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UNITED STATES GENERAL ACCOUNTING OFFICE

Washington, D. C.

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STATEMENT FOR THE RECORD

BY THE

DIRECTOR, GENERAL GOVERNMENT DIVISION

U.S. GENERAL ACCOUNTING OFFICE

SUBMITTED TO THE

SUBCOMMITTEE ON ECONOMIC STABILIZATION

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

UNITED STATES HOUSE OF REPRESENTATIVES

ON

THE TAXATION OF THE PROPERTY/CASUALTY

INSURANCE INDUSTRY

Mr. Chairman and Members of the Committee:

I am pleased to present our views on the taxation of the property/casualty insurance industry. For the last 6 years GAO has had an active interest in the taxation of the insurance industry. In 1981 we submitted to the Congress a report on the taxation of life insurance companies. On March 25, 1985, we submitted to the Senate Finance Committee another report, Congress Should Consider Changing Federal Income Taxation of the Property/Casualty Insurance Industry, GAO/GGD-85-10.

Your Subcommittee's staff requested that we cover four areas relating to the taxation of the property/casualty industry:

--our report and its recommendations,

--the impact of current tax provisions on the industry,

--the industry's pricing stategies, and

--a financial overview of the industry.

I will cover each of these areas in turn.

AREAS OF PROPERTY/CASUALTY INSURANCE TAXATION NEEDING CONGRESSIONAL REEXAMINATION

Our report on the taxation of the industry indicated that three areas of the tax code needed the Congress' reexamination. These areas were

--the deduction currently allowed for loss reserves. The current method of calculating this deduction ignores the time value of money.

--the practice of currently deducting all of the expenses associated with the sale and renewal of insurance policies. The current method allows these expenses to be deducted before the firm takes into income the associated premiums.

--the protection against loss account, which defers a portion of a mutual company's income to provide a cushion for catastrophic loss. This tax deferral may be based on questionable economic assumptions about property/casualty insurance operations.

Our conclusions and recommendations in each of the three areas studied may be summarized as follows:

First, with respect to the loss reserve deduction, our conclusion was that the present practice of deducting in the tax year the full (undiscounted) amount of future estimated settlement costs overstates the loss reserve deduction. Since the assets underlying loss reserves are invested pending final settlement of claims, the firm actually needs to set aside only that amount which, together with subsequent investment earnings, will total expected subsequent claims. Our recommendation was that the Congress should consider amending the tax code to provide that, in calculating the loss reserve deduction for tax purposes, loss reserves are to be discounted. We further stated that the discount rate should be based on a moving average of each company's pre-tax net return on its investment portfolio.

Second, on the matter of acquisition expenses, we concluded that present practice fails to match expenses and revenues. Currently, the tax code permits all acquisition expenses to be deducted immediately, even though the premiums associated with the acquisition expenses are spread over the life of the contract. In this case our recommendation was that the Congress should consider amending the tax code to provide that acquisition costs be allocated over the life of related contracts to match the pattern of premium payments generated by the contracts.

Third, with respect to the protection against loss account, we concluded that this account may not protect mutual companies against catastrophic losses because the money in the account is not earmarked for that purpose. Thus, if a catastrophic loss were to occur, the account does not necessarily insure the company's ability to satisfy its contract obligations. In this case our recommendation was that the Congress consider whether or not this special tax preference for mutual property/casualty insurance companies should be retained in its present form.

IMPACT OF CURRENT PRACTICE

The current practice of deducting the full amount of an incurred loss, even though it may not be paid for a number of years, does not recognize that the assets underlying loss reserves will earn investment income between the time the deduction is taken and the time the claim is actually paid. The present practice results in the sheltering of investment and other income in the year in which the deduction is taken. Thus, taxable income is effectively reduced. The discounting method proposed by GAO would match against current revenues a current (discounted) estimate of a future loss payment.

In addition to the tax shelter resulting from the non-discounting of loss reserves and the current manner of treating acquisition expenses, property/casualty companies also have available to them many of the same shelters and preferences available to other taxpayers. These include the deduction for income arising from tax-exempt securities and the exclusion of a large portion of the dividends received from domestic corporations. Our report shows that between 1975 and 1982 tax-exempt investment income represented about 40 percent of the gross investment income of all property/casualty companies. The dividends received deduction during this period represented about 20 percent of the gross income of the companies.

While our report did show the extent of the property/casualty company use of the tax exempt and dividends received deductions, we did not make any recommendation for changes in the application of these deductions to property/casualty companies. Our assessment was limited to those provisions of the tax code applicable only to property/casualty companies.

PROPERTY/CASUALTY COMPANY PRICING STRATEGIES

A property/casualty company derives its income from underwriting gains (the excess of premiums over claims and expenses) and investment gains. Because of investment gains, a property/casualty company can still have net income even though its premiums alone are not large enough to cover claims and expenses. Thus, even though a company has a ratio of claims and expenses to premiums in excess of 100 percent, which normally would indicate the company had suffered an operating loss, it may well have a positive net income because of its investment gains.

For a number of years now we have been hearing the term "cash flow" underwriting. Our understanding of this term is that the companies are willing to use lower premiums to compete for certain business lines, even though they will have ratios of claims and expenses to premiums in excess of 100 percent. The premium shortfall will then be made up by investment income.

While in past years investment gains exceeded underwriting losses by a fairly wide margin, in very recent years the amount of underwriting losses have come very close to the amount of investment gains. For example, in 1984 underwriting losses for the industry were $20.5 billion, while investment income and realized capital gains were $20.8 billion. As the margin has narrowed, some companies have been raising premiums. We may, therefore, expect to see a return to a greater positive margin of investment gains over underwriting losses.

DATA FOR PROPERTY/CASUALTY COMPANIES 1974-1983

Because of the tax-exempt income and dividend exclusion deductions and the current tax treatment accorded loss reserves and acquisition expenses as well as past pricing practices, many property/casualty companies have not paid federal income taxes for a number of years and in fact have qualified for refunds or the ability to carry back or carry forward losses incurred for tax purposes.

To depict the effects of current code provisions on the property/casualty industry, we studied financial data for stock and mutual companies for the 10-year period--1974 to 1983. This data was obtained from Best's Aggregates and Averages. While Bests' reports omit figures for many small and/or new companies, we believe that our figures provide a good representation of the financial results of the property/casualty industry.

In the following tables we show underwriting gains, investment gains, their combined total, as well as the increase in surplus, dividends to stockholders, and their combined total. Federal income taxes are also shown. Underwriting gains and investment gains indicate sources of income, while the increase in surplus and dividends to stockholders indicate the disposition of the income.

Table 1

Stock and Mutual Companies
1974-1983
(in billions of dollars)

Underwriting gains	Investment gains	Total gains	Federal income tax	Percentage of federal income tax to total gains
($27.9)[a]	$109.6[b]	$81.7[c]	$1.5[d]	1.8%

[a]Positive gains in 1977-78; negative in other years
[b]Negative gain in 1974; positive in other years
[c]Negative total in 1974; positive in other years
[d]Negative taxes in 1974-75; 1982-83; positive in other years.

Table 2

Stock and Mutual Companies
1974-1983
(in billions of dollars)

Increase in surplus	Dividends to stockholders	Total	Federal income tax	Percentage of federal income tax to total
$53.6[a]	$21.9	$75.5[a]	$1.5	2.0%

[a]Negative in 1974; positive in other years.

The figures in tables 1 and 2 refer to mutual and stock companies combined. Since dividends to stockholders are applicable only to stock companies, it might be well to show some ratios for stock companies by themselves.

Table 3

Stock Companies Only
1974-1983
(in billions of dollars)

Total gains	Dividends to stockholders	Federal income tax	Percentage of federal income tax to total gains	Percentage of federal income tax to dividends to stock-holders
$59.0	$21.9	$0.2	0.3%	0.9%

Another aspect of our 10-year study was to see how the 20 largest companies compared with the other companies. Tables 4 and 5 provide results separately for stock and mutual companies.

Table 4

Stock Companies Only
1974-1983
(in billions of dollars)

	Total gains	Federal income tax	Percentage of federal income tax to total gains
20 largest companies	$19.8	($1.0)	(5.1%)
All other companies	39.2	1.2	3.1%
All companies	59.0	0.2	0.3%

Table 5

Mutual Companies Only
1974-1983
(in billions of dollars)

	Total gains	Federal income tax	Percentage of federal income tax to total gains
20 largest companies	$17.2	$0.9	5.2%
All other companies	5.6	0.4	7.1%
All companies	22.8	1.3	5.7%

The data in these tables show that from 1974-1983 property/casualty companies, in spite of their underwriting losses, had positive net gains yet paid a very small percentage of these gains, 1.8 percent, in federal income taxes. For stock companies, the percentages were lower than for mutual companies; 0.3 percent for stock companies and 5.7 percent for mutual companies.

For large companies, the percentages of federal income taxes paid were lower than for smaller companies. For stocks, the 20 largest companies had an income tax rate of -5.1 percent as compared with 3.1 percent for the smaller companies. For mutuals, the 20 largest companies paid 5.2 percent as compared with 7.1 percent for the smaller companies.

I would like to conclude with the following observation. The financial information we have presented indicates that the property/casualty insurance industry has paid a relatively small share of its net income in federal income taxes in recent years. While we are not in a position to comment on what might be an appropriate federal tax burden for the industry, we do believe that the Congress should carefully consider amending the tax code along the lines suggested in our report. It is not possible to determine whether adoption of our suggested changes to the code would ultimately result in tax revenue enhancement, given the other options available to the industry to shelter income from taxation. However, in our view, the changes would result in a better match of the industry's revenues and expenses and represent a more rational approach to its taxation.