
BY THE COMPTROLLER GENERAL
Report To The Chairman
Committee On Finance
United States Senate
OF THE UNITED STATES

Congress Should Consider Changing Federal Income Taxation Of The Property/Casualty Insurance Industry

At the request of the former Chairman of the Senate Committee on Finance, GAO studied the federal income taxation of the U.S. property/casualty insurance industry. GAO concludes that the Congress should consider reexamining three areas of the Internal Revenue Code:

- First is the deduction currently allowed for loss reserves. The current method of calculating this deduction ignores the value of money over time.
- Second is the practice of currently deducting expenses associated with the sale and renewal of insurance policies rather than requiring allocation of these expenses to match the premium revenues associated with them.
- Third is the protection against loss account which defers a portion of a mutual company's income to provide a cushion for catastrophic losses. This tax deferral may be based on questionable economic assumptions.

While Treasury generally agreed with GAO's overall conclusions and recommendations, commentators from the insurance industry disagreed. The report addresses the industry's reservations and presents GAO's responses.

GAO estimated the extent to which these proposed changes might influence the industry's tax liability; however, because of loss carryovers and other reasons, these estimates should not be viewed as a projection of the immediate revenue yields to Treasury.



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Person # 12345



COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON D.C. 20548

B-209677

The Honorable Robert Packwood
Chairman, Committee on Finance
United States Senate

Dear Mr. Chairman:

This report examines the provisions of the Internal Revenue Code under which property/causalty insurance companies are taxed. It discusses three areas of the code that the Congress may wish to consider changing in order to more appropriately measure the taxable income of the industry. We conducted this review at the request of Senator Robert J. Dole as a follow-on to our examination of the federal income taxation of life insurance companies.

We are sending copies of this report to the Director, Office of Management and Budget; the Secretary of the Treasury; the Commissioner of Internal Revenue; and other interested parties.

Sincerely yours,

A handwritten signature in dark ink, reading "Charles A. Bowsher".

Comptroller General
of the United States

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COMPTROLLER GENERAL'S
REPORT TO THE CHAIRMAN
COMMITTEE ON FINANCE
UNITED STATES SENATE

CONGRESS SHOULD CONSIDER
CHANGING FEDERAL INCOME
TAXATION OF THE PROPERTY/
CASUALTY INSURANCE INDUSTRY

D I G E S T

The property and casualty insurance industry is an important part of the American economy. More than 90 percent of American home and car owners protect themselves against financial loss by purchasing property and casualty insurance. Premiums earned in 1983 totaled \$107.2 billion, while industry net income was \$4.9 billion, and assets at the end of 1983 were \$249.0 billion. (See p. 3.)

The former Chairman of the Senate Committee on Finance asked GAO to analyze the appropriateness of methods currently used to determine taxable income of the U.S. property and casualty (p/c) insurance industry.

Generally, p/c companies are taxed similarly to other business enterprises. Premium income is analogous to the sales receipts of ordinary business taxpayers, and the p/c companies' claims paid are similar to an ordinary company's cost of doing business. A difference, however, is that claim payments may not be made until a future year, whereas premiums are received currently. Apart from special lower tax rates available only to small mutual p/c companies, the standard tax rates applicable to ordinary companies also apply. (See p. 9.)

In examining taxation of the industry, GAO focused on the measurement of taxable income. As agreed with the Committee, GAO's study was based on the criterion that annual income is appropriately measured when each year's revenues are matched with the expenses associated with those revenues. This principle is grounded in the idea that to appropriately measure the net income of a business transaction, all expenses associated with the transaction should be "matched" against the income generated by the transaction. GAO used the matching principle as the criterion for

determining annual net income from an insurance transaction and compared it to the existing practice that is used to determine taxable income. GAO found that existing practice does not match revenues with associated expenses. This results in the inaccurate measurement of taxable income. (See p. 11.)

GAO concludes that the Congress should consider revising three areas of the Internal Revenue Code that pertain to the measurement of taxable income of the property/casualty insurance industry. First is the deduction from income currently allowed for loss reserves; this deduction ignores the value of money over time. Second is the current practice of deducting all expenses associated with the sale and renewal of insurance policies; this practice does not match these expenses with associated revenues, which are recognized only when earned. Third is the current provisions for the protection against loss account, a special tax provision that defers a portion of a mutual company's income; this provision needs to be reexamined.

It is important to point out that the analysis and conclusions contained in this report are concerned solely with the measurement of property/casualty insurance company income for purposes of federal income taxation. While these conclusions are based on principles of general applicability, it should not be assumed that the specific conclusions apply to any other industry in exactly the same way as they apply in property/casualty insurance without studying that other industry. Furthermore, because premium determination and investment decisions are so complex, it was not within the scope of this review to ascertain the extent to which the current or any alternative accounting system would influence premiums, the industry's investment decisions, or the industry's ability to compete with foreign insurance companies, factors that the Congress could take into account when considering changes in tax law. (See p. 2.)

Although GAO estimated the extent to which these proposed changes might influence the industry's tax liability, these estimates

should not be viewed as a projection of the actual immediate revenue yields to Treasury. Some companies can reduce their current taxes by using loss carryovers that they have accumulated during the past few years. Further, companies can reduce their future taxes by increasing their investments in tax-exempt securities or stock of domestic corporations. Presently, GAO does not know the amount of loss carryovers available to industry for tax purposes. Furthermore, it is not possible to predict the extent to which the companies might change their investment patterns. (See pp. 17, 19.)

THE BASIS FOR PROPERTY/CASUALTY INSURANCE COMPANY TAXATION

Basically, taxable income is defined as gross income less the expenses of doing business. Property/casualty companies have two sources of gross income, underwriting (premiums) and investments. 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 interest earned on tax-exempt investments and for 85 percent of dividends received from domestic corporations. Losses include claims paid during the tax year and also the annual change made to reserves for future payments arising from claims.

In 1921 the National Association of Insurance Commissioners' (NAIC) accounting method was adopted for federal taxation computations because the system was well established, uniform, and regulated by the state insurance commissioners. In the congressional consideration of this tax change there was no indication that its adoption was intended to confer a tax preference. The presumption was that it served the public interest and could serve reasonably well as a basis for determining taxable income. (See p. 10.)

NAIC accounting methods generally require that certain costs be deducted immediately. Examples of these costs are reserves to satisfy claims and expenses associated with the sale of insurance policies. However, the NAIC

methods recognize only a portion of the premium in the current year. Since the business (and therefore premium receipts) of most companies is growing, the effect of these accounting methods is to consistently understate current taxable income. (See p. 11.)

THE LOSS RESERVE DEDUCTION

About half the industry's business is insurance contracts involving claims that are paid out over a considerable period of time. It is widely recognized by industry experts that there has been growth in third-party liability insurance, such as workers' compensation; an increasing inclination of insured parties to claim work or accident related injuries that result in subsequent litigation; and more liberal court and state insurance commission interpretations of cause and effect between, for example, working conditions and an employee's long-term illness. The result has been protracted settlement of claims extending over many years. For example, 50 percent of the amount of medical malpractice claims and 30 percent of general liability claims incurred during 1977 were unsettled as of 1982. (See p. 6.)

Clearly, loss reserves are needed to ensure that a company has adequate funds to make future payments on claims. Tax deductions for such reserves are appropriate. However, the current practice overstates the amounts needed to satisfy future claims. The amounts being reserved are not reduced by the investment income that will be earned on the reserves between the time they are established and the time they are paid out, resulting in the understatement of taxable income. Furthermore, for property/casualty companies whose reserves for loss payments are growing, the current practice will increasingly understate taxable income. One way to remedy this problem is to discount reserves at a rate based on each company's investment return experience. (See p. 12.)

GAO estimated discounted loss reserve levels at several discount rates for 1980-82 (holding all other factors constant) and the additional tax liability that would have resulted. The higher the discount rate used, the greater the

reduction in the loss reserve deduction and the greater will be the increase in tax liability. (See p. 17.) If a hypothetical discount rate of 5 percent had been used by all companies to discount reserves in 1982, the deduction taken would have been reduced by about \$1.1 billion, and tax liabilities would have been greater by about \$485 million. (See Table 5.) Because some companies were showing losses for tax purposes in 1982, the Treasury would have received only a portion of this amount in additional current taxes. The remainder represents reductions in any tax loss carryovers available to those companies in future years. (See p. 17.)

However, to the extent the discounting procedure increases tax liabilities, companies increasingly might seek ways to shelter investment income and thereby mitigate any increases in taxes. This could be done through increasing their holdings of tax-exempt securities or equity securities of domestic corporations. Therefore, GAO's estimates of effects on tax liabilities from the adoption of discounting should not be viewed as a projection of actual immediate revenue yield to the Treasury. (See p. 19.)

MATTER FOR CONSIDERATION
BY THE CONGRESS

There is a growing tax deferral resulting from the current mismatching of revenues and expenses of the property and casualty insurance industry. If the Congress wishes to assure that the industry's revenues and expenses be more closely matched for purposes of measuring taxable income, it should consider amending the tax code to provide that, in calculating the loss reserve deduction for tax purposes, loss reserves are discounted. The discount rate should be based on a 5-year moving average of each company's pre-tax net return on its investment portfolio (to avoid fluctuations that could occur from year-to-year if only an annual rate were used). For small companies or recently formed companies it might not be feasible to use actual company results, either for payment pattern history or interest rates. In those cases, provision might be made in IRS regulations for the use of industry average results. (See p. 21.)

TREATMENT OF COSTS INCURRED IN
THE SALE AND RENEWAL OF POLICIES

A second income measurement issue is the proper allocation of business expenses related to the sale and renewal of insurance policies. Currently, the NAIC accounting practice permits these costs to be deducted immediately regardless of the life of the policy. On the other hand, premium income on insurance contracts is included in revenues only on a pro-rata basis each year. For example, assume a 1-year contract issued on July 1. In the first year, only 6 months or one-half of the year's premium would be earned, and the balance would not enter into taxable income until the next year. (See p. 22.)

According to GAO's criterion for the proper measurement of taxable income, expenses should be allocated over the same periods in which the corresponding income is recognized. Therefore, GAO concludes that the use of NAIC regulatory accounting practices to measure taxable income is inappropriate because it does not match expenses with associated revenues.

If acquisition expenses were allocated when revenue is recognized, then taxable income would increase. GAO estimated the additional tax liability that would have accrued for the years 1980-82 if this change had been made and everything else had remained the same. Based on these assumptions, the additional tax liabilities would have been approximately \$164 million in 1982. (See Table 8.) This estimate is not a projection of the actual immediate yield to the Treasury because, as indicated previously, only a portion of this would have been collected because some companies were showing losses for tax purposes in 1982. Further, they can reduce their future taxes by increasing their investments in tax-exempt securities or stock of domestic corporations.

MATTER FOR CONSIDERATION
BY THE CONGRESS

If the Congress wishes to assure that the industry's revenues and expenses be more closely matched for purposes of measuring

taxable income, it should consider amending the tax code to provide that acquisition costs be allocated over the life of related contracts. (See p. 25.)

PROTECTION AGAINST LOSS ACCOUNT

GAO also reviewed the rationale for the protection against loss (PAL) account established for the benefit of mutual companies in the Revenue Act of 1962. Unlike the rationale for adoption of the NAIC accounting conventions in 1921, the PAL account was established to confer a tax preference to mutual companies. The reason for this was concern over their lack of access to capital markets in the event that they sustained catastrophic losses. Their stock company competitors are, by law, permitted to offer securities to the public. (See p. 26.)

The protection against loss account operates to defer taxes on a portion of a mutual company's income. For tax purposes, a mutual company sets aside funds based on the size of its incurred losses and underwriting income. These funds, subject to certain statutory limitations, are deductions against current period underwriting gains. (See p. 25.)

The rationale for the PAL account is debatable because if catastrophic losses were to occur, the account does not necessarily ensure the company's ability to satisfy its contract obligations. Moreover, it is questionable whether stock companies, if faced with a catastrophic loss, could successfully access capital markets. (See pp. 26, 27.)

MATTER FOR CONSIDERATION BY THE CONGRESS

GAO suggests that the Congress consider whether or not this special tax preference should be retained in its present form. (See p. 28.)

AGENCY AND INDUSTRY COMMENTS

GAO received comments on a draft of this report from the Department of the Treasury and a number of insurance companies and industry trade associations. These comments were generally organized as an overview dealing with broad issues followed by more specific discussion.

The Department of the Treasury generally agreed with GAO's overall conclusions. Treasury specifically agreed that reserve liabilities should be discounted and that acquisition expenses should be allocated over the lives of related contracts. While GAO suggests that the Congress reexamine the rationale for the PAL account and possibly eliminate it or modify the rules for its use, the Treasury Department concludes that the account should be eliminated. Treasury also suggested using a somewhat different discounting methodology that would, in effect, increase the tax burden of the industry relative to that contemplated under GAO's approach. Treasury commented that in the year a claim is paid some adjustment mechanism would be necessary in implementing the discounting of loss reserves. GAO agrees with Treasury that an adjustment mechanism would be needed to avoid rewarding or penalizing companies. (See pp. 28-30.)

Industry comments were unfavorable and pointed out numerous areas of disagreement with GAO. A chief complaint was that the industry is unprofitable (See Comment 3, p. 33.) and underreserved, (See Comment 1, p. 31.) and because of this their tax burdens should not be increased. Other comments dealt with matters the industry felt should be considered as mitigating factors in reaching any decisions that might result in higher tax burdens. Among these matters were the effect higher taxes might have on the industry's ability to compete with foreign insurers, (See Comment 7, p. 38.) as well as the need for higher premiums to pay higher taxes. GAO has addressed industry comments, in some cases changing the report and in others disagreeing with the comments made. However, as pointed out earlier, it was not within the scope of this review to ascertain the extent to which tax policy changes would influence premiums or the industry's ability to compete with foreign insurance companies. (See p. 2.) GAO believes that the weight given to these factors and the issue of industry profitability are policy issues that Congress could consider in its deliberations of whether or not to change the tax law.

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ABBREVIATIONS

NAIC	National Association of Insurance Commissioners
P/C	Property/Casualty
PAL	Protection Against Loss

CHAPTER 1

INTRODUCTION

The property/casualty (p/c) insurance industry has been taxed under special provisions of the Internal Revenue Code since 1921. In that year the Congress separated, for tax purposes, the life insurance business from the p/c insurance industry and within the p/c component, mutual from stock companies. Thereafter, each of the three entities was taxed differently. Over the years, life companies have been taxed under a variety of formulas, all of which were intended to tax some portion of investment income and, more recently, to tax total income.¹ Stock p/c companies have been taxed on total income since 1921, while until 1962 mutual p/c companies were taxed, if at all, on the greater of investment income at ordinary rates, or gross receipts at a 1 percent rate. Thereafter, they were also taxed on total income.

OBJECTIVES, SCOPE, AND METHODOLOGY

The former Chairman of the Senate Committee on Finance asked us to analyze the appropriateness of methods currently used to determine taxable income of the U.S. property and casualty insurance industry. We were also asked to analyze the tax impact of changing economic conditions and new product trends on property and casualty insurance companies, appropriate methods of determining reserve liabilities for tax purposes, and differences among segments of the property/casualty industry by organization (mutual and stock companies).

This report provides

- an overview of the p/c insurance industry and recent changes in the industry;
- a description and analysis of certain specific provisions of the Internal Revenue Code applicable to the industry; and

¹An insurance company has two primary sources of income: underwriting and investments. Underwriting income is derived from the pure insurance operation, i.e., when premiums exceed the cost of claims and other expenses. Investment income is income earned on invested assets. Total income is the sum of investment and underwriting income. For a detailed discussion of life insurance taxation, see Billions of Dollars Are Involved in Taxation of the Life Insurance Industry--Some Corrections in the Law Are Needed, (GAO/PAD-81-1, Sept. 17, 1981).

- an analysis of three areas of the code that warrant re-examination: the loss reserve deduction, the allocation of acquisition costs, and the protection against loss account.

This review was conducted in two phases. First, a survey of the industry was made to focus on the salient issues, determine what data were appropriate to analyze, and to ascertain what information would be most useful to the Congress. We conducted a literature search and a series of meetings with industry representatives and insurance experts (see app. IV), and we retained the services of a p/c actuary. We also met with and received advice from experts in the fields of accounting and economics. We studied analyses conducted by the Treasury Department, which also examined the taxation of the p/c industry. We then performed extensive analyses of available tax returns, loss and loss reserve data, and estimated the tax impacts of alternative taxation methods. A complete discussion of the methodology used in deriving these estimates is contained in appendix I.

Our work was conducted from October 1982 to December 1983 and was performed in accordance with generally accepted government auditing standards.

Among the topics not considered in this report are

- the propriety of accounting conventions for any purpose other than federal income taxation;
- the appropriateness of financial reporting requirements of any regulatory body or accounting standards-setting body;
- the extent to which the current or any alternative accounting system would influence premiums or industry investment decisions, or the industry's ability to compete with foreign insurance companies; and
- the applicability of this analysis to any industry other than the property/casualty insurance industry.

BACKGROUND AND INDUSTRY PROFILE

The property and casualty insurance industry is an important part of the American economy. More than 90 percent of American home and car owners protect themselves against financial loss by purchasing property and casualty insurance.²

²Insurance Information Institute, Insurance Facts: Property, Marine and Surety, 1980-81, [hereinafter Insurance Facts], p.11.

Premiums earned in 1983 totaled \$107.2 billion.³ In 1983, the industry accounted for 2 percent of funds supplied to the U.S. money and capital markets.⁴ Investment income in 1983 totaled \$16.0 billion, while operations generated an underwriting loss of \$11.1 billion, resulting in net income of \$4.9 billion. Admitted assets at the end of 1983 were \$249.0 billion while policyholders' surplus, a measure of the industry's financial strength, increased by 7.5 percent in 1983 to almost \$65.6 billion.⁵

Purpose of property and casualty insurance

Property and casualty insurance is a process of spreading financial loss sustained by a relative few among many who buy this type of insurance. A contract is made between the insurer, who indemnifies, and the insured, who pays a premium for the contract. Casualty policies are written under two broad categories. The first category, which includes auto physical damage, provides for contracts having direct physical or financial effects on the insured. This is known as first person insurance. Under this type of contract, the insurer reimburses the insured for a stipulated amount, based on the economic loss or personal injury. The second category, which includes workers' compensation, provides for what is called third party liability insurance, covering legal claims against the insured due to personal or property damage suffered by another person. The most common business lines covered by property and casualty insurance are frequently characterized as follows:

Major Property/Casualty Insurance Lines

Third party liability

- Auto liability
- Credit
- General liability
- Medical malpractice
- Surety and fidelity
- Workers' compensation

Other

- Accident and health
- Aircraft
- Auto physical damage
- Boiler and machinery
- Burglary and theft
- Crop-hail
- Fire and allied lines
- Marine--inland & ocean
- Multiple peril

³A.M. Best Company, Best's Aggregates and Averages, Property/Casualty, 1984, Oldwick, New Jersey.

⁴American Council of Life Insurance, Life Insurance Fact Book 1984, (ACLI, 1983), p. 69.

⁵A. M. Best Company, Best's Aggregates & Averages, Property/Casualty, 1984, Oldwick, New Jersey.

Property and casualty insurance companies are principally chartered under state law in one of two organizational forms, stock or mutual. The distinguishing feature between a stock company and a mutual company is the presence or absence of stockholders. Stock companies are owned by stockholders whereas mutual companies are owned by the policyholders. The majority of property and casualty companies are stock companies. In 1983, of the 1,638 companies included in Best's Aggregates and Averages, 1,313 were stock companies and 325 were mutual companies with the stock companies having about 75 percent of the assets.⁶

Changes in net premiums written
over the past decade

Over the last 10 years almost every type of coverage (line) offered by p/c insurance companies has increased in terms of net premiums written (see table 1). Among the lines of insurance that had the largest percentage increases were commercial and farmowners multiple peril insurance, workers' compensation insurance, accident and health insurance, and homeowners' insurance.

Third party liability insurance accounts for almost half of p/c insurance premiums. One of these third-party lines, workers' compensation, insures the employer against claims arising from injuries suffered by workers on the job. By law, workers must accept a schedule of compensation for injuries--hospital costs and disability benefits. Workers, the third parties, accept the state-approved compensation schedule in lieu of suing the employer. Workers' compensation medical costs have increased dramatically in the 1970s and show few signs of abating. Workers in general are more apt to claim work-related injuries or illness or both than in the past. Also, state insurance commissions and courts have tended to interpret very broadly the scope of employer liability by liberally finding cause and effect between working conditions and an employee's long-term illness.

⁶Ibid., pp. 70 and 2B.

Table 1

Property/Casualty Stock & Mutual Companies
Net Premiums Written, Principal Lines 1972 and 1982
 (billions of dollars)

	<u>1972</u>		<u>1982</u>		<u>Percent change 1972-82</u>
	<u>Net premium</u>	<u>Percent of total</u>	<u>Net premium</u>	<u>Percent of total</u>	
<u>Long-tailed business lines</u>					
Auto liability	\$10.4	28.0	\$23.6	24.2	127
Medical malpractice and other general liability	2.6	7.0	6.8	7.0	162
Workers' compensation	4.1	11.1	13.8	14.2	237
Accident and health	1.3	3.5	4.3	4.4	231
Subtotal	\$18.4	49.6	\$48.5	49.8	164
<u>Short-tailed business lines</u>					
Auto property	\$ 6.0	16.1	\$16.0	16.4	167
Fire insurance	3.4	9.2	4.6	4.7	36
Homeowners and farm owners multi-peril	3.3	8.9	11.6	11.9	252
Commercial multi-peril	2.1	5.7	6.9	7.1	229
Inland and ocean marine	1.5	4.0	3.5	3.6	133
Surety and fidelity	0.7	1.9	1.4	1.4	100
Burglary and theft	0.1	0.3	0.1	0.1	0
Boiler and machinery, glass, and aircraft	0.4	1.1	0.6	0.6	50
Other	1.2	3.2	4.3	4.4	258
Subtotal	\$18.7	50.4	\$49.0	50.2	162
Total	\$37.1	100.0	\$97.5	100.0	163

Source: A. M. Best Company, Best's Aggregates & Averages, 1973 and 1983 editions, Oldwick, New Jersey, various pages.

The combination of escalating medical bills and prolonged disability benefits has resulted in the protracted settlement of claims and a pattern of loss payments extending over many years. In the insurance trade, this development is referred to as elongating the payment "tail." The average premium dollar stays longer with the insurer before it must be paid. That the average premium dollar for third-party liability lines is available to earn income for a considerable time before losses must be paid is suggested by the fact that at the end of 1982, 5 years after claim receipt,

--about 50 percent of the amount of medical malpractice claims were still outstanding;

--about 30 percent of the amount of general liability claims remained unsettled; and

--about 18 percent of the amount of workers' compensation claims were unsettled.

Performance

The p/c industry has become less profitable since 1977. Net premiums written between 1977 and 1982 increased by about 44 percent, whereas total income (net investment income and underwriting gains or losses) decreased by about 15 percent (before taxes). The pattern was very uneven, however. Net investment income climbed from \$5.8 billion in 1977 to \$14.9 billion in 1982, a 157 percent increase. But net underwriting income fell from \$1.9 billion in 1977 to a loss of \$8.3 billion in 1982. Part of the poor underwriting performance was due to increases in the cost of auto repairs and medical services. These two components weigh heavily in the cost of settlements for p/c companies. Medical care service fees rose faster than the overall consumer price index between 1977 and 1982, while auto repair and maintenance expenses rose almost as fast as the overall price index.

The relatively poor underwriting performance of p/c companies has adversely affected the industry's earning performance, despite large increases in investment income. Table 2 shows after-tax rates of return as percentages of net worth for p/c stock companies as compared to other industrial sectors.

Table 2

Average Annual Rates of Return on Net Income
After-Taxes as a Percent of Net Worth
Selected Industries 1972-82

<u>Year</u>	<u>Property/ casualty^b</u>	<u>Public utilities</u>	<u>Commercial banks</u>	<u>Services</u>	<u>Manufac- turing</u>	<u>All industries</u>
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	12.1	14.0	15.7	20.3	15.7	14.8
1982	<u>8.9</u>	<u>13.8</u>	<u>14.7</u>	<u>15.4</u>	<u>11.0</u>	<u>11.4</u>
Average 1972-82	12.7	12.9	12.4	16.6	14.7	13.2

^aNet worth at beginning of each year; equivalent to "book net assets" or stockholders' equity.

^bCapital stock companies only.

Source: Insurance Facts, 1982-83, p. 19. Revised 1981 data and 1982 comparable data obtained from Citibank, New York, New York.

In 1977 the p/c industry experienced the highest rate of return to stockholders' equity of all industries shown. But the effect of increasing losses from its underwriting operations is apparent in the industry's steadily declining rate of return since that year. As of 1982, the p/c industry's profitability was the poorest of the major industrial sectors listed in the table. This pattern of fluctuation in profitability is not unusual for this industry. According to a study of this industry, "The property/casualty industry is quite cyclical compared to other industries."⁷ In 1972 the industry's rate of return was greater than any other major business sector. But, as in the 1977-82 period, the rate of return deteriorated until in 1975 its 4 percent rate of return was the lowest of all the sectors shown.

Another look at the question of the profitability of the p/c industry recently appeared in the report of the investment income task force to the National Association of Insurance Commissioners (June 1984). The following is quoted from that report: "The rate of return earned by the property/casualty industry has been increasing in relation to that of the average industry. For the ten years through 1981, the property/casualty earned an approximately average rate of return."

⁷Conning and Company, A Study of Why Underwriting Cycles Occur, November 1979, p. 1.

CHAPTER 2

FEDERAL INCOME TAXATION OF PROPERTY/CASUALTY INSURANCE COMPANIES

Generally, p/c companies are taxed similarly to other business enterprises. Premium income is analogous to the sales receipts of ordinary business taxpayers, and the p/c companies' claims paid are similar to an ordinary company's cost of doing business. A difference, however, is that claim payments may not be made until a future year, whereas premiums are received currently. Apart from special lower tax rates available only to small mutual p/c companies, the standard tax rates applicable to ordinary companies also apply.

Nearly all business firms use the accrual method of accounting. This method requires that income be recognized when earned and that expenses be recognized when incurred. Generally speaking, this method should be in agreement with an accounting principle known as the matching principle. This principle requires that to appropriately measure periodic income, the expenses generated by a transaction be matched against the revenue generated by the same transaction. When examining the taxation of the industry, we focused on the measurement of taxable income. As agreed with the Senate Committee on Finance, the criterion that we used was that annual income is appropriately measured when each year's revenues are matched with the expenses associated with those revenues.

In this chapter we evaluate three portions of the Internal Revenue Code applicable to the p/c industry. The first, and most important, is the current tax treatment of incurred losses. The second is the way acquisition costs are currently allocated. The third is an evaluation of a special tax accounting device called the protection against loss (PAL) account.

BACKGROUND

In general, the tax code (IRC Sec. 446) requires a taxpayer to use a proper and recognized method of accounting, such as the cash receipts and disbursements or the accrual method. But the p/c industry is governed by a special section of the code (IRC Sec. 832) that specifically prescribes the NAIC's statutory accounting method as the basis for determining investment income and underwriting income, the two major components of taxable income. The language contained in this special provision can be traced back to the Revenue Act of 1921.

Until the Revenue Act of 1921, p/c companies were governed by the general tax accounting rules applicable to all business taxpayers. But in congressional hearings on the proposed act, the Treasury Department proposed a special accounting methodology for p/c companies since the business was complex and had

special technical features unique to the industry. Speaking for this amendment of H.R. 8245 (the Revenue Act of 1921), Dr. T. S. Adams, representing the U.S. Treasury Department, stated,

"The law relating to insurance companies today is highly defective. Under the strict letter of the law there is a possibility of duplicating the same deduction three times.

The difference arises from attempting to apply deductions applicable to ordinary corporations to insurance companies and then adding certain special deductions to which insurance companies are entitled. In the plan presented here the income and deductions are expressed in their own technical terms. All these insurance companies, as you know, have to make reports every year. Those are uniform reports. They are carefully worked out, and the interests of the public are properly safeguarded. In the proposed amendment the terms used in this report are employed. It starts out this way: The ordinary insurance company has a possibility of making two kinds of profits; that is, it collects premiums from policyholders and on these may make an underwriting income. Then they invest these funds, and have an investment income, and there is a possibility of a net income from that source. This plan starts out by saying that insurance companies shall be taxed upon their net underwriting income plus their net investment income, if any. Then the whole scheme of computing net income has, as is necessary in the case of insurance companies, to be on the accrued or incurred basis instead of on the actual cash basis. That is the basis of this uniform report, and it is adopted here."⁸

The thrust of Dr. Adams' observation was that the system was uniform and regulated by state insurance commissioners. Therefore, the presumption was that it could serve reasonably well as a basis for determining a p/c company's taxable income since the accounting system was designed with the public's interest in mind. There was no indication in any of the congressional discussion of the adoption of NAIC accounting that it was meant to confer a tax preference.

⁸Testimony of Dr. T. S. Adams, Treasury Representative, Hearings before the Committee on Finance on H.R. 8245, U.S. Senate, 67th Congress, 1st Session, 394 (1921).

Regulatory accounting is not always an appropriate method to determine taxable income. Regulatory accounting methods applicable to p/c companies generally require the immediate recognition of costs (acquisition costs) as well as estimated future losses (the loss reserve deduction). However, regulatory accounting does not recognize either the investment income that reserves will earn (from the time the reserve is established until the claim is paid) or premium income until they are earned. Thus, current and expected expenses are immediately accounted for while income related to the incurrence of these expenses is recognized only as it is earned. This method of accounting is at variance with the more widely accepted accounting convention that to properly measure income, the revenue and expenses necessary to generate that revenue should be matched. Since no tax preference was intended when the statutory accounting procedures were adopted in 1921, we use the widely accepted matching convention as the basis for evaluating the appropriateness of the system in use.

Generally, the accrual method of accounting is a mechanism to give effect to the accounting concept known as the matching principle. This principle is grounded in the idea that to appropriately measure the net income of a business transaction, all expenses associated with the transaction should be "matched" against the income generated by the transaction. Normally, periodic expense recognition achieves the intent of the matching principle. However, in certain instances, where the transaction produces income over many years, the recognition of the entire expense in only the first year understates net income in that year. Similarly, incorrect valuation of such expenses also misstates taxable income. We have compared the determination of annual net income from an insurance transaction using the matching principle with the existing practice that is used to determine taxable income. We found that existing practice does not match revenues with associated expenses.

LOSS RESERVE DEDUCTION

Reserves are liabilities based on estimates of future amounts needed to satisfy claims. When a claim is filed with a p/c company, the company determines the validity of the claim and then prepares an estimate of the claim cost. Amounts needed to settle small individual claims, such as property damage, can usually be readily estimated since there is unlikely to be any litigation associated with claim settlement. On the other hand, larger claims that involve either third-party personal injury, such as workers' compensation claims, automobile personal injury, and medical malpractice lawsuits, or widespread property damage to homes and business establishments caused by natural calamities often present difficulties if parties to the claim cannot agree as to the value of the sustained loss. Thus, p/c companies have to include in their final loss estimate the likelihood of claims being litigated in court, possibilities for

out-of-court settlement, potential legal and appraisal expenses, and the estimated effect of future price inflation on ultimate settlements.

Once loss estimates are made they are recognized as an expense in the current tax period. The code defines the loss deduction as losses actually paid in the tax period plus the difference between unpaid losses at the end of the year and the beginning of the year. In the year a claim is paid, the loss reserve is reduced by that amount. Thus, in the case of a growing company, it can be expected that the year-end reserve account balance will exceed its opening balance by the amount that new unpaid claims received during the year exceeds the settlement of older outstanding claims. Because of this, any distortion in the periodic determination of income is a continuing one, while in the case of a nongrowing company there will be a balancing out after a number of years have passed.

Additions to loss reserves, an item deductible on the tax return, do 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. Taxable income is effectively reduced currently for payments that may not be made for several years. It is in this way that taxable income is understated. By matching against current revenues the undiscounted amount of future loss payments, taxable income is less than it would be otherwise. This can be corrected by using an alternative measure of taxable income that deducts from current revenues only the present value of the future amounts that will be paid. This would match against current revenues a current estimate of a future loss payment.

A simpler way to describe the current method of using undiscounted reserves is to say that this method ignores the "time value of money." For the last 2 years, a task force of the National Association of Insurance Commissioners has been considering the question of investment income and the place that it should have in the rate-making process. This task force, called the NAIC Investment Income Task Force, reported to the NAIC in June 1984. Its primary conclusion seems to be that rate-making should take into account the income a company will earn on its investments. The following is an excerpt from the task force report referring to the "time value of money:"

"The current controversy surrounding the investment income earned by insurers and the rate making process in general has its basis in the high interest rates of recent years. High interest rates have fostered in almost everyone a keen awareness of the time value of money and at the same time have helped to push the investment earnings of insurers to record levels."

To assist in understanding the significance of discounting for the measurement of taxable income, consider the following hypothetical example of a single insurance transaction. For simplicity, the following assumptions apply to this example:

- the policy is issued and the premium is received on June 30, 1980;
- the policy term is 6 months, during which the loss event occurs;
- a single loss payment of \$1,000 will have to be paid 5 years later;
- the premium is invested at a nominal 10 percent interest rate, compounded semi-annually;
- all company earnings are retained and reinvested at the same 10 percent interest rate;
- any negative tax liability is offset against the company's other income;
- the insurance transaction is without expenses (including expenses would not alter the point of the example);
- the premium is set to equal the discounted value of the expected loss payment; and
- the normal corporate tax rate is 46 percent.

The assumption that the premium equals the discounted value of the expected loss implies the transaction is without profit or expense. This assumption is made solely to simplify the example. The same result would have been attained if the example had used a higher premium that included provisions for expenses and profit. In actual practice, premiums will be set on the basis of many expected loss transactions rather than the single one we have used and would generally not be discounted, except in the few states where investment income is required to be reflected. Furthermore, the premium would provide for expected expenses and reflect competitive profit margins.

Setting a premium equal to the expected discounted value of the \$1,000 loss yields a premium of \$613.91 (using a pre-tax interest rate of 10 percent). As can be seen in table 3, at the end of the first year total income would be \$644.61 (the premium of \$613.91 and the interest income for 6 months of \$30.70). Since the discounted expected loss is also \$644.61 (the reserve established at the end of the first year), there is no taxable income in the first year. For 1981-84 the loss reserve deduction in table 3 exactly equals interest income, and there is no tax payable. In 1985 the loss reserve deduction is negative since at year end estimated future loss payments are zero while

the opening balance in the loss reserve account was \$952.38. (When the beginning balance in the loss reserve account exceeds the closing balance, the loss reserve deduction becomes an addition to income rather than a subtraction.) The addition to income of \$952.38 plus the investment income of \$47.62 exactly offset the \$1,000 deduction for the actual loss payment. Again there is no tax liability. So at the end of 1985 the company is in the same position as when it entered into the transaction: a zero cumulative net after-tax income. This is what one would expect since the premium was assumed to be equal to the discounted value of the loss.

Now take the same basic assumptions and apply the present practice of taking a reserve deduction in the first year for the full value of the estimated loss payment. The tax effects of not discounting loss reserves are displayed in table 4. In the first year the loss reserve deduction exceeds the premium and the pretax investment income by \$355.39. As with the discounting case, both the premium and the interest income earned for the last 6 months of 1980 are offset by the loss reserve deduction. But unlike the discounting case, the deduction exceeds current period income by \$355.39. In this example we have assumed the U.S. Treasury immediately paid a refund of \$163.48 on the first day of the next year. Even if the refund was not actually paid, the equivalent of a refund occurs when the excess deduction is applied against other premium income and accumulated investment income that were not subject to policyholder claims.

Because the first year's undiscounted loss reserve deduction required a tax refund of \$163.48, the insurer's earning assets at the beginning of the second year were greater by this sum. The after-tax investment income earned on the refund adds to the insurer's earning assets. At the end of the sixth year and after paying the estimated loss, the insurer had accumulated an after-tax net income of \$30.89. In the preceding discounting case, the insurer had zero net income over the 6-year period. In other words, a transaction that is not profitable can generate a positive net income because the insurer presently uses an accounting method that mismatches revenues and expenses.

In our hypothetical example it was assumed the discount rate was known with certainty over the period between premium receipt and loss payment. This simplification was made to demonstrate how the discounting loss reserves method resulted in zero net income. However, the earnings rate, and hence the discount rate, of an insurer's portfolio of earning assets is not known with certainty, just as future interest rates are not known. Of course, future inflation rates cannot be known with certainty and these may be even more important in setting premium rates. Nevertheless, a workable mechanism can be established that will approximate an insurer's likely portfolio earnings rate and be self correcting.

Table 3

Reserve Deduction Example Using Discounted Reserves

	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>1984</u>	<u>1985</u>
<u>Income</u>						
(1) Premiums	\$613.91	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0
(2) Investment income	<u>30.70</u>	<u>66.07</u>	<u>72.85</u>	<u>80.31</u>	<u>88.54</u>	<u>47.62</u>
(3) Total income (1) + (2)	<u>\$644.61</u>	<u>\$66.07</u>	<u>\$72.85</u>	<u>\$80.31</u>	<u>\$88.54</u>	<u>\$47.62</u>
<u>Expenses</u>						
(4) End of year reserve	\$644.61	\$710.68	\$783.53	\$863.84	\$952.38	\$ 0
(5) Increase in reserve	<u>644.61</u>	<u>66.07</u>	<u>72.85</u>	<u>80.31</u>	<u>88.54</u>	<u>(952.38)</u>
(6) Loss payments	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>1000.00</u>
(7) Total expenses (5) + (6)	<u>\$644.61</u>	<u>\$66.07</u>	<u>\$72.85</u>	<u>\$80.31</u>	<u>\$88.54</u>	<u>\$47.62</u>
<u>Net taxable income</u>						
(8) (3) - (7)	0	0	0	0	0	0
<u>Tax Liability</u>						
(9) 46% of (8)	0	0	0	0	0	0

Note: We used the pre-tax discount rate of 10 percent per annum, payable semi-annually. Using this rate, the annual deduction for additions to loss reserves equalled the before-tax investment income in each of the years subsequent to the initial year in which the premium was received. For all years, before-tax net income was zero.

Table 4

Reserve Deduction Example Using Undiscounted Reserves

	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>1984</u>	<u>1985</u>
<u>Income</u>						
(1) Premiums	\$613.91	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0
(2) Investment income						
(a) On premium generated assets	30.70	66.07	72.85	80.31	88.54	47.62
(b) On net tax-refund assets	0	16.76	14.56	11.94	8.83	5.12
(c) Subtotal (a) + (b)	<u>30.70</u>	<u>82.83</u>	<u>87.41</u>	<u>92.25</u>	<u>97.37</u>	<u>52.74</u>
(3) Total income ^a	<u>\$644.61</u>	<u>\$82.83</u>	<u>\$87.41</u>	<u>\$92.25</u>	<u>\$97.37</u>	<u>\$52.74</u>
<u>Expenses</u>						
(4) End of year reserve	1000.00	1000.00	1000.00	1000.00	1000.00	0
(5) Increase in reserve	1000.00	0	0	0	0	(1000.00)
(6) Loss payments	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>1000.00</u>
(7) Total expenses ^b	1000.00	0	0	0	0	0
(8) Net taxable income ^c	(355.39)	82.83	87.41	92.25	97.37	52.74
(9) Tax liability ^d	(163.48)	38.10	40.21	42.44	44.79	24.26
(10) Net income after tax ^e	(191.91)	44.73	47.20	49.81	52.58	28.48
(11) Cumulative net income after tax	(191.91)	(147.18)	(99.98)	(50.17)	2.41	30.89
^a Row (3) = Rows (1) + (2) ^b Row (7) = Rows (5) + (6) ^c Row (8) = Rows (3) - (7) ^d Row (9) = 46% of Row (8) ^e Row (10) = Rows (8) - (9)						

Since annual earnings rates can fluctuate somewhat sharply, one possible estimate of the future course of an insurer's portfolio earnings rate is to take the moving average of the current year and 4 previous years. The moving average method automatically reflects the ongoing experience of each company's own portfolio return experience and reduces the likelihood of swings in discount rates.

Estimates of increased tax liability

Up to this point the discussion has focused on the appropriate determination of a p/c company's income. It has been shown that the current practice of permitting the advance deduction of the full estimated future loss payments understates income. This is because the present accrual system does not match expenses to the income earned on assets. As shown in the hypothetical example, the timing difference in the recognition of income between the discounting and nondiscounting methods results in tax savings for a p/c company in the early years of a transaction. For the entire industry, the additional tax liability from adopting the discounting method could be quite substantial.⁹ As shown in table 5, additional tax liability for 1982 could have ranged from \$485 to \$613 million, depending on the discount rate assumed. However, because some companies were showing losses for tax purposes, the Treasury would have received only a portion of these amounts. The remainder represents reductions in any tax loss carryovers available to those companies in future years.

Table 5 displays the additional tax liability resulting from discounting at the indicated rate and the current nondiscounting practice as if both systems were in place and ongoing. Implementing the discounting of loss reserves, however, would result in an even larger tax liability because in the initial transition period companies' opening reserves would be valued on a nondiscounted basis while the closing reserves would be discounted. If this occurred, there could be a negative change in reserves resulting in a large addition to taxable income. To mitigate such a large one-time transitional tax increase, appropriate phase-in procedures would have to be devised.

⁹The tax liability estimates are based on data for stock and mutual companies only as reported by A. M. Best Company.

Table 5

Estimates* of Additional Tax Liability for the
Property/Casualty Insurance Industry
From Discounting Reserves
For Calendar Years 1980-1982
(millions of dollars)

	1980 Earning Rates			1981 Earning Rates			1982 Earning Rates ^a		
	5 Per-	6 Per-	7 Per-	5 Per-	6 Per-	7 Per-	5 Per-	6 Per-	7 Per-
	cent	cent	cent	cent	cent	cent	cent	cent	cent
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 tax liability (46% x line 3)	\$ 720	\$ 840	\$ 952	\$ 576	\$ 675	\$ 766	\$ 485	\$ 552	\$ 613

^aEstimates developed by GAO from unpublished preliminary Best's data.

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

Note: See appendix I for a discussion of the methodology used to develop these estimates.

*These estimates should not be viewed as a projection of actual immediate yield to Treasury. For further discussion see pp. 17-19.

Our estimates of increased tax liability from discounting (discussed in the present section) and the allocation of acquisition costs (discussed in the following section) should not be viewed as a projection of actual immediate yield to Treasury for the following reasons:

First, if the industry passed any increases in tax resulting from the changes on to business taxpayers in the form of higher premiums, the tax burden of the insured businesses would decrease. While the Treasury might collect more taxes from the property/casualty industry, this would be offset to some extent by reduced revenue from insured businesses, which can take a deduction for casualty insurance premiums.

Second, we based our estimates of the additional tax liability on the assumptions that insurance companies' investment portfolios will remain essentially unchanged. However, managers can reduce a company's tax liability by increasing the proportion of assets held in the form of tax-exempt state and municipal securities. Another way is through increased investment in equity securities of domestic corporations because 85 percent of dividends received from these companies may be excluded from taxable income. As of 1982, tax-exempt securities constituted approximately 40 percent of the industry's admitted assets (see table 6). Though tax exempts constitute a relatively high percentage of the industry's earning assets, there is ample leeway for companies to increase this ownership still further. Moreover, as long as the yield on tax-exempt securities exceeds 54 percent of the yield on taxable securities, it is profitable for the companies to substitute tax-exempt for taxable securities. This is because when comparing yields on taxable and tax-exempt securities, interest on taxable securities is taxed at a 46 percent rate while the after-tax equivalent yield on tax-exempt securities is 54 percent of the yield on taxable securities. Recent available data, shown in table 7, suggest that some companies may have the opportunity to reduce a substantial portion of the estimated additional tax liability through increased investment in tax-exempt securities.

Third, a number of companies have suffered underwriting losses and have generated loss carryovers in the past few years. To the extent these are available, such companies could use loss carryovers to reduce currently any additional tax burdens.

Table 6

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
(millions of dollars)

	Percentage of publicly held tax- exempt securities	Tax-exempts as a per- cent of admitted assets a	Tax exempt income	Gross invest- ment income	Dividends excluded	Exempt income to gross income	Dividends excluded to gross income	Total exempt and excluded to gross income
1975	14.9%	35.1%	\$1,730	\$4,316	\$1,082	40.1%	25.1%	65.2%
1976	16.2	33.8	1,951	4,976	1,025	39.2	20.6	59.8
1977	18.8	38.6	2,411	6,230	1,326	38.7	21.3	60.0
1978	21.6	41.9	3,148	7,750	1,438	40.6	18.5	59.1
1979	22.7	41.4	3,937	9,787	2,278	40.2	23.3	63.5
1980	22.6	40.5	4,669	11,667	2,531	40.0	21.7	61.7
1981	21.7	39.5	5,415	13,938	2,622	38.9	18.8	57.7
1982	19.3	37.5	6,027	15,701	3,352	38.4	21.3	59.7

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

Flow 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 (unincorporated associations organized to write insurance for their members). 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.

aAssets of an insurer permitted by a state to be taken into account in determining its financial condition.

Table 7

Yield on Municipal and Corporate Aaa Bonds

<u>Period</u>	<u>Corporate Aaa bond rate</u>	<u>Municipal bond rate</u>	<u>Ratio of municipal bond rate to corporate Aaa bond rate</u>
Apr. 77	8.04%	5.73%	0.713
Apr. 78	8.56	5.80	0.678
Apr. 79	9.38	6.29	0.671
Apr. 80	12.04	8.63	0.717
Apr. 81	13.88	10.62	0.765
Apr. 82	14.46	12.59	0.871
Apr. 83	11.51	9.05	0.786

Source: Federal Reserve Bank of St. Louis, May 1983.

Conclusion

Clearly, loss reserves are needed to ensure that a company has adequate funds to make future payments on claims. Tax deductions for such reserves are appropriate. The present method in the Internal Revenue Code, which follows NAIC accounting overstates the loss reserve deduction since it recognizes as an incurred expense the full undiscounted amount of future settlement costs in the current tax year. This treatment understates the periodic determination of income for p/c companies, since the estimated total expense of the transaction is matched only against the current year's portion of the income generated by the transaction. This accounting treatment is therefore at odds with GAO's criterion: to match the expenses of a transaction against the periodic income the transaction generated. The purpose of the matching principle may be achieved by discounting the sum of estimated loss payments.

MATTER FOR CONSIDERATION
BY THE CONGRESS

There is a growing tax deferral resulting from the current mismatching of revenues and expenses of the property and casualty insurance industry. If the Congress wishes to assure that the property/casualty insurance industry's revenues and expenses are more closely matched for purposes of measuring taxable income, it should consider amending the tax code to provide that, in calculating the loss reserve deduction for tax purposes, loss reserves are discounted. The discount rate should be based on a moving average of each company's pre-tax net return on its investment portfolio to avoid fluctuations that could occur from year-to-year if only an annual rate were used. Should the Congress decide to make the changes, implementing legislative language is contained in appendix II. The suggested language covers the broad outline of necessary changes, but does not

attempt to cover all of the details involved in calculating expected payment patterns. IRS regulations should cover these details.

For small companies or recently formed companies, it might not be feasible to use actual company results, either for payment pattern history or interest rates. In those cases provision might be made in IRS regulations for the use of industry average results.

ALLOCATION OF ACQUISITION EXPENSES

A second income measurement issue is the allocation of business expenses that vary with and are primarily related to the acquisition of new and renewal contracts. Such expenses might include agent and broker commissions, salaries of certain employees involved in underwriting and issuing policies, and medical and inspection fees.

Currently the code permits the immediate deduction of acquisition expenses. This practice is adapted from NAIC regulatory accounting but is inconsistent with GAO's matching criterion since the premiums associated with the acquisition expenses are spread on a pro-rata basis.

An insurance company receives premiums in advance. However, insurance companies, as an exception to general code requirements, are permitted to include premiums in current income as the premium is earned. For example, if a 1-year contract is issued on July 1, and a full year's premium is received by the insurer, taxable income will include only one-half (6 months) of the premium in the year the contract is issued, and the remaining premium will be recognized in the following year when it is earned.

If the matching principle is to operate ideally, expenses should be treated the same way. If income, a residual amount left over after expenses are subtracted from revenues, is to be correctly stated for the period, then the matching principle requires that expenses be recognized in a fashion similar to revenue, otherwise, income will be misstated. The code, however, reflecting NAIC accounting methods, does not require that all expenses be spread over the period of the insurance contract.

The June 1984 report of the NAIC Investment Income Task Force prepared for the purpose of considering new and improved methods of rate-making considers the matter of acquisition expenses. The following is an extract from page 16 of that report:

"A significant portion of the unearned premium reserve may be offset by the cost of acquiring business. This includes commissions, premium taxes, other acquisition

expenses, and a portion of general expenses. Under SAP, these items are recognized as an expense when premiums are written. Under GAAP, which attempts to match expenses with their related income, acquisition costs are not recognized as an expense until the premiums to which they relate are earned. The acquisition costs related to unearned premiums are treated either as prepaid expenses, which is a separate asset item, or as an offset to the amount of the unearned premium reserve. Under either treatment, it can be seen that when these costs are not expensed, net income will be higher than it is under SAP. Net worth will also be greater. In adjusting from statutory surplus to GAAP net worth, a cumulative adjustment must be made for the prepaid expenses related to the entire unearned premium reserve. In adjusting from a statutory underwriting profit to a GAAP underwriting profit, the increase in prepaid expenses for the current year must be reflected.

The increase in prepaid expenses is sometimes considered to be a relatively unimportant accounting adjustment. Two points should be made clear. First, it should be understood that the statutory accounting principles are designed to reflect solvency and are very conservative in the sense that, in comparison with a GAAP calculation, both income and equity are usually understated. The reflection of prepaid expenses is a needed adjustment to the financial data to allow it to be compared to that of other industries. A second point is to note the amount of income involved. In the last twenty years, the increase in prepaid expenses for all companies amounted to approximately \$6.8 billion, or more than the statutory underwriting loss for that period."

According to our criterion, the use of regulatory accounting practices for measuring taxable income is inappropriate since revenues and expenses are not matched. If acquisition expenses were allocated as revenue is recognized, then taxable income would be increased. Table 8 displays the additional tax liability for the years 1980 through 1982 from allocating acquisition costs. If acquisition costs had been allocated in 1982, and everything else had remained the same, we estimate that the additional tax liability would have been approximately \$164 million. However, as indicated on p. 17, only a portion of this amount would have been actually collected by Treasury because some companies were showing losses for tax purposes in 1982.

Table 8

Estimates* of Additional Tax Liability
By Allocating Acquisition Expenses
Property/Casualty Insurance Industry
For Calendar Years 1980-82
(\$000,000 omitted)

	<u>1980</u>	<u>1981</u>	<u>1982^a</u>
1. Acquisition expenses deducted (on a non-allocated basis)	\$15,954	\$16,784	\$17,725
2. Acquisition expenses deductible (on an allocated basis)	<u>15,694</u>	<u>16,380</u>	<u>17,368</u>
3. Additions to taxable income (line 1 minus line 2)	<u>\$260</u>	<u>\$404</u>	<u>\$357</u>
4. Additional tax liability (46% x line 3)	<u>\$120</u>	<u>\$196</u>	<u>\$164</u>

^a1982 acquisition expenses rely on forecasted values of net premiums and estimates of acquisition costs by business line.

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

Note: The allocation of acquisition expenses used in getting the figures on line 2 was made by taking the total acquisition expenses on a paid basis (non-allocation) and adding the acquisition expenses deferred as of the end of the year and subtracting the acquisition expenses as of the end of the previous year. In each case the deferred acquisition expenses were obtained by multiplying the paid (nonallocated) expenses by the ratio of unearned premiums to premiums written. For a more complete explanation of the calculations see appendix I.

*These estimates should not be viewed as a projection of actual immediate yield to Treasury. For further discussion, see pp. 17-19.

Conclusion

In the past, the Congress has accepted for tax purposes the regulatory, or NAIC, method of accounting that permits the immediate expensing of acquisition costs. In our opinion, this results in the understatement of income each year since acquisition costs are expensed immediately while the related premiums are prorated over the length of the contract. This results in a mismatching of expenses and income.

MATTER FOR CONSIDERATION BY THE CONGRESS

If the Congress wishes to assure that the industry's revenues and expenses be more closely matched for purposes of measuring taxable income, it should consider amending the tax code to provide that acquisition costs be allocated over the life of related contracts. Should the Congress decide to make this change, implementing legislative language is contained in appendix II.

PROTECTION AGAINST LOSS ACCOUNT

The protection against loss account is solely for tax purposes and a corresponding reserve account is not required for state regulatory authorities. The PAL account applies only to mutual p/c companies. The account operates to defer tax on a portion of a mutual company's underwriting 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, which in turn reduces taxable income. Any amount in the account that exceeds the prescribed limitations is subtracted ("forced out") from the account and added to taxable income. Other provisions ensure that in no event can the deduction annually exceed the company's underwriting gain.

The reason for limiting the tax deferral availability only to mutual p/c insurers relates to the way mutual and stock p/c insurers are able to make additions to their policyholder surpluses, the financial cushion available to insurers to satisfy unexpectedly large policyholder claim losses. According to a report of the House Committee on Ways and Means, mutual companies can only augment their policyholder surplus by setting aside a portion of their underwriting income, whereas stock companies pay extraordinary losses from both retained earnings and paid-in capital. Thus, the committee reasoned,

"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 reserves out of which insurance losses can be paid, and the existence of such reserves is an important protection to the mutual policyholders."¹⁰

After making this observation on the difference between mutual and stock p/c companies, the report states the PAL's effect will be to defer a portion of a mutual company's underwriting gains. The committee report then states that the purpose of this special provision is to give recognition to mutual companies' "lack of access to the capital market for funds with which to pay losses."¹¹

"Under the President's proposal, underwriting gains would have been fully taxed as realized. Under the provisions of your committee's 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. A small portion, however, will still be retained in the special account to take care of extraordinary losses. Eventually, these companies will pay a tax on their total income, but the tax deferral formula of the bill gives recognition to the mutual's lack of access to the capital market for funds with which to pay losses."¹²

The rationale for the protection against loss account is at least debatable. First, if a catastrophic loss were to occur that was not sufficiently covered by policyholder surplus and the reinsurance market, the account does not necessarily assure the company's ability to satisfy its contract obligations. There is not necessarily a relationship between the PAL account which provides tax reduction and deferral, and the company's enhanced ability to meet its extraordinary losses since the tax deferral is not earmarked for this purpose and could be used for some combination of lower premiums, higher expenses, or policyholder dividends. In some cases, the tax code specifies how funds resulting from the tax deferral are to be used by taxpayers. However, that is not the case with the funds accumulated through PAL accounts. The alternative ways in which these

¹⁰Report of the Committee on Ways and Means, U.S. House of Representatives, H.R. 10650, "Revenue Act of 1962," March 16, 1962, Washington, D.C., p. 42.

¹¹Ibid., p. 43.

¹²Ibid, pp. 42-43.

funds may be used leave open to question whether the account will be available to provide a cushion for extraordinary losses. While it is true that stock companies need not designate surplus funds to satisfy catastrophic losses, their surplus theoretically is composed only of after-tax earnings, while for mutual companies PAL account balances are before-tax amounts arising from the deferral of a portion of underwriting gains.

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. In addition, the tax code already allows for the possibility that a corporate entity may suffer an extraordinary loss. The code permits p/c companies to carry losses back 3 taxable years and carry losses over 15 taxable years. To the extent there was a tax liability in those years, the p/c company, as other corporate entities, can claim tax refunds or tax credits for future tax liabilities. The PAL account, which is over and above the general carryback and carryover loss deductions, can be viewed as a tax preference only for mutual p/c companies.

The limitations on the amount of income that can be sheltered and the so-called "force-out" provisions ensure that most of the initial additions to the account are eventually added to taxable income. However, mutual companies enjoy, and the Treasury is denied, the time value of the amounts deferred (the interest that could be earned for whatever period of time the tax collections are deferred). Also, the cyclical nature of the p/c business (i.e., periods of underwriting gains following periods of underwriting losses) ensures that accumulations in the account will at some point in time resume.

Earlier in this report we made estimates of the increased tax liability from recommended changes in the loss reserve deduction and the allocation of acquisition expenses. These estimates were based on data from Best's Aggregates and Averages, the industry's statistical annual. Data on the PAL account, however, are not reported by Best's. Because we were unable to obtain sufficient tax returns, the sole source of PAL account data, we could not estimate the tax liability consequences of the PAL provision.

Conclusion

The preceding analysis indicates that the rationale for the protection against loss account is debatable because if catastrophic loss were to occur, the account does not necessarily assure the company's ability to satisfy its contract obligations. Moreover, it is questionable whether stock companies, if

faced with a catastrophic loss, could successfully access capital markets. Thus, the rationale for the PAL account may be based on questionable economic assumptions.

MATTER FOR CONSIDERATION
BY THE CONGRESS

We suggest that the Congress consider whether or not this special tax preference for mutual property/casualty insurance companies should be retained in its present form.

AGENCY COMMENTS AND GAO RESPONSE

We received comments on a draft of this report from the Department of the Treasury and a number of insurance companies and industry trade associations.

Treasury comments and GAO response

The Department of the Treasury generally agreed with our analysis. Specifically, they agreed with our conclusions that loss reserves should be discounted and that acquisition expenses should be allocated over the life of related contracts. While we have suggested that the Congress reexamine the rationale for the PAL account, the Treasury Department concluded the account should be eliminated. Treasury did, however, indicate that our report failed to address at least three significant tax issues affecting property/casualty insurance companies. These issues are (1) consolidated tax returns of property/casualty companies and other companies; (2) the absence of limitations on tax-exempt investments, and (3) the insurance deduction available to a parent company for premiums paid to wholly or partially owned subsidiaries, the so-called "captive insurance companies." While we agree that these issues have merit, they are beyond the scope of this report.

While agreeing with our basic conclusions that loss reserves should be discounted, Treasury's method of handling discounting would differ in two respects from ours: (1) they would use an after-tax rate instead of a pre-tax rate, and (2) no additions to the original deduction for reserves would be made over the period of the deferral.

The approaches taken by us and by the Treasury differ because of the way the economic transactions of an insurance company are viewed. Our method spreads the incurred casualty loss over the period between premium receipt and future outlay (loss payment). It is commonly accepted in the insurance trade that a p/c company's profitability is determined by summing its underwriting gain (or loss) and its investment income. Thus, we cited the accounting principle known as the matching principle as the basis for our view that incurred losses should be matched against both the premium and investment income.

Treasury's concept of the underlying economic transaction is based on the way insureds are taxed. Treasury observes that if a noninsurance company were to bear the risk of a casualty loss itself (self-insurance), it would not be entitled to deduct from current income funds set aside to provide for the eventuality of a casualty loss. Moreover, as the fund earned investment income, that income would be subject to tax. Therefore, Treasury argues that just because a company is an insurance company should not alter the principle that all investment income should be taxed.

The differences between the two methods, GAO's and Treasury's, are summarized in the following table:

	<u>GAO</u>	<u>Treasury</u>
1. Discount rate	Pre-tax	After-tax
2. Net premiums	Lower	Higher
3. First-year reserve deduction	Lower	Higher
4. Reserve deduction in intervening years	Annual increases	None
5. Tax in intervening years	None	Yes
6. After-tax net income after claim is paid	None	None

Summarizing, the Treasury method would require higher premiums because of the tax payments, but in each case the final result would be the same in that an inherently profitless transaction before tax remains profitless after the application of tax accounting rules (see number 6 above).

An important consideration that should be taken into account when weighing the merits of the two approaches is the feasibility of implementing either tax methodology. Our tax methodology requires only that insurers discount the aggregate of loss reserves. Each year the closing discounted loss reserve aggregate is compared to the opening discounted loss reserve aggregate. The difference, when added to the losses paid, is that year's loss reserve deduction. The insurer need not identify each loss transaction and maintain a separate memorandum reserve account for each claim. Under the suggested Treasury approach, however, an insurer would have to account, in some fashion, for the "release" of policy loss reserves after the claim is paid. This feature is an integral part of the argument advanced by Treasury in favor of its method, but it could

involve some very cumbersome tax accounting rules. Even if Treasury could demonstrate the theoretical superiority of its method, we would still prefer our suggested method on practical grounds.

The Treasury method does not reflect in annual tax deduction calculations the effect of changes in claim estimates until the loss payment is made. For example, suppose a premium is established assuming a certain discount rate, future loss payment, and settlement date, and before the year of settlement the insurer revises upward the claim payment estimate. In the year in which the upward revision is made, the Treasury's method would not provide for any reduction in that year's taxable income. In the settlement year, the amount "released" from reserves would fall short of the loss payment and the insurer would receive a tax "refund." In our method, a higher loss reserve deduction would have to be recorded in the year in which the revision was made. Taxable income for that year would be reduced.

In our opinion, the Treasury method of not permitting adjustment in reserves for payments on future losses is a drawback to its proposal. Their proposal would apparently lock in the initial estimate of each individual claim and not revise it until the claim is actually paid. The initial estimate is usually based on limited information, particularly in the longer tail liability lines where the impact of discounting is greatest. We do not feel it would be proper to ignore additional information that emerges as the claim matures.

Under either method the effect of an upward revision is reflected in lowered taxable income. Under the Treasury approach, taxable income is only correctly measured at the end of the entire time span between premium receipt and loss payment. Under our method, any adjustments to income would be made at the time any change in estimate of the amount or payment date of claim is made without waiting until the date of payment.

Industry comments and GAO response

We received four sets of comments on the proposed report representing the views of 11 organizations and companies.

1. Associations:

Alliance of American Insurers
National Association of Independent Insurers
National Association of Mutual Insurance
Companies
Reinsurance Association of America

2. American Insurance Association (AIA)

3. Insurance companies:
 - American International Group
 - Chubb & Son, Inc.
 - CNA Insurance Companies
 - The Continental Corporation
 - The Home Insurance Company

4. National Association of Insurance Commissioners (NAIC)

Industry comments were generally unfavorable and pointed out numerous areas of disagreement with GAO. A chief complaint was that the industry is unprofitable and underreserved, and because of this their tax burdens should not be increased. Other comments dealt with matters the industry felt should be considered as mitigating factors in reaching any decisions that might result in higher tax burdens. Among these matters were the effect higher taxes might have on the industry's ability to compete with foreign insurers, as well as the need for higher premiums to pay higher taxes.

Since a number of comments we received were similar, we categorized them according to the basic subject matter. This format was chosen as an expedient on our part and should not imply that all comments were identical. Page numbers listed under the various comments refer to page numbers of the comments of the various sources. Where reference is made to a page of the report, this will be clearly noted. Further, our detailed page by page response to these comments is contained in appendix III.

COMMENT 1 - This comment dealt with the inadequacy of companies' reserves.

Comments on this category were received from the associations (p. 22), insurance companies (p. 4), and NAIC (p. 5). In some cases the comments indicate that because reserves are inadequate, effective discounting already occurs. By effective discounting the commentators mean that since outstanding loss reserves are underestimated, the effect of discounting reserves is partially achieved. When loss reserves are underestimated, they are lower than if reserves had been accurately estimated, and the year-to-year change in loss reserves (the loss reserve deduction) may be smaller. This may approximate the deduction that would be realized under our proposed discounting tax change. Thus, if the discounting procedure were to be adopted, the commentators claim that firms that underestimated reserves would be excessively taxed. In other cases, the position is taken that, because of reserve inadequacy, the financial position of the companies is precarious, and any additional taxes (specifically, taxes resulting from discounting reserves) would only worsen an already precarious financial position.

RESPONSE - As stated in our report, the question of adequacy or inadequacy of reserves for statutory purposes is separate from discounting reserves for federal income tax purposes. If reserves are deficient (see the remarks of the President of Insurance Services Office, Inc., a national rate and advisory organization for p/c insurers, on January 10, 1984, attached to the comments of source 1 above), it would appear that such deficiency should be corrected by the companies and, if not, by the regulators responsible for assuring that companies are solvent. Even if we did accept the underreserving position taken by the associations, we do not feel that underreserving is a reason for rejecting what we believe is an appropriate method for determining taxable income as based on the matching principle. Moreover, any underreserving effect may be temporary and could be followed by a period of strengthening reserves and, at times, of overestimating reserves, as apparently occurred in the middle 1970s. It is also the responsibility of the various state insurance departments to ensure that such strengthening occurs, particularly if failure to do so could endanger the solvency of those companies with deficient reserves.

In considering this matter of the inadequacy of reserves it is important to remember that the inadequate reserves usually refer to the industry as a whole and without any consideration of the individual lines of business. It is our understanding that the inadequacy tends to be concentrated in the companies and lines of business that have recently been unprofitable, such as reinsurance, malpractice, and excess casualty. Because of this unprofitability, these companies are not paying tax currently in any case, and their need for stronger reserves will not be adversely affected by a change in the basis of calculating the revenues for tax purposes. Conversely, the proposed change will only generate additional taxes from those companies whose operations are profitable and who should be in a position to strengthen reserves if needed.

COMMENT 2 - The complexity of the calculation of reserves on a discounted basis was the substance of this comment.

This comment was received from the associations (p. 26) and AIA (p. 11). The following is excerpted from the comments of the associations p. 26: "The determination of the proper amount of loss reserves has been a perennial source of misunderstanding 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." The comments of AIA, p. 11, contain the following: "Adoption of discounting in this area would be certain to produce even greater administrative burdens for both the government and taxpayers than those which now exist."

RESPONSE - This comment referred to the administrative complexities associated with both the choice of discount rate to be used and the establishment of a pattern that payments may be expected to follow. We recognize that, with investment yields fluctuating from year to year, it would be preferable to use a moving average to determine an appropriate discount rate. The legislative language provided in the report (see app. II) used a moving average over a 5-year period. This is the same calculation used by life insurance companies (see Code Sec. 805 (b)(3) (A)). We do not consider this calculation complex, since a similar calculation is successfully made in the life insurance industry, nor does it seem likely to impose an excessive burden on the taxpayers required to make such a calculation. The most complex component of calculating reserves is the actuarial estimation process in which likely payouts and their timing are ascertained. Computation of average rates of return on investments and discounting of reserves estimated by the above process seems to us to be relatively straightforward. This comment also suggested that companies with "good investment practices" will be penalized by having reserve deductions lower than companies with lower investment earnings rates. This seems to ignore the basic notion that taxes should be related to earnings, and the companies earning larger investment income, all other things being equal, should pay higher taxes.

With respect to the development of a loss reserve payment pattern, there appears to be some confusion regarding the methods to be used. We refer to a company-by-company method while the comments referred to an industry-wide method. We did not suggest an industry-wide method. (See app. II.)

Also on the issue of payment patterns to be used in discounting reserves, a question in the comments was raised concerning the applicability of past payment patterns to payment patterns in the future. We agree with the commentary of the President of Insurance Services Office, Inc. that "payment patterns remain consistent over time." The studies made in arriving at his conclusion that reserves were inadequate were largely based on this premise. Therefore, applying past payment patterns to future patterns in the calculation of discounted reserves on an individual company basis appears appropriate. Further, the insurers undertake a review of payout patterns when calculating rates, and tables appear in annual statement blanks showing such reserve pattern development. In any event, if payment periods have lengthened, as we suspect they have, the use of past historical payout patterns should result in a tax understatement rather than an overstatement.

COMMENT 3 - The low profitability of p/c companies should be considered before recommending higher federal income tax burdens.

This comment was made by the associations (p. 8) and AIA (p. 18). On page 8, the section heading on this subject is "The Draft Report Fails to Take Proper Account of the Property and Casualty Insurance Industry's Low Profit Margins." A similar heading on page 18 of AIA is "The Financial Position of the Industry is Deteriorating and Its Loss Reserves Have Been Substantially Understated."

RESPONSE - Although profitability of p/c companies was shown in our report to be somewhat less than that of all other industries, the differences do not seem to be as great as the comments indicate. One comment referred to a study covering a 15-year period ending with 1980 and reportedly showed an aggregate rate of return on investment of 11 percent for p/c companies, while the corresponding rate for noninsurance companies was more than 13 percent. Our figures (see p. 7) covered an 11-year period from 1972-82. The average rates for this period are 12.7 percent for p/c companies and 13.2 percent for all industries. It is apparent that because of the cyclical nature of p/c industry earnings, the selection of the period to be studied can make a considerable difference in the results obtained. Furthermore, when the Senate Finance Committee asked us to review the taxation principles and tax accounting methodologies applicable to the p/c industry, we were not asked to consider the desirability of the methods and principles as conditional on the industry's level of profitability. The commentators' concerns about industry profitability as a mitigating circumstance is a factor that could be weighed by lawmakers when considering taxation of the industry. However, the profitability and riskiness of the industry are basically irrelevant to the question of how its income should be measured and taxed. The code already takes account of low profitability in its tax rates: any corporation, in any industry, will be taxed less if its taxable income drops. If taxable income drops to very low levels, then even the rate drops. If relatively unprofitable corporations in other industries do not get special, additional relief when their taxable income drops, it is questionable why p/c companies should obtain such relief. Similarly, any industry that experienced cyclical fluctuations in income will already be benefitted by the general provisions relating to tax loss carrybacks and carryovers.

Another comment concerning profitability stated that a p/c company is entitled to a larger return on investment than other types of companies because of the higher risk involved in the p/c business. In this connection we quote from a recent NAIC task force draft report from Best's Insurance Management Reports (A. M. Best Company, Release No. 3, Jan. 16, 1984):

"Based on all of the indications of relative risk studied, it appears that the property/casualty industry is of average or perhaps somewhat below average risk at the present time. The industry as a whole is not, and has not been, of above average risk."

COMMENT 4 - The issue here was our discounting examples and their misconceived relationship to the pricing mechanism of the industry.

The insurance companies (p. 2) commented on this issue in a section headed "The Draft Report is Based on a Misunderstanding of the Mechanism by Which P & C Insurance Is Priced." The comments list the assumptions used in the draft report's examples (see p. 12) and conclude "It is, therefore, obvious that P & C insurance cannot be and is not priced in the manner assumed in the Draft Report."

RESPONSE - This comment questioned the validity of the examples shown and draws the conclusion that our proposal is based on "a fundamental misconception of the pricing mechanism for P & C insurance" and because of this "the case for discounting must fail." We assumed a premium equal to the expected discounted value of the loss payment solely for the purpose of showing the difference between the two reserve methods, discounted and undiscounted. We realize that in practice premiums will be set differently to cover expenses, profit, and a consideration for competitive factors. If the examples on pp. 15 and 16 of the report had used a premium of \$900 to reflect profit and competition, the accumulated profit would have been \$211.28 on the discounted basis and \$233.77 on the undiscounted basis. This difference between the two methods was what the examples were meant to show. Introducing expenses into the examples (while it would change the final profit figures) would not have changed this outcome.

COMMENT 5 - GAO estimates are unrealistic.

The associations (p. 11) stated that GAO estimates were unrealistic for the following reasons:

- the possibility of changing investment portfolios to more tax-exempt securities, as pointed out in the report;
- the passing on of increased taxes in the form of higher premiums and the consequent lowering of tax liabilities of corporate insureds;
- the effect of loss carryovers currently available to insurers;
- the apparent assumption that most contracts are for a term of more than 1 year;
- the apparent assumption that all loss reserves would be discounted; and
- the effect of a phase-in of the proposed changes.

The conclusion is that "... the Draft Report's revenue estimates are based on factors which result in inflating those estimates."

RESPONSE - The estimates given in the report were necessarily based on the effects of the suggested changes without taking into account a number of factors and actions available to company management that could reduce their tax liability. Methods underlying the estimates are outlined in appendix I. We feel that the estimates are methodologically sound but should not be viewed as a projection of actual immediate yield to Treasury because of these factors.

This comment repeated the caveat stated in our report that changes in investment practices (buying more tax-exempt investments and more stock of domestic corporations) could reduce actual tax liability below the estimates shown. The associations also commented that it would be possible for companies to pass on to consumers any additional taxes in the form of higher premiums and that this would increase deductions and lower taxes for corporate insureds. The report was changed (see p. 19) to state that this latter point was considered but it was impossible to estimate the revenue effects such actions would have. The reason this revenue effect cannot be estimated is it is not known to what extent companies would pass on the additional taxes to policyholders. The associations assume that higher tax liabilities will be passed on, dollar for dollar, to insureds in the form of higher premiums. We are in no position to evaluate whether this would happen. Furthermore, higher premiums reduce the tax liabilities of business insureds, while non-business insureds are not permitted a deduction for premiums under current tax law. Existing data on insurance reserves do not permit a distinction as to what amounts are established for business and non-business insureds. Thus, it is not feasible to accurately adjust our estimates to take account of these secondary effects even assuming a dollar for dollar passthrough of increased premiums.

This comment also mentioned the issue of loss carryovers and the effect this would have on revenue estimates. We recognize that a number of companies reported negative taxes over the last 10 years and that they can reduce their current taxes by using loss carryovers accumulated from these years. However, any increase in taxes will accelerate the depletion of loss carryovers and in that way will increase aggregate revenue over a period of years.

On the question of acquisition expense, a comment was made that we assumed that insurance contracts were for more than 1 year. Actually, the estimates are based on the ratio of unearned premiums to premiums written, and this reflects all of the business, including contracts of 1 year or less as well as those for more than 1 year.

The commentators state that our estimates are flawed because we assumed that all reserves would be discounted and that this might not be the case. Apparently the commentators believe that all reserves might not be discounted. Our estimates were based on the assumption that all reserves would be discounted, since that was the basis of our suggestion. To the extent that reserves for certain lines might involve relatively short-term delay of payment periods, the effect of discounting would be minimal. We agree with the commentators that if all reserves are not discounted, our estimates would be overstated to some extent.

On the question of the effect on our estimates of a phase-in period, we agree with the commentators that this would affect the estimates. However, our estimates were based on the assumption that the proposed discounting of reserves was in place and ongoing (see p. 17 of the report for further discussion of this point).

COMMENT 6 - State regulation and industry solvency would be compromised by our recommendations.

The associations (p. 21) and NAIC (p. 1) commented on these issues. The associations state that the draft report's attempt to separate tax accounting and solvency accounting ". . . ignores the real world." The comments of NAIC include "These proposals, if adopted into law, will, in our opinion, adversely affect the efficacy of state regulation insofar as it relates to insurer solvency issues and the preservation of traditional statutory accounting objectives."

RESPONSE - Both groups of commentators refer to a statement in the draft report that "there is no inherent conflict posed to protection of the public interest by adopting the alternative method of income measurement solely for purposes of taxation." This statement has been deleted because it was not essential since other statements in the report point out that our concern is only with the determination of income for purposes of taxation and that this determination should not be based on solvency considerations. NAIC (p. 3) concludes that ". . . significant tax accounting concepts adopted into law ultimately evolve into generally accepted accounting principles." We do not believe that matters considered for tax purposes will necessarily affect the basis used by state insurance departments in determining reserves for solvency purposes. The proposed departure between regulatory accounting and taxation accounting requirements is not unique (for example, in the life insurance industry different bases for accounting for reserves have existed for many years).

Even though we feel that discounting for tax purposes need not lead to discounting for solvency purposes, we nevertheless believe that, if regulators did change their method of computing

reserves to a more realistic basis (discounting) they could achieve the same level of financial soundness by adjusting the operative rules that govern the behavior of the companies. One such change might be to reduce the ratio of operating leverage so as to permit a lower amount of premium writing per dollar of surplus. For example, if a given company is not now allowed to write more than \$2 of premiums in a given time period for each \$1 of "surplus" and the new method of computing reserves will result in a larger reported surplus, the company could simply be subjected to a different ratio of operating leverage--say, \$1.50 of premiums for each \$1 of surplus. The same could be done with respect to guidelines governing when the regulator would regard "surplus" as so low that special intervention was required: the critical amount or ratio could simply be adjusted upward.

NAIC (p. 5) states "This tax measure may encourage anti-consumer behavior by the insurer. Any discount model imposed by legislation could consciously or unconsciously promote claim payments delays by insurers in order to conform actual claim payment patterns to the assumptions of the model." This comment seems to be based on the misconception that we are suggesting a set "discount model" for all insurers. As noted previously, we proposed a company-by-company determination of payment patterns. Payment patterns are a function of the economic environment in which each company operates, and the use of a company's own payment pattern should not lead to any anti-consumer delays. In fact, with discounting, faster payments might be made to avoid the smaller reserve deductions (and hence higher taxes) that would result from delay in making payments. It thus appears that discounting might furnish an incentive that is PRO consumer.

COMMENT 7 - Foreign competition was ignored by GAO.

The associations (p. 19) commented on this issue as follows: "The discounting of loss 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."

RESPONSE - The comment was that we gave no indication that foreign competition was considered in the report. The report states (p. 2) that among the topics not considered in the report was "the extent to which the current or any alternative accounting system would influence premiums or industry investment decisions." This statement was changed to specifically include foreign competition and to indicate it was beyond the scope of our study. Like our previous remarks on current industry profitability, we believe that matters such as foreign competition are not appropriate in a consideration of the proper measure of taxable income but are mitigating factors that might be weighed by lawmakers when considering the changes we have suggested.

However, according to the experts we contacted, the impact of discounting reserves on industry's ability to compete with foreign insurers would be minimal.

With respect to foreign competition, one expert told us that it is a relatively small part of the U.S. insurance scheme, and most foreign competitors have U.S. subsidiaries or branches and are subject to U.S. tax. Any improvement in the competitiveness of foreign companies will only benefit those foreign companies that have no U.S. operations and can write reinsurance on U.S. risks. However, the adoption of Section 845 in the 1984 Tax Reform Act, which permits the IRS to disregard reinsurance transactions that reduce taxes, should effectively inhibit such transactions. Also, we have been told by experts that relatively few such companies exist; they constitute a small portion of the market, and tax is not likely to be a significant consideration in pricing such reinsurance.

COMMENT 8 - This comment focused on issues of policyholder taxation. This comment was received from the associations (pp. 14-16). Based on a numerical example, the comment concluded ". . . 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."

RESPONSE - The example compares a self-insurance illustration with an insurance illustration. For the latter, commentators have assumed that the loss reserves are discounted, the tax accounting method suggested by us. The result of comparing these two cases is that the discounting tax case involves a combined (insurer plus insured) larger tax bill for the insurance illustration than the non-insurance case.

We have several objections to the comparison. We believe the relevant comparison should be of the undiscounted current tax accounting method versus the proposed discounting tax method. The discounting case would result in a "heavier" combined tax on the transaction (both the insured and insurer combined) than the non-discounting case. The reason there is a heavier tax in the discounting case is that the first-year premium is not completely "sheltered" by the discounted loss reserve deduction. In our opinion, this is an appropriate result. It is appropriate because the illustration consists of two transactions, a financial transaction and a real insurance transaction. The example uses a premium equal to the expected loss of the casualty event--\$100. But the illustration also assumes a 1-year delay in the settlement of the claim. Thus, the insurer knows it will have the \$100 premium for 1 year before it has to pay for the loss. In a competitive industry, which is essential to the argument, the expected investment income would be passed through to the insureds through a lowering of the premium so that the premium would be equal to the costs of insurance (including operating expenses and a return to capital). The

difference between \$100 and the discounted loss reserve ($\$100 - \$90.91 = \$9.09$) represents anticipated income from the delayed settlement. The loss deduction in the first year should appropriately be offset against the insurance component of the premium, which is \$90.91. The investment income component of the premium should be subject to tax: The income derivable from the firm's financial intermediation function should not be "sheltered" by a deduction resulting from the firm's insurance function.

The example starting on page 14 of the associations' comments is of a policyholder incurring a property loss of \$100 for a machine that has been destroyed. We believe it is important, in this connection, to differentiate between property insurance and liability insurance. It is our understanding that, in the case of property insurance, it is usual for claims to be paid without substantial delay. However, for liability insurance it is common to have considerable delays before claims are settled. Consider for the moment the case of medical malpractice insurance. A doctor performing an operation in which malpractice is alleged to have occurred does not suffer any economic loss at the time of the alleged malpractice occurrence. Actually, there is no economic loss unless and until a judge or jury has levied damages against the doctor, perhaps years after the alleged occurrence. However, where malpractice insurance is involved, the insurer is permitted to deduct a loss reserve based on statistical profitabilities of the occurrence and the amount thereof. There is no justification in this case for any policyholder deduction, and if a reserve deduction is permitted the insurer, it should only be on a discounted basis.

In a footnote on p. 17 of the associations' comments, the commentator pursues the same line of reasoning with a different illustration. The illustration is a case where a firm issues travelers' checks for \$1,000 to a customer and the customer uses \$800 over the next 6 months and forgets to cash in the balance until 1 1/2 years later. The firm issuing the checks records a receipt of \$1,000 and a liability of \$1,000 and reports no income. But the firm knows from experience that it will have the use of the funds, on average, for 6 months. At 10 percent the discounted value of the liability would be \$952. The commentator concludes that if the liability is to be discounted, the firm would have income of \$48 immediately on issuing the checks, representing the present value of the income the firm will earn in the future from investing the portion of the \$1,000 that remained uncashed. This income of \$48 from the profitless transaction is an "unsound result," the commentator contends.

The example chosen demonstrates a misunderstanding of our proposed discounting method for federal income tax purposes. The discounting method is applicable only to those economic transactions that are accounted for by current deductions from gross income for expenses currently incurred but not obligated

to be paid until a future tax accounting period. In the travelers' check example, the liability established for the future redemption of the checks is not currently deducted as an expense. The distinction between the p/c loss reserve deduction and the travelers' check example is that in the travelers' check case no expense was incurred in the current tax period. The commentator's example would have been analogous had it been assumed that the traveler's check firm established periodic reserves for check losses. Travelers' check firms are obligated to redeem stolen checks if they are inadvertently cashed. During the current tax period the firm will likely suffer losses from the illicit cashing of checks. If the firm established a loss reserve for these possible losses, we would argue, as above, that the deduction should be discounted to allow for the fact that the deposit earns investment income before the stolen checks are cashed. It is our understanding, however, that no such reserves are now set up.

On pages 18-19, the comment quotes extensively from an article entitled "Observations on the Appropriate Tax Treatment of Future Costs" that appears in the Feb. 20, 1984, issue of Tax Notes. The thrust of these remarks is that "A reasonable tax treatment of casualty insurance must recognize that a loss has taken place during the year of the insurance coverage. For a proper matching of income and expense, that loss should be deductible by someone that year" The article states that the present tax accounting method achieves this result, but the proposed discounting method does not since the insured deducts only the discounted amount of the casualty loss. Further, in February 24, 1984, testimony before the Subcommittee on Oversight of the Committee on Ways and Means of the House of Representatives, the author of this article states "Current law which permits current deduction by the insurance company for the expected claim probably is a workable procedure. Insurance premiums should be set to reflect the fact that the full loss is deductible by the insurance company and no part of the insured loss is deductible by the insured even though the claim is paid after a lapse of several years."

It is stated by the author that the current tax accounting method "probably is a workable procedure." Apparently he reaches this judgment by conditioning it on a requirement that "insurance premiums should be set to reflect the fact that the full loss is deductible by the insurance company." The implications of this statement need to be explained for a full understanding of how he arrives at his conclusion that the current tax method is "probably . . . a workable procedure." By a full loss deduction the author is saying that a discounted loss deduction is only a partial deduction. His conclusion requires that the investment income earned by the insurer on the tax deferral--the tax refund in our nondiscounting example--be reflected in lowered premiums to insureds. In effect, to the extent insurers "pass-on" the investment income earned on the

tax deferral, premiums are lowered and corporate insureds' tax liabilities are raised. In the ideal case, if the insureds' tax liabilities collectively are raised by as much as the insurers' tax liabilities are reduced by the full, as opposed to partial deduction, then the Treasury has not experienced a collective tax deferral. However, a substantial portion of insureds (non-business insureds) are not permitted under current tax law to deduct casualty loss premiums. To the extent insurers "pass-on" the investment income earned on the annual tax deferral, non-business insureds' tax liabilities are unaffected, that is, the Treasury does not recapture the tax deferral through nonbusiness insureds' tax liabilities. Further, it is implicitly assumed that the vigor of competitive forces in the p/c industry will ensure that the investment income earned on the tax deferral will be "passed-on" as premium reductions. However, for several insurance lines, such as workers' compensation, rates are regulated by state insurance commissions. In many states, the rate review process does not consider investment income. Thus, because of regulatory ratemaking in these insurance lines, much of the insurers' competitive vigor is not embedded in premiums, but in ancillary services and selling expenses. On insurance lines where rates are not regulated, a disproportionate amount of the investment income earned on the tax deferral would be used to reduce premiums. Thus, an unintended consequence of the present method could be to induce some insureds to purchase too much of some insurance lines and too little of other lines. Third, it is arguable how reasonable the present tax law is in light of high interest rates and claim payments that extend into the future. The tax benefit of deferral can be considerable when investment returns are high and settlement time spans are lengthy.

Concerning the subject of "pass through" of additional taxes in the form of higher premiums, we feel it is important to keep in mind the maximum effect on premiums, even if a complete dollar for dollar pass through was made. Our maximum estimate, using a 7 percent interest rate, was an additional tax liability for the year 1982 of \$613 million. For the same year, written premiums were \$102 billion. This means that even on a complete dollar for dollar pass through, a 0.6 percent increase in all premiums would take place.

COMMENT 9 - This comment is concerned with the tax deferral mechanism effected through the creation of the Protection Against Loss account. Basically, two sources (AIA p. 28) and the associations (pp. 37-40) argue that the Congress recognized that the PAL would permit mutual p/c companies to defer a portion of their underwriting income from taxation and that this deferral partly offsets the advantages stock p/c companies have in their access to capital markets. These commentators argue that the intent of the Congress in establishing the PAL account was to partly offset the advantage stock p/c companies have in raising capital without paying a tax on these funds. Mutual p/c

companies, on the other hand, are limited to augmenting their capital resources only by retaining after-tax income from operations. The purpose of the PAL account, according to AIA, was to assist mutual p/c companies in their efforts to add to their capital resources. By reducing their tax liabilities, through the PAL tax deferral mechanism, mutual p/c companies are more able to add to their financial reserves and better withstand catastrophic losses should they occur. The associations stated (p. 38) that our criticism of the PAL account is in error since the draft report erroneously assumed that the Congress had thought the stock company advantage was in its ability to raise funds in capital markets once the catastrophic loss had occurred. In fact, the commentator asserts, the assumption implicit in the congressional committee quotation in the draft report was that stock companies are able to build up their net worth from capital provided by stockholders prior to the occurrence of catastrophic losses, not after the loss takes place.

RESPONSE - Based on this comment we have amended the draft report to delete the paragraphs (p. 30 and p. 32 of the draft report) that are referred to by the associations.

Though we agree that the commentator's distinction between building up a financial "cushion" before a catastrophic loss occurs rather than after the loss occurs is correct, we feel that the following points support our conclusion that the Congress needs to reexamine the rationale for the continued existence of the account.

First, neither commentator criticizes our view that there is no direct link between the establishment of the tax deferral and the retention of this tax deferral in the form of capital. The PAL account appears solely on the tax form and does not appear in a company's financial statements. The immediate financial effect for a mutual company that benefits from the deferral is to augment its assets and capital accounts since it had a smaller tax liability than it otherwise would have had. The central issue of the debate concerning the intended purpose of the PAL account is whether mutual p/c companies retain in their capital the amount of the tax benefit or are the additional resources from the lowered tax liability used to reduce premiums or in selling efforts to retain or seek new customers. We point out the tax code does not require that the amount of the tax benefit be added to a mutual company's surplus. The accounting convention of the National Association of Insurance Commissioners also does not require that the tax benefit be identified and separately segregated in a mutual company's accounts. Absent some requirement that the tax deferral benefit be accounted for in a mutual company's financial accounting system, it is difficult to know whether the tax deferral benefit is achieving its intended purpose.

Further, as previously discussed in the report (see p. 27), the tax code already allows for the possibility that a corporate entity may suffer an extraordinary loss. The code permits p/c companies to carry losses back for 3 taxable years and carry losses over for 15 taxable years. To the extent there was a tax liability in those years, the p/c company, as other corporate entities, can claim tax refunds or tax credits for future tax liabilities. In effect, this provision was established in corporate tax law to take into account the fact that corporate taxpayers may have "bad" years. The PAL account, which is over and above the general carryback and carryover loss deduction, is a tax preference only for mutual p/c companies compared with all other corporate taxpayers. Whether, when viewed in this way, the PAL account should be retained or modified is at least worth reconsideration by the Congress.

GLOSSARY

Accident and Health Insurance:

A type of coverage that pays benefits, sometimes including reimbursement for loss of income, in case of sickness, accidental injury or accidental death.

Accrual basis of accounting:

The method of recognizing revenues when goods are sold (or delivered) and as services are rendered, independent of the time when cash is received. Expenses are recognized in the period when the related revenue is recognized independent of the time when cash is paid out.

Accrued:

A revenue (or expense) that has been earned (recognized) even though the related receivable (payable) is not yet due.

Admitted assets:

Assets of an insurer permitted by a state to be taken into account in determining its financial condition.

Automobile Liability Insurance:

Protection for the insured against financial loss because of legal liability for car-related injuries to others or damage to their property.

Automobile Physical Damage Insurance:

Coverage for damages or loss to automobile of policyholder, resulting from collision, fire, theft, and other perils.

Boiler and Machinery Insurance:

Coverage for loss arising out of the operation of pressure, mechanical and electrical equipment. It may cover loss to the boiler and machinery itself, damage to other property, and business interruption losses.

Catastrophe:

In insurance, a term applied to an incident or series of related incidents involving a loss of more than \$5 million dollars.

Commercial Multiple Peril Policy:

A package type of insurance for the commercial establishment that includes a wide range of essential coverages.

Comprehensive Personal Liability Insurance:

Protection for an insured against loss arising out of legal liability to pay money for damage or injury to others for which the insured is responsible. Does not include automobile liability or business operations.

Credit Insurance:

A guarantee to manufacturers, wholesalers and service organizations that they will be paid for goods shipped or services rendered. Applies to that part of working capital that is represented by accounts receivable.

Crop-Hail Insurance:

Protection against damage to growing crops as a result of hail or certain other named perils.

Discount rate:

The interest rate used to convert future payments to present values.

Dividend:

(1) An amount returned to a policyholder by an insurance company out of its earnings. (2) In capital stock companies, a share of profits distributed to stockholders.

Farmowners-Ranchowners Insurance:

A package policy for a farm or a ranch providing property and liability coverages against both personal and business losses.

Fidelity bond:

A promise to make good financial loss due to the dishonesty of employees.

Fire Insurance:

Coverage for losses caused by fire and lightning, plus resultant damage caused by smoke and water.

General Liability:

A form of coverage that pertains, for the most part, to claims arising out of the insured's liability for injuries or damage caused by ownership of property, manufacturing operations, contracting operations, sale or distribution of products, and the operation of elevators and the like, as well as professional services.

Glass Insurance:

Protection for loss damage to glass and its appurtenances.

Group Insurance:

Any insurance plan under which a number of persons and their dependents are insured under a single policy, issued to their employer or to an association with which they are affiliated, with individual certificates given to each insured person.

Health Insurance:

(See Accident and Health Insurance)

Homeowners Policy:

A package type of insurance for the home owner that includes coverages ranging from fire and extended coverage, theft and personal liability, to "all risk" coverages.

Incurred But Not Reported (IBNR):

Losses which have occurred but have not been reported to the insurer or reinsurer.

Inland Marine Insurance:

Generally covers articles that may be transported from one place to another as well as bridges, tunnels, and other instrumentalities of transportation. It includes goods in transit (generally excepting trans-ocean) as well as numerous "floater" policies, such as those covering personal effects, personal property, jewelry, furs, fine arts, and others.

Investment Income:

The portion of a company's income that is derived from the return on any investment of its funds, including the interest and dividends on stocks and bonds.

Liability Insurance:

Covers the insured's legal liability resulting from injuries to other persons or damage to their property.

Malpractice Insurance:

Coverage for a professional practitioner, such as a doctor or a lawyer, against liability claims resulting from alleged malpractice in the performance of the insured's services.

Matching principle:

The concept of recognizing cost expirations (expenses) in the same accounting period when the related revenues are recognized.

Ocean Marine Insurance:

Coverage for sea-going vessels, including liabilities connected with them, and their cargoes.

Operating Profit and Loss:

The sum of underwriting profit and loss, investment profit and loss and taxes.

Package Policy:

A single insurance policy that includes several coverages.

Policyholder:

A person who pays a premium to an insurance company in exchange for the insurance protection provided by a policy of insurance.

Policyholders' Surplus:

Sum left after liabilities are deducted from assets. Sums such as paid-in capital and special voluntary reserves are also included in this term. This surplus is an additional financial protection to policyholders in the event a company suffers unexpected or catastrophic losses.

Premium:

The sum paid for an insurance policy. Net premiums written represent premium income retained by insurance companies, direct or through reinsurance, less payments made for business reinsured. Direct written premiums are the amounts actually paid by policyholders.

Product Liability Insurance:

Protection against financial loss arising out of the legal liability incurred by a manufacturer, merchant or distributor because of injury or damage resulting from the use of a covered product, or out of the liability incurred by a contractor (as a result of improperly performed work) after he has completed a job.

Property Insurance:

Provides financial protection against loss or damage to the insured's property caused by such perils as fire, theft, windstorm, hail, explosion, riot, aircraft, motor vehicles, vandalism, malicious mischief, riot and civil commotion, and smoke.

Reinsurance:

Assumption by one insurance company of all or part of a risk undertaken by another insurance company.

Reserves:

Funds set aside by an insurance company for the purpose of meeting obligations as they fall due. Liabilities set up by an insurer for a particular purpose. In property/casualty insurance, "loss" reserves refer to amounts set aside to meet payments that will be made in the future on claims that have already been incurred.

Statutory Underwriting Profit or Loss:

Premium earned less losses and expenses.

Surety:

The corporation or individual guaranteeing performance or faithfulness under a bond.

Underwriting Profit or Loss:

The amount of money that an insurance company gains or loses as a result of its underwriting operations. A net gain or loss on underwriting operations represents a company's statutory underwriting result less any amount it may pay to its policyholders in the form of dividends.

Workers' Compensation Insurance:

A method of providing (regardless of blame) for the cost of medical care and weekly payments to injured employees (or to dependents of those killed in industry) where the injury arises out of and in the course of employment.

ESTIMATION METHODOLOGYLOSS RESERVE DEDUCTION

In arriving at our estimates, it was necessary to begin with the total loss reserves for p/c companies. These loss reserve totals are presented in table 9.

For purposes of calculating federal income taxes, current practice is to deduct from income the annual change in loss reserves that can be calculated from the last row of table 9. Thus, for example, the total reserve deduction for 1981, rounded to millions, would have been \$9,970 million (\$102,422 million - \$92,452 million). In the following section we show an example of how reserves can be discounted for federal tax purposes.

Example of discount methodology

The approach used in our estimates for the years 1980, 1981, and 1982 was to discount reserve components at several likely interest rates--5 percent, 6 percent, and 7 percent. For example, year-end 1981 total reserves by line were discounted at 5 percent. Beginning 1981 reserves (1980's closing reserves) were discounted similarly. The difference between discounted year-end and year beginning reserves constitutes the loss reserve deduction on a discounted basis. This loss reserve deduction was compared to the loss reserve deduction hypothesized to have been taken by differencing the year-end and beginning undiscounted loss reserves. As shown in table 5, chapter 2, this resulted in a smaller loss reserve deduction on a discounted basis.

To arrive at discounted reserves referred to above, the technique of accident year payment patterns was applied to the five categories (lines or combination of lines) making up Schedule P reserves and the aggregate of the lines comprising Schedule O reserves. Several basic actuarial assumptions were made about several insurance lines in deriving the various discount factors. These assumptions were

- an average payment date of 6 years for reinsurance loss payments;
- an average payment date of 3 years for group accident and health loss payments;
- for Schedule O insurance lines, the insurance reports of 100 of the largest insurance groups were examined,

Table 9

Loss Reserves
(in thousands of dollars)

Line of business	1979	1980	1981
Auto liability ^a	\$21,479,726	\$23,291,740	\$26,152,754
General liability ^a	13,674,681	15,201,655	16,939,097
Medical malpractice ^a	3,891,436	4,653,690	5,511,478
Workers' Comp. ^a	19,553,295	22,141,170	24,955,052
Multiple peril ^a	8,398,089	9,560,249	10,711,267
Reinsurance ^b	5,513,879	6,927,267	7,640,095
Group accident and health ^c	998,092	1,202,980	1,269,156
Schedule O ^d	7,604,051	9,473,097	9,242,888
Total ^e	<u>\$81,113,249</u>	<u>\$92,451,848</u>	<u>\$102,421,787</u>

Note: In arriving at subtotal reserves by line, appropriate adjustments for less than complete coverages were made by a p/c actuarial consultant.

^aThe business lines shown are those required by statute to be reported in Schedule P of the annual statement that all insurance companies are required to file. The reserve totals shown for these Schedule P business lines are taken from the annual Loss Reserve Development publications published by A.M. Best & Co. The totals have been adjusted upward because the Loss Reserve Development data do not provide 100 percent coverage. These adjustments for less than complete coverage range from 3 to 10 percent (depending on the line of business) of the total reserves shown in Loss Reserve Development reports.

^bThe data source for reinsurance reserves is Best's Insurance Reports. Twelve large companies known for their reinsurance business activity were identified. The reserves shown in the summarized balance sheets in the Reports were summed for these 12 companies.

^cGroup accident and health reserves were obtained from Best's Insurance Reports. These reserves represent those shown for group A&H for five subsidiaries or affiliates of mutual life companies known for writing disability insurance.

^dBusiness lines not reported in Schedule P are included in Schedule O of the annual statement. Schedule O reserves were assumed to be equal to the difference between total reserves and the sum of all other identified reserve lines.

^eTotal reserves as shown in the appropriate annual volumes of Best's Aggregates and Averages. These reserves also include estimates of adjustment expenses and claims incurred but not reported (IBNR).

assumed to be representative of all companies writing Schedule O lines, and the weighted-average discount method (described later for a typical Schedule P line) as applied to the loss payment pattern developed.

The weighted-average discount factor by line for Schedule P and the aggregate discount factor for Schedule O lines were obtained in the manner illustrated for the general liability line. Claim payments and reserves were obtained from loss reserve development data. Loss payments, reserves, and incurred losses (claims and expenses) for each accident year are shown in table 10 for the general liability line.

Table 10

Loss Payment Pattern Development
General Liability Business Line
(in thousands of dollars)

<u>Year loss</u> <u>incurred</u> (1)	<u>Loss</u> <u>payments</u> (2)	<u>Reserves</u> (3)	<u>Incurred</u> <u>losses</u> (2+3) (4)	<u>Ratio</u> <u>paid</u> ^a (2/4) (5)
1973 and earlier	\$16,539,610	\$ 884,366	\$17,423,976	0.9493
1974	2,422,981	406,405	2,829,386	0.8565
1975	2,068,995	509,310	2,578,305	0.8026
1976	1,902,434	780,236	2,682,670	0.7092
1977	1,770,105	1,168,859	2,938,964	0.6022
1978	1,597,516	1,769,310	3,366,826	0.4746
1979	1,301,982	2,681,048	3,983,030	0.3269
1980	929,619	3,215,146	4,144,765	0.2244
1981	435,562	3,999,898	4,435,460	0.0983
Total	\$28,968,804	\$15,414,578 ^b	\$44,383,382	

^aColumn 5 represents the proportion of all claims incurred in the year appearing in column 1 that have been paid by December 31, 1981. For example, 94.9 percent of all claims incurred in or before 1973 have been paid by the end of 1981, while 9.8 percent of claims incurred in 1981 were paid by the end of that year.

^bThe total reserves of \$15,414,578 are the outstanding reserves as of December 31, 1981. They are less than the amount shown in table 9 for the general liability line. This was because the source data covered reporting companies that constituted approximately 90 percent of the companies writing general liability insurance.

The industry's loss payment pattern for the general liability line can be estimated from the ratio paid column in table 10. The companies represented by these data had paid 0.0983 of their 1981 incurred losses by the end of 1981. They had paid 0.2244 of their 1980 losses by the end of 1981. If 1980 payments followed the 1981 pattern, then this implies that 0.0983 of 1980's incurred losses were paid by the end of 1980 and 0.1261 ($0.2244 - 0.0983$) of 1980's incurred losses were paid in 1981. For 1979 losses we would similarly estimate that 0.0983 would be paid in 1979, 0.1261 ($0.2244 - 0.0983$) in 1980, the year after the claims were incurred, and 0.1025 ($0.3269 - 0.2244$) in 1981, the second year after the claims were incurred. Carrying the figures further, we can say that column 5 of table 10 shows that 0.0983 of a year's claims are paid in the calendar they are incurred, 0.1261 in the year after, 0.1025 in the second year after, etc., until 0.0928 is paid in the 8th year after claims were incurred and the remaining 0.0507 was paid in the 9th or later years after occurrence.

Table 11 takes the figures developed by the differencing method outlined above and shows these yearly proportions paid as the expected payment pattern, column 2. Note that the figure shown in table 11 for 1981 is 0.1261 and not the 0.0983 shown in table 10. The 0.0983 figure of table 10 for 1981 represented the portion of 1981 claims paid in the same year they were incurred (1981). For table 11, however, this figure is not used since table 11 shows reserves as of December 31, 1981, and since the 0.0983 was already paid by that date, there is no need to consider it in the reserve development.

Table 11
Discount Factor Development
General Liability Business Line
(in thousands of dollars)

<u>Year losses</u> <u>incurred</u> (1)	<u>Expected payment</u> <u>pattern^a</u> (2)	<u>5% Discount</u> <u>factor at</u> <u>12/31/81</u> (3)	<u>Discounted</u> <u>reserve at</u> <u>12/31/81</u> (4)
1973 and earlier	0.0507	0.9759	\$ 863,053
1974	0.0928	0.9595	389,937
1975	0.0539	0.9307	474,034
1976	0.0934	0.9151	714,012
1977	0.1070	0.8996	1,051,490
1978	0.1276	0.8857	1,567,124
1979	0.1477	0.8726	2,339,406
1980	0.1025	0.8502	2,733,460
1981	0.1261	0.8329	3,331,656
Total			<u>\$13,464,173</u>

^aThis column should be interpreted as proportion of losses incurred in the year cited in the first column that has been paid during 1982.

Column (2) in table 11 can be used as a proxy for the expected payment pattern for the 1981 year-end reserve. From the data in this column it can be seen that 0.1261 of losses incurred in 1981 will be paid in 1982 (on average, 6 months into the year); a further 0.1025 will be paid on June 30, 1983; 0.1477 on June 30, 1984; 0.1276 on June 30, 1985, etc. The discount factors shown in column (3) of table 11 are weighted by the payment pattern shown in column (2). For example, for an average dollar of claims incurred in 1975, \$0.1974 (\$0.0539 + \$0.0928 + \$0.0507) remains to be paid as of the reserve date December 31, 1981. On the average, this \$0.1974 will be paid over the next 30 months--\$0.0539 on June 30, 1982, \$0.0928 on June 30, 1983, and \$0.0507 on June 30, 1984, for a total of \$0.1974 in the 30 months following the reserve date of December 31, 1981. The proportion of the \$0.1974 to be paid in each period is discounted over the appropriate period at 5 percent. These numbers are summed to determine the discount factor for 1975. Thus, the 1975 discount factor is derived in the following manner assuming a 5 percent discount rate.

$$\frac{0.0539}{0.1974} \times \frac{1}{(1.05)^{0.5}} + \frac{0.0928}{0.1974} \times \frac{1}{(1.05)^{1.5}} + \frac{0.0507}{0.1974} \times \frac{1}{(1.05)^{2.5}} = 0.9307.$$

After each claim year's discount factor is derived, discounted reserves by claim year are obtained by multiplying each year's undiscounted reserves outstanding by the corresponding year's discount factor. The sum of the discounted reserves for all of the claim years are the 1981 year-end reserve for general liability discounted at 5 percent. This procedure was repeated for all Schedule P reserves for each year 1979, 1980, and 1981. The year-end reserve for 1982 was done differently because loss reserve development data were not available. Total reserves were estimated to be \$110 billion for year-end 1982. This total was apportioned among each of the lines for 1982 in the same proportion that each line bore to the total reserves in 1981. The discount factors derived for 1981 year-end reserves were used to obtain 1982 discounted reserves. Payment patterns for the p/c industry vary only slightly from year to year. Therefore, we believe that the assumption of a similar payment pattern in 1982 is reasonable.

The estimated increased tax liabilities at various discount rates, shown in table 5 in chapter 2, were derived by subtracting the discounted loss reserve deduction from the undiscounted loss reserve deduction and applying the normal corporate tax rate of 46 percent to the difference. The discounted loss

reserve deduction was obtained by subtracting year-end from beginning discounted reserves. These discounted reserves were obtained by summing the major reserve categories after applying the average weighted discount method: Schedule P, Schedule O, reinsurance, group accident and health, all adjusted upward to obtain complete coverage.

Allocation of acquisition costs

The estimates shown in table 8 in chapter 2 were derived on the theory that acquisition costs--commissions, agent expenses, etc.--should be allocated over the life of insurance contracts that generated the costs. As a proxy for specific knowledge of insurance contract maturities, the ratio of unearned premiums to written premiums was used. When contracts are written, the premium is apportioned by the company into two accounts--earned premiums and unearned premiums. The usual assumption is that the written premium will be earned on a pro-rata basis. Thus, if a contract required a \$1,200 premium and was for a period of 12 months and the contract was effective on September 1, 1979, then premiums earned in 1979 would be \$400, and \$800 would be considered unearned at the end of 1979. In chapter 2, we said that the Congress might consider changing this practice so that any acquisition costs associated with writing a contract are allocated in the same proportion that earned premiums bear to net premiums written.

Best's Aggregates and Averages publishes annually, for stock and mutual companies separately, data on experience by line of insurance. Twenty-six lines are shown for each group. Separate columns show the ratio of "commission and brokerage fees" to a "net premiums written" and also the ratio of "other acquisition expenses" to "net premiums written." For each of the 26 lines the two separate ratios were simply summed to obtain a derived ratio of "acquisition costs" to "net premiums written." This ratio was multiplied by "net premiums written" to obtain the dollar amount of acquisition costs by line and by company type.

The acquisition costs were summed by major business lines (some minor lines were aggregated to form an "other" category) and multiplied by each lines' ratio of "unearned premiums" to "net premiums written." The resultant product was an estimate of the portion of the current year's acquisition costs that should be deferred into the following year. For example, table 12 illustrates how 1982's acquisition costs were apportioned between a charge against current year income and a deferred charge against future years' income.

Table 12

Deferred Acquisition Costs
(in millions of dollars)

<u>Business line</u>	<u>Acquisition costs</u>	<u>Unearned premiums/ premiums written</u>	<u>Deferred acquisition costs</u>
Automobile liability	\$4,062	0.331	\$1,345
Auto-physical damage	2,884	0.349	1,006
Workers compensation	1,273	0.272	346
Homeowners and farm-owners multiple peril	2,646	0.546	1,445
General liability	1,140	0.387	441
Fire, allied lines, and earthquake	1,157	0.445	515
Commercial mult. peril	1,654	0.504	834
Surety	402	0.812	326
Fidelity	90	0.821	74
Inland marine	543	0.473	257
Ocean marine	218	0.233	51
Other (reins. etc.)	<u>1,656</u>	<u>0.391</u>	<u>647</u>
Total	<u>\$17,725</u>		<u>\$7,287</u>

Continuing with our example, the 1982 total acquisition cost of \$17,725 million was reduced by the portion charged to the following years--the deferred cost of \$7,287 million. The amount of deferred costs from 1981 applicable to 1982 was added to 1982's acquisition costs. This results in an estimate of the amount of acquisition costs that the p/c industry would have deducted from income in 1982 had costs been allocated. The difference between 1982's unallocated and allocated acquisition costs is the amount of additional income that would have been subject to tax. For 1982 the additional estimated tax liability of \$164 million was obtained in the following manner:

	(millions of dollars)
1982 acquisition costs (estimate of actual deduction).....	\$17,725
plus 1981 deferred costs.....	6,930
minus 1982 deferred costs.....	7,287
hypothetical deduction.....	<u>17,368</u>
1982 estimate of actual deduction.....	\$17,725
less 1982 hypothetical deduction.....	17,368
addition to income.....	357
times assumed marginal corporate tax rate	0.46
Estimate of additional 1982 tax liability	<u>\$ 164</u>

The above procedure was repeated for estimates for the years 1980 and 1981.

LEGISLATIVE LANGUAGELOSS RESERVE DEDUCTION

Section 832(b)(1)(A) of the Code currently reads

(b) DEFINITIONS.-In the case of an insurance company subject to the tax imposed by section 831-

(1) GROSS INCOME.-The term "gross income" means the sum of-

(A) the combined gross amount earned during the taxable year, from investment income and from underwriting income as provided in this subsection, computed on the basis of the underwriting and investment exhibit of the annual statement approved by the National Association of Insurance Commissioners.

Amend Section 832(b)(1)(A) to read as follows:

(b) DEFINITIONS.-In the case of an insurance company subject to the tax imposed by section 831

(1) GROSS INCOME.-The term "gross income" means the sum of

(A) the combined gross amount earned during the taxable year, from investment income and from underwriting income as provided in this subsection, computed on the basis of the underwriting and investment exhibit of the annual statement approved by the National Association of Insurance Commissioners, except that (i) unpaid losses referred to in section 832(b)(5)(B) below shall be calculated on a discounted basis as therein indicated and (ii) that part of expenses incurred defined in section 832(b)(6) which represents Acquisition Expenses shall be allocated over the period of the contracts.

Amend Sec. 832(b)(5)(B) as follows:

(5) LOSSES INCURRED.-The term "losses incurred" means losses incurred during the taxable year on insurance contracts, computed as follows:

(A) To losses paid during the taxable year, add salvage and reinsurance recoverable outstanding at the end of the preceding taxable year and deduct salvage and reinsurance recoverable outstanding at the end of the taxable year.

(B) To the result so obtained add all discounted unpaid losses outstanding at the end of the taxable year and deduct discounted unpaid losses outstanding at the end of the preceding taxable year. Discounted unpaid losses are to be computed by the methods described in section 832(b)(9).

Add to Sec. 832(b) the following subsections:

(7) Investment Assets.-The term "investment assets" means the sum of holdings at the end of the taxable year of real estate and financial claims on third parties and real properties shown on the annual statement approved by the National Association of Insurance Commissioners and shall be computed as the sum of the totals from the annual statement for bonds, stocks, real estate, mortgage loans on real estate (properties occupied by the company and other properties), collateral loans, cash on hand and on deposit, short-term investments, and other invested assets.

(8) Average Discount Rate.-The term "average discount rate" means the average rate of return on the company's investment assets for the current taxable year and the four preceding taxable years, or for all preceding taxable years in which the company filed returns but not to exceed four. The current discount rate for each taxable year is computed as the ratio of investment income, as defined in section 832(b)(2), to one-half of the sum of (i) investment assets held at the end of the preceding taxable year and (ii) investment assets held at the end of the current taxable year. The calculation is carried out for the current taxable year and the four preceding taxable years. The average discount rate to be used to obtain discounted unpaid losses is computed as one-fifth of the sum of (i) the rate obtained for the current taxable year and (ii) the rates obtained for each of the preceding four taxable years. If a taxpayer has less than four preceding taxable years it will add to the rate for the current taxable year the rate calculated for as many preceding taxable years as it had. The resulting sum of rates in the case of less than four preceding taxable years will be divided by the number of the taxable years.

(9) Discounted Unpaid Losses.—The term "discounted unpaid losses" means the sum of (i) net losses unpaid and (ii) unpaid loss adjustment expenses, discounted by the rate defined in section 832(b)(8). In applying the discount rate to unpaid losses the discounting period and the annual discount factors shall be based on each taxpayer's own historical pattern of loss payments or its estimates of the proportions of current taxable year unpaid losses to be paid in future taxable years.

ALLOCATION OF ACQUISITION EXPENSES

Section 832(b)(6) of the Code currently reads as follows:

(6) EXPENSES INCURRED.—The term "expenses incurred" means all expenses shown on the annual statement approved by the National Association of Insurance Commissioners, and shall be computed as follows: To all expenses paid during the taxable year, add expenses unpaid at the end of the taxable year and deduct expenses unpaid at the end of the preceding taxable year. For the purpose of computing the taxable income subject to the tax imposed by section 831, there shall be deducted from expenses incurred (as defined in this paragraph) all expenses incurred which are not allowed as deductions by subsection (c).

Amend Section 832(b)(6) to read as follows:

(6) EXPENSES INCURRED.—The term "expenses incurred" means all expenses shown on the annual statement approved by the National Association of Insurance Commissioners, and shall be computed as follows: To all expenses paid during the taxable year, add expenses unpaid at the end of the taxable year and deduct expenses unpaid at the end of the preceding taxable year. For the purpose of computing the taxable income subject to the tax imposed by section 831, there shall be deducted from expenses incurred (as defined in this paragraph) all expenses incurred which are not allowed as deductions by subsection (c).

Those expenses incurred that are acquisition expenses shall be reduced by that proportion allocable to policy contract periods beyond the current year. This proportion should be determined by each company based on its own experience as to the ratio of premiums earned to premiums written.

AGENCY AND INDUSTRY COMMENTS
AND GAO RESPONSE

At the end of chapter 2 of the report we listed the principal comments of the Treasury Department and gave GAO's response to those comments. We also grouped together the industry comments by general subject and gave our response to those comments. This appendix includes copies of the letters received from the Treasury Department and from the four industry sources. The industry's letters appear on the left-hand side of each page and the GAO response (where applicable) appears on the right-hand side of each page. Where there is no corresponding GAO response, industry comments are printed on both left and right-hand sides. The GAO comments are cross-indexed to a particular page and line of each industry letter and include these page and line(s) references.

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220



ASSISTANT SECRETARY

MAR 30 1984

Dear Mr. Anderson:

Enclosed are the comments of the Treasury Department on the General Accounting Office's draft report entitled: Congress Should Consider Changing Federal Income Taxation of the Property/Casualty Insurance Industry. I apologize for the delay in responding to your request for comments and hope that this has not caused undue inconvenience to you or your staff.

Sincerely,

John E. Chapoton
John E. Chapoton
Assistant Secretary
(Tax Policy)

Mr. William J. Anderson
Director, General Government Division
United States General Accounting Office
Room 3866, 441 G Street, N.W.
Washington, D.C. 20548

Enclosure

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ConclusionsLOSS RESERVE DEDUCTION

- (1) The current system for treating property & casualty reserves produces long-term, permanent distortions in the taxable income of property & casualty insurance companies.
- (2) In order to eliminate these distortions of income, p/c reserves should be discounted or a set of rules should be established that would insure that p/c insurance companies are placed in the same economic position as if their reserves were discounted.
- (3) Further consideration should be given to the question of whether reserves should be discounted on a pre-tax or after-tax basis. If reserves are to be discounted on an after-tax basis, an initial discounted deduction should be granted for the establishment of a reserve for a given claim and no further deduction for additions to reserves with respect to that claim should be granted unless the estimate of the timing or amount of such claim changes.
- (4) Further consideration should be given to the tax consequences in the year a claim is paid. The tax system should contain an "adjustment mechanism" to insure that a p/c company is neither rewarded nor penalized for a misestimate of the timing or amount of a claim.

ACQUISITION COSTS

- (5) Under a proper tax system, the costs of selling an insurance policy should be treated as a capital cost.

PROTECTION AGAINST LOSS ACCOUNT

- (6) The PAL account is unjustified and should be eliminated.

CONSOLIDATED RETURNS

- (7) Because p/c insurance companies and other business entities are subject to different tax rules, the ability of property & casualty insurance companies to file consolidated returns with enterprises other than p/c insurance companies (particularly life insurance companies) creates numerous opportunities for distortion of the combined income of the consolidated group. Accordingly, if such consolidation is permitted to continue, special rules must be imposed to minimize the opportunities for tax avoidance.

RESPONSE OF THE DEPARTMENT OF THE TREASURY
TO THE GENERAL ACCOUNTING OFFICE'S DRAFT REPORT:
CONGRESS SHOULD CONSIDER CHANGING FEDERAL INCOME TAXATION
OF THE PROPERTY/CASUALTY INSURANCE INDUSTRY

March 30, 1984

Introduction

The following constitutes the response of the Department of the Treasury to the General Accounting Office's Draft of a Proposed Report: Congress Should Consider Changing Federal Income Taxation of the Property/Casualty Insurance Industry (hereinafter referred to as the "Draft Report"). No attempt is made in this response to make a complete statement of the views of the Treasury Department on the proper tax treatment of property and casualty ("p/c") insurance companies and their policyholders. In particular, these comments do not address the question of whether it may be appropriate to grant additional reserve deductions to p/c insurance companies to compensate for inadequacies in the tax treatment of insureds.

Overall, we believe that the Draft Report is a well-prepared and thoughtful document which makes a significant contribution to the literature on this subject. In general, we agree with the analysis presented in the Draft Report, although certain points of difference are noted below. In particular we agree with the basic conclusion of the Draft Report that reserves of p/c insurance companies should be computed in a manner that more fully reflects the time value of money.

Treasury's comments generally are confined to Chapter 2 of the Draft Report, relating to the Federal income taxation of p/c insurance companies. Because of time constraints, the only detailed discussion relates to the topic which is the primary focus of the Draft Report: the loss reserve deduction. The amortization of acquisition expenses and the protection against loss (PAL) account are mentioned only to state that Treasury agrees with the analysis presented in the Draft Report. Our conclusions also point out that the draft report fails to address at least three significant tax issues affecting p/c insurance companies:

- the problems arising from allowing p/c insurance companies to file consolidated returns with other enterprises;
- the failure to restrict in any way the tax benefits arising when p/c insurance companies invest in tax-favored forms of investment (in contrast to the limitations that apply to virtually all other taxpayers); and
- the use of captive insurance subsidiaries.

No attempt has been made herein to assess the validity of the revenue estimating methodology of the Draft Report.

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The Draft Report concludes that, in order to correct this understatement of income, reserves must be discounted at a pre-tax discount rate. Thus, the initial reserve deduction of a p/c company is calculated by discounting the estimated future expense at the pre-tax rate of return the company can expect to earn on its reserves, as measured by its average investment return during the preceding 5-year period. Additional reserve deductions are then granted in each succeeding year in an amount equal to the interest income earned on the initial deposit. These additional reserve deductions offset the interest income, so that the interest earned on the initial reserve is effectively exempted from tax. If the initial estimate of the timing and amount of the claim proves to be correct, there will be no further tax consequences when the reserve is released and the claim is paid.

While we agree with the general approach of the Draft Report, we believe that further consideration should be given to the question of whether interest earned on properly discounted p/c reserves should be effectively exempt from tax. A business taxpayer would not be permitted to exclude from taxation interest earned on to cover a future expense or claim (e.g., a product liability claim). The tax system should not provide a different result when a group of taxpayers insure against future liabilities by purchasing insurance from a p/c company. It would be appropriate for the p/c insurer to employ a reserve system based on pre-tax discounting only to the extent that an uninsured taxpayer would be allowed to account for an expense or loss in that manner. Pre-tax discounting may also be appropriate in certain limited situations where the p/c insurer is acting as a financial intermediary.

The effective exemption of interest for taxation would be allowed if reserves discounted on a pre-tax rather than an after-tax basis. If an after-tax discount rate is used for calculating the deduction for the initial contribution to reserves, a higher initial deduction than the reserve discounted at a pre-tax rate will result. Using the example set forth in Table 3 of the Draft Report, a deduction of \$743.78 would be allowed in the initial year. Assume this is also the net premium charged to policyholders. Then, in order that investment income earned by funds in the reserve be effectively subject to tax, this income would not be deductible as an addition to reserves. The after-tax investment income must, however, increase the level of reserves for purposes of determining the tax consequences in the year the claim is paid. This assures that, if the original estimate of the timing and amount of the claim is correct, the net premium amount and the reserve will each have grown to the amount of the claim. This is illustrated by Table A. (The assumptions are the same as those in Table 3 of the Draft Report, except that the claim is paid on January 1, 1986, rather than December 31, 1985.)

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TAX-FAVORED INVESTMENTS

- (8) Consideration should be given to the question of whether p/c insurance companies, in their role as financial intermediaries, should be subject to any restrictions on the tax benefits resulting from investing funds in tax-exempt or tax-preferred investments. In particular, consideration should be given to (a) whether the benefits of investing in tax-preferred investments should be "prorated" between the company and its policyholders (as is done with life insurance companies), and (b) whether restrictions comparable to the corporate tax preference reduction contained in section 291(a)(3) ought to apply to p/c insurance companies.

CAPTIVE INSURANCE SUBSIDIARIES

- (9) Consideration should be given to the question of when a noninsurance company ought to be entitled to a deduction for the insurance of a risk with a wholly or partially owned captive insurance subsidiary. In particular, the significance of outside ownership and outside risks should be evaluated.

Discussion — Loss Reserve Deduction

As the Treasury Department has stated on numerous occasions in testimony before Congress, allowing a taxpayer a current deduction for the full, undiscounted amount of an expense to be incurred in the future produces a distortion in that taxpayer's income because of the time value of money. Thus, while the decrease in the taxpayer's income in the year of the deduction is matched by an increase in taxable income in the year the expense is paid (compared to deducting the expense in that year), because of the timing, considerations the taxpayer retains a permanent benefit. If the taxpayer's marginal tax rates are the same in these two years, the magnitude of this benefit is equal to the investment income the taxpayer can earn on the tax savings during the period between the time the expense is deducted and the time it is actually paid. In other words, the Government has made an interest-free loan of the value of the deduction for this period.

In general, this distortion can be eliminated by requiring the taxpayer to wait until the expense is incurred and paid to take the deduction. For certain taxpayers, however, it may be appropriate to allow a current deduction equal to the present value of the future expense. If the proper discount rate is chosen, the value to the taxpayer (and the cost to the Government) of the discounted current deduction will be the same as the value of the undiscounted future deduction.

These concerns apply equally to property & casualty insurance companies. While property and casualty insurance involves a complex set of economic relationships, in most instances the essential function of p/c companies is to charge customers amounts sufficient to cover future expenses (claims). Thus, if a p/c company estimates that it will have to pay one claim of \$1,000 in five years, the allowance of a \$1,000 reserve deduction currently understates the p/c company's income.

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If the estimate of the timing or amount of the claim proves to be incorrect, a subsequent adjustment must take place. We believe that further thought needs to be given to the operation of this adjustment mechanism and to the question of whether it produces the correct economic results. The simplest adjustment mechanism, of course, is to compare the reserve for a claim to the amount of the claim actually paid: if the payment exceeds the reserve, an additional deduction is allowed in the year of payment equal to such excess. If the reserve exceeds the claim, the excess reserve is treated as taxable income. Using the example in Table A, if a claim of \$1,100 is paid on the first day of 1985, the company would receive a net deduction in 1985 of \$152.44 (the excess of \$1,100 over the reserve of \$947.56). If a claim of \$800 is paid at the beginning of 1983, the company would recognize income of \$50.77.

This adjustment feature should be designed to assure that the p/c company will be neither penalized for an underestimate of future claims nor rewarded for an overestimate. Of course, the final year adjustment cannot eliminate year-to-year distortions; it can, however, assure that overpayments of tax will be refunded and underpayments will be made up, each with interest.

If after-tax discounting of reserves is a correct model, this simple adjustment mechanism produces the correct result. To see why this is so, consider the same situation as presented in Table A except that the p/c company estimates that the claim paid at the beginning of 1986 will be \$1,344.48. In this case, the net premium will be exactly \$1,000.00, this being the discounted value of the estimated future claim. Suppose, however, that the claim turns out to be only \$1,000.00. When the reserve of \$1,344.48 is released, the excess of \$344.48 is subject to a 46% tax, leaving \$182.06 after the \$1,000 claim and the tax of \$158.46 are paid. The entire transaction is illustrated in Table B.

Table A
Reserve Deduction Example Using After-Tax Discounted Reserves

	1980*	1981	1982	1983	1984	1985	1986
Income							
(1) Net Premiums	\$743.78	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0
(2) Investment income**	37.19	78.30	82.63	87.20	92.03	97.12	0
(3) Income from release of reserve	0	0	0	0	0	0	1000.00
(4) Total income (1) + (2) + (3)	\$780.97	\$ 78.30	\$82.63	\$ 87.20	\$92.03	\$ 97.12	\$1000.00
Expenses							
(5) Deductions for additions to reserves	\$743.78	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0
(6) Loss payments	0	0	0	0	0	0	1000.00
(7) Total expenses (5) + (6)	\$743.78	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	\$1000.00
Net taxable income							
(8) (4) - (7)	\$ 37.19	\$ 78.30	\$ 82.63	\$ 87.20	\$ 92.03	\$ 97.12	\$ 0
Tax							
(9) 46% of (8)	\$ 17.11	\$ 36.02	\$ 38.01	\$ 40.11	\$ 42.33	\$ 44.68	\$ 0
After-tax income							
(10) (8) - (9)	\$ 20.09	\$ 42.28	\$ 44.62	\$ 47.09	\$ 49.70	\$ 52.45	\$ 0
Reserve							
(11) End-of-year reserve	\$763.87	\$806.12	\$850.77	\$897.86	\$947.56	\$1000.00	\$ 0

* The premium is assumed to be received on 6/30/80. Hence the reserve must be discounted to reflect a 5-1/2 year time lag between the receipt of premiums and payment of the claim.

** Investment income earned at 10%, compounded semiannually.

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Table B
Reserve Deduction Example Using Undiscounted Reserves and Retaining
After-Tax Income in the Reserve

	1980	1981	1982	1983	1984	1985	1986
<u>Income</u>							
(1) Net Premium	\$1,000.00	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0
(2) Investment income	50.00	105.27	111.09	117.24	123.73	130.58	0
(3) Income from Release of Reserve	0	0	0	0	0	0	\$1,344.48
(4) Total expenses (1) + (2) + (3)	\$1,050.00	\$105.27	\$111.09	\$117.24	\$123.73	\$130.58	\$1,344.48
<u>Expenses</u>							
(5) Deduction for additions to reserve	\$1,000.00	0	0	0	0	0	0
(6) Loss payments	0	0	0	0	0	0	1,000.00
(7) Total expenses (5) + (6)	\$1,000.00	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	\$1,000.00
<u>Net taxable income</u>							
(8) (4) - (7)	\$ 50.00	\$105.27	\$111.09	\$117.24	\$123.73	\$130.58	\$ 344.48
<u>Tax</u>							
(9) 46% of (8)	\$ 23.00	\$ 48.42	\$ 51.10	\$ 53.93	\$ 56.92	\$ 60.07	\$ 158.46
<u>After-Tax Income</u>							
(10) (8) - (9)	\$ 27.00	\$ 56.85	\$ 59.99	\$ 63.31	\$ 66.81	\$ 70.51	\$ 182.06
<u>Reserve</u>							
(11) End of Year Reserve	\$1,027.00	\$1,083.84	\$1,143.84	\$1,207.15	\$1,273.96	\$1,344.48	\$ 0

The \$186.02 amount which remains after the claim and tax are paid is exactly the same amount the company would have had if it had charged the same \$1,000 premium but set up the proper initial reserve of only \$743.78, as in Table A. In this case, the excess of the premium over the initial reserve (\$256.22) would be subject to tax in 1980, leaving \$138.36. After 5-1/2 years, this amount would grow to exactly \$186.02, as is illustrated in Table C.

Table C

	<u>After-Tax Growth of Excess Premium</u>					
	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>1984</u>	<u>1985</u>
(1) Opening Balance	\$138.36	\$142.09	\$149.96	\$158.26	\$167.02	\$176.76
(2) Interest	6.92	14.56	15.37	16.22	17.12	18.07
(3) Tax	3.18	6.70	7.07	7.46	7.87	8.31
(4) After-Tax Interest	3.74	7.86	8.30	8.76	9.24	9.76
(5) Closing Balance	\$142.09	\$149.96	\$153.26	\$167.02	\$176.26	\$186.02

Comparing Table B with Tables A and C together illustrates that a company derives no permanent benefit from setting up a \$1,000 reserve to cover a claim which turns out to be only \$1,000, so long as:

- (1) the interest earned on the reserve is subject to tax currently;
- (2) the after-tax interest earned increases the level of the reserve, although this amount is not deductible;
- (3) any excess reserve is treated as taxable income in the year the claim is paid; and
- (4) the company's effective tax rate is the same in all periods.

In other words, if these four conditions are satisfied, the distortion from an overestimate of a future claim will be offset by an income item in the year of the claim. Moreover, the offset automatically will contain an interest component measured by the after-tax income the company actually earns on the excess reserve. Of course, the offset mechanism functions in exactly the same way if the excess reserve deduction in the initial year results not from an overestimate of a claim but from the failure of the tax system to require the discounting of reserves. In other words, the offset mechanism can produce the correct economic result in the long run even if no discounting of reserves is required. A more complete discussion of this issue and a formal proof that the above assertions are valid may be found in Neubig and Steuerle, "The Taxation of Income Flowing Through Financial Institutions: General Framework and Summary of Tax Issues," OTA Paper 52, September 1983, at pp. 61-70.

Comments of
Alliance of American Insurers,
National Association of Independent Insurers,
National Association of Mutual Insurance Companies
and Reinsurance Association of America

Concerning
Draft of a Proposed Report Entitled
"Congress Should Consider Changing
Federal Income Taxation of the
Property/Casualty Insurance Industry"
Prepared by the Staff
of the United States General Accounting Office

February 24, 1984

Comments Concerning
Draft of a Proposed Report Entitled
"Congress Should Consider Changing
Federal Income Taxation of the
Property/Casualty Insurance Industry"
Prepared by the Staff
of the United States General Accounting Office

This memorandum is filed by the Alliance of American Insurers, National Association of Independent Insurers, National Association of Mutual Insurance Companies, and Reinsurance Association of America (hereafter sometimes referred to as the "Associations") for purposes of commenting upon the Draft of a Proposed Report prepared by the Staff of the United States General Accounting Office ("GAO") and entitled "Congress Should Consider Changing Federal Income Taxation of the Property/Casualty Insurance Industry" ("Draft Report"). (We have reviewed the comments on the Draft Report made by the American Insurance Association. As we agree with the views expressed by such comments, we endorse those comments and commend them to you for consideration.)

The Draft Report proposes the following three matters for consideration by the Congress with respect to changing the manner in which property and casualty insurers are taxed:

1. The Congress should consider amending the tax code to provide that, in calculating the deduction for losses incurred, loss reserves should be discounted;

THE ASSOCIATIONS

page line

2 11 Footnote This error was corrected (p. 4 of final report)
 2 by adding a statement that the companies referred to in the
 report were those reported in Best's Aggregates and Averages.

2. The Congress should consider amending the tax code to provide that expenses associated with the sale, renewal, and servicing of property/casualty company insurance policies should be allocated over the life of the related policies;

3. The Congress should reexamine the rationale for the protection against loss ("PAL") account.

The recommendations contained in the Draft Report are based on fundamental misperceptions of the nature and operation of the property and casualty insurance industry. In addition, the Draft Report contains factual errors.* The Associations submit that the merits of the conclusions and recommendations of the Draft Report are, therefore, subject to substantial doubt.

*The Associations note, for example, that the Draft Report, citing A.M. Best Company, Best's Aggregates & Averages, Property Casualty, 1983, states that in 1982 there were 1,268 stock companies and 322 mutual companies. (Dr. Rpt., p. 4) In fact, there are more than 3,400 property and casualty companies doing business in the United States--more than twice as many as indicated in the Draft Report. Apparently overlooked in the Draft Report are hundreds of companies which are too small to report their operations to Best's but which are nonetheless large enough to be subject to tax under Sections 821-832 of the Code.

I GENERAL COMMENTS

The Draft Report Fails to Take Proper Account of the Nature of Property and Casualty Insurance

The Draft Report states the fundamental criterion of the GAO study as follows:

GAO's study was based on the criterion that the appropriate measure of annual income requires the matching of each year's revenues with the expenses associated with those revenues. This criterion is consistent with Statement of Financial Accounting Standards No. 60, Accounting and Reporting by Insurance Enterprises, issued by the Financial Accounting Standards Board (FASB) and dated June 1982. (Draft Report, pp. i-ii).

The Draft Report then states that the prime objective of the regulatory accounting system which, under state insurance laws, must be used by property and casualty insurers, is to ensure the solvency of the regulated companies, not necessarily to accurately reflect income. The Draft Report concludes, without giving any supporting rationale, that this accounting method results in mismatching of income and expenses and understatement of income. (Dr. Rpt., pp. 12-13)

It must first be noted that in the Statement of Financial Accounting Standards No. 60, the FASB has stated:

3 14 GAO's original position was that while Statement of Financial Accounting Standards No. 60 does not require discounting, it permits discounting. On this basis, we said the Statement was not inconsistent with our position that reserves should be discounted. We believe this position was correct; however, we agreed with the comment that the Financial Accounting Standards Board does not require discounting. Since FASB 60 applies primarily to issues of financial disclosure and not to the determination of taxable income, we removed all references to this Statement from the final report.

A liability for unpaid claim costs relating to insurance contracts other than title insurance contracts, including estimates of costs relating to incurred but not reported claims, shall be accrued when insured events occur. A liability for estimated claim costs relating to title insurance contracts, including estimates of costs relating to incurred but not reported claims, shall be accrued when title insurance premiums are recognized as revenue.

The liability for unpaid claims shall be based on the estimated ultimate costs of settling the claims (including the effects of inflation and other societal and economic factors), ... (FASB Accounting Standards (1982), p. 58012)

The FASB has said further that "if the time value of money is considered in estimating liabilities for unpaid claims and loss adjustment expenses relating to short-duration contracts," a disclosure is required of the "carrying amount" of such liabilities and the discount rates used. (Ibid., pp. 58012, 58025).

The FASB has specifically declined to rule on the question of whether "certain claim liabilities" of property/casualty insurers should "be discounted" (Ibid, p. 58009), but also said it is working on the question. (FASB letter 12/15/80).

These statements of FASB, which deal directly with the treatment of loss reserves, are not cited or noted in the Draft Report.

Moreover, the Draft Report's unsupported conclusion that the accounting method used by property and casualty insurers results in a mismatching of income and expenses reflects a fundamental lack of understanding of the nature of the property and casualty insurance industry and the manner in which it operates. An understanding of the special nature of insurance underwriting is essential in order to determine how the industry should be taxed.

Insurance is an institution to permit the pooling of funds by policyholders in order to share risks. Casualty insurance is fundamentally different from life insurance. In casualty insurance the risk shared by pooling relates to economic loss currently sustained.*

The essential concept 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

*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.

5 10-11 We disagree with this comment. Casualty insurance and life insurance are not fundamentally different. All insurance is based on the pooling of risk. The difference between casualty insurance and life insurance is the certainty of the event covered occurring. For casualty insurance, a loss may or may not occur during the period of coverage. For a whole life insurance policy, if it is kept in force for its full term, there is certain to be a claim at the time of the eventual death of the policyholder. Also, the time period of coverage can be different. We note that with the recent shift from whole life insurance to term insurance, the two industries are becoming more similar because both risks--death and the casualty event--may or may not occur during the term of the contract.

5 12-13 This comment regarding pooling is not entirely correct. The pooling of risk begins with the payment of premium by the insured to cover a risk that may or may not occur. The comment regarding "economic loss currently sustained" is not entirely correct, since there is a pooling of the risk before any loss has been sustained.

5 thru 14 17 The principal point made here is that all income, both premium and investment income, should be held in a pool for the benefit of policyholders until it is evident that assets are no longer needed to satisfy claims. We disagree with this conceptual approach since it would result in no tax on income until years after it was earned. In effect, this approach assumes that income does not inure to the company until all transactions are completed, while assets are earning income continuously. This investment income should be taxed as earned.

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 not to be needed and thus released from the pool ("surplus").

Tax rules must, of necessity, 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

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.

It is in light of the foregoing background that taxation of property and casualty insurers must be viewed.

The Draft Report Fails
to Take Proper Account of
the Property and Casualty
Insurance Industry's
Low Profit Margins

The Draft Report states that as of 1977 the property and casualty industry experienced the highest rate of return to stockholders' equity of the industries shown in a GAO study.

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it is clear that funds 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 of insurance protection ("unearned premiums") are still needed and are not subject to tax until "earned". Premiums that relate to the current or prior periods of insurance protection (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 have been set aside to pay out on the policyholders 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 that 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

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By 1982 the property and casualty insurance industry's profitability was the poorest of the major industrial sectors listed in the GAO study. The Draft Report concludes that, "This pattern of fluctuation in profitability is not unusual for this industry." (Dr. Rpt., p. 8).

What the Draft Report does not show is that even though the industry's profitability has historically been cyclical, the overall pattern has been that return on net worth has consistently been lower than in non-insurance industries. This is shown by a report, Comparative Profits, Property and Casualty Insurance vs. Other U.S. Industries, which was prepared by an insurance industry group and published in February, 1982. This report included the financial results of stock and mutual property and casualty insurers writing the overwhelming majority of property and casualty business for the 15-year period ending in 1980 taken from Best's Aggregates and Averages. The non-insurance industry data came from Standard and Poor's COMPUSTAT Service data base, which includes approximately 850 major companies listed on the United States stock exchanges. Each of the companies is included in one of the COMPUSTAT aggregates (i.e., industry groups), primarily according to its type of sales by product line. Each aggregate as developed by COMPUSTAT contains from two to sixty-five companies, with the majority having between five and fifteen companies included. The rate of return on net worth was the measure of profitability used for inter-industry comparisons.

9 6 These comments relate to the low profitability of the industry. Our response to comment 3 (see p. 34 of the report) indicates that while the industry's profitability overall has been somewhat lower than the profitability of all other industries combined, the differences in profitability were not great. As pointed out on p. 6 of the report, there were years when the profitability of the p/c industry was considerably higher than that of other industries. Also, we added a line at the bottom of table 2 to show the average profitability figures for 11 years for each of the industries shown.

The major findings of that report are as follows:

Over the fifteen-year period ending in 1980, the property and casualty insurance industry had an aggregate return on investment of eleven percent. For the same period, non-insurance industries (represented by eighty-six COMPUSTAT aggregates) had an average return of more than thirteen percent. Over eighty percent of the non-insurance industries had a fifteen year average return larger than insurance.

In short, as the Draft Report recognizes, the property and casualty insurance industry was in 1982 realizing an alarmingly low level of profitability. That remains the case today and current projections do not foresee an early improvement in the situation. What the Draft Report does not recognize is that even when historical upturns in profitability are taken into account, the property and casualty insurance industry has trailed behind American industry in general in profitability.

The implications of these facts are evident:

-- Given the relatively high risk involved in the property and casualty insurance industry, a higher rate of return should be expected. Thus, not only is the industry faring poorly when compared with other industries, but, when the relative risk factors of the various industries are considered, the property and casualty insurance industry's performance is even more dismal.

- 10 -

10 17 We believe the Final report does recognize accurately the profitability level of the p/c industry. We agree with the comment that "... the property and casualty insurance industry has trailed behind American industry in general in profitability." However, we do not believe the difference in profitability is great.

10 23-28 As pointed out in our response to comment 3, in our opinion p/c companies are not subject to a higher degree of risk than other companies. Our opinion is based on a recent draft of a study done by the National Association of Insurance Commissioners, which concluded the industry as a whole is not, and has not been, of above average risk.

-- Since the profitability is based on after-tax rates of return, it can reasonably be concluded that the property and casualty insurance industry should not be singled out as a target for additional tax.

The Draft Report's
Revenue Estimates

The Draft Report sets forth estimates of the additional revenues which could be raised as a result of implementing two of its three recommendations.* (Dr. Rpt., pp. 21, 27) The revenue estimates are subject to an expressed caveat--the assumption that property and casualty insurance companies' investment portfolios would remain unchanged as a result of implementing the Draft Report recommendations. The Draft Report notes, however, that the companies can reduce tax liability in several ways, and alludes specifically to the possibility of increasing investments in tax-exempt state and municipal securities, and of increasing investments in equity securities of domestic corporations. (Dr. Rpt., p. 23) There is, in fact, no reason to believe that property and casualty insurers, like other taxpayers, will not adjust their holdings of tax-exempt securities to maximize economic returns in light of all factors, including the manner in which they are taxed.

*No estimate is given for its recommendation that the Congress reexamine the rationale for the PAL account. (Dr. Rpt., p. 33)

11 1-4 Regarding the after-tax profitability, see our response to comment 3.

11 7-22 Regarding comments concerning our revenue estimates see comment 5, p. 35.

Accordingly, the Draft Report's revenue estimates may, in fact, be affected by the factors it has noted.

In addition, other factors will further mitigate the estimated revenue increases. Increases in costs to insurers will, at least to some extent, be passed on to policyholders in the form of higher premiums. Where commercial lines are involved, the higher premiums will result in greater deductions by the policyholders. The Draft Report's revenue estimates do not take this into account.

Nor does the Draft Report take into account the impact of loss carryovers that are currently available to property and casualty insurers.

Moreover, the revenue estimate relating to loss reserve discounting appears to assume that all loss reserves would be discounted. Should this not be the case, the revenue estimates would be defective in this regard as well.

Additionally, the revenue estimate relating to allocation of acquisition expenses apparently assumes that most insurance contracts are for a term of more than one year. This is not the case. This will also affect the revenue estimate.

Finally, as the Draft Report notes at page 23, any change would require a phase-in, which would further affect the

12 4-9 The report was changed on p. 19 to note that the effect on our estimates of increased liability of the "pass on" of higher taxes to insureds was considered. See our response to comment 5 of the report for a fuller discussion of this comment.

12 10-12 It is our opinion that the impact of loss carryovers would be temporary and that over time the effect of discounting loss reserves would be to increase tax revenues. See our response to comment 5.

12 13-16 We agree with the comment that if all loss reserves are not discounted, our estimates of increased tax liability would be lower. See our response to comment 5.

12 17-20 Our estimate of increased tax liability relating to the allocation of acquisition expenses did not assume most contracts were for a term of more than 1 year. See our response to comment 5.

12 21-22 Our estimates of increased tax liability were based on the assumption that the proposed change to discounting was in place and ongoing. We agree with the comment that a phase-in period would affect the revenue estimate. See response to comment 5.

13 4-11 We disagree with the comment that possible reductions in the revenues that might be raised by changes in the tax code call into question the wisdom of the report. In our opinion, the matters for consideration by the Congress, if otherwise desirable, should not be dependent on or subject to the amount of tax revenue that might be raised.

13 18 See response to comment 8 on pages 39-42 of report.

revenue estimate.*

In short, the likelihood is that the Draft Report's revenue estimates are based on factors which result in inflating those estimates. Since any revenue to be realized by implementation of the Draft Report's recommendations are likely to be substantially reduced by factors not taken into account in the revenue estimates, the wisdom of the Draft Report recommendations to radically change the basis on which the property and casualty insurance industry has operated and has been taxed for more than 60 years is further called into question.

II Comments Concerning Proposal to Discount Loss Reserves

Items Which the Draft
Report Fails to
Consider in Analyzing
Loss Reserve Deduction

1. Loss Reserves Relate to Existing Losses. Loss reserves are established by property and casualty companies only with respect to economic losses that have already

*In this regard, it is noted that the proposed new life insurance legislation does not even provide for a phase-in. Rather, life insurance companies are given a "fresh start" by which the tax resulting from the institution of deducting smaller amounts of reserves is completely forgiven.

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. If, as the Draft Report recommends, the loss were to be reduced by some discount factor, the effect would be to collapse and tax immediately the stream of income that will be realized in the future.

An example will illustrate. Assume 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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17 2

The numerical example starts at this point with the conclusions drawn from it running to the top of page 17. Since the example does not state many of the assumptions used in it, it is difficult for us to reply directly to it. For example, it is not stated when premiums are paid, how premiums are calculated and on what date the claim is paid. As pointed out in our report, the suggested discounting is for tax purposes only, discounted reserves would be applicable only at the end of the taxable year (also calendar year), and the discounting would only be for the period from the end of the year to the date of claim payment. Only in the case of a claim incurred on December 31 of 1 year with payment on the next December 31 would the period of 1-year discounting used in the commentator's example apply.

The comment states on page 16, line 16 that discounting would tax income to be earned in the future before the time it is earned. However, if a premium of \$100 is received 1 year before the claim is paid, then the discount, \$9.09, represents implicit interest income earned by the insurer at the time the premium is paid. In our opinion this should be taxed when received, as well as any explicit interest income earned on the investment of the premium funds after that point.

Let's take the same example used by the commentator and extend it to cover specific claim and payment dates, June 30 of 1 year for occurrence of the claim and June 30 of the next year for payment. The insurance company would have \$9.55 taxable income in the first year, composed of \$100 premium plus interest of \$4.89 for 6 months and less the reserve deduction of \$95.34 (\$100 discounted for 6 months). At a tax rate of 46 percent the tax on the \$9.55 would be \$4.39. At the end of this first year the insurance company would have assets of \$100.50 (\$100 premium plus \$4.89 interest less tax of \$4.39). Interest on \$100.50 for 6 months (to the date of claim payment) would be \$4.91. Therefore, there would be \$105.41 (\$100.50 + \$4.91) to meet the claim payment of \$100.00.

Let's now assume that the premium charged is \$90.91 rather than \$100.00, with other assumptions remaining the same. The taxable income in the first year would be 0--\$90.91 premium plus \$4.43 interest less reserve deduction of \$95.34. The company will start the second year with assets of \$95.34, will earn \$4.66 interest in the first 6 months, and will have assets of \$100 to meet the \$100 claim.

For further discussion of these comments see response to comment 8.

immediately 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

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

Finance which concluded that the current tax rules permitting insurance companies to deduct the undiscounted estimate of their future claims are seriously flawed.

Noting that Treasury may be rethinking this analysis, Mr. Sunley states:

Treasury supports its conclusion with a technical appendix which is a reworking of the appendix from the mining reclamation testimony. This appendix, however, is not applicable to the insurance case.

Casualty insurance in the simplest case involves the payment of a premium to cover losses incurred during the year. The actual payment of claims may be made over a period of years. A reasonable tax treatment of casualty insurance must recognize that a loss has taken place during the year of the insurance coverage. For a proper matching of income and expense, that loss should be deductible by someone that year. . . .

Consider now the two Treasury alternatives for the world where insurance companies pay out casualty claims over several years. If the deduction is deferred until the insurance company actually pays the claims, there is a mismatch between the time when the loss is incurred and the time at which someone, in this case the insurance company, is able to take a deduction for the loss. If, instead, the insurance company takes a deduction up front for the discounted present value of the future payment, the full amount of the loss is never deductible. The logical implication of the Treasury position would be to permit the insured to the extent casualty losses are deductible, to take a current deduction for the difference between the claim payment expected in the future and the present value of that claim.

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

In a recent article, "Observations on the Appropriate Tax Treatment of Future Costs," Tax Notes, February 20, 1984, Mr. Emil M. Sunley, Deputy Assistant Secretary of the Treasury for Tax Analysis from 1977 to 1981, critiqued testimony by the Department of the Treasury before the Senate Committee on

"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.

19 20 The final report was changed on p. 2 to indicate that we considered the impact on foreign competition beyond the scope of the report. This issue should be weighed by legislators in making decisions of tax policy. See our response to comment 7, p. 38 of the report.

These present value calculations could lead to significant IRS/taxpayer disputes. Current law, which permits a current deduction by the insurance company for the expected claim, probably is a workable procedure. Insurance premiums should be set to reflect the fact that the full loss is deductible by the insurance company and no part of the insured loss is deductible by the insured even though the claim is paid after a lapse of several years.

* * *

In the case of the casualty insurance testimony, Treasury failed to recognize that a casualty loss occurs during the year of the insurance coverage. That loss should be deductible that year if income and expenses are going to be matched properly. (Emphasis added)

(A copy of Mr. Sunley's article is attached as Exhibit A.)

2. Impact on foreign competition. Discounting of loss reserves would seriously disadvantage the domestic insurance industry in its competition with foreign insurers. Insurance is a highly portable international business. Substantial plants and equipment are unnecessary. 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 loss 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. The Draft Report gives no indication that this fact was taken into account.

3. Increase in non-insurance, self-insurance and captives. The substantial increase in the cost of doing business for the property and casualty insurance industry resulting from the discounting of loss reserves would of necessity have to be passed on to the consumer of insurance services. This could result in increasing numbers of individuals being unable to purchase insurance and companies being forced (or electing) to self-insure. The social costs are self-evident--increasing numbers of victims of the types of injuries covered in long-tail lines (such as automobile bodily injury and occupational disease claims) will not be compensated for their injuries.

The increasing costs could also accelerate the trend toward increased use of captive insurers. Given the problems which the Internal Revenue Service already faces in dealing with captives, this result can hardly be viewed favorably. Moreover, it could result in upsetting the current competitive balance to the disadvantage of small insurers, since it is precisely those insurers that are likely to be most severely impacted by the increased costs and complexities which discounting would entail.

4. Impact on state solvency regulation. The Draft Report asserts that "there is no inherent conflict posed to

20 3-23 The extent of the increases referred to in this comment cannot be evaluated in advance, and we believe them to be beyond the scope of this report. The factors that would influence such increases appear to us to be multiple and should not be attributed solely to any changes in the tax code.

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thru

21 3 The specific statement referred to in the draft report by this comment has been deleted from the final report. We feel the statement, while accurate, was capable of misunderstanding.

21 4-26 Basically, this is the same as the comment made on pp. 5-8, that income for a p/c insurance company does not emerge until after the insurance contract is terminated. As pointed out in our response to the earlier comment, we disagree with this perception. The deferral of tax until contract termination would result, in our opinion, in the unjustified deferral of taxation.

protection of the public interest by adopting an alternative method of income measurement solely for purposes of taxation." (Dr. Rpt., p. 12) This assertion ignores the real world.

Although in the abstract discounting for tax purposes need not dictate discounting for financial or regulatory purposes, in the real world 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.

22 1-22 The report states clearly that it is concerned only with the measurement of deductions allowed for tax purposes. We expressly stated on p. 2 of the report that we did not consider "the appropriateness of financial reporting requirements of any regulatory body or accounting standards-setting body . . ." In our opinion, the question of measuring reserves for tax purposes can and should be separate and apart from measuring reserves for solvency or regulatory purposes. If this is borne in mind, the example of an insolvent company trying to use tax discounted reserves to stave off insolvency could not occur. The only way it could occur would be if state solvency regulations were changed to require discounting. We take no position on this.

22 23

25 32 The issue of reserve inadequacy is covered in our response to comment 1, pp. 31-32 of the report. GAO is not in a position to either agree or disagree with the conclusion of the President of Insurance Service Office, Inc. that reserves are currently inadequate. However, as stated in our response to comment 1, we feel that a proposal to correct an inappropriate measure of taxable income should not be dismissed on grounds that are unrelated to the measurement of taxable income. The various state insurance departments are responsible for ensuring that inadequate reserves are strengthened. We note that in the May, 1984 issue of Coopers & Lybrand Insurance Newsletter, the President of Insurance Service Office stated ". . . a number of companies have strengthened their loss reserves in the fourth quarter of 1983 . . ." He also indicated that prices for insurance products are becoming more stable and have moved upward to meet higher losses. During June 1984, the same industry expert, in an address to the Association of Insurance and Financial Analysts in New York City, said, "The turn in the underwriting cycle is started." He is also quoted as being "very bullish on the industry" for the long term.

Regulators will be operating in a climate where managements are wishfully thinking, with Congress' blessing, that they really do not need to reserve at the level required by state regulators. An irresistible force in favor of reducing reserves for all purposes will have been turned loose.

A dramatic example of an instance in which the impact of discounting reserves might be felt by state regulators is when they seek to take over a company deemed by them to be in financial straits. If the Congress has concluded (even if only for tax purposes) that a company only needs to reserve a discounted amount for paying losses, the subject company could (and will) argue in court that it is not really impaired or insolvent. The argument would be that the regulator is not looking at the company's financial posture correctly--that it need only reserve for losses on a discounted basis rather than on the full-reserve basis uniformly required by state regulators. This argument is made even now. It will be made more frequently, and with more weight, if the Congress should sanction a new method of determining what a company must hold aside to pay its obligations. Even if regulators should ultimately win, they will be in court repeatedly, in 50 states, for years, until the standards are hammered out.

5. Experts assert that reserves are already inadequate. The loss reserves established by the property and

casualty insurance industry are already said to be seriously deficient. This fact has most recently been remarked upon by Mr. Daniel J. McNamara, President of Insurance Service Office, Inc. * Mr. McNamara stated:

The risk of loss reserve deficiency is critical, as it directly reduces surplus.

We've studied the aggregate loss reserves of the 200 companies that write over 90% of the business and make up A.M. Best Company's Casualty Loss Reserve Development Report. Our studies reveal very disquieting patterns. We've examined the development of paid losses by accident year for the five Schedule P lines that represent 90% of all loss reserves. These lines of insurance comprise general liability; multi-peril, including homeowners; automobile liability; workers compensation; and medical malpractice. Based on our analyses, we conclude that the industry's total loss and loss expense reserves, as of December 31, 1982, are inadequate by more than 10%.

* * *

The industry's complete financial results for 1983 aren't yet available. But the results for the first three quarters of 1983 show no strengthening of loss reserves. In fact, the industry's loss reserves increased in that period at an

*The Insurance Service Office ("ISO") is the national rate and advisory organization for property and casualty insurers. Its primary aims are (1) to gather, store and disseminate statistical and other information to regulators as required by law, and to insurers for their own use, and (2) to develop and assist in implementing programs that help define and cover risks and promulgate advisory rates.

annual rate of only 8 percent, continuing the slowdown in the rate of increase that we've seen in recent years. That 8 percent annual rate of increase would be the lowest rate of increase in loss reserves in 20 years.

* * *

The industry's financial position looks even worse, when you consider current and prospective commercial lines underwriting results. For all commercial lines of insurance, we estimate the combined ratio* to be at least 115 for 1983, and we see no improvement in 1984. For three key ISO lines, the results, to say the least, will be very poor.

For General Liability, the combined ratio was 116 in 1981 and 129 in 1982. We estimate 137 for 1983 and forecast the same level in 1984. Given an industry combined ratio of 137, assuming reasonable payout patterns and an investment yield of 8.5%, insurers will lose 4 cents on every dollar of General Liability premium that they write this year. That is after investment gains but before taxes. This 4% negative rate of return can only come out of policyholders' surplus.

For Commercial Automobile, the combined ratio was 112 in 1981 and 119 in 1982. We estimate 120 for 1983 and forecast no improvement in 1984. If the industry continues to write at this composite ratio of 120, it will lose 6 cents on every dollar of Commercial Automobile premium written in 1984 -- again after investment gains but before taxes.

*The "combined ratio" refers the ratio of losses and expenses to premiums. A combined ratio of 100% means that premiums are sufficient to cover losses and expenses exactly. A combined ratio in excess of 100% means that losses and expenses exceed premiums by the percentage indicated.

25 24-32 The examples of reserve strengthening referred to in lines 28-32 are undoubtedly instances of the actions referred to in the interview cited in the preceding response.

Let's look at Commercial Multi-Peril. The combined ratio was 107 in 1981, 116 in 1982, and we estimate 120 for 1983. If there is any improvement in 1984, it will be slight. If the industry continues to write at this combined ratio of 120, it will lose 6 cents for every dollar of Commercial Multi-Peril premium written in 1984 -- again based on reasonable assumptions of payout patterns, investment yield, and ignoring tax implications.

For each of these three major Commercial lines, we are forecasting a negative rate of return in 1984. These 3 lines represent 40% of the total commercial premium volume and must lead to a drain on policyholders' surplus. This drain will aggravate the significant drain on surplus that will occur when the inadequacy of present reserves becomes painfully evident over the next few years.

(The complete text of Mr. McNamara's speech is attached as "Exhibit B".)

One needs look no further than a recent issue of the Wall Street Journal to find concrete examples of substantial insurance companies that have had to face up to adding significant amounts to loss reserves which had been grossly inadequate. Thus, the Firemen's Fund Insurance Co. found itself in the position of having to add \$230 million to its loss reserves. And the Arco Insurance Group, Inc. had to add \$180 million to its reserves. (Wall Street Journal, P. 3, January 31, 1984).

It is particularly ironic that at a time when the industry's loss reserves are viewed by knowledgeable observers as being seriously deficient, the General Accounting Office should recommend that Congress consider taking steps which would inevitably lead to exacerbating the reserve deficiencies.

Moreover, if a company should conclude that its reserves are inadequate, any attempt to bring those reserves to an appropriate level at a time when discounting has been required for tax purposes will inevitably result in assertions by IRS revenue officers that the reserve increases are motivated by an attempt to mitigate the effects of discounting for tax purposes. Companies will thus be discouraged for acting in a manner which is responsible.

6. Discounting would be a nightmare for taxpayers and the IRS 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 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.

26 1-5 As stated earlier, our position is that discounting loss reserves for tax purposes is independent of measuring reserves for solvency or regulatory purposes. If loss reserves are now deficient, as would appear from reliable industry sources, we feel they should be strengthened. However, if discounting is considered to be advisable for tax purposes, it should be legislated whether or not companies or regulators see that loss reserves are strengthened, weakened, or maintained at current levels.

26 6-13 While this observation is speculative, it raises the issue of the adversary nature of tax administration. Reserve strengthening, whether the reserve is discounted or not discounted, is an increase in a tax deduction that would merit the attention of the IRS. The added incentive to strengthen discounted reserves will no doubt be obvious to any IRS examining agent. Any additional attention an examining agent may give to such reserve strengthening may increase the accuracy of the tax return. We do not feel that decisions to make changes in the tax code should be influenced by the anticipation by taxpayers of increased suspicions of IRS examining agents.

26 14-24

27 thru 1-6 We referred earlier in our response to comment 2 to the question of the determination of the rate to be used for discounting as well as the schedule by which claims might be expected to be paid. In our opinion, the determination of the discount rate to be used is similar to the method used by life insurance companies for 25 years. We disagree that the IRS does not have the resources to evaluate loss reserve determination. We do not believe this comment raises issues sufficient to discard proposals intended to properly measure taxable income.

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 involve judgments, based on an array of statistical data). Endless controversy would be sure to result.

7. Property and casualty insurance is different from life insurance. A life insurance 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 life 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

27 7. The point of this comment is that because there is no
thru 17 savings element which inures to the policyholder (as there is in
whole life insurance) there should be no tax on the earnings of
reserves between the time they are established and the time the
claim is paid. We disagree, and we believe these earnings
should be taxed. However, loss reserves adjusted for the time
value of money are a legitimate deduction for tax purposes.

28 22
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29 3 The definition of "reserves" in the glossary of the report has been changed to reflect this comment.

"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 property and 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. Rather, the property and 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.

Errors in the Draft
Report Concerning
Discounting of Loss
Reserves

1. The Draft Report defines "reserves" as

"funds set aside by an insurance company for the purpose of meeting obligations as they fall due. Liabilities set up by an insurer for a particular purpose."

This definition is incomplete. It does not recognize that reserves represent the estimated unpaid portion of losses which have already occurred.

2. The Draft Report states that, in the case of a growing company, the year-end loss reserve will generally exceed the beginning of the year reserve. It concludes from this fact that income will therefore be distorted. (Dr. Rpt., P. 14). No basis is provided for concluding that any relationship exists between an increase in loss reserves and a distortion in income. The fact that loss reserves have increased has no bearing on whether income is properly reflected. Similarly, a reduction in loss reserves would not indicate that income has been overstated.

3. The Draft Report confuses the payment of an expense with the accrual of the expense. This suggests a misunderstanding of accrual-basis accounting. The Draft Report refers to losses for events which have already occurred as "a future expense." (Dr. Rpt., P. 14). This demonstrates a misunderstanding of the term "expense". The reference to "future expense" is misleading.

4. On pages 15-20, the Draft Report sets forth an example which is intended to demonstrate the propriety of discounting. The example is wholly unrealistic in that it assumes that premiums would be set at the same level whether or

29 4-13 The report was changed on p. 11 to reflect this comment.

29 14-20 The report was changed on p. 11 to reflect this comment.

29 21 thru

30 6 See response to comment 4, p. 35 of the report.

30 7
thru
31 14 See response to comment 2.

not loss reserves are discounted. Since discounting would result in imposing greater costs on property and casualty companies, premiums would be lower where loss reserves are not discounted. By failing to recognize this fact, the example in the Draft Report is fatally flawed and cannot be relied upon to prove the point which it purports to illustrate.

5. The Draft Report expressly recognizes that

[t]he earnings rate, and hence the discount rate, of an insurer's portfolio of earnings assets is not known with certainty, just as future interest rates are not known. (Dr. Rpt., p. 20).

The Department of the Treasury, in its testimony before the Committee on Finance, United States Senate, June 13, 1983, also recognized that discounting loss reserves would present substantial problems:

92

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. (Testimony of Hon. John E. Chapoton, Assistant Secretary for Tax Policy, Department of the Treasury, S. Hrg. 98-339, p. 45, June 13, 1983).

Despite the recognition of the problems inherent in selecting an appropriate discount rate and in determining when

claims will be paid, the Draft Report proposes statutory language to make those determinations without ever considering or explaining why the methodology proposed is the best or most workable. For example,

-- The "average discount rate" is defined to be "the average rate of return on the company's investment assets for the current taxable year and the four preceding taxable years, or for all preceding taxable years in which the company filed returns but not to exceed four." (Dr. Rpt., p. II-3) Does anyone think that the rate of return during the recent inflationary period will be an accurate barometer of rates of return in the future?

-- Is there any basis for selecting a five-year period, rather than some shorter period?

-- "Discounted unpaid losses" are defined to mean the sum of (i) net losses unpaid and (ii) unpaid loss adjustment expenses.

-- What is meant by "net" losses unpaid?

-- Allocated loss adjustment expenses have a payout rate different from the payout rate for related losses. Is the discounting

- 31 -

31 15-16 The 5-year period was selected because the same period has been used for a similar calculation in taxation of the life insurance industry for 25 years. The actual period to be used could either be this 5 years or a different period to be established by legislation or regulations.

31 20 "Net losses unpaid" means the difference between year-end and year beginning unpaid losses.

31 21 thru

32 4 We recognize that matters such as these must be decided; however, details of this nature should be the domain of IRS regulations and are beyond the scope of this report. In our opinion, however, they are feasible.

32 5-9 This comment is also the domain of IRS regulations; however it seems to us that different payout patterns should be recognized for the varying lines.

32 10-17 Again, this is a matter for IRS regulations.

32 18-23 See response to comment 2. In our opinion, differences in discount rates among companies will reflect different investment earning experience. All other things being equal, companies with good investment practices will pay higher taxes because they earned more. This appears to us to be a normal result.

period to be different for losses and loss adjustment expenses?

-- How are unallocated loss adjustment expenses to be discounted?

-- Different lines of insurance have different payout patterns--for example, medical malpractice typically has a longer tail than Auto BI. Is the discounting period to be determined separately for each?

-- The same line of insurance has different payout patterns depending upon factors such as geography. For example, workers' compensation payments in Illinois may be subject to a different payout pattern than the same line in another state.

-- Are these differences to be taken into account?

-- What competitive impact will company-by-company discount rates have in the industry? Will large companies be advantaged over small insurers? Or vice-versa? Should companies with good investment practices be penalized through the allowance of smaller loss deductions?

33 1-5 See response to comment 2. The assumption we made was
that prior payout patterns are a valid basis for projecting
future payout patterns.

33 6
thru 5 The report and legislative language were changed to
36 eliminate from the definition of acquisition expenses those
items about which there is some question as to whether they
should be allocated.

-- As Mr. Chapoton noted, companies are not
currently required to determine when claims will
be paid in the future. Is there any basis for
assuming that prior payout patterns are a valid
basis for projecting future patterns?

III
Comments Concerning
Proposal to Allocate Acquisition Expenses

Items which the
Draft Report Fails
to Properly Consider

1. The Draft Report indicates at p. viii that the
GAO is concerned not only with "expenses directly related to
the solicitation and procurement of business, such as agents'
commissions" but also "elements of overhead such as developing
a sales staff, and policy servicing expenses such as
reconciling records related to premiums." This is enlarged on
page 26 to include:

"... activities related to developing a
sales staff, writing policy contracts,
receiving and paying premiums and
commissions, collecting premiums from agents
and insureds, reconciling records relating
to premiums, compiling expiration lists and
notices of premiums due, and paying
commissions and allowances to agents,
brokers, and employees."

Furthermore, the draft legislative language on page II-5 states
that acquisition expenses to be deferred would include not only

"commissions and allowances paid to agents, brokers and employees," but "the expenses of writing policy contracts, receiving and paying premium and commissions, collecting premiums from agents and insurers, and advertising." This would seem to go both beyond the GAAP standards promulgated by the Financial Accounting Standards Board and beyond the provisions of the Internal Revenue Code applicable to other taxpayers.

Financial Accounting Standards Board Statement 60 in requiring that "acquisition costs . . . be capitalized and charged to expense in proportion to premium revenue recognized," defines "acquisition costs" as those that "vary with and are primarily related to the acquisition of new and renewal insurance contracts." (Emphasis added) The only examples provided are "agent and broker commissions," "salaries of certain employees involved in the underwriting and policy issue functions," and "medical and inspection fees." (FASB Accounting Standards (1982) pp. 58011, 58017 and 58027). It is specifically stated, in fact, that "cost incurred during the period, such as those relating to . . . general administration and policy maintenance that do not vary with and are not primarily related to the acquisition of new and renewal insurance contracts, shall be charged to expense as incurred." (Ibid., pp. 58011, 58016) Thus, general overhead items, policy servicing, and advertising would be specifically excluded under the FASB rules.

Furthermore, the regulations under the Internal Revenue Code provide as to taxpayers generally there is "not required to be included for tax purposes in the computation of the amount of inventoriable costs (regardless of their treatment by a taxpayer in his financial report)" but can be deducted as current expenses:

- "(a) Marketing expenses,
- "(b) Advertising expenses,
- "(c) Selling expenses,
- "(d) Other distribution expenses,

* * *

"(l) General and administrative expenses incident to and necessary for the taxpayer's activities as a whole, rather than to production or manufacturing operations or processes, and

"(m) Salaries paid to officers attributable to the performance of services which are incident to and necessary for the taxpayer's activities taken as a whole rather than to production or manufacturing operations or processes." (Regs. § 1.471-11(c) (2) (ii))

In addition, in Rev. Rul. 68-561, 1968-2 C.B. 117, it was held that salaries paid to sales representatives and advertising "are less directly and significantly productive of intangible assets having a value extending beyond the taxable years in which they were paid or incurred" and "may, therefore, be treated as ordinary and necessary business expenses deductible

under § 162 of the Code." In the situations described in the regulations and the ruling no income is taxed until the inventory is sold or other services rendered. There is no reason why property and casualty insurers should be singled out for different treatment.

2. Nature of the Insurance Business. The Draft Report states that "An insurance company receives premiums in advance." (Dr. Rpt. 26) The Draft Report also states that "insurance contracts frequently extend for two or more years" (Dr. Rep. P. 15) and postulates an example in which the insurance company receives a premium payment that is for a 3-year insurance contract. (Dr. Rpt. 27) In fact, neither of these situations reflects current trends. An ever increasing proportion of premiums is not received in advance. Rather, premiums are being paid in installments over the term of the policy. And the multi-year policy has largely gone the way of the dinosaur--few policies are being written by property and casualty insurers which exceed one year in duration. In fact, a huge proportion of personal line policies--such as automobile coverages--is being written for terms of less than one year in duration.

3. Competitive Impact. Property and casualty insurer operations vary dramatically from company to company. Some company's sell through an independent agency force; others

36 6 The report was changed to eliminate references to multi-year policies.

36 22

37 thru 7 The differences that companies experience with respect to the cost of doing business is not, in our opinion, a factor that should influence legislative action to change taxes.

operate exclusively through the mails. Hence, the portion of their expenses which relate to sale of the insurance product will vary dramatically. Therefore, any change in the tax treatment of those "acquisition expenses" which do relate to sales of insurance have the potential for causing serious competitive disruptions. The Draft Report gives no consideration to this fact.

IV
Comments Concerning
Proposal to Reexamine Rationale for PAL Account

Items Not Properly
Considered in the
Draft Report

1. The PAL Account Has Served Its Intended Purpose.
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 account 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.

The Draft Report discounts as "debatable" the rationale that the Protection Against Loss Account is justified by the fact that mutual companies, unlike stock companies, "... lack access to the capital market for funds with which to pay losses." (Dr. Rpt., p. 30) The Draft Report criticizes the rationale because it "assumes implicitly that stock companies, if faced with a catastrophic loss, could issue securities in the capital market to obtain funds, whereas mutuals cannot." It goes on to say that "if a stock company were to suffer a catastrophic loss exceeding its recoverable reinsurance and its policyholder surplus, it is questionable whether it could successfully offer securities in the capital market." (Dr. Rpt., p. 32) This misses the point. Stock companies are able to build up their net worth from capital provided by stockholders prior to the occurrence of catastrophic losses, not after such losses occur. In short, they have a "cushion" of invested capital to fall back on in the event of a catastrophic loss, which mutual companies do not have. It is for purposes of providing a similar cushion that the PAL account was created.

38 5-24 In recognition of the comments concerning the building up of capital and surplus by a stock company prior to the occurrence of catastrophic losses, we deleted the references to same on p. 32 of the draft report. The response to comment 9, pp. 43-44 of the final report covers this matter in more detail.

Surveys of member companies of the Associations show that the PAL deduction has served the purpose for which it was intended. More importantly, the PAL deduction has allowed many smaller companies--particularly small regional mutuals writing business in a limited geographical area which are exposed to risks from local catastrophes--to stay afloat.*

2. PAL Account Puts Small Mutuals on a More Competitive Footing With Stock Companies. The ability of a company to write insurance, and therefore to grow, is limited by its capital and surplus. Small stock companies have access to capital markets and thus can look outward for infusions of capital necessary for growth. Small mutual companies, on the other hand, have no such access to outside sources of capital. The PAL deduction permits small mutuals to retain in surplus amounts which, in absence of the PAL account, would be paid out in taxes. The elimination of the PAL deduction could seriously undermine the ability of small mutual companies to compete with stock companies. The Draft Report does not consider this potential impact.

3. Little Tax Revenues Would Be Gained From Eliminating the PAL Account. The Draft Report does not estimate the tax revenue consequences of the PAL provision.

*It is precisely these small regional companies which, as noted above, the GAO has apparently excluded from its study.

39 1-19 Information on PAL accounts is available only from tax returns, and is not reported by Best's. In addition, Best's publications do not give information on smaller companies. Accordingly, we could not adequately evaluate the tax returns of small companies. To the extent that smaller companies may still need the help of the tax deferral inherent in the PAL account, it would seem that this is something that Congress could take into account in any reconsideration it gives to this matter.

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40 6 We are unable to estimate the tax liability consequences of the PAL provision. In our opinion, this should not necessarily be the deciding factor in whether the Congress should reexamine the need for the PAL account, if it can be determined that for most companies it is no longer serving the purpose for which it was enacted.

OBSERVATIONS ON THE APPROPRIATE TAX TREATMENT OF FUTURE COSTS

by Emil M. Sunley



Studies done by the Association indicate that no significant tax revenue would result from elimination of the PAL account. On the other hand, elimination of the PAL deduction would likely result in substantial disruptions and distortions in competition between stock and mutual insurers. The Draft Report fails to weigh these facts.

CONCLUSION

The Associations appreciate the opportunity extended by the General Accounting Office to comment upon the Draft Report. The Associations will be pleased to discuss their comments with the staff of the GAO.

Respectfully submitted,

Alliance of American Insurers
National Association of
Independent Insurers
National Association of Mutual
Insurance Companies
Reinsurance Association of
America

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In this article, Sunley critiques recent Treasury testimony relating to the tax treatment of mining reclamation costs and loss deductions claimed by casualty insurance companies. As Sunley points out, the questions raised by that testimony have important implications for similar questions arising in connection with the tax treatment of expenditures for product liability and warranty claims, nuclear power plant decommissioning costs, and the costs of dismantling offshore oil rigs.

While agreeing that the Treasury's analysis of future cost issues is correct in the case of ordinary business expenses, Sunley concludes that Treasury is incorrect when a future payment is an investment outlay that must be incurred if income is to be earned currently. He also concludes that Treasury's analysis of the appropriate tax treatment of casualty insurance companies is incomplete.

Recent Treasury testimony has focused on the time value of money in determining the appropriate tax treatment of certain future payments. For example, Treasury has opposed mining companies taking a current deduction for estimates of future reclamation payments. Treasury has also opposed casualty insurance companies taking a current deduction for future outlays.¹ Instead, Treasury has suggested that delaying the deduction until the expense is actually paid always produces the correct result. Alternatively, Treasury has suggested that taxpayers could be allowed a current deduction for the discounted amount of the future outlay. The future outlay would be discounted at the after-tax discount rate, and no further deduction would be allowed.

¹Statement of John E. Chapoton, Assistant Secretary of the Treasury (Tax Policy), on December 7, 1982, before the Subcommittee on Energy and Agricultural Taxation of the Senate Finance Committee. See also, the Statement of William S. McKee, Acting Deputy Assistant Secretary of the Treasury (Tax Policy), on May 23, 1982, before the same subcommittee. ²Statement of John E. Chapoton, Assistant Secretary of the Treasury (Tax Policy), on June 13, 1983, before the Senate Finance Committee.

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- 40 -

The Treasury testimony has broad implications not only for the tax treatment of mining reclamation expenses and casualty insurance liabilities, but also for the tax treatment of expenditures for product liability and warranty claims, costs of decommissioning nuclear power plants, and the costs of dismantling offshore drilling rigs. The general thrust of the Treasury testimony on the "premature accrual" of future liabilities has been accepted by the Joint Tax Committee. Last June in a pamphlet prepared for the Finance Committee, the Joint Committee suggested that the

"accrual rules could be amended to provide that an expense is not currently deductible unless the recipient of the payment is known and the taxpayer has a present liability to make the payment. Another alternative would be to require taxpayers to report certain deferred payment transactions using the cash method of account."¹

The Committee on Taxation of the New York City Bar Association also recently examined the tax treatment transactions involving deferred payment of accrued liabilities.² The Committee concluded that (1) substantial economic distortions may be produced under existing law in some important cases, (2) this subject deserves urgent attention, and (3) legislative solutions may be required.

In this paper, no attempt is made to provide a comprehensive survey of the appropriate tax treatment of future outlays. Instead, the focus is on the analysis contained in the Treasury testimony relating to mining reclamation and casualty insurance. To anticipate the conclusion, the

¹Joint Committee on Taxation, "Background on Tax Shelters," Joint Committee Print, June 23, 1983, p. 18.

²Committee on Taxation of the Association of the Bar of the City of New York, "Transactions Involving Deferred Payment of Accrued Liabilities: Federal Income Tax and the Time Value of Money," Tax Notes (August 28, 1983), pp. 698-714.

Recent Treasury testimony on mining reclamation and casualty insurance has confused the issue of the appropriate tax treatment of future costs.

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Exhibit A

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Treasury (and the Joint Committee) analysis is correct when the future payment is an ordinary and necessary business expense, but the analysis appears to be incorrect when the future payment is an investment expenditure that must be incurred in the future if income is going to be earned currently. Moreover, the Treasury analysis of the appropriate tax treatment of casualty insurance companies is incomplete and incorrect, because consideration was not given to the appropriate tax treatment of the insured.

What follows is a simple example of an investment that yields positive cash flow for a number of years and then requires a significant outlay at the end. The example is used to examine the appropriateness of alternative tax treatments of the final outlay. This example could represent an investment in surface mining, a nuclear power plant, or an offshore oil rig.¹ These investments have significant negative salvage value; that is, the costs paid at the end for reclaiming, decommissioning, or dismantling exceed the value of the salvageable materials. It should be noted that the positive cash flows cannot be earned without incurring the negative outlay at the end. For example, to obtain the positive cash flows from a nuclear power plant the plant must be turned on. Once it has been turned on, some type of decommissioning will be required at the end of its operating life. Similarly, once land has been disturbed by surface mining, state and federal environmental laws require mining companies to reclaim it.

Consider a \$3,000 investment that yields positive cash flow of \$1,000 per year for five years and then requires "dismantling" expenses of \$1,401. This investment in a world without taxes would have an internal rate of return of 10 percent as shown below.

TABLE 1

Year	Cash Flow	Present Value (<i>r</i> = .10)
1	\$1,000	\$909.09
2	1,000	826.45
3	1,000	751.32
4	1,000	683.02
5	1,000	620.92
5	-1,401	-780.92
		\$3,000.00

Economic Depreciation

The issue concerns the appropriate tax treatment of the final outlay of \$1,401. Treasury has argued that this outlay should be expensed in the year paid, I suggest that a proper matching of income and expense requires that the final outlay be "depreciated" over the life of the investment. Tax depreciation (or capital "recovery") is neutral, as Paul Samuelson has shown, if (and only if) the true loss of economic value is permitted as a tax-deductible depreciation expense.² Moreover, if economic depreciation is allowed, the effective tax rate is equal to the nominal tax rate.

¹It does not represent the case of casualty insurance, which is discussed later.
²Paul A. Samuelson, "Tax Deductibility of Economic Depreciation to Insure Invariant Valuations," *Journal of Political Economy* (December 1964).

Economic depreciation can be determined by discounting for each year the remaining before-tax cash flow to the beginning of that year using the before-tax discount rate.³ Economic depreciation is then equal to the change in the present value of the future cash flow.

TABLE 2

Year	Cash Flow	Present Value of Future Cash Flow Discounted to Beginning of Year (<i>r</i> = .10)	Depreciation ⁴
0	-\$3,000	\$3,000.00	
1	1,000	2,299.95	\$700.05
2	1,000	1,529.95	770.00
3	1,000	982.95	847.00
4	1,000	-248.77	931.72
5	1,000	-1,273.64	1,026.87
6	-1,401	-1,401.00	127.36
			\$4,401.00

⁴Equal to the change in the present value of the future cash flow.

The interpretation of the third column of Table 2 is fairly straightforward. At the end of year 0, someone would pay \$3,000 for this investment. At the end of year 1, once the first \$1,000 of positive cash flow has been realized, someone would pay only \$2,299.95 for the future cash flow. At the end of year 4, the value of the future cash flow has become negative. That is, the owner of the investment would have to pay someone to take the investment off his hands. The reason for this, of course, is that the present value of the future detriment (the \$1,401) is greater than the present value of the future positive cash flow—the \$1,000 at the end of year 5.

The Treasury... analysis is correct when the future payment is an ordinary and necessary business expense, but the analysis appears to be incorrect when the future payment is an investment expenditure....

It should be noted in the last column of Table 2 that economic depreciation permits \$4,401 of capital recovery over the life of the project. Put another way, economic depreciation spreads the \$3,000 initial investment plus the \$1,401 final outlay over the life of the investment. One might view this result as similar to what accountants call "negative salvage value depreciation" where the depreciable base is equal to original cost less salvage value. If the salvage value is negative, the depreciation allowed over the life of the investment is greater than the original cost. It is equal to the original cost plus the negative salvage value.⁵

³It can also be obtained by discounting the after-tax cash flow by the after-tax discount rate.

⁴Whether negative salvage value depreciation would be neutral would depend on the timing of these deductions, not just the amount.

Table 3 demonstrates that if economic depreciation, as calculated in Table 2, is allowed, the effective tax rate is just equal to the nominal tax rate. For purposes of Table 3, a 50 percent tax rate is assumed. The after-tax rate of return is now 5 percent, which is just half of the 10 percent before-tax rate of return.

TABLE 3

Year	Before-Tax Cash Flow	Economic Depreciation	After-Tax Cash Flow ¹	Present Value (<i>r</i> = .05)
1	\$1,000	\$700.05	\$450.02	\$809.54
2	1,000	770.00	885.00	802.72
3	1,000	847.00	923.90	797.77
4	1,000	931.72	985.85	794.28
5	1,000	1,026.87	1,024.87	793.55
6	-1,401	127.36	-85.68	-51,045.15
				\$3,000.00 ²

¹Equal to the change in the present value of the future after-tax cash flow.

²Equal to (1-m) × PV, where m is the marginal tax rate. If, as the Treasury assumes, economic depreciation is allowed, it is also the depreciation allowed for tax purposes.

³Equal to the present value of \$1,401 discounted at 5 percent. The final outlay has no tax effect inasmuch as it has been depreciated over the life of the investment.

⁴The present value of the cash-flow is just equal to the initial investment.

The Appendix, *infra*, further explores the appropriate tax treatment of an outlay for mining reclamation or nuclear decommissioning. The criterion in the Appendix is neutrality between a normal investment (where the investment outlay is made only at the beginning of the project) and a negative salvage value investment (where a significant outlay is made at the end of the project).

Expensing—The Treasury View

The Treasury, as indicated above, maintains that expensing is the appropriate tax treatment of a required final outlay such as the cost of mining reclamation.⁶ The Treasury argument, however, is faulty. Treasury's criterion for the appropriate tax treatment is a rule which would ensure that the amount charged by the seller reflects no more than the resource cost of completing the transaction. Treasury first assumes that in a world without taxes the discount rate is "1." When taxes are introduced, Treasury makes a fatal error when it assumes that the after-tax discount rate in the world with taxes is the same as the discount rate in the world without taxes. This assumption forces the conclusion that expensing or its equivalent (in present value terms) is required if the amount charged by the seller is not going to rise.⁷ Expensing or its equivalent ensures that the before-tax and after-tax rates of return are equal. The effective tax rate is zero.

In contrast, if Treasury had assumed that the after-tax discount rate falls to (1-m) times the discount rate in the

⁵See testimony of John E. Chapoton, December 7, 1982, particularly the Appendix to that testimony.

⁶Actually, if companies can borrow at the before-tax discount rate and interest expense is deductible for tax purposes, companies will be able to lower their prices in a world with expensing compared to the world without taxes.

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world without taxes where "m" is the tax rate.⁸ Treasury would have concluded that the cost of the final outlay should be spread over the life of the investment in the pattern of economic depreciation.

Casualty Insurance

The Treasury Department has applied its analysis of the time value of money to the issue of the appropriate tax treatment of the liabilities of casualty insurance companies.⁹ Treasury concluded that the current tax rules which permit insurance companies to deduct the undiscounted estimates of their future claims are seriously flawed. According to Treasury, two alternative approaches should be considered. One method would be to defer the deduction until the insurance company actually pays the claim. Another would be to limit the deduction for unpaid losses to the discounted present value of the future payments.

Treasury supports its conclusion with a technical appendix which is a reworking of the appendix from the mining reclamation testimony. The appendix, however, is not applicable to the insurance case.

Casualty insurance in the simplest case involves the payment of a premium to cover losses incurred during the year. The actual payment of claims may be made over a period of years.¹⁰ A reasonable tax treatment of casualty insurance must recognize that a loss has taken place during the year of the insurance coverage. For a proper matching of income and expense, that loss should be deductible by someone that year.¹¹

Consider first a world without insurance. In order to stay in business, companies would have to set prices for their products at levels sufficiently high to cover expected casualty losses. Some companies would have actual losses, and these losses would be deductible for tax purposes. When all companies are considered together, however, the amount charged customers (and included in taxable income) for expected casualties would just equal the amount deducted by companies that had actual casualty losses.

Now introduce casualty insurance but assume that the insurance companies pay their claims the same year the losses occur. Companies would have to set prices for their products sufficiently high to cover the premiums for casualty insurance. These premiums would be deductible

⁸This assumption seems particularly appropriate if before-tax discount rate is equal to the cost of borrowed funds and interest is deductible. Investors will borrow at rate *r* as long as they can earn (1-m)*r* after taxes. It should be noted, however, that the before-tax discount rate in a world with taxes may be higher than the discount rate in a world without taxes. Even so, economic depreciation is required for the effective tax rate to be equal to the nominal tax rate.

⁹See testimony of John E. Chapoton, June 13, 1983. The Treasury may be reworking this analysis.

¹⁰Casualty insurance typically does not provide that the insured must pay a premium for the entire term of the policy. A policy could be written providing that in the event of a loss, the amount paid would equal the amount of the loss plus interest from the date of the loss. In this situation one would need to worry about the appropriate tax treatment of the interest income.

¹¹Note that a taxpayer who self-insures may not be able to deduct the loss currently under the rules of accrual accounting because the amount of the loss cannot yet be determined with reasonable accuracy. Also note that the discussion does not apply to structured settlements where the amounts paid exceed the amount of the loss.

SPECIAL REPORT

COVERAGE OF FUTURE COST ISSUES

For a special report by the Association of the Bar of the City of New York, entitled "Transactions Involving Deferred Payment of Accrued Liabilities," see *Tax Notes*, August 20, 1983, pp. 699-714.

For news coverage of the December 7, 1982 hearing at which Treasury presented testimony regarding the treatment of mining reclamation costs, see *Tax Notes*, December 13, 1982, pp. 878-879.

For coverage of the June 13, 1983 Finance Committee hearing regarding the tax treatment of losses incurred by casualty insurance companies, see *Tax Notes*, June 20, 1983, p. 1110.

TABLE 5

Year	Before-Tax Cash Flow	Economic Depreciation	After-Tax Cash Flow	Present Value (r = 10)
1	\$1,000.00	\$620.92	\$379.08	\$771.87
2	1,000.00	653.02	346.98	541.51
3	1,000.00	751.32	248.68	759.45
4	1,000.00	820.82	179.18	913.22
5	1,000.00	909.09	90.91	954.54
				\$3,790.80

^aEqual to the change in the present value of the future after-tax cash flow.

^bEqual to $(1 - r) \times \text{cash flow}$, where r is the marginal tax rate. r is the before-tax cash flow, and D is economic depreciation which is also the depreciation allowed for tax purposes.

^cThe present value of the cash flow is just equal to the initial investment.



letters to the editor

GULF SAYS ROYALTY TRUSTS ARE LOSERS

at the corporate level. Obviously, both of these Mesa spokesmen cannot be correct, and I am confident that when the Congressional revenue estimators complete their study they will confirm that the royalty trust proposed by Mesa would result in a substantial loss of federal tax revenues.

I am confident that... the Congressional revenue estimators... will confirm that the royalty trust proposed by Mesa would result in a substantial loss of federal tax revenues.

Of course, the entire tax scheme relating to royalty trusts depends on whether the IRS recognizes the avoidance of the corporate tax. At this time, there is reason to believe that the IRS will not condone such an avoidance scheme.

Very truly yours,
J. J. Ross
Chief Tax Officer
Gulf Oil Corporation

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APPENDIX

That a future outlay for mining reclamation or nuclear decommissioning should be written off over the life of the project may be accomplished by a number of methods. One method is to make a normal investment where the investment outlay is spread out over the beginning of a project and the other a negative salvage value investment where a significant outlay is made at the end of the project.

For convenience, the two investment projects may be considered an underground mine and a surface mine. Both projects yield a positive cash flow of \$1,000 per year for five years. The underground mine requires an initial investment of \$3,790.80, and the surface mine requires an initial investment of \$3,000. Both projects require annual expenditures of \$1,401, essentially the same before-tax rate of return.

Given these two investment projects, a mining company would be indifferent between them in a world without taxes. Inasmuch as they both would yield a 10 percent rate of return. Given that these two investments have the same before-tax rate of return, the tax law should not favor one over the other.

If tax depreciation is equal to economic depreciation then the after-tax rate of return for both projects will be the same and the effective tax rate will be equal to the nominal tax rate. Table 4 shows that the after-tax rate of return for the underground mine is 10 percent before-tax rate of return. Table 5 shows that the after-tax rate of return for the surface mine is 10 percent before-tax rate of return. It should be noted that the pattern of economic depreciation is the same for the underground mine as for the surface mine. (Compare the last column of Table 4 with the last column of Table 5.) In both cases the total investment is \$3,790.80 for the underground mine and \$4,401 for the surface mine—\$1,000 for the life of the project. Finally, Table 6 shows that with tax depreciation equal to economic depreciation, the after-tax rate of return for the underground mine is equal to 5 percent, the same as the after-tax rate of return for the surface mine, as shown in Table 3.

What does this mean? That if there is proper matching of income and expenses relative to the cost of the investment, the expense is actually paid does not produce the correct result.

TABLE 4

Year	Cash Flow	Present Value (r = 10)
1	\$1,000	\$909.09
2	1,000	820.82
3	1,000	751.32
4	1,000	683.02
5	1,000	620.82
		\$3,790.80

TABLE 5

Year	Cash Flow	Present Value of Future Cash Flow Discounted to Beginning of Year (r = 10)	Depreciable ^a
0	-\$3,790.80	\$3,790.80	
1	1,000.00	3,169.88	620.92
2	1,000.00	2,486.86	653.02
3	1,000.00	1,735.54	751.32
4	1,000.00	909.09	820.82
5	1,000.00	0.00	909.09
			\$3,790.80

^aEqual to the change in the present value of the future cash flow.

TAX NOTES, February 20, 1984

SPECIAL REPORT

for tax purposes but would be included in the taxable income of the insurance companies. Assuming all companies are in the same tax bracket, the tax savings from the deduction of the premium would just equal the tax paid by the insurance company on the premium income. The insurance company also would deduct the amount of the claim paid which would just equal the amount of insured losses. The companies would not include the insurance proceeds in income, because the proceeds are just a reimbursement. Taking all companies together, it should be noted that the casualty losses are deducted for the year in which the loss occurs, just as in the world without insurance.

Consider now the two Treasury alternatives for the world where insurance companies pay out casualty claims over several years. If the deduction is deferred until the insurance company actually pays the claim, there is a mismatch between the time when the loss is incurred and the time at which someone, in this case the insurance company, is able to take a deduction for the loss. If, instead, the insurance company takes a deduction up front for the discounted present value of the future payment, the full amount of the loss is never deductible. The logical implication of the Treasury position would be deductible, to take a current deduction for the difference between the claim payment expected in the future and the present value of that claim.¹

These present value calculations could lead to significant IRS/taxpayer disputes. Current law, which permits a current deduction by the insurance company for the expected claim, probably is a workable procedure. Insurance premiums should be set to reflect the fact that the full loss is deductible by the insurance company and no part of the insured loss is deductible by the insured even though the claim is paid after a lapse of several years.

Conclusion

Recent Treasury testimony on mining reclamation and casualty insurance has confused the issue of the appropriate tax treatment of future costs. In the case of the mining reclamation testimony, Treasury, by assuming that the after-tax discount rate in a world without taxes is the same as the discount rate in a world with taxes, assumed its conclusion that delaying the deduction for mining reclamation costs until the expense is actually paid always produces the correct result. In the case of the casualty insurance testimony, Treasury failed to recognize that a casualty loss occurs during the year of the insurance coverage. That loss should be deductible that year if income and expenses are going to be matched properly.

¹Under the IRS regulations (section 1.165-1(d)(2)), no portion of a loss with respect to which a reimbursement may be received is sustained until it can be determined with reasonable certainty whether or not such reimbursement will be received. Taxpayers are allowed to deduct the loss when incurred and then later include the insurance proceeds in income.

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REMARKS OF Daniel J. McNamara President

at the Thirteenth Annual Meeting
of Insurance Services Office, Inc.
January 10, 1984

In previous annual reports at these meetings, I outlined ISO activities in a number of areas which, in my judgment, had considerable significance for the entire property-liability insurance business. I'm tempted to take a similar approach today because, indeed, the many insurer representatives who serve on our committees have accomplished an impressive number of innovative objectives over the past twelve months. Their deep interest and support throughout the year—to say nothing of the quality of their contributions—are gratefully acknowledged.

However, I've rejected the temptation to give you a full chronicle of ISO's 1983 accomplishments because those accomplishments, admittedly, achieved with some detours and problems, have been documented through circulars and other forms of communication. Therefore, I'll touch on only a few highlights this afternoon because I want to take this opportunity to make a few personal observations on the financial condition of our business.

The watchwords for the next ten years for the winners in our business—and, in fact, for all business—are product differentiation and lower overhead costs. As a service organization, ISO has not ignored the realities of the business environment.

Last year, we completed development work on both occurrence and claims-made versions of the commercial general liability policy form. The concept of alternative ISO products for insurers to use as they see fit reflects the realities of the marketplace, and, at the same time, rejects the "good old days" when one mandatory ISO product served as the answer to every need of buyers and sellers.

These new versions of the commercial general liability policy form are the result of an intensive review by many industry interests of an earlier exposure draft. That review—the most rigorous ever undertaken for a new ISO product—generated much attention and evoked controversial and diverse points of view. We appreciate the thorough, professional response provided by this group of industry interests, and each of their suggestions was carefully reviewed by appropriate ISO insurer committees. While we did not accept all the suggestions that were submitted, I believe the industry review process, while rigorous and time consuming, resulted in a better product for ultimate industry use.

The new policy form, which will be filed shortly with state regulatory authorities for a November 1, 1985 effective date, modernizes the current general liability policy form. We modernized the form by consolidating many separate coverages into one broad contract that is appropriate for the typical risk in today's commercial insurance market. Except for the coverage trigger mechanism, its related provisions and the premium, the occurrence and claims-made versions are identical.

It's significant that the claims-made version is quite different from other claims-made policies now in the marketplace. For one thing, the new CGL claims-made policy gives insureds the right to buy "tail" coverage that extends the claim reporting period, without time limit, for injuries that occur before the policy is terminated. Also, that "tail" coverage will be available—with a maximum ISO advisory price in the manual—whether the insured or the company cancels or doesn't renew the contract for any reason other than

premium non-payment. In addition, with no retroactive date, the claims-made policy will apply to injuries that occur before its inception date, provided the claim is first made against the insured during the policy period. For such claims, the coverage will be on an excess basis if prior policies also apply. These coverage features, together with an inherent price advantage over the occurrence contract, should make the claims-made policy an attractive alternative in the marketplace.

I fully appreciate that some insurers and producers are not totally enamored with every aspect of this ISO program with two separate versions of the contract. But we believe this approach is right, and it's in keeping with the view that product differentiation will separate the winners from the losers in the years ahead. In order to insure the program's smooth implementation in the marketplace, ISO will, over the next two years, conduct comprehensive education and training programs for insurers and producers throughout the country.

Our business environment also dictates cost efficiency and, here again, ISO has been responsive. During 1983, ISO reduced its work force 9% by restructuring our field operations—without diminishing our essential services to insurers and producers. This work-force reduction will result in a \$9 million annual saving to participating insurers. In 1983, ISO operated at \$5.2 million or 3.5% below budget, as we continued to demand increased productivity and aggressively pursued our "sunset-reprioritization" program. "Sunset-reprioritization" simply means that all ISO products and services are constantly reviewed to determine if they're still essential to our participating insurers. If they are—fine. If not, we kill them.

In fact, our 1983 expenses were less than in 1982. Our 1984 budget is 1% below last year's expenses and projects ISO's lowest level of spending since 1979. ISO's excellent fiscal performance could not have been achieved without the

dedication, loyalty, hard work and understanding of our professional staff. For that, I am most grateful.

Efficiency through automation is the theme of another major development at ISO—the delivery of ISO products and services via telecommunications. Our second wholly-owned subsidiary, ISO Telecommunications, Inc., or ISOTEL, was formed on October 1, 1983.

ISO frequently has commented on the deteriorating results for the Commercial Lines of insurance, specifically noting the marked differences between ISO advisory rate changes and industry premium changes over the last several years. Unfortunately, 1983 was no different. In meeting our number one corporate objective of adequate advisory rates, ISO achieved a countrywide average advisory increase of 8% for the Commercial Lines of insurance, while industry premiums remained essentially flat.

Ultimately, the pricing practices of insurers have the greatest impact on their overall financial results. Those results—and our analysis of those results—sadly indicate that the overall financial strength of our business is being relentlessly weakened by the brutal battle for commercial market share.

There are many who say that excess capacity is the cause of this competition. Policyholders' surplus is perhaps the best measure of this capacity, and it is a fact that surplus has been growing over the last several years. The industry ratio of written premium to surplus, which reached a high of 2.7 to 1 in 1974, stood at 1.7 to 1 at the end of 1982 and is estimated to be 1.6 to 1 for 1983. But surplus figures are reliable only to the extent the underlying estimates of assets and liabilities are sound.

I will not dwell on the assets side of the picture today. You all are aware of the buoyant effect on

surplus of carrying bonds at amortized rather than market value

On the liabilities side, we are looking at essentially two entries—the unearned premium reserve and the loss and loss expense reserve. The unearned premium reserve is the one that can be estimated with a high degree of accuracy. But it was more than twenty years ago that this entry was the major liability. It has diminished over the years and is now only a third the size of loss and loss expense reserves.

So today I'll concentrate on loss and loss expense reserves—supplementing the earlier observations of our retiring Board Chairman. The risk of loss reserve deficiency is critical, as it directly reduces surplus.

We've studied the aggregate loss reserves of the 200 companies that write over 90% of the business and make up A.M. Best Company's Casualty Loss Reserve Development Report. Our studies reveal very disquieting patterns. We've examined the development of paid losses by accident year for the five Schedule P lines that represent 90% of all loss reserves. These lines of insurance comprise general liability; multi-peril, including homeowners; automobile liability; workers compensation; and medical malpractice.

Based on our analyses, we conclude that the industry's total loss and loss expense reserves, as of December 31, 1982, are inadequate by more than 10%. The results, of course, vary by line of insurance and, even more importantly, by individual insurer. I would like to advise you of the conclusions for two major ISO Commercial Lines. Multi-peril loss reserves, from our studies, are deficient by more than 10% and general liability loss reserves are deficient by more than 20%.

The industry ratio of loss reserves to policyholders' surplus, at the end of 1982, stood at 1.9 to 1. A 10% understatement of loss reserves translates to a pre-tax 20% overstatement of policyholders' surplus. A correction for this reserve deficiency would increase the industry's loss reserve to surplus ratio to 2.5 to 1, which

would be an all-time high. The 1982 premium to surplus ratio would increase from 1.7 to 2.1.

The industry's complete financial results for 1983 aren't yet available. But the results for the first three quarters of 1983 show no strengthening of loss reserves. In fact, the industry's loss reserves increased in that period at an annual rate of only 8 percent, continuing the slowdown in the rate of increase that we've seen in recent years. That 8 percent annual rate of increase would be the lowest rate of increase in loss reserves in 20 years.

It is bad enough that a reserve inadequacy can misstate the financial picture at any given time. Regrettably, reserve inadequacy can also have an adverse prospective impact on pricing. Individual company pricing decisions may be biased downward, and even ISO advisory rates may be understated for a period of time.

The industry's financial position looks even worse, when you consider current and prospective commercial lines underwriting results. For all commercial lines of insurance, we estimate the combined ratio to be at least 115 for 1983, and we see no improvement in 1984. For three key ISO lines, the results, to say the least, will be very poor.

For General Liability, the combined ratio was 116 in 1981 and 125 in 1982. We estimate 137 for 1983 and forecast the same level in 1984. Given an industry combined ratio of 137, assuming reasonable payout patterns and an investment yield of 8.5%, insurers will lose 4 cents on every dollar of General Liability premium that they write this year. That is after investment gains but before taxes. This 4% negative rate of return can only come out of policyholders' surplus.

For Commercial Automobile, the combined ratio was 112 in 1981 and 119 in 1982. We estimate 120 for 1983 and forecast no improvement in 1984. If the industry continues to write at this composite ratio of 120, it will lose 6 cents on every dollar of Commercial Automobile premium written in 1984—again after investment gains but before taxes

Let's look at Commercial Multi-Peril. The combined ratio was 107 in 1981, 116 in 1982, and we estimate 120 for 1983. If there is any improvement in 1984, it will be slight. If the industry continues to write at this combined ratio of 120, it will lose 6 cents for every dollar of Commercial Multi-Peril premium written in 1984—again based on reasonable assumptions of payout patterns, investment yield, and ignoring tax implications.

For each of these three major Commercial Lines, we are forecasting a negative rate of return in 1984. These 3 lines represent 40% of the total commercial premium volume and must lead to a drain on policyholders' surplus. This drain will aggravate the significant drain on surplus that will occur when the inadequacy of present reserves becomes painfully evident over the next few years.

Facts are stubborn things which, at times, do not make for happiness and contentment. Popular opinion to the contrary, the fundamentals of our insurance business have not really changed over the years; only the specifics of managing the fundamentals have changed with changes in internal and external conditions. Now is the time for insurers to stabilize their commercial lines underwriting operations. It is always better to create a sense of urgency rather than react to a state of crisis. In the long run, no insurer can survive if it does not recover the costs of providing its products or services. The winning insurers will bring their commercial premiums into better sync with their underlying loss costs because, regardless of short term market share objectives, prices have to be determined by costs in the long run. Cost containment will not suffice. Acting on price may involve internal controversy, setbacks and sacrifices, but we should act with the knowledge that history helps those who help themselves.

The next three years will be traumatic for some insurers. The recent early, encouraging signs of recovery—which I hope will be sustained—may be too late for some of these insurers. It's very clear that for those companies that persist in

doing business as if there were no tomorrow, there will in fact be none. And all insurers are by statute, put in the position of ultimately having to "pick up the tab" for those companies' lack of prudence. In this new commercial insurance environment, such a "ball out" program, financed under state guaranty funds by intense competitors, makes little sense, on any score, to me.

These funds were created as a small solution to what was then a small problem. Neither supporters nor opponents of these funds ever said that this mechanism could cope effectively with insolvencies of large, multi-line insurers or of medium-sized companies writing high exposure specialty coverages such as medical malpractice and products liability.

Post-assessment guaranty funds exist today in virtually all states and cover virtually all lines of property/casualty insurance. States originally created these funds—with the support of a large segment of the industry—in response to a national concern for the policyholders and claimants of the many borderline, non-standard automobile insurance writers which became insolvent during the late 1950's and 60's. Proponents of the funds believed that the overall problem was minor, that insolvency detection by state insurance departments was improving, that such funds would be inexpensive to operate, that assessments under the funds would be a small price to pay to avoid further damage to the industry's already tarnished public image, and finally, that the existence of the funds would avoid imposition of an unwanted and overreaching solution by the federal government.

From 1969 through 1983, guaranty funds served eighty-two relatively small insolvencies, with a total projected gross cost to insurers of some \$400 million. But each time a potential major insolvency has loomed on the horizon, the inadequacies of the post-assessment fund mechanisms have become apparent. Solutions have been achieved through the infusion of fresh capital, takeovers by outside interests and voluntary, insurer-supported rehabilitation efforts. The

ANALYSIS OF Loss Reserves for the Property-Casualty Insurance Industry

The following results are obtained:

Line of Insurance	Estimated Reserve Deficiency
General Liability	-24.3%
Medical Malpractice	-79.4%
Multiple Peril	-13.3%

The reserve deficiency for the three lines studied represents 10.7% of total industry reserves.

The methodology employed, as well as the conclusions reached, are conservative. The methodology was applied to industry aggregates and may not be appropriate for analyzing individual insurers, because:

- the underlying assumptions may not apply to individual insurers.
- large individual claims may distort the results for any single insurer.
- the product mix of individual insurers varies from that of the industry as a whole.

The attached exhibits present an analysis of the adequacy of industry loss and loss adjustment expense reserves as of December 31, 1982 for three Schedule P lines. The data underlying the analysis are from A. M. Best Company's Casualty Loss Reserve Development Reports which aggregate Schedule P information for selected companies representing over 90% of the industry.

The method used traces movements in accident year paid losses for several evaluations. Based on these historical developments of paid losses, factors are developed and applied to the December 31, 1982 evaluation of paid losses in order to estimate the needed reserve levels.

The method assumes that:

- (1) Payout patterns remain consistent over time. This assumption appears reasonable given the stable link ratios that are shown for each line of insurance.
- (2) Reserves for accident years 1978 and prior are correct.

erty/casualty insurance and, consequently, also extend protection to the most sophisticated and financially solid insurance purchasers. And the funds even provide coverage for the owner-insureds of specialty companies.

A fundamental reexamination of the "scope of coverage" is overdue. A number of questions need to be debated, namely:

What lines of insurance are appropriate?

Why are commercial lines included?

Should coverage be restricted to personal lines?

Should per claim limits be lowered and deductibles raised?

Should unearned premiums be covered?

Should coverage be limited to economic loss only?

The guaranty fund situation presents substantive challenges to both our industry and government. The continued vitality of state regulation will ultimately depend upon how it deals with solvency regulation in this new insurance/financial environment. While not an ISO responsibility, I believe that our industry has a golden opportunity to step back and reexamine these state guaranty funds. I trust we will neither shirk from this challenge nor miss this opportunity.

The next few years will test all of us in the property-liability insurance business. But we've been tested before and, as before, I know our industry will show the clear thinking, adroit management, and resolute leadership that will see us through this difficult period and permit us to share, with other industries, in the profitable growth period ahead for all business.

I would like to conclude with another tribute to the ISO staff—professionals all. Their competence, dedication and effort are gratefully acknowledged. I am, personally, most appreciative of their efforts.

Thank you for the privilege of serving you again as President last year.

funds were not the solution. The recent Baldwin-United situation once again highlights the inadequacy of the current guaranty fund system to handle impairments of major magnitude.

And when confronted with a major insolvency, the tax-offset method of recoupment will prove unacceptable to the public. Tax revenues would be diminished at the very time state governments are struggling to meet their own budget deficits.

Today, when aggressive competition in commercial lines is testing even the best insurer managements, when profit margins are slimmer than ever before, and when profitable cash flow underwriting is easier to achieve in concept than in execution, I believe it is time to reevaluate the fundamentals of a system which requires solvent and well-managed insurers to contribute their funds to bail out the policyholders of insolvent, poorly managed insurers.

The costly coverage provided by the current guaranty fund system is illustrated dramatically by the inclusion of medical malpractice insurance. ISO's review of Schedule P loss reserves indicates that the industry in the aggregate was under-reserved, at the end of 1982, by at least 50% for medical malpractice insurance. Over 50% of this insurance is written by relatively new companies providing coverage for their owners at rates considerably lower than those charged by conventional insurers of this business. By the nature of this "long tail" line of insurance, the claims experience will be excellent for the first few years, and then steadily deteriorate. If insolvencies result, the economic burden of those insolvencies will be borne by the conventional market—those same insurers whose higher rates were undercut in the first instance. And the individuals protected will be those very same individuals who were responsible for the underpricing.

Post-assessment funds were created to protect policyholders of "high risk" auto insurers, a class of insurance consumers with few options and the least ability to protect themselves. But today, these funds cover virtually all types of prop-

Loss Reserve Analysis
General Liability
Paid Loss Development

*** Includes reserves for years 1976 and prior which are assumed to be correct

PAID LOSS DEVELOPMENT LINK RATIOSPAID LOSS DEVELOPMENT FACTORS

48 Months to Ultimate	2.200
36 Months to Ultimate	3.192
24 Months to Ultimate	5.203
12 Months to Ultimate	12.066

* SOURCE A.M. Best's Casualty Loss Reserve Development Report (000's omitted).

APPENDIX III

APPENDIX III

Loss Reserve Analysis
Medical Malpractice
Paid Loss Development

Loss Reserve Analysis
Medical Malpractice
Paid Loss Development

LOSS & LOSS EXPENSE PAYMENTS AT END OF:

Accident Year	12 Months	24 Months	36 Months	48 Months	60 Months
1976	8796	31651	73168	137207	222815
1977	15426	44111	99576	182063	284607
1978	19565	61052	132961	248760	377301
1979	23943	77912	180873	325792	—
1980	29892	109380	251727	—	—
1981	37465	146439	—	—	—
1982	57600	—	—	—	—

PAID LOSS DEVELOPMENT LINK RATIOS

Accident Year	12-24 Months	24-36 Months	36-48 Months	48-60 Months	60 Months-Ultimate**
1976					
1977				1.624	2.878
1978			1.828	1.563	2.552
1979	3.254	2.178	1.871	1.517	2.315
1980	3.659	2.322	1.823	Average 1.568	Average 2.582
1981	3.909	2.301	Average 1.841		
	Average 3.607	Average 2.267			

PAID LOSS DEVELOPMENT FACTORS

48 Months to Ultimate	4.049
36 Months to Ultimate	7.453
24 Months to Ultimate	18.897
12 Months to Ultimate	60.947

* SOURCE: A.M. Best's Casualty Loss Reserve Development Report (excludes one company) (000's omitted)
** Based on Reported Ultimate Losses + Paid Losses as of 60 months.

Accident Year	(1) Paid Losses as of 12/31/82	(2) Paid Loss Development Factor	(3) Estimated Ultimate Incurred Losses (1) x (2)	(4) Estimated Reserve (3) - (1)	(5) Reported Reserve	(6) Difference (5) - (4)	(7) Total Reported Reserve as of 12/31/82***	(8) Estimated Reserve Deficiency (8) - (7)
1979	329792	4.049	1335328	1005536	678300	-327236		
1980	251727	7.453	1876121	1624394	891836	-732558		
1981	146439	16.897	2474380	2327941	1117593	-1210358		
1982	57600	60.947	3510547	3452947	1394166	-2058781		
					TOTAL	-4328913.	5481677	-79.4%

** Includes reserves for years 1978 and prior which are assumed to be correct.

Loss Reserve Analysis
Multiple Peril
Paid Loss Development

LOSS & LOSS EXPENSE PAYMENTS AT END OF:

Accident Year	12 Months	24 Months	36 Months	48 Months	60 Months
1976	3455774	4949539	5312797	5555371	5732975
1977	3785076	5538276	5929702	6197334	6413127
1978	4373176	6332792	6823695	7143211	7404407
1979	5784426	8266583	8834612	9243059	—
1980	6819461	9816262	10470791	—	—
1981	7076682	10014783	—	—	—
1982	8612280	—	—	—	—

PAID LOSS DEVELOPMENT LINK RATIOS

Accident Year	12-24 Months	24-36 Months	36-48 Months	48-60 Months	60 Months- Ultimate**
1976	1.429	1.078	1.045	1.032	1.064
1977	1.439	1.069	1.047	1.035	1.065
1978	1.415	1.067	1.046	1.037	1.062
1979	—	—	—	—	—
1980	—	—	—	—	—
1981	—	—	—	—	—
Average	1.428	1.071	1.046	1.035	1.064

PAID LOSS DEVELOPMENT FACTORS

48 Months to Ultimate	1.101
36 Months to Ultimate	1.152
24 Months to Ultimate	1.234
12 Months to Ultimate	1.762

* SOURCE: A.M. Best's Casualty Loss Reserve Development Report (000's omitted).
** Based on Reported Ultimate Losses - Paid Losses as of 60 months

Loss Reserve Analysis
Multiple Peril
Paid Loss Development

Accident Year	(1) Paid Losses as of 12/31/82	(2) Paid Loss Development Factor	(3) Estimated Ultimate Incurred Losses (1) x (2)	(4) Estimated Reserve (3) - (1)	(5) Reported Reserve	(6) Difference (5) - (4)	(7) Total Reported Reserves as of 12/31/82***	(8) Estimated Reserve Deficiency (8) - (7)
1979	9243059	1.101	10176608	93549	814396	-119153	—	—
1980	10470791	1.152	12062351	1591560	1287941	-303619	—	—
1981	10014783	1.234	12358242	2343459	2110013	-234446	—	—
1982	8612280	1.762	15174837	6562557	5749686	-812871	—	—
TOTAL	—	—	—	—	11067116	-1468089	—	-13.3%

*** Includes reserves for years 1978 and prior, which are assumed to be correct

Operating Results After
Investment Income
General Liability

ANALYSIS OF
Pre-Tax Rates of Return

for the
Property-Casualty Insurance Industry

The attached exhibits develop the pre-tax rate of return reflecting investment income for General Liability, Commercial Multiple Peril and Commercial Automobile. The model assumptions are best presented by explaining the numbered columns in the attached exhibits.

Column (1)—Years (From Policy Inception):

The model tracks both income and outgo generated by a single policy beginning at policy inception and continuing until the final loss payment is made. The model assumes that all payments (other than dividends) are made at year end.

Column (2)—Premium Collection:

The model assumes that the entire premium is available for investment by the insurer at policy inception.

Column (3)—Expense & Dividend Payment:

Expenses other than loss adjustment expenses are assumed paid at policy inception. The assumptions on premium collection and expense payment are consistent. Dividends are assumed to be paid 6 months after policy expiration. The column (3) total represents A. M. Best's estimate of the 1983 expense and dividend ratios.

Column (4)—Loss & Loss Adjustment Expense Payment Pattern:

The loss and loss adjustment expense payment patterns are based on studies of the industry's payment pattern for each of the lines of business. The total is the assumed loss and loss adjustment expense ratio for the line.

Column (5)—Net Payment Pattern:

This column represents the net income and outflow to the insurer in nominal dollars. The total is the assumed combined ratio for the line.

Column (6)—Discount Factor:

This factor is applied to discount the value of the eventual income and outflow and evaluate the net flow at policy inception. It is assumed that all available monies are invested at 8.5% per annum.

Column (7)—Discounted Payment Pattern:

The total of this column represents the rate of return reflecting investment income.

The rate-of-return model can be applied to individual insurers, based on their expected payout pattern, their expected combined ratios and their expected investment yield. The model's results are on a pre-tax basis, and tax implications for individual insurers can vary significantly.

(1)	(2)	(3)	(4)	(5)	(6)	(7)
Years (From Policy Inception)	Premium Collection	Expense & Dividend Payment	Loss & LAE Payment Pattern	Net Payment Pattern (2)-(3)-(4)	Discount Factor 1-(1.085) ^t	Discounted Payment Pattern (5)×(6)
0	1,000	.324	.000	.676	1.000	.676
1			.093	-.093	.922	-.086
1.5		.008	.000	-.008	.885	-.007
2			.114	-.114	.849	-.097
3			.156	-.156	.783	-.122
4			.135	-.135	.722	-.097
5			.125	-.125	.665	-.083
6			.104	-.104	.613	-.064
7			.104	-.104	.565	-.059
8			.073	-.073	.521	-.038
9			.052	-.052	.480	-.025
10			.052	-.052	.442	-.023
11			.030	-.030	.408	-.012
Total	1,000	.332	1.038	-.370		-.037
		Expense & Dividend Ratio	Loss & LAE Ratio	Combined Ratio (=1.37.0)	Rounded Rate of Return Reflecting Investment Income	-.04

0 Dividend Payment

† The exponents used in the formula are the numbers of years from policy inception, as listed in column (1).

APPENDIX III

Operating Results After Investment Income Commercial Automobile

(1) Years (From Policy Inception)	(2) Premium Collection	(3) Expense & Dividend Payment	(4) Loss & LAE Payment Pattern	(5) Net Payment Pattern (2)-(3)-(4)	(6) Discount Factor 1-(1.08) ^t	(7) Discounted Payment Pattern (5)×(6)
0	1.000	.326	.000	.674	1.000	.674
1			.395	-.395	.922	-.364
1.5		.007	.000	-.007	.885	-.006
2			.199	-.199	.849	-.169
3			.120	-.120	.783	-.094
4			.069	-.069	.722	-.050
5			.044	-.044	.665	-.029
6			.016	-.016	.613	-.010
7			.010	-.010	.565	-.006
8			.004	-.004	.521	-.002
9			.010	-.010	.480	-.005
Total	1.000	.333	.867	-.200		-.061
		Expense & Dividend Ratio	Loss & LAE Ratio	Combined Ratio (=120.0)	Rounded Rate of Return Reflecting Investment Income	

± Dividend Payment

† The exponents used in the formula are the numbers of years from policy inception, as listed in column (1).

Operating Results After Investment Income Commercial Multiple Peril

(1) Years (From Policy Inception)	(2) Premium Collection	(3) Expense & Dividend Payment	(4) Loss & LAE Payment Pattern	(5) Net Payment Pattern (2)-(3)-(4)	(6) Discount Factor 1-(1.08) ^t	(7) Discounted Payment Pattern (5)×(6)
0	1.000	.403	.000	.597	1.000	.597
1			.354	-.354	.922	-.326
1.5		.008	.000	-.008	.885	-.007
2			.191	-.191	.849	-.162
3			.073	-.073	.783	-.057
4			.052	-.052	.722	-.038
5			.039	-.039	.665	-.026
6			.021	-.021	.613	-.013
7			.023	-.023	.565	-.013
8			.018	-.018	.521	-.009
9			.009	-.009	.480	-.004
10			.003	-.003	.442	-.001
11			.006	-.006	.408	-.002
Total	1.000	.411	.789	-.200		-.061
		Expense & Dividend Ratio	Loss & LAE Ratio	Combined Ratio (=120.0)	Rounded Rate of Return Reflecting Investment Income	

± Dividend Payment

† The exponents used in the formula are the numbers of years from policy inception, as listed in column (1).

APPENDIX III

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AMERICAN INSURANCE ASSOCIATION



February 24, 1984

Mr. William J. Anderson
Director, General Government Division
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Anderson:

As President of the American Insurance Association, I thank you for the opportunity to comment on the draft of a Proposed Report ("draft" or "report") prepared by the Staff of the U.S. General Accounting Office (GAO) entitled "Congress Should Consider Changing Federal Income Taxation of the Property/Casualty Insurance Industry." One hundred seventy casualty insurance companies, predominantly organized as stock companies, are members of the American Insurance Association. In 1982 our member companies accounted for twenty-nine percent of the industry's total premium volume. This letter is in response to your request that we provide comments to assist the Congress in its consideration of your recommendations.

Industry Agreement

We have reviewed the comments on the draft made by the National Association of Independent Insurers, the Alliance of American Insurers, the National Association of

Mutual Insurance Companies and the Reinsurance Association of America. As we agree with the views expressed by such comments, we endorse those comments and commend them to you for consideration.

GAO Recommendations

The GAO draft recommends that the Congress consider changes in the following three areas:

- (1) The Congress should consider amending the tax code to provide that, in calculating the loss reserve deduction for tax purposes, loss reserves should be discounted. The discount rate should be based on a moving average of each company's pre-tax net return on its investment portfolio;
- (2) The Congress should consider amending the tax code to provide that acquisition costs should be allocated over the life of related contracts; and
- (3) The Congress should consider whether continuation of the protection against loss account is warranted.

The report recognizes that "the property and casualty insurance industry is an important part of the American economy" (dr. Digest, p.i). Casualty insurance companies serve the public interest by providing protection against the risk of financial loss to both businesses and individuals. The industry operates under a regulatory

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system governing its investments, marketing and solvency which has provided a high degree of reliability to policyholders and injured parties.

The American Insurance Association and its member companies are prepared to assist in the review of the taxation of casualty insurance companies, and our comments on the draft are intended to continue the dialogue on that subject. For the reasons noted below, we conclude that the draft is fundamentally flawed and cannot serve as the basis for legislation. We believe the draft's proposals require substantial additional study and consideration given their far-reaching impact and the complexities inherent in the subject matter.

The GAO Draft Does Not Justify Its Recommendation That Loss Reserves Should Be Discounted

We seriously dispute the draft's conclusion that loss reserves should be discounted. The basic premise of the draft that leads to such conclusion is that there is a mismatching of revenue and expenses. The draft's premise that mismatching exists is incorrect and is based on an example (Tables 3 and 4) constructed on unrealistic assumptions calculated to establish the desired conclusion. These assumptions oversimplify the operation of casualty insurance companies to such a degree that the

Page Line
3 19

4 2 The premise of mismatching is not based on the examples (tables 3 and 4 of the report). The examples were developed to illustrate the premise, and in our opinion they do illustrate this point. The response to comment 4, page 35 of the report explains why such things as loading for expenses were omitted from the examples. It further states that introducing such things would not have changed the outcome which the examples were meant to show. The present undiscounted reserve deduction results in a profit being realized from an otherwise profitless transaction.

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example does not provide any basis for legislative change.

The draft contains several conclusory statements that mismatching exists, but the draft's only attempt to support this conclusion is by a comparison of the results in its Tables 3 and 4. These tables compare the alternative economic and tax consequences of a specific assumed factual situation using discounted and undiscounted loss reserves. They lend a surface plausibility to the conclusion that there is mismatching and are superficially appealing, but on close consideration it is clear that they have been constructed on totally unrealistic assumptions, which are not representative of actual conditions, for the apparent purpose of proving that mismatching exists. As the tables are the sole justification for the draft's conclusion on mismatching, the assumptions underlying such tables merit close scrutiny.

Two critical assumptions were made in constructing the tables (dr. p. 16): (1) "a loss payment of \$1,000 will have to be paid 5 years later;" (emphasis added) and (2) the premium and all earnings retained and reinvested will provide a 10 percent return, compounded semi-annually.

As a theoretical concept, discounting may be appropriate where definite payments are to be made at

4 3-18 The examples were based on clearly stated assumptions and were unrealistic only to the extent they ignored expenses and were based on premiums lower than companies would probably be willing to charge. The tables are only for the purpose of illustrating the point and are not the sole justification for the conclusion that mismatching exists. The mismatching occurs because the amount of deduction taken under the undiscounted reserve deduction method is not allocated over the period of deferral, whereas the offsetting premium income is allocated.

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specific points in time, and we submit that such conclusion is all that the example provided by Tables 3 and 4 illustrates. But the assumption of a fixed and definite payment (\$1,000) at a specific point in time (in 5 years) is far removed from the realities of establishing loss reserves of casualty insurance companies.

The establishment of casualty company loss reserves is a complex and difficult process -- one that is full of uncertainties. The ultimate loss may be zero or \$2,000 rather than \$1,000. The loss payment may be made immediately or in one or two years rather than in five. These obvious uncertainties exist but are assumed away by the tables.

In fact, if the ultimate loss should turn out to be \$1,000 and if the \$1,000 were paid in five years as projected, recent past history indicates that the loss reserve established would have been only \$910 rather than \$1,000. This will be substantiated by the discussion below on the industry's lack of success in recent years in fully measuring the extent of the industry's losses.

The second critical assumption of the tables is that one can project the rate of future earnings. Certainly the varying rates of return enjoyed by investors in recent years are indicative of the uncertainties inherent in such projections. The draft acknowledges that its investment

5 3-13 The use of a specific point in time (5 years) as the expected time of payment is used for illustration. We do not agree that it is far removed from the realities of establishing loss reserves of casualty insurance companies. As the comment states, property casualty companies in their rate-making of necessity must use expected payment patterns. The period used represents a single case selected as an example of many cases with different payout patterns. Other examples representing payouts in 2, 3, or 4 years might also have been used to make the same point as the examples we used. In light of the above, we do not feel that any uncertainties are assumed away by the tables. We do recognize that there can be uncertainty about the time of payment of any individual claim, although in the aggregate it is possible (and necessary for rate-making purposes) to determine an average period of payment deferral.

5 14-20 The \$910 reserve mentioned in this paragraph apparently refers to a 10 percent underreserving as previously referred to in the report of the President of Insurance Services Offices, Inc. It can be shown that if table 4 had used this amount as a reserve deduction instead of the full amount of \$1,000, the comparison of the two examples would not have been greatly different. The results of the discounted reserve deduction in table 3 would have been a profitless transaction, while table 4, using \$910 instead of \$1,000 as a first year reserve deduction, would have shown cumulative profit.

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6 8 With regard to discount rates the draft did state that future interest rates are not known with certainty. It did not state that the assumption was not realistic. The 5-year moving average of an individual company was suggested as a practical mechanism that could approximate the company's future earnings rate. It also stated that the use of a 5-year moving average would with the passage of time tend to be self correcting.

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assumption is not realistic and that earnings and interest rates cannot be known with any certainty (dr. p. 20). In fact, the draft recommends the use of a moving average of current and prior investment returns as a discount rate for the very reason that earnings rates do fluctuate sharply (dr. p. 21). This does not cure the unrealities of the assumption and at best will ameliorate its effect in some limited situations.

This 10% rate of return also assumes that all of the premium will be available for investment and that it will be available immediately. This, of course, is not what happens. A company's receipt of premiums often is delayed. Even after premiums are received, some must be used for purposes other than investment. The example altogether ignores the existence of any expenses.

The three assumptions -- the certainty of the amount of the eventual payment, the time it will be paid, and the ability to project future earnings accurately -- are critical to the draft's conclusions. Because these assumptions are so removed from the realities of the complex and uncertain process of establishing loss reserves, any conclusion derived from the example is suspect and not relevant to the question of whether loss reserves should be discounted for tax purposes.

6 9-15 As previously mentioned, for illustrative purposes expenses were not included in the examples. This, however, does not mean that the use of an assumed rate of 10 percent in the examples was incorrect. Expenses could have been reflected both in the premium charged and in the annual deductions from taxable income, and the two examples would still have illustrated the point that they were designed to show. Admittedly, this would have made for a more realistic example, but the final result would have been the same: without discounting, the profitless transaction becomes profitable. See response to comment number 4.

6 16-24 See the last four responses immediately above.

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Almost every other assumption made in constructing the tables also is subject to question. The use of a \$613.00 premium and a \$1,000 anticipated loss provides a dramatic example of apparent mismatching. But as dramatic as that difference seems to be, this relationship of an assumed premium (\$613) and a projected loss (\$1,000) has little resemblance to reality. When looking at aggregate projected losses for the purpose of setting a premium rate, an anticipated loss to premium ratio of 163% (the ratio used in the table) cannot be considered representative even in these difficult times. Setting premiums on the basis of such assumptions would lead to certain disaster. Finally, the tables assume that the company will have income from other sources. Given recent history, this too may be an unwarranted assumption as many casualty insurance companies have been reporting losses in recent years.

Where the assumptions underlying the tables are so different from what actually occurs and where the tables are the sole support for the alleged mismatching, there is no basis for the draft's conclusion that loss reserves should be discounted. The burden of showing that discounted reserves will improve the current system of taxation has not been satisfied. Thus, the draft's

7 1-13 See response to comment number 4.

7 13-17 The profitability of the property/casualty industry has generally been characterized by cycles. The losses reported by some companies for tax purposes over the last few years were the result of a downward cycle. However, according to an industry expert, this downward cycle may be coming to an end. The president of the Insurance Services Office, in a recent address before the Association of Insurance and Financial Analysts in New York City, indicated that the turn in the underwriting cycle has started and that for the long term he is "very bullish on the industry." In any event, the stage of the cycle the industry is in at any point should be irrelevant to the issue of good tax law for the whole cycle.

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8 2 We disagree with the statements in this paragraph. See our response to the comments starting on page 3, line 19 of this source.

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Page 8

recommendation is fatally flawed and must be reconsidered.

The Recommended Discounting Merely Accelerates
the Reporting of Future Income

The mismatching perceived by the draft is the allowance of a current deduction for the amount that a casualty insurance company expects to pay as the result of a loss which has occurred in the current taxable year unreduced by the future investment income to be earned in taxable years subsequent to the one in which the loss occurred.

The draft apparently recognizes that it would be improper to require a casualty insurance company to include future investment income (which the company may or may not actually earn) as part of its current tax base. Nevertheless, it seeks to achieve that same result indirectly by reducing the otherwise allowable current deduction for incurred losses by an amount reflecting the company's expected future investment income.

Under present law a casualty insurance company includes in taxable income all underwriting and investment income it earns as of the end of the taxable year. This method of reporting income is in accordance with the accounting methods approved by the National Association of Insurance Commissioners ("NAIC"), which have served as the

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9 2 This statement does not properly reflect the fact that unearned premiums are not included in taxable income. This is in accordance with accounting methods approved by the National Association of Insurance Commissioners, and in our opinion this is the principal reason why mismatching results. The total amount of any premium is included in income, but any portion of it that is not earned in the current year is added to the unearned premium reserve and therefore gets excluded from that year's income, even though under present NAIC rules a deduction for the full amount of expenses is allowed.

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basis for the taxation of casualty insurance companies for more than 60 years.

The special nature of the casualty insurance industry and its obligation to policyholders was noted by the Tax Court in Bituminous Casualty Corp. v. Commissioner, 57 T.C. 58 (1971) at p. 77:

-- 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 manufacturer 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. (Emphasis added.)

Granting insurers a deduction for losses incurred is consistent with the fundamental policy of not subjecting to tax amounts received which are subject to substantial restrictions on their use. State insurance laws require companies to establish reserves which are adequate to meet their obligations to policyholders and claimants. They are not available to the company for its unrestricted "use and enjoyment."

9 26 We agree with the basic premise stated in this paragraph. However, we differ with them with respect to the amount to be deducted. The interest earned on reserve funds is available to the company.

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All income (underwriting and investment) is reported for tax purposes as soon as it is not required for policyholders or claimants. The present method of accounting for tax purposes recognizes the special nature of the industry and its obligation to policyholders. It should not be changed merely to correct a perceived mismatching of expenses and revenue.

The Treasury Department Has Rejected Discounting
Of Future Expenses

In response to a question asked of Assistant Secretary John Chapoton during his testimony before the House Ways and Means Committee on February 22, 1984, Secretary Chapoton explained that the Treasury Department had studied discounting of future expenses but found that it was "a thicket which you will never get out of." His written statement makes it clear that the complexity and inaccuracy of any discounting formula would make it impossible to administer:

Our proposal has been criticized for failing to match properly the future expense with the current income that gives rise to that expense. Those who express this criticism argue that future expenses should be deductible at discounted values over the period of economic activity giving rise to the expenses. While allowing a current deduction for the present discounted values of future expenses clearly is proper from the perspective of creditors and others who utilize financial statements, various practical considerations preclude implementing such a rule for income tax purposes.

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11 20 The testimony of Assistant Secretary of the Treasury referred to in this section did not address insurance company taxation. It was specifically directed to the overstatement of deductions by accrual method taxpayers who in certain cases can currently deduct expenses that will not be paid for many years. For Treasury's position on taxation of property/casualty insurance industry in general and reserve discounting in particular, see Treasury comments printed at the beginning of this appendix.

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As an administrative matter, determining the present discounted values for all kinds of future expenses would introduce unmanageable uncertainty and undesirable complexity. Discount rates could not be determined individually for each business. Rather, certain economy-wide average discount rates would have to be employed. These discount rates would have to be applied to mere estimates of the amount of the expenses to be incurred at estimated dates in the future. Any discounted expenses therefore would represent only an estimate of future expenses, and that estimate would be wrong in every case in which either the amount of the future expenses or the time for economic performance was estimated incorrectly. A system that allowed current deductions for discounted future expenses would have to include a complex set of recomputation rules for recalculating overstated and understated deductions when the future liabilities were actually satisfied at a time or in an amount different from that originally projected.

The introduction of "unmanageable uncertainty and undesirable complexities" referred to by the Treasury Department's statement on the discounting of future expenses applies with greater force to the discounting of current loss reserve liabilities of casualty insurance companies. Although the GAO report incorrectly refers to such liabilities as "future expenses" (dr. pp. 14-15), they are estimates of payments to be made on losses that already have occurred. There is no justification for the adoption of a complex formula to determine loss reserves for federal income tax purposes. Adoption of discounting in this area would be certain to produce even greater administrative burdens for both the government and taxpayers than those which now exist.

11 21-26 We do not agree that any possible complexities in the discounting of future expenses apply with greater force to insurance companies. Property casualty insurance, by its very nature, is based on managing uncertainty, and the handling of complexities is inherent in the background of casualty insurance rate-making and management.

11 27-29 This matter has been corrected in the final draft. See p. 12 where the term "future expenses" has been changed to "future loss payments".

11 31-34 The question to be decided here is whether any additional administrative expense is justified by additional tax revenue. This issue is beyond the scope of this report although it is a factor that the Congress could consider before making any changes.

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Prior Consideration by Others Has Not Led to a
Recommendation For Discounted Loss Reserves

There is no regulatory requirement that loss reserves of casualty insurance companies be discounted. The propriety of such discounting has been the subject of study and consideration by both regulatory and accounting groups. The National Association of Insurance Commissioners, The American Institute of Certified Public Accountants, and The American Academy of Actuaries all have given substantial time in considering the propriety of discounting. None of these regulatory or professional bodies has recommended the adoption of discounted loss reserves.

The draft relies on the Statement of Financial Accounting Standards 60, Accounting and Reporting by Insurance Enterprises, issued by the Financial Accounting Standards Board ("FASB") on June, 1982 to support its determination that "matching" of expenses and revenues is an appropriate measure of annual income and yet ignores that organization's failure to recommend the discounting of loss reserves.

The accounting groups considering this issue have a special concern for the proper matching of revenues and expenses for financial reporting to investors. They have not recommended the practice of discounting loss reserves

12 3-13 The fact that various regulatory bodies and others have not recommended the adoption of discounting is in our opinion not conclusive since these organizations are not directly concerned with the establishment of tax policy. However, it is our understanding that the recent NAIC report on investment income does effectively discount reserves. (See Report of the Investment Task Force to the NAIC, June 1984).

12 14-21 FASB 60 permits but does not at this time require discounting of reserves. We have changed the report to eliminate reference to FASB 60, although it is still our position that discounting is not in conflict with that accounting statement. However, since FASB 60 does not apply to the determination of taxable income, we removed all references to FASB 60 from the report.

12 24-25 This statement is true as of the present time but see note above opposite lines 3-13.

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to achieve such matching. Even if discounting were warranted, one or more of such groups should be the first to recommend its use.

The NAIC strenuously opposes discounting of loss reserves for tax purposes. In a letter dated October 17, 1983 to the Honorable Robert Dole, the National Association of Insurance Commissioners expressed its grave concern about the impact of discounting loss reserves for federal tax purposes by noting:

...the NAIC is gravely concerned that the proposed changes in the accounting for loss reserves and the accounting for premiums for federal income tax purposes will adversely affect:

- o The integrity and credibility of currently prescribed statutory accounting principles,
- o The solvency and financial stability of the U.S. property and casualty insurance industry, and
- o The timeliness of claim payments by insurers to their policyholders and claimants.

This recognition of the problems inherent in discounting and the potential impact that discounting would have on the industry are policy issues that raise legitimate concerns and should be taken into account in any legislative consideration.

13 1-3 As stated in response to the comment on page 12, lines 3-13, the accounting and other groups named in the comment have no direct concern with tax policy and as such there is no reason to expect that they should be the first to recommend its (discounting) use.

13 4-24 Attached later in this appendix is a letter containing direct comments from the NAIC. We refer the reader to our response to those comments.

At this point we would comment on the question of "timeliness of claim payments" mentioned on lines 18 and 19. We are unable to see how the proposal for discounting would adversely affect the timeliness of claim payments since the faster a claim is paid the larger the current deduction. If anything it should be an incentive to speed up claim payments.

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The Uncertainties Inherent in Establishing Loss Reserves Distinguish Them From Financing Arrangements and Life Insurance Reserves Whose Accuracy May Be Improved by Discounting

Adopting a separate measurement of casualty company reserve liabilities unique to the federal tax code would be justified only if it produced an accurate measurement of current loss liabilities. Discounting introduces the substantial additional uncertainty of the timing of loss payments to the already complex process of determining the amount of proper liability estimates.

The method of discounting used by the draft in making its revenue estimates suggests that the pattern of payments should be determined on the basis of historical experience. The timing of payments in prior years will not necessarily provide an appropriate standard for determining the pattern of payments in subsequent years if, for example, payments in the past have been unduly delayed or accelerated.

Departure from a prior payment pattern can occur for many reasons. It can occur upon the adoption of new policy forms (e.g., reflecting a change from occurrence to claims made coverage in malpractice insurance), upon a change in underwriting standards, as well as upon a change in a company's general settlement practices. Payment patterns will vary from one line of business to the next

14 8-11 We do not agree that discounting "introduces the substantial additional uncertainty of the timing of loss payments to the already complex process of determining the amount of proper liability estimates." The matter of the timing of loss payments must have already been an integral part of not only the reserve development but also the premium calculations.

14 12-26 Discounting does infer that a pattern of payments will be used. We do suggest that the pattern of payments should be determined on the basis of historical experience. The commentator does not agree that this will necessarily provide an appropriate standard for future payments. While past history will not always be reproduced in the future, its use, if updated from year to year, should over time approximate actual experience. We feel that the basis for our suggested use of historical experience is strengthened by its use by recognized experts in the casualty insurance industry. We refer to the study by the President of Insurance Services Office, Inc. which is the principal basis for the industry claim that loss reserves are understated. The pertinent quotation is as follows:

"The method assumes that: (1) 'Payout patterns remain consistent over time. This assumption appears reasonable given stable link ratios that are shown for each line of insurance.'"

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and even within a single line from one year to another.

More significantly, payment patterns will vary substantially from company to company so that an industry average is not a meaningful standard. The consequences of an inaccurate standard for determining payment patterns or discount rates to individual members, to competitive balance, and to the industry as a whole could be dramatic as well as unforeseen.

Where liabilities are fixed and the time of payment is known, there may be some justification for discounting. Discounting is taken into account in determining original issue discount where bonds and other debt obligations are issued at a specified issue price that is less than the stated redemption price at maturity. Under such circumstances, the difference between such known amounts will be taken into income over a specific period of time. But such tax consequences are proper only because all essential elements are certain.

Discounting also is involved in the establishment of life insurance reserves where the essential elements are known or can be predicted with substantial certainty. Life insurance reserves reflect a liability to pay a specified amount in the future. They represent an accumulation of funds to pay that amount. As all insureds will die, the event is certain, and the only uncertainty

15 3-4 We agree with this statement that "an industry average is not a meaningful standard." We would point out, however, that our suggestion was not for an industry average method but for a company by company one. Page 59, Appendix II under (9) Discounted Unpaid Losses reads:---In applying the discount rate to unpaid losses the discounting period and the annual discount factors shall be based on each taxpayer's own historical pattern of loss payments or its estimates of the proportions of current taxable year unpaid losses to be paid in future taxable years." Special rules would likely be needed for small and newly formed companies. This should be handled by IRS regulations.

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21 This comment relating differences between life insurance and property/casualty insurance apparently attempts to show that the property/casualty business involves a much greater degree of uncertainty than life insurance and because of this it would be improper to discount p/c loss reserves. It seems to overlook the fact that p/c insurance, as well as life insurance, is largely based on historical statistical experience. This statistical experience is used to estimate all phases of claim experience.

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is the time of death. Even as to this uncertainty, mortality tables have been developed which provide substantial certainty as to the rates of death at various ages. Thus, there is (1) a certainty that payments will be made, (2) a certainty as to the amount of such payments and (3) a substantial certainty as to the time when such payments will be made. Loss reserves of casualty insurance companies differ from such life insurance reserves in that (1) the event that may require the payment of a liability has occurred; (2) the amount of any eventual payment is uncertain and (3) the timing of the payment cannot be accurately forecast.

Where certainty does not exist, discounting may merely reduce an already inadequate tax deduction for existing liabilities rather than reflect the time value of money. This would be the case if the loss reserve liability to be discounted has been underestimated. Because of the uncertainties inherent in the establishment of unpaid loss liabilities, casualty insurance company unpaid loss reserves are the least appropriate place to require discounting to reflect the time value of money.

As a result of the industry's reserve underestimations in recent years the federal government already may have realized a substantial economic benefit. Such benefit may even be comparable to that which it might

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17 2 Our position is that if reserves are inadequate they should be strengthened by the state regulators responsible for such activity and then discounted for tax purposes.

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have realized from any required discounting of more accurate loss reserve estimates over such period.

The Proposed Method for Determining a Discount Rate Will Lead to Distortions

The draft has not established the necessary foundation for its recommendation on discounting because the fundamental premise of mismatching which underlies such recommendation has not been substantiated.

Accordingly, we will not comment on the draft's suggested method of implementing such discounting or other details discussed in the draft. Nevertheless, we must point out that the draft's method of determining a discount rate (i.e., a moving average of each company's investment return for the current and preceding 4 years) is totally inappropriate.

From 1976 through 1981, the average annual prime interest rate has ranged from 6.8 percent in 1976 to 18.9 percent in 1981. Other investments experienced similar fluctuations. To discount for the future on the basis of a moving average of past experience will cause serious distortions whenever the future investment return varies in any substantial manner from that of the historical period. Recent fluctuations indicate that this is a real possibility. Furthermore, such a method of determining the discount rate can lead to revised investment practices

17 12-15 We disagree that the draft's method of determining a discount rate is totally inappropriate. An identical 5-year moving average has been used in the life insurance tax law for the last 25 years. While there have been questions, principally concerning the assets to be used in the rate's determination, we believe that the use of a 5-year average has never been in question. Nevertheless, the actual period to be used could either be this 5 years or a different period to be established by legislation or regulations.

17 16 We do agree that interest rates can fluctuate. However, the 5-year average suggested is a portfolio rate, and the swings in this rate from year to year are not of the nature suggested by the cited changes in prime rates.

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by the industry and is inconsistent with a tax system that seeks neutrality on such matters.

The Financial Position of the Industry
is Deteriorating and its Loss Reserves
Have Been Substantially Understated

Although the report recognizes that the industry is an "important part of the American economy," the industry profile fails to convey certain significant characteristics of the industry's operations:

- o competition for market share is intense, and the market is not concentrated -- the business is not dominated by a few large firms;
- o competition among carriers for market share has been intensified by loss of business to captives and other self-insurance arrangements;
- o in recent years, increases in premium levels have been held to a minimum, a development which causes many observers to be concerned not merely for profitability but for the solvency of a number of companies;
- o the industry has reached a tenuous moment in its evolution: reliance upon high interest rates to offset underwriting losses -- "cash flow underwriting" -- has permitted underwriting losses to grow so large that observers fear that changes in investment returns may lead to

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23 7 This section of the comments relate to industry profitability and the matter of underreserving. Comment number 1, pages 31-32 of the report covers the matter of underreserving and comment number 3, pages 33-34 of the report, concerns industry profitability. For our overall response the reader is referred to these comments.

18 10-15 The question of competition was considered by us but was felt to be beyond the scope of the report.

18 16-20 A recent interview of the President of Insurance Services Offices, Inc. reported in the May 1984 issue of Coopers and Lybrand Insurance Newsletter included comments on this matter of premium levels. We will quote two statements from the interview on this subject.

1. "Insurers for personal lines have already stabilized and moved their prices upward. Fortunately there are signs that commercial prices are becoming stable."

2. "...but more and more producers say companies are refusing to cut prices below a certain point." In the opinion of this expert, it would appear that a turning point in the low-premium underwriting loss cycle may have been reached.

Even though we have given the above quotations concerning the present position in the cycle, it is our opinion, as pointed out in a previous comment, that the present position in the cycle should be irrelevant to good tax law for the whole cycle.

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substantial operating losses; individual companies have in fact sustained substantial operating losses for 1983. For example, CIGNA has determined that it sustained a \$26,000,000 loss in 1983 from its casualty operations taking into account both underwriting and investment returns.

John G. BurrIDGE, a Best's executive, commented in a recent article:

Those who have assumed that underwriting losses up to a certain point are acceptable because they can be offset by investment income overestimate the ability of management to control the loss ratio so finely as to hold to a given limit... Now the companies are reaching the point where they can see that underwriting losses already have or soon will cut off the flow of money needed to maintain an increase in investment income. The only solution is to stabilize the underwriting operation.

"Review and Preview" by John G. BurrIDGE, Best's Review, January 1984, 28 at p. 30.

A brief review of industry statistics will illustrate the dilemma now facing insurers. Insurers' profitability is measured by underwriting profit or loss and investment gain or loss. In 1982, the industry recorded an underwriting loss of over \$8 billion, or 8.1 percent of earned premiums. Estimates by A.M. Best Company, the principal data collection service for the industry, show

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thru 20 2 These statistics for 1982 are incomplete in that they refer only to underwriting losses and do not mention the investment gains. Best's Aggregates and Averages figures show for 1982 that the mutual and stock companies they cover had underwriting losses of about \$8 billion, investment gains of about \$19 billion, increase in surplus of about \$8 billion, dividends paid to stockholders of \$3.7 billion, and federal income taxes paid of -\$0.6 billion. We feel this gives a more complete picture of the profitability of p/c companies in 1982. Similar figures for 1983 were underwriting losses of about \$10.6 billion, investment gains of about \$19.7 billion, increase in surplus of about \$5.2 billion, dividends paid to stockholders of \$1.8 billion, and federal income taxes paid of -\$1.1 billion.

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an underwriting loss for 1983 of \$12.2 billion on a premium volume of \$108.44 billion.

The draft acknowledges that the casualty insurance industry had become less profitable since 1977. It points out that net premiums written between 1977-82 increased by about 47 percent, but total income (net investment and underwriting gains or losses) decreased by about one-third (before taxes). (dr. p. 6)

A 1981 report comparing insurers' rate of return to that of 85 other industries showed that over a 15 year period (1966-1980) the casualty insurance industry's average rate of return was lower than average returns for the median non-insurance industry. In addition, insurers showed lower annual returns in 11 of the 15 years. Table 2 (dr. p. 7) reflects that the trend continued in 1982 when the casualty insurance industry's 8.9 percent rate of return as a percentage of net worth was only 81 percent of the 11.0 percent rate of return reflected by the next lowest industry (manufacturing).

The deteriorating financial picture of the casualty insurance industry may be even more serious than the above statistics indicate because it also appears that the liabilities of the industry for incurred losses have been understated in recent years. Such underreserving is indicative of the difficulties inherent in the process of

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21 22 See our response to comment 3 of report for discussion
of industry profitability.

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establishing appropriate reserves and is especially prevalent with respect to long-tail lines. Generally, loss estimates on long-tail lines have been short because of events that could not be foreseen at the time the reserves were established.

For example, in the mid-seventies, the industry experienced dramatic shifts in expenses as the economy went from high inflation to price controls, and then saw dramatic "protective" price increases following the end of price controls. Projections of health care costs, the rate of inflation and other economic factors considered in ratemaking and reserving could not be taken into account rapidly enough to follow the shifts in economic trends. While reserve deficiencies in long-tail lines such as medical malpractice and workers' compensation were pronounced, even short-tail lines such as automobile physical damage and bodily injury, which require projections of repair and health care costs, were hard-hit by difficulties in projecting trends.

More recent evidence of continued underreserving is found in the remarks of Daniel J. McNamara, President of the Insurance Services Office, Inc. ("ISO") made on January 10, 1984 at the Thirteenth Annual Meeting of the ISO wherein he stated:

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We've studied the aggregate loss reserves of the 200 companies that write over 90% of the business and make up A.M. Best Company's Casualty Loss Reserve Development Report. Our studies reveal very disquieting patterns. We've examined the development of paid losses by accident year for the five Schedule P lines that represent 90% of all loss reserves. These lines of insurance comprise general liability; multi-peril, including homeowners; automobile liability; workers compensation; and medical malpractice. Based on our analyses, we conclude that the industry's total loss and loss expense reserves, as of December 31, 1982, are inadequate by more than 10%.

* * *

The industry's complete financial results for 1983 aren't yet available. But the results for the first three quarters of 1983 show no strengthening of loss reserves. In fact, the industry's loss reserves increased in that period at an annual rate of only 8 percent, continuing the slowdown in the rate of increase that we've seen in recent years. That 8 percent annual rate of increase would be the lowest rate of increase in loss reserves in 20 years.

* * *

The industry's financial position looks even worse, when you consider current and prospective commercial lines underwriting results. For all commercial lines of insurance, we estimate the combined ratio [the ratio of losses and expenses to premiums] to be at least 115 for 1983, and we see no improvement in 1984. (Emphasis added.)

The NAIC letter to Senator Dole expressed its concern as to the impact that discounting loss reserves for tax purposes would have on this serious problem when it stated that: "[a]ny change in the accounting for loss reserves will encourage further under-reserving."

Recommendations which lead to the imposition of additional tax liabilities on an industry which has

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experienced a declining profit picture, that has a lower rate of return on net worth than other industries and that has substantially underestimated its present liabilities appear to be misguided policy even if such recommendations are based on theoretically correct premises. Where, as in the instant case, they are based on invalid assumptions, they are totally unwarranted.

Economic Effects on the Industry and its Customers
Also Must Be Considered Prior to Recommending
Legislation Which Mandates Discounting

No major legislative change should be adopted without consideration of the potential impact of discounting on the present competitive balance of the various types of companies in the casualty insurance industry, on the competitive balance between the industry and self-insurers and captive insurance companies, on the potential loss of insurance business to foreign insurers, on the increased cost of insurance to consumers (with the consequent revenue loss resulting from the increase in deductible premiums for business insurance), and on the extent it would influence investment decisions by the industry. Any recommendation for a revision of the current statute can be made only after extensive studies have been completed on at least the matters described above and on the operations and economics of the industry in general.

23 5-7 We disagree with the statement that invalid assumptions have been used in the report.

23 12 We found no evidence that our suggestions for possible changes in tax policy would affect the competitive balance of the various types of companies in the p/c industry. None of the comments we have received from industry sources have said that discounting would affect competitive balance between say, stock and mutual companies, self insurers and insurers, etc.

23 17 See response to comment 7, p. 38 of report.

23 18 We were not able to evaluate the increased cost of insurance to consumers because of lack of concrete knowledge as to the degree of "pass-on" of higher taxes in premiums, etc.

23 21 We recognized that there could be changes in investment decisions and included a disclaimer in the report since it is impossible to estimate beforehand the extent of such investment changes.

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Revenue Estimates

The draft's revenue estimate reflecting the proposed discounting of loss reserves appears to be substantially overstated. The draft's revenue estimate does not take into account that casualty insurance companies must pass on the burden of any tax increase to policyholders. To the extent that increased premiums will be required on business insurance, such premiums will be deductible for tax purposes and will reduce the taxes otherwise collected from such policyholders. Assuming these policyholders will be subject to an effective tax rate that exceeds that of the financially troubled casualty companies, there will be a loss of revenue. Thus, the true revenue impact of discounting may be substantially less than projected even if all the draft's assumptions in making such estimate are correct.

Allocation of Acquisition Expenses

The draft states that the current deduction of certain expenses which it labels "acquisition" expenses presents a second area of mismatching of revenue and expense. The expenses so labelled include expenses related to "receiving and paying premiums and commissions, collecting premiums from agents and insureds, reconciling records relating to premiums, compiling expiration lists and notices due, and paying commissions and allowances to

24 4-6 See response to comment 5, pages 35-36 of report. The report was changed on page 19 to include a reference to this.

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28 7 The draft report definitions of "acquisition" expenses have been narrowed in the final draft so as to cover only those expenses about which there should be little cause for disagreement. Regulations would be needed to specify the actual items to be included.

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agents, brokers, and employees" (dr. p. 26). Although not mentioned in the text of the draft, the legislative language proposed by the draft also includes "advertising" as part of this category (dr. p. II-5). In this respect, contrast the draft's proposal with the Internal Revenue Service's present position in Treas. Regs. §1.471-11(c)(2)(ii) and Rev. Rul. 68-561, 1968-2, C.B. 117.

The illustration of mismatching in this second area of recommended change assumes the issuance of a 3-year policy for which an insurance company receives premiums in advance. Such premiums are included in current income only as earned. The draft concludes that "if the matching principle is to operate correctly, expenses must be treated the same way" (dr. p. 27).

Although the text of the draft appears to be concerned only with multi-year policies, the revenue estimate indicates that the recommendation encompasses "acquisition" costs of one-year contracts where the policy year falls within two taxable periods.

The recommendation that acquisition expenses be capitalized and amortized over the life of the contract is contrary to the general principle of tax accounting that an expenditure need not be capitalized where its benefit does not extend "substantially beyond" the close of the

25 9-15 The example on page 22 of the report has been changed from a 3-year policy to a 1 year policy to remove any cause for misunderstanding that our suggested tax changes were based on multi-year contracts, which no longer are the norm.

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thru 26 9 Our position is to achieve closer matching even if the contract is only for 1 year or less. Premiums paid for a period beyond the end of the year of issue are allocated as earned and unearned, and we feel the same treatment should be used for acquisition expenses. This would involve changes in existing regulations as well as legislation. We do not feel that under our suggestion there would be any problem of tracking expenses, since once a particular expense is identified as being acquisition, it is allocated solely on the ratio of total earned to total premiums.

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taxable year in which it is paid or accrued. Treas. Regs.
\$1.461-1(a).

Under current tax accounting principles, amortization of acquisition expenses over the life of a one-year policy would not be justified. Substantial administrative expenses would be required in tracking and allocating acquisition costs over two taxable years and this would result in only a slight shift in expenses which over time would not have any substantial effect on revenues.

Moreover, the draft report's recommendation is inconsistent with the Treasury Department's determination when it reviewed this issue. In testimony before the Senate Finance Committee on June 13, 1983, Assistant Secretary John Chapoton stated:

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

If the industry's long-standing practice does constitute mismatching, it is mismatching for one year at most and is comparable to that allowed other taxpayers where payments received are to be included in income as earned. (See for example, the deduction allowed for circulation expenditures under Section 173 coupled with the deferral of prepaid subscriptions as income pursuant to Section 455.)

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We are concerned that in the effort to present a case for mismatching, the draft report presents an example which is inaccurate and misleading. As an example of the mismatching which might occur, the report assumes the issuance of a three-year contract. Quite simply, three year policies are not common within the insurance industry. One-year policies are the norm, and in lines which are experiencing pricing problems, policies often are issued for only six month periods. A review of the draft's Table 4 in Appendix I (dr. p. I-10) indicates that almost all of the revenue estimate on this recommendation is attributable to one-year policies.

To the extent that "acquisition" costs remain level, the amount of annual deductions allowed under the draft proposal will be the same as those allowed under the current system. By deferring the tax deduction of "acquisition" costs (which in almost every case will be for only one year), this recommendation will adversely affect only those insurance companies with increasing "acquisition" costs and therefore a lesser tax deduction under the GAO recommendation than presently allowed. Such increase in acquisition costs may occur because a company's business is growing. In times of high inflation, it also may occur solely because of inflation. Under such circumstances, any additional tax revenue

27 5-9 See response to comment 5, pages 35-36 of report.

27 18-20 We agree with this statement, but according to studies made by Best's, most companies are growing both as to premium income and amount of insurance coverage. However, it should be pointed out that growth and additional tax revenue, if any, because of inflation is not unique to the property/casualty industry.

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generated by this recommendation would be attributable to such inflation.

This recommendation would change a long-standing practice, which is not unique to the casualty insurance industry, to achieve a theoretical purity not considered necessary by the Treasury Department. Its adoption is not justified.

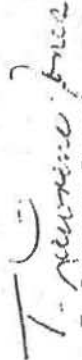
Protection Against Loss Account

Mutual companies cannot look to shareholders for capital that may be required to maintain or increase their capacity for writing insurance. To alleviate this problem Congress provided the PAL account whereby the tax on certain amounts can be deferred and thereby retained as part of the surplus of such companies. Nothing in the draft indicates that the PAL account has not served its intended purpose or that it will not continue to do so in the future. In the context of present law the draft's conclusion on this matter is questionable.

Further Assistance Available

We appreciate the opportunity you have given us to comment upon the draft and we will be pleased to discuss our comments with you or your representatives.

Sincerely yours,


T. Lawrence Jones
President

THE HOME
INSURANCE
COMPANY



MICHAEL J. NEVENS
ASSISTANT VICE PRESIDENT
212 504-6937

February 22, 1984

Mr. Natwar M. Gandhi
Senior Evaluator
Program Analysis Division
United States General Accounting Office
General Government Division
Washington, D. C. 20548

Dear Mr. Gandhi:

We enclose a statement of our comments on the draft of a proposed report entitled "Congress Should Consider Changing Federal Income Taxation of the Property/Casualty Insurance Industry" which was prepared by the staff of the United States General Accounting Office. For your convenience two additional copies of the statement are enclosed.

This statement is submitted on behalf of the following property/casualty insurance companies:

American International Group
Chubb & Son, Inc.
CNA Insurance Companies
The Continental Corporation
The Home Insurance Company

Very truly yours,


Michael Nevens
Assistant Vice President
The Home Insurance Company

MN:cp
Enc.

Comments on
The Draft of a Proposed Report Entitled
"Congress Should Consider Changing
Federal Income Taxation of the
Property/Casualty Insurance Industry"
Prepared by the Staff of the
United States General Accounting Office

In its draft of a proposed report entitled "Congress Should Consider Changing Federal Income Taxation of the Property/Casualty Insurance Industry," the Staff of the U.S. General Accounting Office has suggested that Congress give consideration to three changes in the manner in which property and casualty ("P&C") insurers are taxed under the Internal Revenue Code. One of those suggestions, and the only one to which these comments are addressed, is the proposal that Congress enact a requirement that P&C insurers discount their unpaid losses for federal income tax purposes. The omission of any discussion of the other two proposals, which deal with acquisition expenses and the PAL account, is not intended and should not be interpreted to imply agreement with the suggestions made in the Draft Report.

These comments are not intended as a comprehensive critique of that portion of the Draft Report dealing with unpaid losses. They are limited to a discussion of two central points. First, the case for discounting the unpaid losses of P&C insurers made in the Draft Report rests upon a fundamentally erroneous understanding of the pricing

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See response to comment number 4, page 35 of report.

2 1-6 See response to comment number 1, page 32 of report.

mechanism of P&C insurance. Second, the Draft Report fails to take into account the serious inadequacies in the existing unpaid losses of P&C insurers and, as a result, ignores the devastating impact of applying a discounting requirement to estimates which understate the ultimate loss payments.

The Draft Report Is Based on a Misunderstanding of the Mechanism by Which P&C Insurance Is Priced

In an attempt to justify a discounting requirement, the Draft Report sets forth, at pages 15 through 17, what purports to be a simplified, but realistic, hypothetical example of a P&C insurance transaction. The example begins with the assumed fact that the P&C insurer issues a six-month policy for which the premium is received on June 30, 1980, and it assumes, for the sake of simplicity, that the insurer incurs no expenses in connection with the transaction.

The example then assumes that (1) "the premium is set to equal the discounted value of the loss payment," (2) the P&C insurer will have to pay a loss of \$1000, (3) the loss will be paid on June 30, 1985, (4) the premium will be invested at a 10 percent interest rate, compounded semiannually, (5) all of the P&C insurer's earnings will be reinvested at the same 10 percent rate, and (6) the P&C

insurer has other income against which it can offset any negative tax liability arising from the transaction. On the basis of these assumptions, the example concludes that the P&C insurer will charge a premium of \$613.91.

However, the first assumption is false, and the remaining assumptions are simply unrealistic. The falsity of the first assumption becomes readily apparent if one additional assumption is made: the P&C insurer had a policyholders surplus at January 1, 1980 of \$500, an amount certainly sufficient to support premium writings of \$613.91. At December 31, 1980, policyholders surplus would be reduced to \$195.86 (\$500 plus investment income of \$51.25 plus

premiums of \$613.91 plus investment income of \$30.70 less unpaid losses of \$1,000). If the insurer were to renew the policy for another six months on December 30, 1980, it would be insolvent for regulatory purposes on or before June 30, 1981. Its policyholders surplus of \$195.86 would be increased by the renewal premium of \$613.91, and by investment income of \$90.49, but would be decreased by the new unpaid loss of \$1,000). Barring infusions of additional capital, the P&C insurer would be placed in liquidation by state regulatory authorities.

It is, therefore, obvious that P&C insurance cannot be and is not priced in the manner assumed in the Draft Report. A discussion of the actual process employed by P&C insurers to determine the amount to be charged as premiums, i.e., rating, appears in the written statement submitted to the Senate Committee on Finance with Mr. William F. Gleason,

3 5-22 This assumption that "the premium is set to equal the discounted value of the loss payment" is not false. It was, however, used for illustrative purposes only, knowing that a higher premium, reflecting expenses and profit, would have produced the same result, even though different numerical figures would be shown.

The examples starting on page 13 of chapter 2 of our report were of single transactions or policies. This was done to simplify the examples and to more readily illustrate the point of the different results between discounted and undiscounted loss reserves. However, in actual practice, there would be many policies and transactions involved; some policies would result in early claims, others would not.

The commentator is correct that a company, with a single policy and the quoted amount of surplus, could not remain solvent, particularly if it were to continue with this policy for another 6-month period and experience another claim. It is not clear to us what the actual impact of this example is meant to be. It is clear that a company's surplus is meant to cover all of its policies, and as we said some become claims and many do not. The insurance principle could not operate if it was assumed that every policy would result in a certain claim.

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4 18 See response to comment number 4, page 34 of report. The pricing mechanism used in the examples was for illustrative purposes only and does not invalidate the case for discounting. An example showing actual pricing approaches and real data would show comparable results.

Jr.'s letter of June 24, 1983. A copy of that statement was delivered to Mr. Natwar M. Gandhi, Senior Evaluator, Program Analysis Division, U. S. General Accounting Office.

Accordingly, in lieu of a reiteration of the details of rating, it would seem sufficient to note that under the assumptions made in the Draft Report or under any variation thereof in which the premiums charged by the P&C insurer were less than the amount of the P&C insurer's losses and expenses, no P&C insurer could ever report an underwriting profit. However, some P&C insurers consistently report underwriting profits, and the P&C industry as a whole cyclically reports underwriting profits. The assumptions of the Draft Report cannot be reconciled with these well-documented facts, and it follows, therefore, that those assumptions are erroneous. Since the case for discounting in the Draft Report rests upon a fundamental misconception of the pricing mechanism for P&C insurance, it also follows that the case for discounting must fail.

The Draft Report Fails To Take Into Account the Devastating Impact of Discounting the P&C Industry's Already Inadequate Estimates of Unpaid Losses

In order to determine the present value of a future payment, one must know, among other things, the amount of the future payment and the date upon which it will be paid.

5 3-4 We disagree that the draft report, in effect, oversimplifies the matter of determining the amount of loss and the date of payment. While we deal with a single transaction in our example, it is only representative of a large number of similar transactions. In the aggregate the law of large numbers results in a high degree of predictability of the amount and date of loss and the date of payment of the loss. For small and newly formed companies special arrangements, covered by IRS regulations, could be made.

5 24-27 This has been corrected in the final draft, see page 12 of report.

As noted above, the example set forth on pages 15 through 17 of the Draft Report resolves these two issues by simply assuming that in the year the loss occurs, the P&C insurer knows both the amount and date of payment.

These assumptions are simply unrealistic. A P&C insurer pays its losses in a continuous stream on dates which it cannot foresee either when it writes its policies or when it estimates the amount which it will have to pay on a loss which has occurred but has not yet been settled. As of the date of the occurrence of the loss, the amount that the P&C insurer will be required to pay is similarly uncertain. In the case of losses which remain outstanding over a period of time, the estimate of the amount that will have to be paid to resolve the claim will be reviewed at regular intervals and will, in light of the facts known at the date of review, be increased or decreased accordingly.

Although the example on pages 15 through 17 of the Draft Report employs the unrealistic assumptions that the P&C insurer knows as of the date it fixes the premium the amount and date of payment of the loss, the Draft Report acknowledges elsewhere, in imprecise terms, that P&C insurers do not know the amounts of ultimate loss payments that will have to be paid on existing unpaid losses. Draft Report, p. vii. The Draft Report uses the phrase "the amounts needed to pay future claims" instead of the correct "the amounts needed to pay currently outstanding losses."

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The Draft Report contends, however, that the fact that unpaid losses represent estimates rather than fixed amounts does not represent an obstacle to discounting unpaid losses, even though a discounting requirement referenced to current estimates would not yield the present value of the future payments. The Draft Report argues that "the uncertainty associated with the reserve estimation process exists whether or not the reserves are discounted" and that "reserve estimates are made annually, and any errors in one year can be corrected in a subsequent year." Draft Report, p. vii.

For any P&C insurer which has underestimated the amounts which it would ultimately be required to pay, the impact of a discounting requirement would be to limit the deduction for unpaid losses to an amount less than the theoretical present value of those losses. If the underestimation were sufficiently severe, then a discounting requirement would be punitive.

It is well recognized that the P&C Industry's estimates of unpaid losses are seriously deficient. Mr. Daniel J. McNamara, President of Insurance Services Office, Inc., ("ISO"), discussed the inadequacy of those estimates in the course of his remarks on January 10, 1984 before the Thirteenth Annual Meeting of ISO. The functions of ISO include the collection and analysis of data relating to the P&C industry. A photocopy of Mr. McNamara's remarks is attached hereto.

Mr. McNamara stated that ISO had analyzed the aggregate

6 12-18 Comment number 1, pages 31-32 of the report, discusses the matter of underestimation of loss reserves. We agree with the statement in lines 12 through 16, but feel that the remedy for this is to have companies correct their underestimations before discounting.

loss reserves at December 31, 1982 of the 200 P&C insurers which wrote 90 percent of the business written by all P&C insurers and had concluded that the P&C Industry's total loss and expense reserves at the end of 1982 were inadequate by more than 10 percent. Thus, if a discounting requirement had been imposed for the year 1982, its impact would have been to magnify the inadequacy rather than to reduce the future payments to an assumed present value.

Looking to the future, Mr. McNamara indicated that ISO, using reasonable payout patterns and discounting unpaid losses at an assumed 8.5 percent investment yield, has calculated that for 1984 the P&C Industry will have negative pre-tax rates of return ranging from 4 to 6 percent on three major commercial lines of business, i.e., general liability, commercial auto, and commercial multi-peril, over the period required to pay the losses. If a requirement that unpaid losses be discounted for federal income tax purposes were to be added to this dire scenario, the results would obviously be catastrophic.

The Draft Report's contention that the impact of discounting inadequate estimates in one year would be corrected in a subsequent year ignores the fact that the tax imposed as the result of discounting inadequate estimates may not be recoverable when the correction occurs. In that event the payment of the tax would simply serve to reduce the funds needed to pay losses.

7 20-26 The question of recoverability resulting from adjusting for earlier inadequate estimates does not seem to be different in the case of discounting reserves than undiscounting. Recoveries in either event would be limited only by carryback and carryover provisions.

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February 24, 1984

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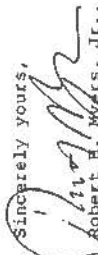
Dr. Natwar Gandhi
U.S. General Accounting Office
1201 E Street, N.W.
Room 606
Washington, D.C. 20223

Re: NAIC Comments to GAO Draft Report: "Congress Should
Consider Changing Federal Income Taxation of the
Property/Casualty Insurance Industry"

Dear Dr. Gandhi:

Enclosed are the comments of the National Association of Insurance Commissioners (NAIC) to the U.S. General Accounting Office draft report entitled "Congress Should Consider Changing Federal Income Taxation of the Property/Casualty Insurance Industry." It is respectfully requested that these comments be carefully reviewed and taken into consideration in the formulation of the final report. It is also requested that they be published with that report.

Sincerely yours,


Robert H. Myers, Jr.,
Counsel to the National Association
of Insurance Commissioners

RMH, Jr./slw
Enclosure (6 copies)
cc: The Honorable Bill Gunter, President, NAIC
The Honorable Bruce Bunner

STATE OF CALIFORNIA
DEPARTMENT OF INSURANCE

600 SOUTH COMMONWEALTH AVENUE
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February 23, 1984

Mr. William J. Anderson, Director
General Government Division
United States General Accounting Office
Washington, D. C. 20548

Dear Mr. Anderson:

As Chairman of the National Association of Insurance Commissioners (NAIC) Property and Casualty Taxation Task Force, we present in the paragraphs which follow our collective comments relating to our review of the Draft of a Proposed Report entitled "Congress Should Consider Changing Federal Income Taxation of the Property/Casualty Insurance Industry" prepared by the staff of the U. S. General Accounting Office (GAO).

The GAO is proposing three major tax law changes: (1) the discounting of loss reserves; (2) the amortization of policy acquisition costs over related policy terms; and (3) the elimination of the protection against loss (PAL) account.

The PAL account is a tax concept applicable solely to mutual insurers and unrelated to statutory accounting and thus not a significant concern to the NAIC. We expect the insurance industry will address its concerns with respect to this GAO proposal.

The NAIC is principally concerned with the above mentioned changes relating to the accounting for loss reserves and the accounting for policy acquisition expenses. These proposals, if adopted into law, will, in our opinion, adversely affect the efficacy of state regulation insofar as it relates to insurer solvency issues and the preservation of traditional statutory accounting objectives.

1 24-27 We do not agree, see response to comment number 6.

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The GAO appears to overlook either intentionally or unintentionally the fiduciary character of the insurance industry. The GAO comment on page 12 of the draft proposal states "there is no inherent conflict posed to protection of the public interest by adopting an alternative method of income measurement solely for purposes of taxation," is most disappointing and distressing to the NAIC.

The GAO uses the criteria of Financial Accounting Standard No. 60 (FASB No. 60) Accounting and Reporting by Insurance Enterprises dated June 1982 to support its argument that the statutory accounting of the NAIC is an improper accounting model to measure taxable income because statutory accounting does not match expenses with associated revenues.

The difference between FASB No. 60 and statutory accounting is not as divergent as the GAO would have us believe. Premiums, losses, loss adjusting expenses, maintenance and operating expenses associated with the underwriting function of insurers, and investment income and expenses under both statutory accounting and FASB No. 60 (which conforms to generally accepted accounting principles) are in fact properly matched. Moreover, to the issue of discounting of loss reserves, neither the American Institute of Certified Public Accountants nor the Financial Accounting Standards Board (in its FASB No. 60 pronouncement) have officially adopted accounting principles for loss reserves that are dissimilar to those prescribed by the NAIC.

Although statutory accounting is based on solvency concerns, most statutory adjustments are balance sheet oriented and adjusted largely through valuation adjustments (as non-admitted assets) directly to policyholder surplus. The principal deviation of statutory accounting from FASB No. 60 that affects statutory net income and thus, proposed taxable income are policy acquisition expenses. Again the GAO would have us believe that premiums are largely written for periods in excess of one year. This is the exception not the rule. Premiums are written largely for periods of one year or less and the trend is very definitely toward periods of less than one year.

2 2-6 See comment number 6. This statement was deleted from the final draft since it seemed to lead to misunderstanding on the part of more than one commentator, and in any event, the position it expressed was adequately made elsewhere in the report.

2 7-23 See our response to comment of the Associations, p. 3 line 14.

2 30-33 We do not believe that premiums are largely written for periods in excess of 1 year. See response to comment number 5.

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If fiduciary and public interest objectives are relevant to the insurance industry, then the NAIC would strongly urge that the use of conservative accounting principles in the determination of both statutory and taxable income should be preserved. As for the deferral and amortization of acquisition expenses, why abandon sound statutory accounting practices at the risk of weakening public interest objectives and solvency concerns of the insurance industry solely to achieve the pro-rata of acquisition expenses over short periods of one year or less. Perhaps the GAO proposal, if adopted, more appropriately should relate to such expenses only when contractual premiums are billed and collected for periods in excess of one year.

The proposed tax changes of the GAO trend in the least conservative direction. The erosion of conservative accounting practices does not, in our opinion, serve the public interest. The proposed Life Insurance Tax Act (S 1992) changes also are indicative of such adverse trends. For example, the proposed life insurance tax changes abandon net level reserving for the less conservative CVM reserving method, require the least conservative mortality and morbidity assumptions for reserving purposes, and incorporate disincentives to economic growth for small life insurance companies (which are not so small) as defined in the proposed legislation. The GAO proposals for property and casualty insurers similarly trends in the least conservative direction. Discounting of loss reserves and the deferral of policy acquisition costs are unrealized income sources, the recognition of which obscures the financial health of the insurer for solvency purposes.

We believe it is fair to conclude that significant tax accounting concepts adopted into law ultimately evolve into generally accepted accounting practices. Likewise, statutory accounting will not be an exception and thus, will evolve in the same direction. The proposed tax measures will be a radical change that will overturn a long standing "partnership" between state insurance regulation and federal tax laws applicable to property and casualty insurance companies.

3 4-9 Our suggestion is that allocation of acquisition expenses be based on the ratio of unearned premiums to premiums written. Premiums, both unearned and written, will be for contracts of all lengths, including those of 1 year or less, as well as those for longer periods. We do not suggest that sound accounting principles be abandoned. Again, we would stress that our concern is with the matching of revenue and expenses for tax purposes, with no consideration of changing any statutory accounting principles felt to be necessary to ensure solvency.

3 13-27 See response to comment number 6, page 37 of report. We disagree with this comment since it is our position that tax and solvency accounting methods serve separate and distinct purposes.

3 28-34 The statement starting on line 28 is a matter of opinion and is certainly not true in all instances. See page 11 of the Digest where we limit the scope of the report to measuring income for purposes of federal income taxation only.

APPENDIX III

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The accounting concepts articulated by Financial Accounting Standard No. 60 is not a panacea to solving tax revenue problems of the property and casualty insurance companies. Again, the questionable tax results of the proposal hardly merit the abandonment of sound statutory accounting practices as a basis for the determination of taxable income for this industry. The proposed tax changes do not adequately provide for satisfactory long term income tax revenue objectives. The expected tax revenues are illusory and, to the extent tax revenues are realized, they will be substantially realized only in the transition taxation year or during the phase-in period. The proposed changes simply accelerate the accumulated timing differences existing between the current statutory practices and the proposed tax accounting methods.

The NAIC believes that there are better taxation alternatives if "reform" is truly the rationale as purported by the draft GAO report. Further, the NAIC believes that these alternatives can be formulated and implemented without placing the state regulation of insurance at risk.

Other specific comments and observations relating to the proposed tax measures insofar as they affect statutory accounting, solvency and stability of the industry, and the interests of the consumer are presented below:

Discounting of Loss Reserves

Recognition of the discounted value of aggregate loss reserves for tax purposes anticipates future income. Thus, a tax will be imposed on unrealized investment income that will immediately diminish policyholders' surplus in the amount of the tax imposed. Moreover, the tax imposed could reduce policyholders' surplus by 5% or more, assuming an effective tax rate of 50% and a discount factor of 5%. This results from the size of the industry's loss reserves to surplus, as explained further in the succeeding item.

4 3-6 In our opinion, statutory accounting is not necessarily appropriate for tax purposes. For many other regulated industries the regulatory accounting scheme is not used for tax purposes.

4 11-13 We disagree with this statement. Discounting of loss reserves and allocation of acquisition expenses will increase tax revenues on an ongoing basis, all other things (investments, pass-on of extra taxes, etc.) remaining the same.

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Any change in the account for loss reserves will encourage further under-reserving. The May 1983 edition of Best's Review estimates that the long tail lines (Schedule P reserves) are already under-reserved by 10%. The Insurance Services Office reported similar findings earlier this year. Should statutory accounting for loss reserves be changed to conform to the proposed tax measures, marginal insurers would suddenly appear financially healthy. Aggregate loss and loss expense reserves of most companies, including the top 10 insurers, exceed 2 to 3 (and sometimes more) times policyholders' surplus. Thus, a discount factor of 5% can have a multiplier effect, increasing policyholders' surplus, 10% to 15% or more, respectively.

Discounting of property and casualty loss reserves is not analogous to life insurance obligations. Unlike life insurance, where premiums contain a savings element (that is set aside for benefits and claims that will occur in the future) in a future benefit reserve at its present value, the loss reserves of the property and casualty insurers are for claims already occurred (both reported and unreported).

This tax measure may encourage anti-consumer behavior by the insurer. Any discount model imposed by legislation could consciously or unconsciously promote claim payments delays by insurers in order to conform actual claim payment patterns to the assumptions of the model.

State regulation already has legal and accounting problems with nonadmitted foreign based reinsurers. This tax measure may promote further proliferation of novel foreign based reinsurance arrangements designed solely to circumvent both Federal taxes and sound statutory accounting practices. These contracts often minimize the amount, if any, of risk transfer and unfortunately result in the transfer of actual reserve funds to locations outside the supervision or control of state regulation.

- 5 6&7 See response to comment number 6. We specifically do not advocate this.
- 5 21-25 See response to comment number 6. We did not propose a model but rather the use of each company's own historical pattern. See page 59, appendix II.
- 5 27-30 See response to comment number 7.

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Amortization of Policy Acquisition Expenses Over Policy Terms

Acquisition expenses related to premiums are in essence an insurer's selling costs. The principal selling cost, although not always, is agents' commissions. Deferral of selling costs, as proposed by the GAO, is not required of other industries. If symmetry is relevant, proposed Section 811 of the Life Insurance Tax Act (S 1992) does not contemplate deferral of commissions and other selling costs.

Commissions to agents and brokers are typically reported in the agents' and brokers' taxable income when received or when the policy is invoiced to the policyholder. Again, if symmetry is relevant, should the insurer be required to defer such costs?

If selling costs are deferred, the GAO draft report is silent with respect to recoverability issues related to the capitalized costs. Unearned premiums must be sufficient to pay all future losses occurring within their unexpired term and including the recovery of related deferred acquisition expenses. If recoverability from unearned premiums cannot be clearly demonstrated, the GAO formula runs the risk of currently capitalizing future underwriting losses.

The statutory accounting system, as currently sanctioned by the Treasury Department, has worked well for over 60 years in achieving its ultimate goal of assuring that the property and casualty industry can perform as to its promises and obligations to the insurance public. This tax proposal, if enacted in its current form at this time, could do irreparable financial damage to this industry and to its policyholders.

- 6 3-5 This statement does not recognize the fact that while other industries are not required to defer selling expenses, they also cannot defer recognition of revenues, as property casualty companies can.
- 6 10-14 The point that seems to be missed in this paragraph is that an agent or broker is usually a cash basis taxpayer, while an insurance company is an accrual basis taxpayer. Symmetry between these two bases is by definition impossible.
- 6 15-22 We agree that the issue of recoverability of capitalized costs is a concern that requires consideration. However, it is a regulatory issue and should be apart from the determination of taxable income.
- 6 27-29 We disagree with the statement that our suggested tax proposals could do irreparable financial damage to the p/c industry and its policyholders.

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It is the NAIC's desire to assist the Treasury Department in the development of possible tax alternatives that would best achieve sound long-term tax revenue objectives without compromising solvency regulation and the integrity of the current conceptual framework for statutory accounting.

Very truly yours,



BRUCE BURNER
California Insurance Commissioner
Chairman of NAIC Property and Casualty Taxation Tax Force

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