of the Assistant Secretary's indirect suggestion of the manner in which a discounting requirement could be applied to the assumed facts in his oversimplified example. Under present law, X would report an underwriting loss of $100 in the taxable year, i.e., the difference between the assumed aggregate premium income of $900 and the assumed unpaid losses of $1,000, and would report the assumed investment income of $304 over the assumed five-year period during which the losses remain unpaid. The Assistant Secretary's written presentation states that X "is much better off under present law than it would be if it were required to report income of $150 in the first year and $54 of investment profit spread out over the next five years."

If X were required to discount its assumed unpaid losses of $1,000 at December 31 of each of the five years for which the losses are assumed to remain unpaid to the assumed date of payment at the rate of 6 percent, then X would presumably report the assumed underwriting loss of $100 in the following manner:

	Taxable Year	Succeeding Years 1	2	3	4	5
Premium Income	900	0	0	0	0	0
Losses Paid	0	0	0	0	0	1000
Add: Unpaid Losses 12/31	747	792	840	890	943	0
Less: Unpaid Losses 1/1	0	747	792	840	890	943
Losses Incurred	747	45	48	50	53	57
Underwriting Income[1]	153	(45)	(48)	(50)	(53)	(57)

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[1] Since the imposition of federal income tax on the purported underwriting profit of $153 in the taxable year would reduce the funds available to X for investment, the Assistant Secretary's statement that X would realize the same net profit after six years under a discounting requirement as it would under present law is simply incorrect.

As applied to the facts assumed in the Assistant Secretary's example, the above calculation of X's underwriting income, which substitutes discounted unpaid losses in the computation of losses incurred, may have a surface appeal. However, the example is based on assumptions that the appropriate discount rate is an easily determined constant, that the amount of loss to be paid is fixed, and that the date of payment is similarly fixed. These assumptions are simply invalid.

The example assumes that the appropriate discount rate applicable on the date of the initial estimates is easily determined and that the discount rate thus selected will never change between the date of the initial estimates and the dates of payment. The problem with these assumptions lies in the computation of the discount rate. In the example the computation is based upon the after-tax rate of investment return. This computation requires determination of a before-tax rate of return and a marginal tax rate applicable to investment income. The example apparently contemplates using the overall rate of investment return and marginal tax rate. Obviously, the investment decisions of a P&C insurer are governed by the expected stream of payment of its liabilities. The overall rates of return are, therefore, not necessarily appropriate to specific liabilities.

Furthermore, the overall marginal tax rate on investments may vary from 0% to 46%. During the six-year period covered by the example, it would not be unusual to encounter several different rates within this range. To the extent that the marginal tax rate is lower in the taxable year than in the five succeeding years, the discount rate, if permanently fixed, would be overstated. Obviously, an understatement could also occur. Thus, the assumptions that the discount rate is easily determinable and will never change are, at best, of dubious validity.

The example also assumes that as of the end of the taxable year the ultimate amounts that will be paid on the losses occurring in that year are known and that the estimates of the unpaid losses never change between the date of the initial estimates and the dates of payment. The unpaid losses of a P&C insurer do not represent fixed amounts payable at fixed future dates but rather estimates of the amounts, based upon its prior experience with similar cases, that the insurer will be required to pay at some unknown future dates. Thus, the assumption of an equivalence between X's estimates of $1,000 of unpaid losses at the end of the taxable year and the ultimate payments of $1,000 is wholly unrealistic. In the absence of coincidence, X will in fact pay more or less than $1,000. As to any individual estimate, the amount ultimately paid may vary greatly from the initial estimate.

Even the law of large numbers does not assure that there will be an equivalence between the overall estimates of unpaid losses and the amount paid thereon. Yet, under a discounting requirement, the amount to be discounted would be the future payments, not the current estimates of what those payments may be. It is far from clear that a workable method exists to identify the amount to be discounted. For example, assume that on the basis of its prior experience, X has historically underestimated its unpaid losses by 10 percent. Thus, its estimated unpaid losses of $1,000 probably understate the amounts that it will ultimately be required to pay. In these circumstances, it would clearly be unfair to require X to discount the unpaid losses of $1,000. For purposes of applying a discounting requirement, would X's unpaid losses of $1,000 first be grossed up to reflect the amounts that X is likely to pay in future years? On the other hand, how would the adjustment for discounting be made if it were found that X had historically overestimated its unpaid losses by 10 percent?

On any given claim, a P&C insurer's initial estimate of the amount that it will be required to pay is not a constant figure that, once made, remains unchanged until the date or dates of payment. Instead, particularly in the case of types of losses which take a comparatively long time to settle, the estimate of the amount that will ultimately be paid on each outstanding claim will be reviewed at regular

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intervals and when deemed necessary revised upward or downward to take into account those facts existing at the date of revision.

The difficulties of taking these changes in estimates into account under a discounting requirement would obviously be formidable. Assume that in the Assistant Secretary's example, X at the end of the first year increased its estimates of the unpaid losses incurred in the taxable year from $1,000 to $1,050. The increase of $50 would have to be discounted over a period different from the unpaid losses at the end of the first year on losses occurring during the first year. In the case of the unpaid losses outstanding at the end of the second year, changes in estimates on losses occurring in the taxable year, changes in estimates on losses occurring in the first year, and unpaid losses on losses occurring in the second year would all have to be discounted over different periods, etc.

The discounting of changes in estimates would either have to be done over a different period than the original estimate or related back to the date of the original estimate. In either case, the data processing effort to identify those unpaid losses as of a given year end as to which the estimate had been changed and to determine the amount of change would be enormous.

The period between the occurrence of the loss event and ultimate settlement varies significantly among individual losses. These variations occur not only among types of business but among losses within the same types of business. Except in limited instances these variations are not within the control of a P&C insurer. For example, the average dollar of claim for damage to the property of the insured by fire may be settled within three months, whereas the average dollar of claim for damage suffered by a third party because of a defective product manufactured by the insured may be several years.

In view of the great differences in the average time for which different types of losses typically remain outstanding, it should be obvious that any requirement that unpaid losses be discounted could not fairly prescribe a single period over which all unpaid losses of P&C insurers were to be discounted. On the other hand, the assignment of different average periods of time over which unpaid losses in different types of coverage were to be discounted would greatly complicate the federal income tax provisions applicable to P&C insurers.

The Assistant Secretary's example assumes that X wrote only a group of liability policies. Even if the example could be read to suggest that discounting of unpaid losses should be confined to losses arising under liability policies issued by P&C insurers, it fails to take into account the multitude of different types of liability coverage each of which has its own individual characteristics. If, for example, some of X's policies were umbrella liability policies issued to individuals, others were medical malpractice policies issued to doctors, and others were product liability policies issued to manufacturers, the average period from occurrence to settlement for losses arising under the different types of policies would not be the same, and, therefore, could not fairly be assumed to be the same for federal income tax purposes.

Given the lack of uniformity in the period a loss is outstanding as between different types of coverage and the fact that the period is not within the control of the insurer, predictability of the period as to a group of losses is, at best, somewhat haphazard. This problem is particularly acute for those losses which have occurred as of a given year end but have not yet been reported to the insurer. These unpaid losses, commonly called "IBNR," in some types of coverage and for reinsurers represent a substantial, if not the greater, part of unpaid losses. How would discounting be applied?

In summary, a discounting requirement would of necessity involve determination of an after-tax rate of return on investments (a changing rate), the ultimate amount of loss (an ever changing figure), and the date of payment (uncertain). It is submitted that administration of any provision requiring use of these elements in a manner which would apply fairly to all P&C insurers is beyond the resources of the Internal Revenue Service.

The suggestion of the Assistant Secretary that unpaid losses of P&C insurers be discounted is based upon a fundamental misconception of the pricing mechanism used by P&C insurers. In addition, the discounting methods suggested in the statement of the Assistant Secretary and the statement submitted on behalf of the General Accounting Office are predicated on wholly unrealistic assumptions and fail to consider the panoply of practical problems that would be involved in implementation and administration of a discounting rule.

It is submitted, therefore, that if the P&C industry is to survive in a form that serves the interests of the economy of the United States and is to compete with foreign insurers not subject to income tax provisions comparable to those discussed in the statements of the Assistant Secretary and the General Accounting Office, the suggestions advanced in those statements must be rejected.

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July 12, 1983

Roderick DeArment, Chief Counsel
Senate Finance Committee
Room SD-219
Dirksen Senate Office Building
Washington, D.C. 20510

Re: S 1564

Dear Mr. DeArment:

In lieu of testifying at the hearing on S 1564, I am submitting these comments which I request be made a part of the record of the hearing on this bill.

S 1564 is intended to put an end to certain perceived abuses arising out of leases of property to tax-exempt entities, including governmental agencies and political subdivisions. The abuses arise because in certain cases taxable lessors pass the benefit of investment credit and ACRS depreciation to the tax-exempt entity through lower rent. These abuses, however, are not present in the cases of leases by tax-exempt entities to taxable lessees. To the best of my knowledge, the information recently gathered by various Congressional Committees does not involve any cases where tax-exempt entities have acquired property with an intent to lease that property to a taxable entity and thereby indirectly secure some tax benefit. The reason for this is simply that this is not an area of potential abuse.

There are, however, instances of government owned buildings that will be renovated only if the taxable lessee can retain the benefits of the investment credit and ACRS depreciation attributable to its leasehold improvements. Of course, these benefits could be obtained if the lessee simply purchased the property from the governmental entity. In many of these cases, however, for various political and other reasons, the property cannot be sold by the political entity to the taxable entity. In these cases leasehold improvements may technically be owned by the owner of the fee, i.e., the governmental entity. In these situations, there is no potential for abuse in allowing the lessee to claim the investment credit and ACRS depreciation for the cost of its leasehold improvements.

The problem is that S 1564 as presently drafted applies to property "used by" a tax-exempt entity. Pursuant to Treas. Reg. 1.48-1(j), property is considered "used by" a tax-exempt entity if that entity either (a) uses the property as a lessee or (b) owns the property even if the property is leased to a taxable entity. As a result of this regulation, Section 48(a)(4) was recently amended. One of the reasons for this amendment was to encourage the rehabilitation of property owned by a tax-exempt entity and leased to a taxable entity. It makes little sense for S 1564 to defeat the purpose of this recent legislation.

Accordingly, S 1564 should be modified to clarify that it applies only to property leased to a tax-exempt entity. In the alternative, S 1564 should be modified to clarify that it is not applicable to leasehold improvements installed by the lessee regardless of which party is technically the owner of the leasehold improvements.

Sincerely yours,

Donald Bennett

DPB:egr

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June 7, 1983

Mr. Roderick A. DeArment
Chief Counsel, Committee on Finance
Room SD221, Dirksen Senate Office Building
Washington, D.C. 20510

Dear Sir:

Responding to the invitation contained in Press Release No. 83-135, Coopers & Lybrand, an international accounting firm, respectfully submits the attached statement on the taxation of property and casualty insurance companies which will be the subject of the Senate Committee on Finance hearings on June 13, 1983. Specifically, the statement addresses the following:

> Whether the affiliation of property and casualty insurance companies, life insurance companies, and other unrelated businesses provides unintended opportunities for tax planning.

Our Firm renders audit and tax services to a number of insurance companies, large and small, and we are recognized leaders in the insurance industry. I have personally co-authored The Consolidated Tax Return published by Warren Gorham & Lamont. My partners and I have also co-authored a text entitled Income Taxation of Insurance Companies published by Ronald Press. Both of these publications are recognized by attorneys, accountants, and other professionals and by the business community as the premier texts in these areas.

It is our considered judgment that while the insurance industry is a unique business and the taxation of such companies is somewhat complex, involving special tax accounting rules, consolidation of insurance companies with non-insurance companies is both feasible and appropriate. To be sure, the stock property and casualty insurance companies have been permitted to consolidate with non-insurance companies for over 40 years, and life and mutual property and casualty companies were granted such permission by Congress beginning in 1981.

Under Internal Revenue Code Section 1502, the Treasury has the authority to prescribe consolidated tax regulations which are legislative in nature and through which unintended tax benefits can be controlled. Evidence of this is contained in the final regulations issued on March 15, 1983 on the consolidation of life, mutual property and casualty and non-insurance companies.

If we can be of any further assistance, please contact Mr. Gerald Lenrow, my tax partner, or myself at 212-536-2000.

Respectfully submitted,

Anthony P. Rua

Anthony P. Rua
Tax Partner

APR/rjh
Attachment

Senate Committee on Finance Hearing on
Taxation of Property and Casualty Insurance Companies
Monday, June 13, 1983

As noted in Press Release No. 83-135, one of the issues which the Senate Committee on Finance will review in examining the tax structure applicable to property and casualty insurance companies is "whether the affiliation of property and casualty insurance companies, life insurance companies, and other unrelated businesses provides unintended opportunities for tax planning."

We submit that the filing of consolidated returns by all affiliated groups is both appropriate and to be recommended because the consolidated return:

1. is an administrative convenience for the taxpayer and creates economies in tax administration for the Internal Revenue Service

2. recognizes the "economic family" as a single tax-paying entity

3. has been available to stock property and casualty companies for filing with non-insurance businesses for over 40 years

4. has been available to all insurers since 1981 because of 1976 legislation which permits them to join in a consolidated return with non-insurance companies providing certain affiliation tests are met. Recently published regulations with respect to the inclusion of life and mutual property and casualty companies in such groups contain restrictive and protective rules which will preclude achieving unintended benefits through tax planning.

Property and Casualty Insurance Companies

Stock property and casualty insurance companies have been includible in a consolidated federal income tax return of an affiliated group since 1942. The following statement was contained in Senate Report No. 75, 77th Congress, 1st Session, p. 14:

> "Section 730 of the present law dealing with consolidated returns under the excess-profits tax does not permit an insurance company to join in a consolidated return with a non-insurance company. This restriction was inserted because of the special manner in which the income of insurance companies is computed under the income tax laws. It is believed, however, that the differences of computation in the case of an insurance company other than life or mutual are not so significant as to prevent such a company from filing a consolidated return with an ordinary corporation with which it is affiliated. Consequently, this section amends section 730 to permit such insurance companies, i.e., those subject to taxation under section 204, to join in consolidated returns with ordinary corporations."

In Bituminous Casualty Corporation vs. Commissioner, 57 TC 58 (Acq. CB 1973-2, 1), the court stated:

> "The nature of casualty insurance requires accounting rules substantially different from the accounting rules applicable to general commerce.
>
> In commerce generally, expenses come first and income follows. The manufacturers must incur the cost of manufacturing his product before he gets paid for it. The merchant must purchase his inventory before he can resell it.
>
> In the insurance industry, however, the reverse is true. The policyholder pays the insurance company in advance and the insurance company's costs, which are primarily the payment of claims, come afterwards. If the premiums were to be taxed as received and the deductions allowed only as they later became fixed, the result would be to tax very large sums of money as income when in fact those amounts will never really become income because they will have to be paid out to policyholders and other claimants."

Property and casualty companies have had to conduct their business under special rules from the beginning. Prior to 1921, the Insurance Commissioners of the various states, acting through the National Convention of Insurance Commissioners (now the National Association of Insurance Commissioners) developed a special format for reporting casualty company income. In 1921 when the insurance provisions were adopted, the applicable tax statute specifically provided that income would be computed on the basis of "the underwriting and investment exhibit" approved by the National Convention of Insurance Commissioners. That format, although since modified and rearranged, remains essentially the same today.

The Annual Statement relies on estimates which, in Bituminous Casualty, the court recognized did not meet the "all events" test of definitive liability required by general tax accounting. Thus, instead of taking all premiums received or accrued into income, casualty companies take into income the portion of those premiums which are estimated to be "earned." Similarly, the major deductions from income — "losses" and "loss adjustment expenses" are estimated amounts which Treasury regulations accept, providing such estimates are based upon company experience in similar cases. The justification for this treatment is clearly stated in the citation from Bituminous Casualty above.

Property and casualty companies, as a matter of investment policy, invest a significant amount of their admitted assets in tax exempt securities, as shown by the following consolidated industry statistics for property and casualty companies as of December 31, 1981:

Bonds - U.S. Governments	9.6%	
State, municipals, etc.	12.2	
Special revenue	27.3	
Others	12.3	
		61.4%
Common Stocks		15.3
Preferred Stocks		4.1
Other assets		19.2
		100%

As can be seen 39.5% of total property and casualty industry admitted assets were invested in state, municipal and special revenue bonds. The investment decision to dedicate such huge sums to tax exempt securities with extended maturities is an investment decision and not one motivated by the current underwriting fortunes of the insurance business. Since they do, for the most part, represent long term investments, because of the vagaries of the market, they may not be readily disposable without experiencing significant capital losses and reduction of statutory surplus. Thus, these investments are not necessarily the result of current tax planning predicated on the includibility of the company in a consolidated return.

Also it must be recognized that not all casualty companies are included in consolidated returns and those which are not would naturally prefer to maximize income by purchasing taxable instead of tax exempt securities and utilize the heavy underwriting losses which have been experienced by the companies in the past two or three years. The fact of the matter is that a property and casualty company historically invests a large portion of its assets in tax exempts whether its underwriting experience is favorable or adverse. Insurance companies are no different than other organizations which also invest in tax exempts and which are includible in consolidated returns with unrelated businesses.

The utilization of losses in a consolidated return is quite appropriate for an affiliated group of companies. If a finance company or bank were included in the group filing consolidated returns and it, instead of the property and casualty company, invested in tax exempts, the losses of the property and casualty company would still be available for offset against the profits of all other affiliated members of the group.

In today's business environment, legitimate and prudent tax planning is an ever-present management consideration in efforts to achieve profitable and successful operations. This concept was very cogently stated by Judge Learned Hand in Sydney R. Newman v. Commissioner, 159 Fed. 2d 848 (2d Cir, 1947):

> "Over and over again courts have said that there is nothing sinister in so arranging one's affairs as to keep taxes as low as possible. Everybody does so, rich or poor; and all do right, for nobody owes any public duty to pay more than the law demands. Taxes are enforced exactions, not voluntary contributions. To demand more in the name of morals is mere cant."

The practice of property and casualty companies in investing heavily in tax exempt securities should be viewed positively rather than as a tax planning maneuver to achieve an unintended tax benefit. In no event would it be proper to indirectly diminish coverage of Internal Revenue Code Section 103 without appropriate bearing. Furthermore, it would be contrary to established National policy if legislative actions were taken which would negatively impact on the ability of state and local governments to generate needed revenues through the issuance of tax exempt bonds. It is apparent from the statistics cited above, that property and casualty companies represent a ready market for tax exempt issues. The public purpose served by property and casualty companies to the tax exempt market is no different than the role played by the Domestic International Sales Corporation (DISC). The purpose of the DISC is to enhance the penetration of foreign markets by U.S. business. The DISC is not permitted to be included in a consolidated return but its U.S. parent company is. Thus, 42.5% of the profits diverted through a DISC are tax-deferred solely because its existence serves a National purpose.

Life Insurance Companies

For years beginning after December 31, 1980, Internal Revenue Code Section 1504 (c) (2) now permits affiliated groups which include life, mutual property and casualty, and non-insurance companies to file a consolidated federal tax return. It should be noted that life insurance companies are taxed under a much more complex taxing formula than property and casualty companies. The establishment of the tax base involves a separate computation for the company's investment income and another separate computation for underwriting income. Notwithstanding the complexities, Congress deemed it appropriate to permit consolidation of diverse life/non-life groups. The Treasury issued final regulations on March 15, 1983 which address the unique taxing formula for life companies and establish very demanding criteria and rules. These include the eligibility of life companies to participate in a consolidated return, separate computations for the life and non-life groups, the utilization of losses of one group against the profits of the other group, and rules to preclude unintended benefits which may result from expansion of the business or change in the character of the business through acquisitions, reorganizations, etc. The Treasury has stated that the regulation provisions are specifically intended to frustrate any tax planning which will permit the group to achieve unintended benefits through tax planning.

Conclusion

The nature of the insurance business is unique. In addressing the taxation of insurance companies, Congress has established taxing formulas designed to meet the unusual character and protracted risk term of many types of insurance policies. The insurance business is one which impacts on all business activity. It is so inextricably woven into the fabric of the National economy that its regulatory control has been placed in the hands of State Insurance Commissioners who have coordinated their efforts to establish uniform rules in the conduct of the business, investment policy, establishment of reserves for the protection of the policyholders, etc. The achievement of these purposes is accomplished through the Annual Statement report to the State Commissioners. The uniform format and procedures reflected in the Annual Statement were adopted by Congress in 1921 by requiring the use of the Annual Statement investment and underwriting income in arriving at taxable income of insurance companies. The investment policy of property and casualty companies represents a stabilizing factor in the implementation of National Policy with respect to preserving the ability of states and municipalities to raise revenues.

Stock property and casualty companies have been entitled to consolidate with non-insurance companies for over 40 years. Life insurance companies and mutual property and casualty companies are now permitted to file consolidated returns with non-insurance companies. While the mechanics for arriving at taxable income may differ because of the unique nature of the insurance business, there would appear to be little justification for not permitting insurance companies to aggregate their separately computed taxable incomes with other members of the economic family to arrive at consolidated taxable income. As demonstrated by the restrictive and protective provisions of the recently finalized life/non-life regulations, it is possible to require rules of consolidation which will preclude unintended benefits through tax planning.

STATEMENT

OF

MUTUAL LIFE INSURANCE COMPANY

EXECUTIVE COMMITTEE

This statement is submitted by the Mutual Life Insurance Company Executive Committee (see attached list) in the interest of the nation's mutual life insurance companies.

In the April 29 press release announcing these hearings, witnesses were invited to address five specific issues. The fourth of these issues is: "Whether the affiliation of property and casualty insurance companies, life insurance companies, and other unrelated businesses provides unintended opportunities for tax planning." Since this question goes to the heart of the taxation of life insurance companies, we wish to comment on it.

I. ANY FAILURE UNIFORMLY TO TAX ECONOMIC INCOME LEADS TO TAX-AVOIDANCE POSSIBILITIES

To the extent that corporate taxpayers with net economic income are uniformly taxed on such income, affiliations among them rarely contribute to tax avoidance. Even an artifical transaction that might shift income from entity A to entity B usually has no net effect on the entities' aggregate tax liability. This principle underlies the general rules governing consolidated returns filed by affiliated groups of taxpayers.

In contrast, any failure uniformly to tax economic income creates numerous opportunities for tax avoidance. The opportunities arise whenever (1) economically equivalent amounts of income are taxed differently in the hands of different taxpayers or (2) the tax on a given amount of economic income in the hands of a single taxpayer can vary as a result of noneconomic characterization of the income for tax purposes. In the first case, affiliated taxpayers may attempt to shift income into the hands of the entity with the lowest marginal tax rate. In the second, cooperating entities may enter transactions whose central purpose is to help one of the parties transform income from a more highly taxed to a less highly taxed category.

Accordingly, a failure uniformly to tax economic income is more than a theoretical violation of sound tax policy. It breeds tax gamesmanship as taxpayers attempt to transform income into a form that is economically equivalent, but more lightly taxed. And tax gamesmanship breeds administrative complexity as Treasury and the IRS seek to maintain artificial distinctions that run contrary to the inherent economic fungibility of money.

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II. CURRENT LAW DISTINGUISHES LIFE INSURANCE COMPANIES BY FAILING TO TAX THEM ON THEIR ECONOMIC INCOME

On the whole, the Internal Revenue Code taxes corporations other than insurance companies on the taxpayer's economic income. Similarly, the tax rules applicable to property and casualty insurance (P&C) companies are also designed to yield a tax base composed of the companies' economic income. Thus P&C companies must declare their receipts as gross income, they do not distinguish between various classes of income, they deduct amounts paid to or credited on account of their policyholders, and they do not, in general, receive deductions or indefinite deferrals for amounts unrelated to their current or anticipated costs of doing business.

Since both P&C companies and noninsurance companies are taxed essentially on their economic income, affiliations among such companies create little potential for tax avoidance. (We do not deal in this paper with issues raised by so-called "captive" insurance companies.) Treasury allows affiliated groups of such companies to file consolidated returns in more or less the same way that any other affiliated group files a consolidated return. See Treas. Reg. § 1.1502-47(h). The allocation of various types of business to one company or another does not create major tax planning opportunities, nor does reinsurance offer the possibility of reducing the aggregate tax burden of the ceding and the assuming companies.

In contrast, life insurance companies are not currently taxed on their economic income.

First, a noneconomic distinction is made between investment income and underwriting income, with the latter category being taxed at less than half the rate of the former. For example, in many companies investment income is taxed on 46%, and underwriting income is taxed at less than 23%.

Second, companies are allowed less than a full deduction for many amounts paid or credited to policyholders. Indeed, under the 1959 Act provisions that are scheduled to come back into force, this limitation will have particularly perverse results. In theory, the limitation restricts the deduction that can be taken for providing customers with flexible pricing features like policyholder dividends. See I.R.C. § 809(f); Rev. Rul. 82-133, 1982-28 I.R.B. 11. In practice, however, the limitation means that most mutual life insurance companies will receive no deduction at the margin for most of their ordinary and necessary business expenses such as salaries, rents, and advertising.

Third, certain favored companies are allowed noneconomic deductions and indefinite "deferrals" that are unrelated to any current or expected costs of doing business.

III. THE FAILURE TO TAX LIFE INSURANCE COMPANIES ON THEIR ECONOMIC INCOME CAUSES AFFILIATION WITH OTHER COMPANIES TO GENERATE TAX-AVOIDANCE POSSIBILITIES

Just as theory suggested, the failure to tax life insurance companies on their economic income has led in practice to massive tax planning -- some would say tax-avoidance -- possibilities. By establishing a tax base that is different from economic income, the statute inadvertently -- but effectively -- encourages tax gamesmanship by which companies attempt to take advantage of distinctions that have meaning in tax law but not in the real, economic world. This tension between tax incentives and economic incentives has inevitably led to administrative complexity. The complexity is created as Treasury and the Service vainly try to deter and nullify by rules and regulations the very behavior that is unintentionally encouraged and potentiated by the statute.

The tax gamesmanship has taken a wide variety of forms. First, various types of business may be placed in different companies in order to minimize total taxes. P&C companies, under certain circumstances, can issue life insurance products. For example, a company doing accident and health business and life insurance business may be treated as a P&C company for tax purposes. If an affiliated group includes both a phase II positive life insurance company and a profitable P&C company, new business generating start up losses could be placed in the P&C company and the mature life insurance business generating underwriting income could be left in the life company. Such an allocation of business allows income of the life company to be taxed at 23 percent yet allows losses to offset income of the casualty company taxed at 46 percent. If the new business were instead issued by the life company, the losses would offset income taxed at 23 percent. The financial press has widely reported that Baldwin-United employed an analogous pattern of allocation prior to its current crisis.

Similarly, because P&C taxation is generally more rational than life company taxation, it may be advantageous to issue certain life insurance products from a P&C company. If so issued, these products are entitled to full deduction for all amounts paid or credited to policyholders. By contrast, if a life insurance company issued these products, it would be limited in the deductions it could take for the cost of providing consumers with flexible pricing features analogous to policyholder dividends.

Second, a reinsurance agreement can often reduce the aggregate tax liability of the parties to the agreement, so long as even one of them is taxed as a life insurance company. Because of the irrational structure of the taxation of life insurance companies, fortuitous tax benefits may result even when (as is often the case) a substantial business purpose is the primary motivation for a reinsurance agreement.

Third, many affiliated groups of companies that include one or more life insurance companies have sought to use consolidated returns as a means of reducing their aggregate tax bills. This attempt has led to extensive controversy with the IRS and with Treasury. In order to perpetuate some of the non-economic distinctions found in the taxation of life insurance companies, IRS and Treasury wish to require a unique form of consolidation. They would impose on an affiliated group or subgroup of life insurance companies a new, nonstatutory set of noneconomic distinctions and restrictions that parallel the statutory distinctions and restrictions applicable to the individual companies. The industry, on the other hand, has contended that once the statutory restrictions have been applied at the level of the individual company, consolidation should proceed in the same manner as for affiliated groups that do not contain any life insurance companies.

Even under Treasury's consolidated return rules, consolidation offers opportunities for tax planning. A phase II positive life company member may exclude from taxation one-half of its underwriting income in excess of taxable investment income and may offset the other one-half with losses of other members, such as P&C companies. For example if the life member had underwriting income of $1 million (and taxable investment income of $500,000) and the P&C member had an underwriting loss of $500,000, total taxable income of the group would be $500,000. If all the business were instead placed in the life company, taxable income would be $750,000.

IV. THE ONLY WAY TO END THE TAX GAMESMANSHIP AND THE ADMINISTRATIVE COMPLEXITY IS TO TAX LIFE INSURANCE COMPANIES ON THEIR ECONOMIC INCOME

To end the tax gamesmanship and administrative complexity, it is necessary to identify and deal with the source of the problem -- the possibilities for tax avoidance that are inevitably created when companies' tax bases diverge from their economic income. The problem inheres in the divergence itself. It lies neither in the quantity or quality of statutory anti-tax-avoidance provisions nor in the volume of administrative resources that may be dedicated to policing such compliance provisions and to designing new ones. So long as the divergence continues, the affiliation of life insurance companies with each other, with P&C companies, and with noninsurance companies will lead to unintended possibilities for tax avoidance.

The mutual life insurance companies would like to end this divergence and the problems that it engenders. We urge that during this session of Congress the law be changed to tax life insurance companies, like all other taxpayers, on net economic income. Attached for the Committee's consideration are copies of a prepared statement, and of a supplemental statement, which discuss these matters and which we recently submitted to the Subcommittee on Select Revenue Measures of the Committee on Ways and Means of the House of Representatives. We would welcome an opportunity to discuss any of these issues in greater detail with Members of the Committee or with staff.

June 3, 1983

SUPPLEMENTAL STATEMENT

OF

MUTUAL LIFE INSURANCE COMPANIES

ON

LIFE INSURANCE COMPANY TAX LEGISLATION

On May 10, 1983, representatives of mutual life insurance companies testified on permanent life insurance company tax legislation before the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means. We also submitted at that time a detailed prepared statement. The present statement supplements our testimony and prepared statement by reviewing briefly several basic questions raised at the hearings. We respectfully request inclusion of this supplemental statement in the record of the hearings.*/

1. Should the 1959 Act be Replaced?

The 1959 Act is seriously defective and must be replaced. The 1959 Act distorts competition by taxing similar products

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*/ By letter of May 31, 1983, from Robert V. Van Fossan to Chairman Fortney H. (Pete) Stark, Jr., we responded in brief to a number of statements that were made by stock company representatives during their testimony. A copy of this letter is included as an attachment to this supplemental statement.

differently, and because of unnecessary complexity, the Act lends itself to numerous forms of tax gamesmanship.

The need to replace the 1959 Act with a new, permanent law was strongly supported by Subcommittee Members, Treasury, and all other independent witnesses. Chairman Stark commented in opening remarks that a return to the 1959 Act "stretches credibility" and that the Subcommittee members recognize that the 1959 Act is "broken." Assistant Secretary John E. Chapoton stated that in the Treasury's view the 1959 Act contains "some of the most complex and least logical provisions in the tax law," and he concluded emphatically that the law "is seriously flawed and is in need of a major overhaul." Independent Subcommittee witnesses, Professors Henry Aaron and Norma Neilson, also spoke in favor of a fundamental change in the life insurance company tax laws.

Only some stock company representatives spoke in favor of a continuation of the 1959 Act. But this very support is due to the flaws in the 1959 Act. Any company that pays no taxes or has a tax-generated competitive advantage can be expected to resist a change in the status quo.

In sum, the overwhelming weight of the testimony at the hearings supports replacement of the 1959 Act with a simpler, more rational law.

2. Should the Stopgap Legislation be Extended or Made Permanent?

The stopgap legislation is an improvement over the 1959 Act because it moves closer to an economic income tax base. However, the stopgap legislation does not respond to most of the policy concerns with the 1959 Act, and, indeed, it has created new uncertainties. These uncertainties concern the taxation of economically equivalent products issued by mutual and stock companies. Consequently, except as a necessary evil as compared to a return to the 1959 Act, the stopgap legislation should neither be extended, nor used as a basis for permanent legislation.

At the hearings, many Members and witnesses expressed the view that an extension of stopgap legislation should not be considered except as a last resort. We were also encouraged by the resolve of the Subcommittee Members to attempt to achieve a permanent solution this year. As we stated in response to questions, a permanent resolution is achievable this year if the Subcommittee makes it clear to all concerned that it intends to replace the current structure with a simpler, more rational corporate income tax.

3. What Basic Elements Should a Permanent Tax Law Contain?

The goal of a new permanent tax structure should be a corporate tax designed to tax all life insurance companies on their economic income. As corollaries to this principle, the tax law should allow a full deduction for the costs of doing business, including all benefits paid or credited to policyholders, and should provide a reasonable allowance for reserve liabilities. Similarly, noneconomic deferrals and deductions should be eliminated. This approach would put the taxation of life insurance companies on the same basis as the taxation of corporations generally.

This framework is consistent in its general terms with the opening remarks of the Subcommittee Chairman, the testimony of the Treasury Department, and the testimony of the independent witnesses at the hearings. The Chairman indicated that the Subcommittee's goal was to develop an equitable and understandable corporate tax based on a total income approach. The Treasury Department in its testimony outlined a conceptional framework which, except in one respect discussed below, contains each of the principal features we discussed in our testimony. Finally, Professors Aaron and Neilson outlined in their testimony similar total corporate income tax approaches. In sum, those witnesses that believe a new law is needed are in substantial agreement on the basic framework and criteria for a permanent solution.

4. <u>What, If Any, Ownership Differential Should be Imposed Upon Mutual Companies Under a Permanent Law?</u>

The question of an ownership differential presents the most difficult conceptual issues considered at the hearings.

It is also the most critical question because any ownership differential will have a direct impact on the ability of mutual and stock companies to compete in the marketplace. We believe a continuing exchange of views on this issue is needed. However, for the record, let us summarize the mutual company position on this important question.

As a matter of sound tax policy, imposition of an ownership differential on mutual companies is not justified. We object to the ownership differential theories because they all begin with the premise that mutual companies are stock companies in disguise. Mutual companies, however, are fundamentally different in their structure and philosophy from stock companies. To ignore this fact in designing the new legislation would be to base mutual companies' tax liability on a fiction. Mutual companies are organized to provide insurance at cost to their policyholders; they are not organized to earn a profit for an investor. Any fair tax law would acknowledge this fact.

Also, as we explained in our testimony, a total income approach contains an adequate built-in ownership differential. Mutual companies would include all premiums (including purported equity contributions) in income and deduct all payments to policyholders. Stock companies would exclude all equity contributions and would not deduct the return on equity. These rules for mutual companies and stock companies are mathematically equivalent, and thus these rules would provide equivalent company level treatment.

The Treasury Department and Professor Henry Aaron testified in favor of an ownership differential in the form of an imputed return on equity capital. However, neither dealt with the fact that an adequate differential would be imposed through the inclusion in the tax base of all premiums, including purported equity contributions. On the other hand, Professor Norma Neilson's testimony seems to confirm that no differential in addition to the built-in differential would be appropriate. Her research indicates that increases in all mutual companies retained earnings, computed on a total income basis with a full deduction for policyholder dividends, exceeds their imputed return on surplus. Thus, even without any separate ownership differential provision, the imputed return would be fully taxed under the suggested total income tax approach.

Moreover, as Professor Michael Boskin of Stanford University testified, the imposition of an ownership differential on mutual companies would be a move in exactly the opposite direction of most current economic thinking.

Finally, even if policyholder dividends were treated in part as a return on equity, no significant tax at the company level should be required in lieu of a policyholder tax. The critical question is the amount of tax that would be paid by our policyholders on any purported equity return from mutual companies and not what stockholders pay, even if that amount were determinable. The amount of tax our policyholders would pay is de minimis. Most mutual company policyholders are low and middle income taxpayers with insignificant amounts of dividend income. Thus, the current $100/$200 dividend exclusion would largely eliminate any potential tax liability.

As we noted at the hearing, it is very unclear what level of tax is currently paid on stockholder dividends. Although we do not know the exact figures for stock life insurance companies, it is estimated that generally about 20 to 25 percent of all common stock is held by tax-exempt pension funds. Also, stock is often held by other corporations that qualify for either an 85 percent or 100 percent dividends received deduction.

5. Should the Current Rules for Policyholder Taxation be Retained?

Mutual companies support the retention of the current rules for policyholder taxation. However, we would restrict the application of those rules, through a definition of life insurance, to only those policies whose predominant purpose is the provision of life insurance protection.

Under the mutual company proposed definition of life insurance, a life insurance contract is defined as a contract that provides for death benefits and that develops a cash value which does not exceed the net single premium for the current benefits provided under the contract. This definition addresses a number of concerns expressed by Treasury about an appropriate definition of life insurance.

First, policies with cash value accumulations in excess of those amounts necessary to provide life insurance benefits will not fully qualify for treatment as life insurance policies. To the extent of the excess cash value, these contracts are serving an investment rather than a life insurance function.

Second, the cash values taken into account under the definition are those necessary to fund current benefits only. Cash values to fund future increases on benefits will be taken into account only when benefits actually increase. Prefunding future increases in death benefits very greatly increases the investment orientation of a contract.

Third, in order to qualify as a life insurance policy, endowment contracts maturing before age 95 must have a stated maturity date that is no earlier than age 70 1/2 and that will occur at a duration of at least 20 years. As Treasury noted in its testimony, the earlier a policy endows, the greater its investment orientation. Thus, under the proposed definition, endowment contracts that are heavily investment oriented will not qualify as life insurance contracts.

Mutual companies believe that if the proposed definition is adopted, no changes in the tax rules applicable to life insurance policies, including the treatment of surrenders, loans, and withdrawals, would be necessary. Properly defined, the primary purpose of life insurance is to provide protection, and, as such, life insurance does not compete with taxable forms of investments.

6. How Should Reserves be Determined Under an Economic Income Tax Base?

The Treasury Department testified at the hearings that the approach used by life insurance companies to compute their reserves is conceptually sound. However, the Treasury concluded that several aspects of the computation of reserves under current law lead to an unwarranted acceleration of deductions for additions to reserves. The Treasury Department questioned the use of "rule-of-thumb" approximations under Code section 818(c)(2). Also, the use of the net level reserve method was questioned as using unrealistic assumptions to allocate loading charges among premiums. Finally, Treasury asserted that current law allows life insurance companies to use overly pessimistic mortality assumptions to estimate future death claims and unrealistically low interest rates in discounting future liabilities. We agree with some of these points.

First, the Treasury Department's concern with regard to rule-of-thumb approximations is legitimate. For this reason, mutual companies proposed elimination of the approximate revaluation methods under section 818(c)(2). As discussed below, however, this provision has continued justification if specifically targeted as a small company provision.

Second, there is justification for concern about the use of the net level reserve method, particularly where the method is not used for purposes of valuing reserves under state law. Therefore, in the context of an economic income tax base, mutual companies would support a limitation on reserves, such as the use of the Commissioner's Reserve Valuation Method (CRVM) for individual life insurance policies. If this approach were adopted, however, companies should be allowed as a minimum to deduct any current cash value liability to policyholders.

Third, mutual companies believe that the Treasury Department's concern about the use of unrealistic mortality and interest rate assumptions is not well founded. In fact, state law mortality and interest rate assumptions are modified to reflect changes in mortality and economic conditions. However, these assumptions must reflect the long-term nature of the life insurance liabilities. Moreover, since death or surrender benefits may have to be paid at any time, companies cannot merely match their obligations to policyholders with specific long-term investments. The company's actuarially certified assumptions should not be disregarded merely because they appear conservative in the context of short-term trends in mortality or interest rates. Finally, the implicit alternative of federal standards for mortality and interest rate assumptions would add unjustifiable administrative complexity. Accordingly, we urge continued reliance upon the actual interest and mortality assumptions used by companies to compute reserves for state law purposes.

7. Should the Tax Laws Provide Special Incentives for Small Companies?

The tax laws have traditionally provided special provisions applicable only to small companies to foster competition and entry into the marketplace. Mutual companies have consistently supported similar types of incentives for small life insurance companies, both small mutual companies and small stock companies.

Our concern has been that some of the so-called small company incentives in current law are not really limited to small companies. For example, as the testimony at the hearings indicated, section 818(c)(2), which was intended as a small company provision, actually benefits large mutual and stock companies to a greater degree in absolute dollar terms than it benefits small companies.

At the hearings, however, representatives of small companies testified that they rely to a substantial extent on the provisions of section 818(c). Moreover, small company representatives testified that some small companies do not in fact have the computer capacity to use the exact method of revaluing reserves and thus need to rely on approximate revaluations such as those provided under section 818(c)(2). In view of this testimony, mutual companies would support a continuation of 818(c) if it were directed specifically at small companies. For example, we would suggest consideration of a cap of $1 million on deductions available because of the revaluation under section 818(c). To further limit this benefit to small companies, the $1 million amount could be phased out as a company's reserves exceed specified dollar amounts.

R. V. Van Fossan
Chairman of the Board

Mutual Benefit Life
520 Broad Street
Newark, NJ 07101

May 31, 1983

Honorable Fortney H. Stark
1034 Longworth House Office Building
Washington, D.C. 20515

Dear Pete:

On behalf of mutual life insurance companies, I wish to express my appreciation again for the opportunity we received to present our views to the Subcommittee during its hearings on May 10. Your leadership made the hearings meaningful despite the extreme complexity of the subject matter. We remain hopeful that the Subcommittee will now move forward to develop new permanent legislation that will provide fair treatment to all segments of the life insurance industry.

In due course, we will be filing a formal supplemental statement dealing with a variety of new and old issues raised at the hearings. I am writing now simply to respond in brief to a number of statements that were made by stock company representatives in the course of their testimony on May 11.

1. Stock Company Statement: At least 40% of mutual companies' policyholder dividends represent distribution of profits to the companies' equity owners and should therefore be nondeductible.

Response: Even if one were to accept such a theory of mutual company ownership, the maximum justifiable nondeductible percentage is but a small fraction of the number the stock companies suggest, on the order of 3 to 5%.

Any deemed equity contribution by the policyholders of a mutual company is reported in the company's tax returns as premiums. Unless such deemed "equity" contributions are excludible by the company when received (like the equity contributions to a stock company), any deemed return on that "equity," as well as the "equity" itself, must be deductible when paid out. Otherwise, even under the stock companies' theory of ownership, the mutuals would be unfairly disadvantaged.

A full deduction of dividends would not result in avoidance of tax on these equity returns. This fact is confirmed not only by our computations, but also by the studies undertaken by Professor Neilson in connection with her testimony.

2. Stock Company Statement: The mutual companies have enjoyed substantial underwriting profits on which they have paid no taxes.

Response: There have been no untaxed profits and thus there has been no tax avoidance.

What is at issue is the characterization of mutual company policyholder dividends that are paid out of that portion of gross income which is in excess of investment income. Even the stock companies concede that such amounts are refunded to policyholders in their capacity as customers, not in their capacity (if any) as equity owners. Amounts so refunded to customers are not "profits." Calling them "underwriting profits" before this Subcommittee does not alter that fact.

Unlike stock companies, mutual companies are not allowed artifical special deferrals or deductions under the 1959 Act. Indeed, under current economic conditions, the deductibility of policyholder dividends is severely limited. Contrary to the assertion that mutual companies somehow escape tax on underwriting profits, the dividend limitation actually results in a tax base that is greatly in excess of true economic income from all sources.

The stock company assertion is also in direct conflict with their own prepared statement. On page 30 of that statement, the Stock Information Group concludes that the 1959 Act correctly measures a mutual company's income. While we strongly disagree with this conclusion, it certainly contradicts the notion that somehow, in some manner, mutual companies have escaped tax on a portion of their profits. We are forced to conclude that the statement made at the hearings was simply an attempt to divert attention from the incontrovertible fact that an estimated $9 billion of real stock company profits have gone untaxed under the 1959 Act.

3. Stock Company Statement: An "ownership differential" should be imposed on the stock subsidiaries of mutual companies.

Response: The stock companies have never suggested that the policyholders of a mutual company's stock subsidiary are its equity owners. Thus even under the stock companies' purported rationale for the differential, there is no basis for imposing it on such a subsidiary.

The purported rationale for an "ownership differential" is that a mutual company's policyholders are deemed to be its equity owners. But even the stock companies do not claim that this rationale applies to a mutual company's stock subsidiaries. The stock companies would impose an additional tax on these subsidiaries on the assumption (which is unfounded) that such subsidiaries might sell insurance at cost to their nonowner policyholders.

Such an additional tax would, therefore, not be an "ownership differential."

In any event, the stock company subsidiary of a mutual company would not provide insurance at cost to the policyholders of the subsidiary. From the mutual parent's point of view, the investment in the stock subsidiary would be like any other investment and would have to show an appropriate return. To do so, the subsidiary would have to operate at a profit. Accordingly, the fear that the subsidiary would provide insurance at cost is not a real one.

4. Stock Company Statement: The unique nature of the life insurance business justifies the special deductions and deferrals in the 1959 Act.

Response: There is no economic justification for these provisions.

The special deductions and deferrals represent amounts that exceed the company's own estimates of the present cost of its future benefit payments. If these special amounts represented true economic costs, the company's actuaries would make provision for them in the company's life insurance reserves. A tax based on income has no place for deductions or deferrals that represent hypothetical future costs that the taxpayer itself does not expect to incur. Indeed, these special provisions were originally added to the law not in order to determine companies' income with greater accuracy but in order arbitrarily to allocate the industry's total tax burden among its various segments ("segment balance").

Moreover, even if the special provisions once had some secondary economic motivation, developments over the last quarter century have made such a defense of these provisions untenable. First, they have proved unnecessary. Second, stock companies's insurance sales are no longer characterized by fixed-price, fixed benefit nonparticipating policies. Rather, these companies now rely extensively on flexible pricing features, which make their policies economically equivalent to formally participating insurance. Because flexible pricing features shift to the policyholders much of the risk that previously was borne by stock companies, the advent of policies containing such features has ended any need the companies may once have had for special, noneconomic deductions and deferrals.

5. Stock Company Statement: Bottom-line consolidation does not present abusive tax avoidance possibilities.

Response: So long as the phase system of the 1959 Act remains in the law, bottom-line consolidation provides a broad avenue for tax avoidance.

Under the 1959 Act, items of income and deduction can have a 46%, a 23% or a 0% impact on a life insurance company's tax liability. Bottom-line consolidation allows effective tax planning so that losses can be taken at

46% and gains taken at some lesser rate. Assistant Secretary Chapoton referred to these possibilities in his prepared statement (pp. 30-31). The business press has widely reported that, prior to its current difficulties, Baldwin-United made extensive use of precisely such tax avoidance possibilities. It is our understanding that other stock companies are currently employing the same devices.

6. Stock Company Statement: The mutual companies agreed last year to bear 60% of the industry's overall tax burden.

Response: We agreed to support an industry stopgap proposal even though that resulted in a disproportionate tax burden on mutual companies while tolerable for a two year period. For the long term the tax burden must be apportioned according to a company's economic income.

As was demonstrated by our acquiescence to the Rolland-Beck compromise, the mutual companies have been willing to agree to substantial sacrifices in order to achieve broad based consensus on company taxes. Another such concession was last year's acceptance of the stopgap bill. But we did not then and we do not now accept the stock companies' proposition that the tax burden should be allocated in a fashion that ignores companies' economic income. Economic income is the only fair basis for an income tax. If we become successful enough to earn more than 60% of the industry's aggregate economic income, we should pay -- and we are prepared to pay -- more than 60% of the total tax. If we earn less than 60% of the industry's aggregate economic income, tax liability equal to 60% of the total burden would be unjustified.

We expect to elaborate further on these matters in the formal statement we will be filing for the record. In the meantime, we remain prepared to discuss with you in greater detail all issues pertaining to the taxation of life insurance companies and products. We thank you again for your consideration.

Cordially yours,

R. V. Van Fossan

RVV:sb

TESTIMONY OF

LYNDON L. OLSON, JR.

Chairman, State Board of Insurance

for the State of Texas

on behalf of the

NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

before the

UNITED STATES SENATE COMMITTEE ON FINANCE

Hearings on Taxation of

Property and Casualty Insurance Companies

June 13, 1983

Mr. Chairman, I am Lyndon L. Olson, Jr., Chairman of the State Board of Insurance for the State of Texas. I am appearing on behalf of the National Association of Insurance Commissioners, also known as the "NAIC." The NAIC is comprised of the chief insurance regulatory officials of the 50 states, the District of Columbia, Puerto Rico, the Virgin Islands, Guam, and American Somoa. We, as insurance regulators, are responsible for maintaining the financial health and solvency of the insurance industry and its responsiveness to the insuring public. Because of the direct and immediate impact of federal taxation on the insurance industry and its ability to provide consumer responsive financially secure services to the public, we are particularly interested in these hearings.

The regulation by the states of the insurance industry preceeded the enactment of the federal corporate income tax. Over the years, the states have successfuly protected the best interests of the public, maintained insurer solvency, and generally regulated the insurance industry in a manner that has permitted the insurance industry to grow and become more responsive to consumer demand. The preeminence of state regulation of the insurance industry was incorporated into federal law by way of the 1945 McCarran-Ferguson Act.

The NAIC is specifically concerned with the subject matter of these hearings because any alteration in the current method of taxation of the insurance industry could have a negative impact on the solvency of some insurance companies and, conceivably, all insurance companies. Further, any alteration in the current system could have a detrimental impact upon the competitive balance between various types of insurance companies. Any alteration in the system of taxation which would result in increased taxes on U.S. insurers could work to the advantage of foreign competition.

Any changes in the current tax laws could have a substantial impact on the insurance industry, its relationship to the consuming public, its dependability and its solvency. In other words, the public policy towards the insurance industry, which has evolved over the past century, could easily be altered, whether or not such an impact was intended by the drafters of the legislation.

It is for these reasons that I am appearing today before this Committee on behalf of the NAIC to request that the Committee consider with great care any changes in the current tax laws. Two matters of particular interest to the NAIC are likely to be discussed before this Committee. The first is the discounting of loss reserves. The second is the challenge to the annual statement method of accounting.

Reserve discounting is the reduction of permissible loss reserves to take into consideration the value of money over the payout period. While it is recognized that current reserving practices limit the amount of capital of the insurer which is subject to taxation, it must be recognized that the establishment of reserves is directly related to the desired goal of insurer solvency.

An increase in taxes could have a multiple effect upon insurer solvency. The reserve held to protect policy holders would be reduced by the amount of additional taxes paid. A smaller reserve would mean loss of investment income and, conceivably, the necessity to sell assets. The reduced reserves could result in a diminished capacity to write further insurance.

Insurers are not free to utilize their reserves for any purpose they might consider to their advantage. A fiduciary responsibility is imposed upon insurers regarding the reserves by state law.

Reserving practices are closely related to the second area of particular concern to the NAIC--the possible attack on the annual statement method of accounting. The annual statement method was developed by the state regulators of the insurance industry as a method of providing consistent, uniform information regarding the industry. It has been essential to the successful regulation of insurance by the states.

The principles involved in annual statement accounting evolved over the years in response to the particular and specific needs of the insurance industry. The insurance industry, of course, is not alone in requiring specially adapted accounting treatment. The Internal Revenue Code recognizes the validity of special accounting methods for federal income tax purposes in other industries such as banking, farming, railroads, and mining. The annual statement method of accounting has been recognized as the method of accounting to be used for federal income tax purposes since 1921.

In view of this history, any alteration of this well established accounting method for the purpose of raising taxes or otherwise, could have a significant adverse impact upon the insurance industry. For example, as noted previously, it could detrimentally affect the financial stability of the insurance industry by having a negative impact on reserving practices. It could certainly interfere with the well established regulatory practices which are designed to protect the interests of the consumer. Moreover, more broadly, any change in these accounting practices could have a detrimental effect on the industry and its impact on the U.S. economy.

Mr. Chairman, the NAIC is vitally interested in these hearings and any legislation that may result from them. We would welcome the opportunity to further participate, provide information, and otherwise to assist in the legislative process. Thank you.

NATIONAL ASSOCIATION of CASUALTY & SURETY AGENTS
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June 22, 1983

The Honorable Robert Dole
Chairman, Finance Committee
United States Senate
Washington, DC 20510

Re: Proposal To Tax Employee Health Care Benefits

Dear Chairman Dole:

The National Association of Casualty and Surety Agents (NACSA), an association representing the leading domestic, commercial insurance agencies and brokerage firms, opposes any proposal to tax employee health care benefits, whether used to raise funds to reduce the federal deficit or to provide health care to the nation's unemployed. NACSA believes taxing employees' health care benefits would be unfair.

A tax on employee health benefits would discriminate against older and handicapped workers, against employees in high-risk occupations, and against those living in areas with a high cost of living. These groups pay higher premiums than the average for the same health insurance. We believe it would be unfair for these workers to pay more in taxes than others for the same health protection.

This tax would constitute a form of double taxation. Since the government does not reimburse hospitals for all costs associated with treating Medicare and Medicaid patients, the private sector is forced to absorb the difference. In 1982 alone this 'cost shift' amounted to $5.8 billion. This, in effect, is a hidden tax. It would be unfair for the government to shift these costs to private payors of health care and then tax the resulting higher premiums.

NACSA urges you, Chairman Dole, to reject any proposal to tax employee health care benefits. There is no reason to justify taxing working Americans' health benefits. We respectfully request this letter be included in the record of the Finance Committee's hearing of June 22, 1983, on the taxation of employee health care benefits.

Sincerely,

Joan Albert Dreux
Government Affairs Director

JAD:jb

SENATE FINANCE COMMITTEE HEARING ON
TAXATION OF PROPERTY & CASUALTY INSURANCE COMPANIES
JUNE 13, 1983

This statement, submitted for inclusion in the printed record of the Monday, June 13, 1983, 9:30 a.m. United States Senate Finance Committee Hearing on Taxation of Property and Casualty Insurance Companies, has been prepared by the Governmental Affairs Department of the Risk and Insurance Management Society, Inc., commonly known as RIMS. RIMS is a non profit organization representing corporate and governmental bodies in 73 chapters located throughout the United States and Canada. Corporate members include 90% of the top Fortune 1300 companies, and are responsible for the purchase of over $30 billion worth of insurance services.

At this point one might ask, "What is risk management?", "Who are risk managers?", and "Why are they so keenly interested in the taxation of property/casualty insurance companies?". Starting with the latter question, RIMS, as a representative of the large volume insurance purchaser, is acutely aware that at least a significant portion of any increased tax burden on the property and casualty insurance company will be borne by the consumer -- the RIMS member. Similarly, our members, as corporate taxpayers, are vitally interested in a particular area for which this Committee has requested comment -- how "insurance" should be defined for tax purposes.

As to who are risk managers and what is risk management, some brief historical background information is necessary.

In the not too distant past, most corporations handled their business risks by delegating a clerk to purchase insurance. The clerk shopped around until he found what was hoped to be the right coverage at the lowest price. Sometimes a company wound up with too much or too little insurance, but in general the corporation was adequately protected.

In recent years, life has become more complex, and so has insurance buying. Today corporations are confronted with business risks that are greater and more varied than ever before. The same technology that has dramatically improved our way of life has also created new exposures for disaster. For instance, nuclear reactors are a valuable source of energy, but an accident could cause incalculable damage to human life and the environment. Modern medicine has conquered many once fatal diseases but, we discovered too late, that some drugs can have tragic side effects. The expense of developing technology has created other risks. Huge concentrations of capital may be invested in a single operation and if a disaster strikes, a corporation could lose millions of dollars in a single accident.

Other risks are posed by changing social attitudes. Consumers and government now demand that business assume greater responsibility for product safety and the effect of their operations on the environment. Many industries are also affected by global uncertainty and multinational firms are faced with the direct risks of political unrest and instability.

Unfortunately, as business risks have escalated, it has also become more difficult to buy insurance to cover these exposures. Premiums for standard coverages have risen astronomically and many insurance companies simply refuse to cover high risk operations. It has been under these circumstances of growing corporate and governmental liability exposure that the field of risk management has evolved. Risk management is the process of planning, organizing, directing and controlling the resources and activities of an organization in order to minimize the adverse effects of accidental losses on that organization at the least possible cost. In the last ten years, risk management has been evolving from infancy to maturity and today many top corporations give high priority to risk management programs.

As the role of risk management has grown, so has the status of the risk manager; from a clerk relegated to the purchase of insurance to an expert on risk identification, risk measurement and evaluation, risk elimination or reduction, and risk finance. Obviously, not all risk can be eliminated, and it is the risk manager's task to devise the most economically efficient means to deal with the organization's risk of loss. It is this process, risk finance, which is rapidly changing the insurance industry today. To ignore this process in determining how insurance should be defined for tax purposes, would be akin to regulating transportation as if the horse and buggy were the prevalent means of travel.

Today, more and more corporations are financing a major portion of their losses internally, particularly when such losses are frequent and predictable. The instances of corporations buying so-called "first dollar" insurance, where coverage is obtained for the full extent of the loss, is becoming rarer. A brief illustration will explain why.

A supermarket chain might find that its loss history over a ten year period for "slip and fall" tort liability claims is relatively consistent, say approximately $500,000 a year. The corporation could purchase so-called "first dollar" coverage of insurance which would cover the corporation for the full extent of its losses. However, to do so would involve an expenditure by the corporation in the form of a premium to the insurance company well in excess of the anticipated $500,000 loss. This is because the premium charged by the insurance company reflects not only the anticipated $500,000 in losses it intends to pay out, but profit and overhead as well. It is in this situation that the field of risk management comes into play -- to determine what type and the percentage of risk that should be assumed internally by the organization and, similarly, to determine the type and percentage of risk that would be more economically efficient to handle through the purchase of commercial insurance. It is these techniques of risk finance which the Committee should consider in examining the definition of insurance for tax purposes.

One such technique is to establish a reserve for expected losses. This method acknowledges the existence of risk and creates a reserve on the balance sheet. The IRS has recognized this technique in Code Section 537 (b)(4), which allows the accumulation of reasonable product liability loss reserves, without subjecting the reserve to a tax on unreasonable accumulation of earnings. It should also be emphasized that the practice of maintaining a reserve plan is not only recognized but in essence mandated by the Financial Accounting Standards Board (FASB) in its FASB Standard Number 5 (FASB-5). FASB-5 states that highly predictable future payments arising from events that have occurred, including self-insured losses, are to be charged to income in the current period. This directive reflects FASB's concern that predictable losses should be reflected on the corporate balance sheet.

While the technique of using reserves is an important one in risk management, it is vital to understand that commercial insurance will still be purchased by firms regardless of size. Again using the supermarket example, the corporation, while it can internally handle the $500,000 anticipated losses from "slip and fall" cases, may be crippled if a single $5 million judgment is assessed against them. Such reserves are not established to cover catastrophic losses. Similarly, the corporation may feel that $500,000 in losses is the most that it can handle internally, and wishes to purchase insurance for losses which may occur over that amount. Thus the risk manager will purchase "excess" insurance for losses which may exceed the $500,000 threshold.

Even under circumstances not involving excess or catastrophic coverage the risk manager will still seek commercial insurance coverage. Again, using the supermarket example, the risk manager may find that while it does not pay to purchase first dollar liability coverage, the insurance company can still provide the supermarket with important services such as claims handling or engineering safety surveys, less expensively than the corporation could. Risk financing techniques have been developed, with the active cooperation of the insurance industry, which allow the partial self insurer to purchase those coverages and services which address its corporate insurance needs in the most cost efficient manner.

Virtually every sizeable corporation utilizes some element of self insurance similar to or based on the risk management techniques and principles outlined above. Yet the tax code permits a deduction only for premiums paid to a commercial insurer. Similarly, the Internal Revenue Service insists on an external transfer of risk before such a deduction is allowed. RIMS most strongly contends that this emphasis on commercial insurance purchase and risk transfer is misplaced.

Congress, in permitting a deduction for insurance premium purchases, recognizes that protecting an entity from accidental loss is essential to sound economic planning. Congress similarly recognizes the importance of encouraging a stable funding mechanism through which claimants can receive just compensation. Yet, under our present system of taxation, the emphasis is placed on whether insurance is purchased or the risk transferred, rather than on the quality of the funding mechanism.

There are many sound policy reasons for amending the code to permit a deduction for self insurance reserving practices. Congress and the courts have been enlarging the scope of corporate responsibility in almost every area, from product liability to toxic waste. This has not been without ramifications. The greater the liability exposure the higher the cost of securing commercial insurance coverage, if such coverage is available at all. These higher insurance costs are passed on to the ultimate consumer of the insured corporation's products and services. Moreover, the development of new products and services can be hindered because of excessive costs of insurance coverages for new risk exposures created by technological advances. Similarly, corporate funds are being devoted to securing insurance coverage at the expense of much needed capital investment. This in turn has a detrimental impact on the competitiveness of American industry.

Given the demands of the courts and Congress, a viable mechanism for self insurance is essential to deal with these enlarged loss exposures. A qualified self insurance program permits the corporation to lower insurance costs which would otherwise be passed on to consumers. It encourages the development of new products and services by providing an affordable mechanism to insure against certain risks.

It frees funds devoted to insurance purchase for much needed capital investment. Most importantly, self insurance combined with the purchase of insurance coverage, allows the corporation to secure the broadest coverage at the least cost. Given these facts, it makes no sense to exclude qualified self insurance reserves as a permissable tax deduction.

RIMS is keenly aware that the Committee is examining the taxation of property and casualty insurance with an eye toward revenue enhancement. Expanding the tax definition of insurance to include self insurance is not incompatible with this goal. First and foremost, the Committee should be aware that a significant portion of the deduction for insurance premiums allowed under the code, reflects the profit, administrative, and overhead expenses of the insurance company. That portion of the cost which the corporation will seek to deduct as self insurance would be lower than the deduction now obtained through the purchase of insurance, because neither the profit nor overhead is added in. Thus a lower deduction would be claimed by the partial self insurer than by his counterpart purchasing first dollar insurance coverage.

An added and not insignificant benefit to the Treasury is the fewer losses incurred by the self insurer. A recent editorial in the noted trade publication Business Insurance (Nov. 22, 1982, page 8) stated, "It is quite clear from the experience in the United States that a company that pays its losses out of its own pocket in the first instance is more serious about controlling losses than the fully insured company." Companies that do self insure are aggressive about loss prevention, because the losses are felt directly on the corporate bottom line. Besides the tremendous benefit to society of fewer injuries and losses, the fiscal impact on the U.S. Treasury is clear. Fewer losses mean fewer deductions, and fewer deductions mean more tax dollars taken in.

In determining the definition of insurance for tax purposes RIMS urges the Committee to reform the tax code to permit taxpayers who elect to self insure certain types of risks to receive, with respect to self insured reserves, the same tax treatment as if they opted to purchase commercial insurance. One partial step which the Committee can take to achieve this tax equity would be by treating self insured and insured as the same, and allowing a deduction for the value of all claim liabilities. As the reserves of the self insurer and commercial insurer serve the same purpose and are subject to the same claim liability, there is no rational reason in differentiating their treatment for tax purposes. This conclusion, though restricted to the area of workers' compensation, was reached by the United States District Court for the Northern District of California in Kaiser Steel vs. the United States, (82-2 USTC).

While RIMS believes that such an incremental step toward achieving equality for the self insurer would be most useful, we would also urge the Committee to consider the more comprehensive approach taken by Representative Bill Frenzel in H.R. 2642, introduced on April 20, 1983. The bill permits a tax deduction for certain self insurance reserves or set-asides and provides the assurance that the taxpayer will be around to pay these loss claims when they become due.

Under H.R. 2642 the taxpayer can set up a trust vehicle similar to the 501(c)(9) trust for employee benefit plans presently found in the tax code. This bill specifies that such reserves would have to be funded in a self insurance trust mechanism or through some other option as outlined within the scope of the measure.

The key to this bill is tax equality; that one class of taxpayer, the self insurer be treated the same way as another taxpayer class, the buyers of insurance. With respect to self insured reserves, they would be treated in the same manner as reserves established by commercial insurers. Such equality would well serve the potential claimant, the insured, the commercial insurer, and most importantly, the American taxpayer.

Above all, RIMS urges the Committee, no matter what its determination on the tax treatment of reserves or definition of insurance may be, to recognize the absolutely crucial importance of having the commercial insurer and self insured corporation maintain an adequate reserve funding mechanism to deal with future losses. Without such an adequate reserve mechanism, not only will the future solvency of the commercial insurer and corporate self insurer be jeopardized; the potential claimant will be left without assurance of compensation as well. Any decisions which the Committee makes as to the taxation of these reserves will have a major impact on the financial solvency, stability and integrity on these funding mechanisms. RIMS is confident that the Committee will carefully consider this impact in devising an equitable policy of taxation for the insured, commercial insurer, and self insured.

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