Part C. Property and Casualty Insurance Companies

This Part discusses proposals to curtail favorable tax rules for property and casualty ("P&C") insurance companies. The system of reserves for unpaid losses would be revised to assure correct treatment of the underwriting and investment income earned by P&C companies. Special provisions that reduce the effective tax rate on P&C companies would be eliminated. Specifically, the deduction for contributions to a protection against loss account would be repealed. Special tax exemptions, rate reductions, and deductions of small mutual P&C companies would be repealed. The deduction for policyholder dividends by mutual P&C companies would be limited in conformity with the deduction allowed mutual life insurance companies.

REVISE TREATMENT OF LOSSES BY PROPERTY AND CASUALTY INSURANCE COMPANIES AND ALLOW DEDUCTION TO CERTAIN OF THEIR POLICYHOLDERS

General Explanation

Chapter 10.10

Current Law

Property and casualty ("P&C") insurance companies are allowed a reserve deduction for "losses incurred" during a taxable year. The deduction includes the company's estimate of "unpaid losses," whether or not unpaid losses have accrued under normal tax accounting rules. Unpaid losses include amounts that will be paid in connection with claims filed with the company during the taxable year as well as amounts that relate to claims expected to arise from events occurring during the taxable year that have not been reported to the company. The deduction for these claims generally is not discounted to reflect the fact that they will not be paid until some time in the future. Moreover, the reserve does not grow over time to reflect the investment income earned on the reserve. A company is also permitted to set up an unearned premium reserve for premiums received during one taxable year that relate to coverage to be provided in subsequent years.

In the case of taxpayers who sustain losses, the tax treatment of the losses depends upon a number of factors, including whether the loss is a business or a personal loss, whether the loss is to the person or property of the taxpayer or is a tort or other liability to a third party, and whether the loss is covered by insurance. First, most personal losses are nondeductible. For example, individual taxpayers can claim a deduction for casualty losses to personal property only to the extent the losses exceed ten percent of the individual's adjusted gross income; deductions for medical expenses are limited to those in excess of five percent of adjusted gross income. Second, otherwise deductible tort and similar liabilities to a third party generally are not treated as incurred (and hence are not deductible) until payment is made to the third party. Third, although certain uninsured losses sustained by a taxpayer are deductible at the time the loss is incurred, no deduction is allowed at this time if the loss is insured. In general, no account is taken of the taxpayer's loss of the time value of money resulting from any delay between the time the loss is incurred and the time the insurance claim is paid.

Often, as part of the settlement of a liability to make payments for personal injury damages, a property and casualty company or an uninsured defendant will agree with the injured party to assign the liability to make periodic settlement payments to another person, such as an affiliate of a life insurance company, who will fund the "structured settlement" by purchasing an annuity contract. Third-party assignees who assume other persons' liabilities to make periodic payments as personal injury damages or settlements may exclude from gross income amounts received in consideration for such assumptions, to the extent such amounts are invested in annuity contracts to fund the liabilities. The third-party assignees' basis in the annuity contracts is reduced by the amount of excluded income. Third-party assignees recognize income as they receive payments on the annuity contracts but may deduct periodic payments to the injured parties.

Reasons for Change

The deduction by P&C companies of reserves for claims to be paid in the future, unadjusted for the investment income that will be earned on those reserves, results in deferral of P&C companies' tax liability and reduces their effective tax rates. In other cases where tax deductions for reserves are allowed, either the allowable reserves are discounted for the expected future investment earnings on the reserve funds (as is the case with life insurance reserves) or the investment income earned on the reserve is added to the reserve (as is the case with nuclear decommissioning trust funds).

The current tax treatment of P&C insurance reserves distorts the choice between self-insurance and third-party insurance. P&C companies deduct currently the full amount of the future liability for many casualty losses that would not be deductible currently by a self-insurer. Because a current tax deduction is more valuable than a future deduction, individuals and businesses are encouraged to insure against risks with a P&C company in order to take advantage of this favorable tax treatment.

With respect to persons sustaining losses covered by insurance, current law is inaccurate in failing to recognize the effect of a delay between the time a loss is incurred and the time an insurance claim for such loss is paid. Even a taxpayer who suffers a loss of property that is fully insured for its current fair market value suffers an uninsured loss measured by the loss of the value of the property during the period the incurred loss remains unreimbursed. If the current system of taxing P&C companies were changed without correcting this defect, the tax system would discourage the purchase of insurance with respect to losses that would otherwise be deductible (primarily business property losses and large personal casualty losses).

Finally, in the case of third-party assignees, the current tax treatment of amounts received from assignors and amounts paid to injured parties effectively exempts from tax the investment income on the amount assigned. This exemption is not warranted nor is it required by the exclusion from injured parties' income of periodic payments received as personal injury damages pursuant to structured settlements. That is, the rationale for the tax treatment of injured parties is not to allow them tax-free investment of damage awards, but rather to remove a tax disincentive to injured parties who accept payment in the form of a structured settlement as an alternative to a lump sum. Just as injured parties are taxed on income from the investment of damage awards once received, third-party assignees should be taxed on income from the investment of funds prior to payment to injured parties.

Proposal

The deduction by P&C companies for unpaid losses during a taxable year would be computed under the "qualified reserve account" ("QRA") method. Under this method, the company would establish reserve accounts for claims to be paid in an amount estimated by the company to be sufficient to fund payment of the claims, taking into account the company's estimates of the amount of the claims, the time of payment of the claims, and the company's after-tax rate of return on its investment assets. Separate reserve accounts would be established by line of business and year of policy issuance. In other words, one account would be established for all claims under all policies in a particular line of business issued in a particular taxable year. This account would take the place of the current separate reserve accounts for unearned premiums, incurred but not reported ("IBNR") losses, and reported claims.

The initial amount deductible with respect to a given reserve account could not exceed the combined statutory unearned premium reserve, IBNR reserve, and claims reserves on policies covered by that account. Beyond this, the company would not be subject to federally prescribed rules in establishing the reserve account.

Each reserve established by the company would be increased annually by a percentage equal to the after-tax rate of return actually earned by the company on its investments during that year. To prevent the company's investment income from being sheltered from tax, no additional reserve deduction would be allowed for the annual increase in the reserve accounts attributable to the allocation of investment income.

The after-tax rate of return for a company during a given taxable year would be equal to the total net investment income of the company (including tax-exempt income) for that year, reduced by taxes attributable to that income, divided by the average total surplus and reserves of the company for the year. Thus, in effect, the QRA proposal would prorate the taxable and tax-exempt income among all the reserves and surplus of the company. To the extent a P&C company is able to increase its after-tax income through investment in tax-exempt securities, its reserves would grow more quickly. This would require the company either to take smaller initial reserve deductions or realize greater income from the release of reserves when claims are paid.

The company would be allowed a deduction each year for the full amount paid to satisfy claims, but would be required to include in taxable income an offsetting amount released from the appropriate reserve account. If the reserve was insufficient to cover all claims, the excess claims would be deductible when paid. Conversely, if any amount remained in a reserve account after payment of the last claim in that account, that amount would be included in taxable income.

A company would be permitted to strengthen a reserve it determined was insufficient to cover future claims and a deduction would be given for additional amounts placed into a reserve. However, the company would be required to establish the need for reserve strengthening by a showing of objective factors affecting the amount needed to fund the payment of claims. Such factors would include a strengthening of the company's reserves on its annual statement or a decline in prevailing interest rates. Companies also would be free to release into income additional amounts from reserves it felt to be excessive. This would allow companies to avoid a bunching of income in a single year from the release of an excessive reserve.

A company would not be able to maintain a reserve indefinitely. Rules would be established limiting the maximum life of a reserve, depending on the line of business. Any reserve balance at the end of the maximum life would be released into income. Any subsequent claims under policies covered by that reserve would be deductible when paid.

This proposal would also apply to reserves for unpaid losses not included in life insurance reserves held by life insurance companies. Thus, a life insurance company issuing accident and health policies would be required to use the QRA method to account for unpaid losses on such policies.

Taxpayers suffering losses covered by insurance would be permitted to elect to claim a deduction with respect to those losses without regard to the prospect of recovery from the insurance company. In other words, electing taxpayers would be allowed to deduct the loss in the taxable year the loss is incurred as if the loss were uninsured. Insurance proceeds would be taxable income when received, but an exclusion would be given equal to the amount of any portion of the loss that was not deductible. Current law would continue to apply to nonelecting taxpayers.

Third-party assignees of liabilities to make personal injury damage payments would include the full amount of consideration received from the assignor in gross income. An assignee purchasing an annuity contract to fund its liabilities to an injured party would be treated as the owner of the annuity and would be taxed on the income component thereof. The assignee would be permitted to elect either to treat the purchase of an annuity used to fund its liabilities to an injured party as a deductible expense at the time of the purchase or to treat each payment to the injured party as deductible at the time the payment is made.

Effective Date

The proposal would be effective for all losses incurred in taxable years beginning on or after January 1, 1986 that are insured under policies issued on or after January 1, 1986. The proposal on third-party assignments of personal injury liability would be effective for all assignments entered into on or after January 1, 1986.

Analysis

Under the proposal, P&C companies would still be permitted to use the reserve method to match income and losses occurring in different taxable years. The QRA method, however, would take into account the time value of money. A current deduction of $1,000 is worth considerably more than a future deduction of $1,000 because investment income will be earned on the tax saving produced by the deduction. For the same reasons, less than $1,000 needs to be held in reserve to fund a future liability of $1,000. For example, if interest income accumulates at an after-tax rate of six percent, a reserve of only $792.09 is needed to provide sufficient funds to satisfy a liability four years in the future of $1,000. If a fund of $1,000 is set aside and deducted, it is appropriate to recognize the growth of that fund to $1,262.48 and to include the excess amount of $262.48 in income when the claim is paid.

The system of qualified reserve accounts does not require the discounting of reserves. This feature of the proposal avoids the difficult problem of choosing a mandatory discount rate in an environment where investment returns vary widely from company to company and from year to year. Companies are free to discount reserves using any set of assumptions as to future interest rates (e.g., the assumptions used in pricing the policies) or even to establish undiscounted reserves. This flexibility is possible because the QRA method assures that the ultimate after-tax return that a company realizes on a group of policies does not depend on the amount the company places into the reserve for those policies, assuming that the company's tax rate is constant over time. The company would not have a tax incentive to overreserve since any excess tax deduction would be recaptured when the claims are ultimately paid with an interest factor equal to the company's actual after-tax rate of return on investment assets. Conversely, companies that underreserve would receive additional deductions at the time they pay their claims to ensure that they will not be penalized for underreserving.

This feature of the QRA method is not present in a system that requires pre-tax discounting of reserves and grants additional deductions for investment income earned on reserves. Such a system, while clearly an improvement over present law, would penalize a company for underestimating the amount of a claim or overestimating the length of time until payment of the claim. Conversely, a company would receive a windfall on any claim that was overestimated or whose payment was delayed. More significantly, such a system would continue to undertax P&C companies since investment income on reserves held by P&C companies would not be taxed. Such a system thus fails to tax the entire income of P&C companies and continues the distortionary effect of current tax law that favors third-party insurance over self-insurance.

A substantial portion of the claims paid by P&C companies are paid in years subsequent to the year in which premium income is received and a deduction for losses paid or incurred is claimed. Table 1 shows the average period of loss payment for all insurance written by P&C companies and for several major lines of business. As shown on the table, over 60 percent of all losses of P&C companies are paid after the year of deduction. The actual discounted value of these losses at the time the premium income is received, assuming a six percent discount rate, is approximately 91 percent of their undiscounted value. In the case of medical malpractice insurance, a line of business where long delays in the payment of claims are common, more than one-half of all losses are paid beyond the fourth year after the year of deduction and the discounted value of the losses at the time the premium is received is only approximately 76 percent of their undiscounted value.

It has been argued by some that the present system of undiscounted claims reserves results in "rough justice" since it allows a deduction to some taxpayer in the full amount of an economic loss (of either the policyholder or a third party to whom the policyholder is liable) when the loss is incurred. Arguably, it is proper to match the time of the P&C company's deduction to the time the underlying economic loss is sustained. However, except in the case of business property losses, a large portion of property and casualty liabilities would not be deductible losses to the party suffering the underlying economic loss. To the extent losses would be deductible by the person suffering the loss if uninsured, the proposal would allow a deduction for insured losses and insurance proceeds would be included in income when received. This would achieve a far more accurate result than the "rough justice" arguably afforded by present law, since the taxpayer actually suffering the loss is made whole. Under the current system, a taxpayer suffering the loss is penalized while the policyholders not suffering losses have a windfall to the extent the P&C company passes through its tax benefits in the form of lower premiums. The P&C company also has a windfall to the extent it does not pass through the tax benefits.

The combination of the QRA reserve proposal and the proposed change in the tax treatment of third-party assignees assures that the investment income on amounts set aside to fund structured settlements would be subject to tax. This change would make the tax system a neutral consideration in the choice between structured settlements and lump-sum payments while preserving the current rule that plaintiffs should not have to pay tax on any personal injury damage awards.

The P&C industry may argue that the QRA proposal is not appropriate for an industry with large underwriting losses (-$11.0 billion in 1983). However, the large underwriting losses occur primarily because P&C companies lower premiums (discount) for the future investment income expected to be earned prior to the payment of claims, while the statutory reserves used in calculating underwriting income are not discounted. Total net income is the appropriate

Table 10.10-1

Time Pattern of Loss Payments by Major Lines of Business of Property and Casualty Insurance Companies - 1975 to 1983 Experience

Time Between Payment and Loss	Payments as Percent of Losses Incurred by Line of Business 1/					
	All Policies	Auto Liability	Other Liability	Medical Malpractice	Workers' Compensation	Multiple Peril
Same year	36.7%	36.0%	12.1%	5.8%	27.4%	56.2%
1 year	26.1	29.7	15.6	8.6	24.8	26.2
2 years	10.5	14.4	11.4	9.0	12.7	5.1
3 years	8.3	9.0	13.1	12.1	8.8	4.5
4 years	4.6	4.5	9.9	10.3	4.9	2.3
5 years	3.2	2.6	8.3	10.6	3.6	1.4
6 years	2.4	1.2	7.0	8.1	2.9	1.3
7 years	1.4	0.9	6.5	3.3	1.4	0.7
8 years or later	6.7	1.8	16.2	32.1	13.7	1.6
Present value loss of $100 incurred 2/	$90.56	$92.40	$81.34	$76.28	$87.48	$95.13

Office of the Secretary of the Treasury — May 28, 1985

1/ As an example of how to read this table:
81.6 percent of total losses and loss expense incurred on all policies in 1980 were paid by the end of 1983 (36.7 + 26.1 + 10.5 + 8.3). Only 73.3 percent of total losses and loss expense incurred on all policies in 1981 were paid by the end of 1983 (36.7 + 26.1 + 10.5). Assuming constant payment streams across years, 8.3 percent of losses and loss expense incurred are paid in the third year following the year in which the loss was incurred.

2/ The payment stream discounted at six percent. Assumes payments are made in the middle of the year and discounted to the middle of the first year. The present value is overstated because the payments eight years or later are discounted for only eight years, which would particularly affect medical malpractice, other liabilities, and workers' compensation.

Source: Unpublished tabulations from Schedule P of the insurance companies' annual statement from A. M. Best Company.

measure of company profitability, not underwriting income. Moreover, even in times of overall net losses, the tax system should limit tax losses to properly measured economic losses and should tax profitable enterprises on their properly measured economic income.

The QRA would be only a bookkeeping entry. The QRA reserve system would increase the tax liabilities of P&C companies and affiliated companies but, as described above, the proposal would simply eliminate the deferral of tax liability allowed under current law or impose an appropriate interest charge on the deferral. P&C companies could be expected to increase their premiums to cover any increased tax liability resulting from the more accurate measurement of their taxable income.

The QRA system would not affect State law requirements for reserves to protect policyholders against company insolvency. The amount of tax reserves would be different than the amount of statutory reserves but, because the QRA method does not require the discounting of reserves, tax reserves would not necessarily be lower than statutory reserves. State law presumably would continue to require adequate funding of statutory reserves.

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REPEAL MUTUAL PROPERTY AND CASUALTY INSURANCE COMPANY PROTECTION AGAINST LOSS ACCOUNT

General Explanation

Chapter 10.11

Current Law

Most mutual property and casualty ("P&C") insurance companies are allowed deductions for net contributions to a protection against loss ("PAL") account. A deduction is generally allowed for contributions to the account in an amount equal to one 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 that 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 one 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 five-year deferral period. The remaining amount, 12.5 percent of underwriting income, continues to be deferred indefinitely, until the company has underwriting losses.

Reasons for Change

The special PAL deduction is unrelated to the measurement of economic income. The PAL deduction is allowed in addition to the full deduction that mutual P&C companies receive for estimates of losses to be paid in the future. Furthermore, the PAL account is simply a bookkeeping entry made for tax purposes; a corresponding reserve account is not required by State regulatory authorities to provide for the financial solvency of the companies.

The tax deferral resulting from the deductibility of contributions to a PAL account reduces the effective tax rate on mutual P&C companies with underwriting income. The lower effective tax rate provides a competitive advantage to mutual P&C companies vis-a-vis stock P&C companies and life insurance companies that offer similar insurance products.

The calculation of the PAL account requires an arbitrary distinction between underwriting and investment income. This distinction increases the complexity of the tax code and increases the possibility that companies will undertake uneconomic transactions solely to minimize tax liability.

Proposal

The deduction for contributions to a PAL account would be repealed. Amounts currently held in the account would be included in income no later than ratably over a five-year period.

Effective Date

The proposal would apply to taxable years beginning on or after January 1, 1986.

Analysis

The benefits of the special PAL deduction accrue largely to profitable companies that do not have underwriting losses and therefore obtain the maximum tax deferral. The special deduction provides little benefit to companies with periodic underwriting losses. Repeal of the special PAL deduction should have minimal impact on premium rates.

REPEAL SPECIAL TAX EXEMPTIONS, RATE REDUCTIONS, AND DEDUCTIONS OF SMALL MUTUAL PROPERTY AND CASUALTY INSURANCE COMPANIES

General Explanation

Chapter 10.12

Current Law

Numerous special rules reduce or eliminate the tax liability of certain small mutual property and casualty ("P&C") insurance companies. Mutual P&C companies with taxable investment and underwriting income of not more than $6,000 are exempt from tax; a limitation on the rate of tax on income in excess of $6,000 phases out between $6,000 and $12,000. Mutual P&C companies that during the taxable year receive a gross amount of not more than $150,000 from premiums and certain investment income are also exempt from tax, regardless of the amount of their taxable income. Unless they elect to the contrary, companies that receive a gross amount from premiums and certain investment income of more than $150,000 but not more than $500,000 are taxed only on their investment income (and are not taxed at all if their investment income is not more than $3,000); their underwriting income is exempt from tax. A limitation on the rate of tax on the investment income of such companies in excess of $3,000 phases out between $3,000 and $6,000. A further reduction of the rate of tax on the investment income of such companies phases out as the gross amount from premiums and certain investment income increases from $150,000 to $250,000. Finally, mutual P&C companies that receive a gross amount from premiums and certain investment income of less than $1,100,000 are allowed a special deduction against their underwriting income (if it is subject to tax). The maximum amount of the deduction is $6,000, and the deduction phases out as the gross amount increases from $500,000 to $1,100,000.

Reasons for Change

The special tax rules that reduce or eliminate the tax liability of certain small mutual P&C companies provide competitive advantages to those companies vis-a-vis stock companies and larger mutual companies. The application of these rules requires arbitrary distinctions between underwriting and investment income, thereby increasing the complexity of the tax code.

Proposal

The special tax exemptions, rate reductions, and deductions of small mutual P&C companies would be repealed.

Effective Date

The proposal would be phased in over a five-year period, starting with the first taxable year beginning on or after January 1, 1986.

Analysis

Small mutual P&C companies would be placed on a par with all other small corporations. Elimination of preferential rates based on the size of the firm (other than the graduated rates made available to small corporations generally) would reduce tax-induced distortions that favor the sale of insurance through small firms.

LIMIT MUTUAL PROPERTY AND CASUALTY INSURANCE COMPANY DEDUCTION FOR POLICYHOLDER DIVIDENDS

General Explanation

Chapter 10.13

Current Law

In general, stock and mutual property and casualty ("P&C") insurance companies are allowed to deduct dividends and similar distributions paid or declared to policyholders in their capacity as such. These distributions are treated by policyholders as price rebates rather than as taxable distributions. Dividends paid by stock P&C companies to their shareholders are not deductible by the company and are includable in the gross income of the recipient.

In the case of life insurance companies, the amount of the deduction allowed mutual companies for policyholder dividends is subject to certain limitations. The deductibility constraint stems from a recognition that policyholder dividends paid by mutual companies are, to some extent, distributions of the companies' earnings to policyholders in their capacity as owners of the company. Consequently, the deduction for policyholder dividends is reduced by an amount determined to be the owner/policyholder's share of the distributed earnings of the company.

Reasons for Change

The different tax treatment of income distributed in the form of policyholder dividends by mutual P&C companies and shareholder dividends paid by stock P&C companies provides a competitive advantage to mutual P&C companies vis-a-vis stock P&C companies and other corporations. This competitive advantage of mutual companies was recognized in the 1984 overhaul of the life insurance company tax rules, which imposed a limitation on the deductibility of policyholder dividends by mutual life insurance companies. A similar limitation on the deductibility of mutual P&C company policyholder dividends would reduce the distortion caused by the deduction and by the policyholders' treatment of the dividends as price rebates.

Proposal

The deduction for policyholder dividends allowed mutual P&C companies would be reduced in a manner similar to the way in which the deduction for policyholder dividends allowed mutual life insurance companies is reduced under current law. Additional study is needed to determine the size of the competitive advantage that the current treatment of policyholder dividends provides to mutual P&C companies and to set the appropriate deduction limitation.

Effective Date

The proposal would be effective for taxable years beginning on or after January 1, 1986.

Analysis

The proposal would subject all income of mutual P&C companies, including profits distributed to policyholders, to tax at the company level. Mutual companies may distribute a lesser amount of policyholder dividends and charge slightly higher premiums as a result of the tax on equity income, similar to the effect of corporate taxes on other companies. The advantage of mutual companies over stock companies would be reduced, as would the advantage of mutual P&C companies selling insurance products in competition with life insurance companies.