AMERICAN INSURANCE ASSOCIATION

Property & Casualty Insurance Company Taxation

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The Property & Casualty Insurance Industry and Tax Reform

The Property & Casualty (P/C) insurance industry serves a unique role in the U.S. economy by protecting businesses and consumers against financial harm from liability, property, and casualty risks. This unique role requires a very different business model and a far greater degree of regulatory oversight than the typical manufacturer, retailer, or service provider. Federal income tax law has consistently recognized these differences by establishing special tax rules that are intimately linked to how the industry does business and is regulated.

However, tax reform discussions in recent years have threatened to disrupt this orderly system. The proposals introduced in 2014 by then-Chairman of the House Ways and Means Committee Dave Camp (R-MI) would change P/C insurance company taxation in ways that diverge from the well-established grounding of taxation in the regulatory framework of the industry, produce economically inappropriate results, and introduce excessive complexity and administrative burden.

As you will read in this booklet:

1. The P/C insurance industry is broad and diverse, and it has a significant role in the U.S. economy not only in facilitating the management of risk, but also through the investments it holds and taxes it pays.
2. Because P/C insurance companies receive premiums upfront but must set aside a large portion of those premiums to provide for benefits to be paid potentially years or even decades later, the annual financial performance of a P/C insurer by necessity involves estimation. However, through statistical concepts and techniques, financial results can be estimated with reasonable accuracy.
3. Insurance is a highly regulated industry. State insurance regulators, guided by the National Association of Insurance Commissioners (NAIC), have established extensive accounting and financial reporting standards that are designed to appropriately measure income and solvency and to create transparency into the financial activity of each P/C insurer subject to those standards.
4. There are meaningful differences between P/C and life insurance companies, and to appropriately measure income, these differences should be recognized and incorporated in tax law.
5. The current tax regime that applies to P/C insurance companies is grounded in the state regulatory environment and in the accounting and reporting framework established by the NAIC. The largest P/C insurance tax adjustments are to reserves and to the treatment of tax-preferred investment income.
6. Chairman Camp's proposals introduce significant changes to the tax treatment of reserves and tax-preferred investment income for P/C insurance companies. The proposals raise critical technical and practical concerns, including divergence from the established regulatory structure, economic distortions, and unnecessary complexity that will burden both insurers and tax administrators.

We look forward to continuing to discuss alternatives to Chairman Camp's proposals, to ensure that reforms made to the taxation of the P/C insurance industry maintain the essential connection of the tax regime to the business model and regulatory foundations of the industry, and that any expansion of the industry's tax base is commensurate with the benefit of rate reduction.

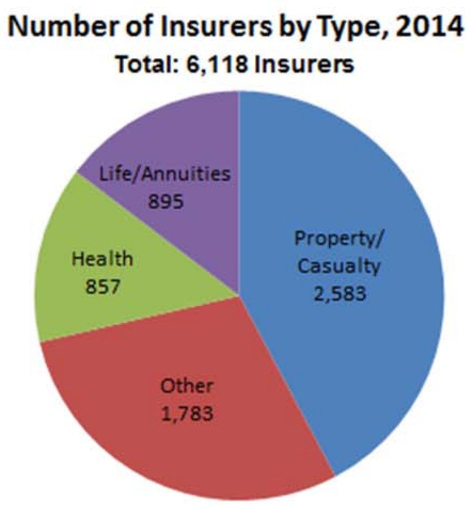
Property & Casualty Insurance

Unique among businesses, an insurance company protects its customers—the unrelated policyholders—with a promise to pay benefits in the future in the event of an insured loss. That promise to pay is supported by the capital of the insurance company and subject to strict regulation at state and federal levels. While regulators and rating agencies generally push for more capital to support that promise, the highly competitive nature of the industry and the interests of investors pressure companies to manage their businesses in a way that makes efficient use of that capital and distributes any "excess" capital whenever possible. While tax has a role in decision-making, it is only one among many factors; insurers' business decisions are driven by shareholders, regulators, customers, rating agencies, competitors, and the business concerns that affect any company.

The insurance industry is divided into two major segments:

Life insurance companies provide protection from the financial impact of risks such as:

- Premature death
- Outliving retirement savings
- Long-term illness or disability



Source: NAIC, 2014 Insurance Industry Resources Report, Vol. 1, page 37.

Property & Casualty insurance companies (also referred to as P/C or nonlife companies) provide protection from the financial impact of risks such as:

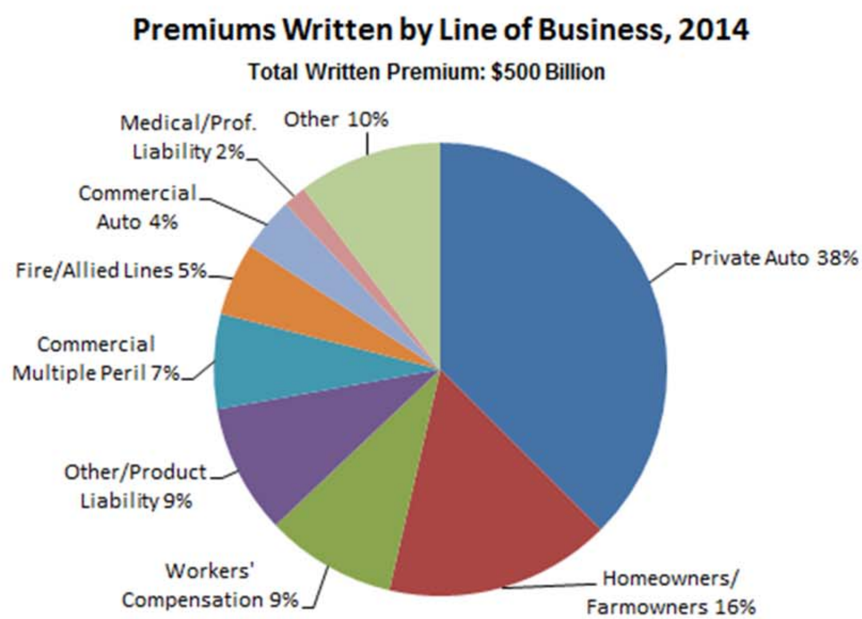
- Destruction of property by events like fire, hail, and tornadoes
- Damage and injury from motor vehicle crashes
- Being injured at work
- Theft
- Being sued for causing harm to another person
- Disability

Accident and health insurance may be sold by either life or P/C insurance companies or by standalone health insurance companies. Other organizations, such as health maintenance organizations and warranty companies, are also part of the insurance industry. For tax purposes, each company is considered to be either a life insurance company, a nonlife insurance company, or a company other than an insurance company, depending on the characteristics of its business during a taxable year.

P/C insurance companies provide protection for a wide variety of risks, selling insurance to individuals and families (known as *personal lines*) or to businesses (*commercial lines*) in exchange for a *premium*.

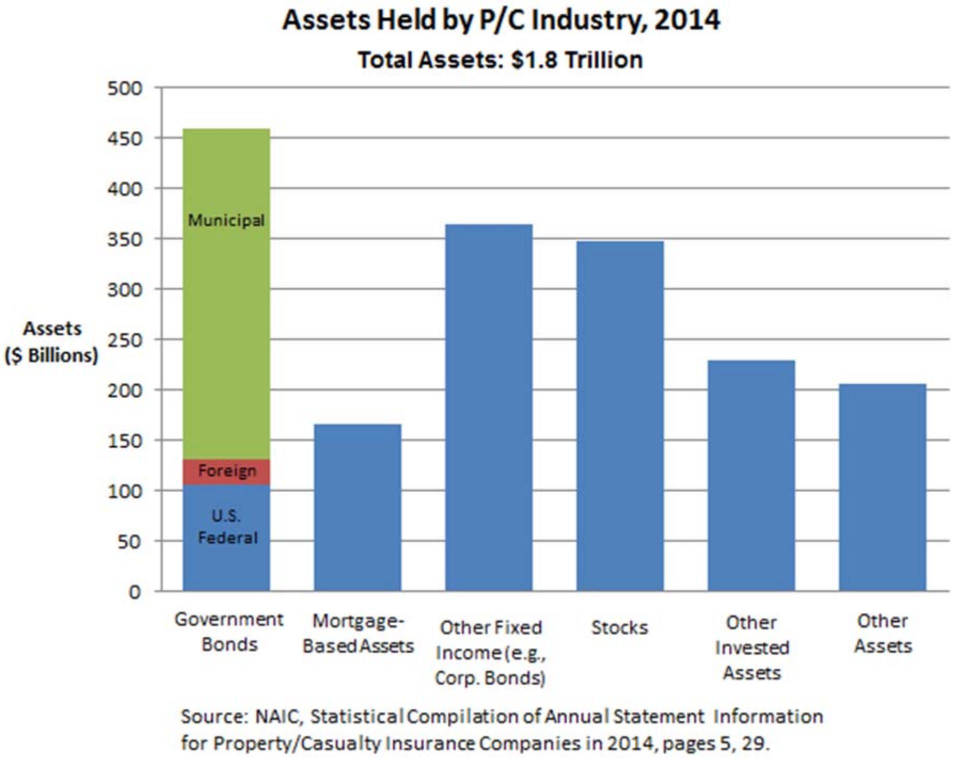
Coverage can be classified based on how long it normally takes for claims to arise as a result of a covered event:

- **Short-tail**—claims are paid during or shortly after the policy period, such as for physical damage to automobiles and homes
- **Long-tail**—claims may be paid many years after the policy period, such as for medical malpractice or workers' compensation



Source: NAIC, Statistical Compilation of Annual Statement Information for Property/Casualty Insurance Companies in 2014, page 23.

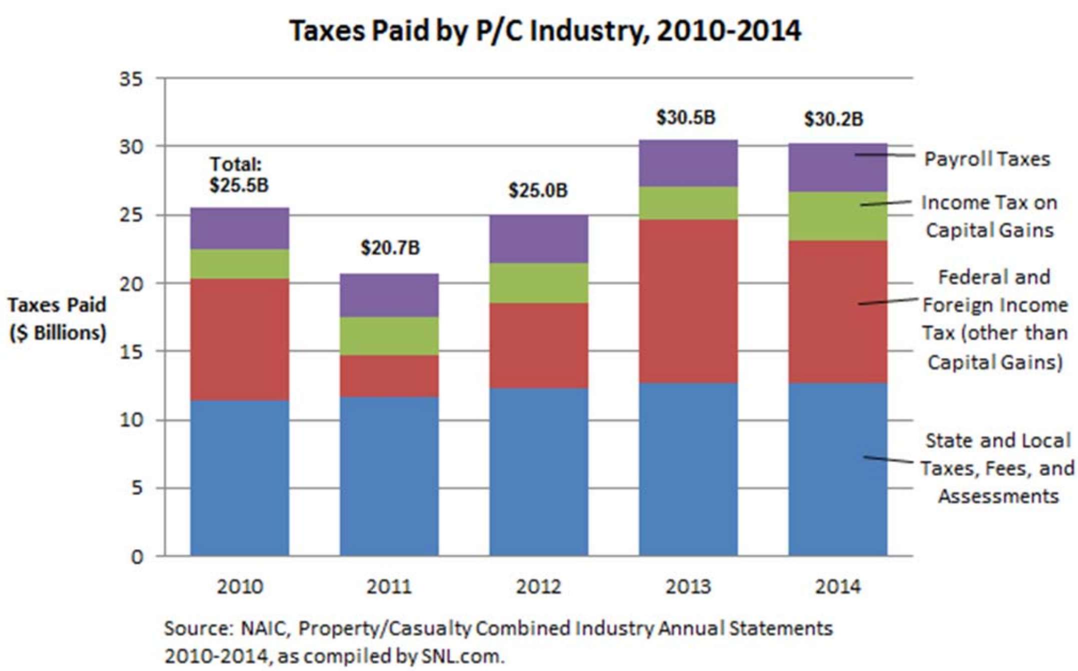
In addition, the investments held and taxes paid by the insurance industry help provide and maintain a reliable foundation for the U.S. economy.



Through the investments they make, insurance companies provide critical funding for businesses and municipalities, providing financial support for research, innovation, expansion, infrastructure, and other opportunities.

Taxes paid by the industry include typical business taxes (e.g., on federal or foreign income, payroll, and real estate) as well as special state insurance obligations:

- **Premium taxes** paid by insurers on premiums received, which fund state insurance department operations and other state budget needs
- **State guaranty fund assessments**, through which financially healthy insurers assume responsibility for claims incurred by policyholders of a company that becomes insolvent
- **Other state assessments and fees**, such as for workers' compensation funds, uninsured motorist funds, or licensing and franchise taxes



How P/C Insurance Works

Insurance companies are paid premiums in order to assume risks from individuals, families, and businesses. The insurer invests the premiums and pools risks, ultimately paying benefits if and when insured losses arise, e.g., from house fires, automobile crashes, or injuries to third parties:

If fewer or smaller claims occur than the insurance company expected when it determined the premiums, the company is more profitable. If more or larger claims occur, the insurance company may not be profitable. Insurers are able to provide this protection and make reasonably accurate projections because of the *law of large numbers*—when you have a large enough number of homogenous, independent risks, the average result is likely to be close to the expected outcome.

Insurance Reserves

A typical manufacturer incurs costs of labor and raw materials upfront and collects revenue later when the product is sold. Insurance company cash flows run in the reverse order:

- Insurers collect premiums upfront but incur costs later, potentially many years later, when (and if) the insured event occurs.
- In order to appropriately match the timing of income and expenses, insurance companies must establish *reserves*—amounts set aside to provide for incurred losses and related expenses that will be paid in the future but are attributable to the current accounting period.
- Insurance companies employ actuaries, who use data, models, and statistical techniques to determine reserves, in accordance with actuarial standards of practice and other professional requirements. Actuaries can estimate future outcomes quite accurately because of the law of large numbers.

Measuring Annual Profits

Because the eventual amounts and timing of claims and related expenses are not known with certainty at the end of any accounting period, insurance companies rely on actuaries to estimate the *unpaid losses*—losses that have been *incurred* (meaning the event triggering the damage or injury has occurred) but have not yet been paid by the company.

P/C insurance companies maintain the following types of reserves for unpaid losses:

- **Case reserves**—relating to events that have occurred and have been reported to the company, but payment has not yet been made (e.g., workers' compensation benefit payments relating to an injury that is known to the insurer)
- **Incurred But Not Reported (IBNR) reserves**—relating to events that have occurred, but the company has not yet been informed (e.g., benefits to be paid under an asbestos policy to employees who were exposed to asbestos on the job in the past but have not yet reported a related illness)
- **Loss adjustment expenses**—relating to the costs of administering and recording claims for both reported and IBNR losses

Investments

- Premiums that are not needed to pay current expenses and claims are invested by the insurance company.
- An insurer's investments must be of high quality and must be liquid enough to be available when needed to satisfy claims.
- The insurer must hold assets at least as large as the reserves and other liabilities plus the *required capital*—a buffer to absorb fluctuations in claims, financial markets, and other events, based on factors prescribed by insurance regulators—in order to remain solvent.

The income of a P/C insurance company has two components: *underwriting income* and *net investment income*.

Underwriting income =
Premiums earned
– Losses incurred
– Expenses

Net investment income =
Interest, dividends, rents, etc.
+ Capital gains (losses)
– Investment expenses

Operating income =
Underwriting income
+ Net investment income
– Income taxes

Underwriting income =
Premiums earned
– Losses incurred
– Expenses

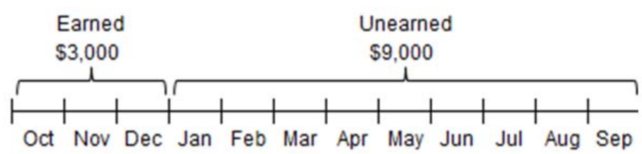
Components of Premiums Earned

Written premium is the total premium assessed during a period and is recorded when a policy is issued.

Earned premium is the portion of written premium for which insurance protection has already been provided.

Unearned premium is the portion for which coverage has not yet been provided. P/C insurers must hold *unearned premium reserves* to provide for this future coverage, and generally this amount will be refunded if the policyholder cancels the policy before the end of the policy period.

For example, a policy sold on October 1 for $12,000 will have earned premium of $3,000, and unearned premium of $9,000, as of December 31:



Types of Expenses

Loss adjustment expenses include expenses for reviewing claims, determining and disbursing benefits, retaining investigators and attorneys, and similar activities.

Selling costs include commissions paid to agents, premium taxes and fees paid to state insurance departments, and other similar items.

Administrative and service costs are other costs needed to run the business of insurance.

Components of Losses Incurred

Paid losses are amounts paid during the year for covered claims.

Unpaid losses are estimates of amounts that will be paid during future years arising from events that occurred during (or prior to) the current year. P/C insurers must hold reserves for unpaid losses and related loss adjustment expenses to provide for these payments.

Incurred losses are the losses paid during the year, plus the increase in the reserves for unpaid losses.

For example, assume a company paid $5,000 in losses during a year, and the unpaid losses were $8,000 at the beginning of the year and $9,000 at the end of the year. Then:

Incurred losses = $5,000 + ($9,000 – $8,000) = $6,000

Regulation of Insurance

Because of the insurance industry's critical role in protecting individual consumers and businesses at the times when they are most in need, the industry is highly regulated. The primary responsibility for insurance regulation in the U.S. resides with the 50 states, five territories, and the District of Columbia. The framework of state oversight has been in existence for over 150 years and has been affirmed by Congress, including in the McCarran-Ferguson Act of 1945.

Each state has an insurance department, which oversees the insurance companies and agents operating in that state. The head of the department is typically called the *commissioner*.

The Beginnings of Insurance Regulation in the U.S.

"Benjamin Franklin helped found the insurance industry in the United States in 1752 with the Philadelphia Contributionship for the Insurance of Houses from Loss by Fire. The current state insurance regulatory framework has its roots in the 19th century with New Hampshire appointing the first insurance commissioner in 1851."

Source: NAIC, "State Insurance Regulation: History, Purpose and Structure," http://www.naic.org/documents/consumer_state_reg_brief.pdf (accessed 5/10/2016).

The McCarran-Ferguson Act of 1945

"The Congress hereby declares that the continued regulation and taxation by the several States of the business of insurance is in the public interest...."

Source: 15 U.S.C. §1011.

The functions of state insurance departments include:

- Regulating the licensing and operation of insurance organizations and insurance agents
- Reviewing and approving product forms and rate filings
- Regulating and monitoring financial solvency, through reserve requirements, capital standards, financial reporting and disclosure requirements, detailed restrictions on the types of assets that can back reserves and required capital, and standards for governance and risk management
- Performing periodic examinations of financial condition and market conduct

To help facilitate coordination and common standards across the states, the state insurance commissioners in 1871 formed the National Association of Insurance Commissioners. The NAIC:

- Does not have direct regulatory authority over insurers, but rather develops standards, including model acts and model regulations, which individual states then review for potential adoption
- Is responsible for defining Statutory Accounting Principles, including requirements for insurance companies to prepare detailed financial statements and disclosures in a standardized Annual Statement
- Serves as a resource for insurance regulators around the country and facilitates consistency among the states

In addition to being regulated by the states, as guided by the NAIC, an insurance company may also subject to oversight by one or more of the following U.S. agencies, depending on the situation:

- Securities and Exchange Commission
- Federal Reserve
- Federal Insurance Office
- Department of Labor

Insurance companies that are owned by foreign parents or that do business outside the U.S. are also subject to oversight by foreign regulators and regulatory bodies.

Additionally, actuaries must meet extensive educational, technical, and professional requirements, including compliance with the Actuarial Standards of Practice developed by the Actuarial Standards Board.[1]

[1] See, e.g., *Utah Medical Insurance Ass'n. v. Commissioner*, TC Memo 1998-458 (unpaid losses within actuarially reasonable range developed by qualified actuary in accordance with actuarial standards of practice were "fair and reasonable estimates of actual unpaid losses"); *Acuity & Subsidiaries v. Commissioner*, TC Memo 2013-209 (same).

How the Distinctive Characteristics of the P/C Insurance Industry Inform Its Taxation

Although the basic business model of a P/C insurance company has similarities to life insurance companies, there are also some important differences that must be considered when contemplating the economics of each part of the insurance industry and the corresponding accounting and tax treatment.

Nature of the risk:

- A traditional whole life insurance contract provides protection ***when*** the insured person dies. The insurer knows the insured person will die someday, but it does not know when.
- For P/C insurance, especially long-tail lines, generally both ***if*** and ***when*** are critical. The insurer does not know whether a covered event will occur at all. If it does occur, the insurer does not know when the claims will come due. For example, if an insurer issued a policy protecting a business against claims of former employees exposed to asbestos on the job, the employees' injuries may not appear for decades, if at all.

Timing of claims reflected in reserves:

- For life insurance and annuity contracts, insurance companies predominantly hold reserves for *future unaccrued claims*—benefit payments arising from events that have not yet occurred.
- For P/C insurance contracts, insurance companies generally hold unearned premium reserves and reserves for *incurred claims*—benefit payments arising from events that have occurred. For certain lines of businesses, P/C insurers may also establish catastrophe reserves to allow for potential large-scale future events.

Approach to computing reserves for regulatory and tax purposes:

- Traditionally, life insurance reserves have been formulaic and prescribed. The NAIC and states determine specific required methods, mortality tables, interest rates, and other assumptions, and these form the basis for determining tax reserves.[2]
- Unpaid loss reserves for P/C insurance contracts do not have prescribed regulatory methods and assumptions. Because of the wide variety of products, the NAIC requirements are principle-based and are predominantly driven by actuarial professional standards. Tax reserves for unpaid losses on P/C insurance contracts are grounded in the NAIC Annual Statement, and unpaid losses are required to be a "fair and reasonable estimate of the amount the company will be required to pay" (Treas. Reg. §1.832-1(b)).

Comparison to Banks

Insurance companies are also different from banks. An insurance company's reserves are not a deposit or a fund to be drawn down if something unexpected occurs. They are an actuarially developed, regulator-controlled estimate of the amount that is required to be set aside in order to meet the contractual obligations the insurance company has to its policyholders.

Congress has recognized these differences and established tax rules that are intimately linked to how the P/C insurance industry does business and how it is regulated. The existing tax law recognizes the many economic, legal, regulatory, and tax policy considerations that distinguish insurance from other businesses:

(1) The income-first economics of insurance coverage

(2) The diverse range of insurance products

(3) Transactions special to insurance companies, such as reinsurance (insurance purchased by an insurance company)

(4) Characteristics that distinguish stock insurers (which are owned by shareholders) and mutual insurers (owned by their policyholders)

(5) The impact of regulatory and statutory accounting rules

(6) The role of insurance companies as financial intermediaries

[2] Over the past decade, life insurance industry regulation has been moving in the direction of principle-based, rather than rules-based, approaches, which in many ways more closely resemble nonlife insurance reserve approaches.

Taxation of P/C Insurance Companies under Current Law—Reserves

In the current tax regime:

- Insurance companies are treated as corporations subject to subchapter C of the Internal Revenue Code and have the same tax rate (generally 35%), but they are subject to important insurance-specific provisions defined in subchapter L.
- The tax base includes:
  - Underwriting income
  - Investment income
  - Other items of income and expenses
  - Worldwide income subject to U.S. taxation
- Taxable income begins with the NAIC Annual Statement. Adjustments are made primarily to reserves and to tax-preferred income.
- Generally speaking, the same rules apply to all P/C insurance companies doing business in the U.S., whether they are insurance companies that write business directly or reinsurers that assume risks from direct writers, and whether they are domiciled in the U.S. or in a foreign country.

The NAIC Annual Statement Controls the Taxation of P/C Insurance Companies

"Section 832(b)(1)(A) requires an insurer to use 'the underwriting and investment exhibit of the annual statement approved by the [NAIC]' to determine its 'gross income.'...

"State insurance commissioners' preferences about [loss] reserves thus are not some intrusion on federal tax policy; using their annual statement is federal tax law."

Source: *Sears, Roebuck & Co. v. Commissioner*, 972 F.2d 858, 866 (7th Cir. 1992), *aff'g* in part and *rev'g* in part 96 TC 61 (1991).

Reserve Adjustments—Unearned Premium Reserves (UPR)

Since the 1986 Tax Reform Act, the statutory UPR has been subject to a 20% "haircut" for taxable income purposes. The following example shows how the 20% haircut operates:

	12/31/2015	12/31/2016
UPR on Annual Statement	**100**	**120**
Statutory income/(expense) arising from the change in UPR during 2016	**(20)** = 100 – 120	
Taxable income/(deduction) arising from the change in UPR during 2016	**(16)** = (20) * 80%	

The haircut has the effect of reducing the benefit that arises from being allowed to defer unearned premium income while currently deducting all expenses associated with earning the business.

Reserve Adjustments—Unpaid Losses

For NAIC reporting purposes, reserves for unpaid losses are typically required to be held on an undiscounted basis—if a company expects to pay 100 for a loss that has been incurred, it will hold 100 in unpaid losses. For some long-tail lines of business, companies discount unpaid losses for NAIC reporting to reflect the time value of money.

The 1986 Tax Reform Act introduced loss reserve discounting for *all* lines of P/C insurance business, both short-tail and long-tail.

- Discount factors are applied to the undiscounted unpaid loss reserves from the Annual Statement to determine deductible reserves.
  - Factors are applied to each line of business separately, following the classifications on the Annual Statement.
  - The greatest impact of discounting is on long-tail lines of business.

- Discounting requires an assumption as to when payments will be made, known as the *loss payment pattern*.
  - There are two approaches under current law:
    - Loss payment patterns based on industry aggregate data, redetermined by Treasury every five years
    - If elected by a company, loss payment patterns based on company-specific data, redetermined every year
  - Under either approach, the loss payment patterns are determined separately for each line of business, using historical data as presented on Annual Statements.
  - Current law also provides for a limit of three years, 10 years, or 15 years of discounting after the accident year, depending on the line of business.
- Discounting also requires an assumption as to what interest rate to apply. Current law uses the *applicable Federal interest rate* or *AFIR*, which is a 60-month average of Federal mid-term rates (i.e., market yields on U.S. government obligations with a term of over three years but not over nine years). The AFIR approximates a risk-free rate of return.
  - The AFIR reduces market rate volatility by averaging the rates over a reasonably long period of time.
  - Use of a risk-free rate recognizes that benefit payments are contractual obligations that, to the policyholder, *are risk-free*—the company will pay the benefits regardless of investment performance.

How Loss Reserve Discounting Works

The following example illustrates discount factors for a sample property line of business. The factors are developed for the 2015 accident year using a hypothetical interest rate of 3.00%, in order to determine the discounted unpaid losses as of 12/31/2015. Note that this is a short-tail line of business; discounting has a greater effect on long-tail lines.

Payment year	(a) Estimated losses paid each year (industry average)	(b) Discount rate to 12/31/2015	(c) = (a) x (b) Value at 12/31/2015 of the estimated losses to be paid in the year shown
2015	55	n/a	n/a – already paid
2016	35	$\frac{1}{1.03^{0.5}} = 0.985$	34.5
2017	5	$\frac{1}{1.03^{1.5}} = 0.957$	4.8
2018	5	$\frac{1}{1.03^{2.5}} = 0.929$	4.6

Total undiscounted unpaid losses as of 12/31/2015	(d) = sum of (a) for years after 2015	**45**	**Translation:** The average company already paid 55 in losses during 2015. It expects to have 45 left to pay in future years, spread as shown in column (a) above.
Total discounted unpaid losses as of 12/31/2015	(e) = sum of (c)	**43.9**	**Translation:** The present value as of 12/31/2015 of the 45 left to pay in future years is 43.9, spread as shown in column (c) above.
Discount factor for tax year 2015	(f) = $\frac{(e)}{(d)}$	**97.6%**	**Application:** Each insurance company's management determines how much the company is expected to pay in future benefits as of 12/31/2015 for accidents that occurred on this line of business during 2015. The amount selected is typically based on actuarial indications that employ statistical techniques and are prepared in accordance with statutory accounting requirements and actuarial standards of practice. The company then multiplies the undiscounted unpaid losses by the industry-wide discount factor of 97.6% to get the company's discounted unpaid losses for tax purposes.

Proposed Changes to the Taxation of P/C Insurance Loss Reserves under the Camp Bill

In December 2014, Chairman Camp officially introduced H.R. 1, the *Tax Reform Act of 2014*, following a discussion draft released earlier that year. The proposed P/C insurance-specific reforms would have the effect of disrupting the well-functioning system described in the previous pages.

The proposals in H.R. 1 for loss reserve discounting are to:

- Replace the 60-month average Federal mid-term interest rate with a 24-month average of the corporate bond yield curve
- Eliminate the election to use company-specific experience for loss payment patterns
- Extend the loss payment period beyond the current limits of three, 10, and 15 years

These proposals would have many detrimental impacts on the P/C insurance industry:

- **Economically inappropriate discounting**—The Camp proposal's changes to the interest rate used for loss reserve discounting would lead to economically inappropriate results, as detailed in the boxes on the next page.
  - Loss reserve discounting should be based on a risk-free interest rate to reflect the fact that, from the policyholder's perspective, benefit payments are risk-free.
  - The shorter averaging period (24 months instead of 60) is inconsistent with the way a typical P/C insurer manages its investments.
  - If a non-risk-free rate is used, it should be adjusted to reflect the investment's default risk.
- **Loss of accuracy**—Removal of the company-specific experience election distorts taxable income.
  - There are competitive differences in claim experience and claim handling among P/C insurance companies, which can be accurately recognized under current law but would be disregarded under the Camp proposals.
  - Through the election, insurers can also reflect variations among the products offered within a line of business; H.R. 1 would prohibit them from reflecting the actual risk profile and claims emergence of their own products.
- **Divergence from NAIC Annual Statement**—The extension of the loss payment periods is not consistent with industry experience or with the record-keeping required by the Annual Statement.
  - The extension disproportionately affects certain products, such as workers' compensation and product liability insurance.
  - Unlike life insurance companies, which already have systems in place that can handle differences between statutory and tax reserving requirements, P/C insurance companies are fully grounded in NAIC reporting and have systems set up based on existing practice and rules.
  - Because some of the loss payment years required to compute discount factors under the Camp proposal are not currently reported separately on the Annual Statement, the proposal also runs contrary to the long-standing policy preference for having reserve calculations based upon publicly available data, as well as complicating audits of the extended tail by the Internal Revenue Service (IRS).

Overall, the changes to loss reserve discounting introduced in H.R. 1 would have economically inappropriate effects and would depart from the well-established history of the taxation of the P/C insurance industry being based fundamentally on NAIC reserving and reporting requirements as adopted by the states. The Camp proposal effectively accelerates future investment income—***income that may never actually be realized***—into the current tax year as ordinary income.

Risk-Free vs. Risky Obligations

The five-year corporate rate (shown in the graph at left for comparison purposes) is generally 0.5%-1.0% higher than the Federal mid-term rate, but this spread can vary drastically in times of financial volatility—in a way that P/C insurance reserves should not vary.

Due to extensive regulatory oversight, capital requirements, and state guaranty funds, benefit payments to policyholders are risk-free. The market and financial risks are borne by shareholders, not policyholders.

Loss reserve discounting should reflect this risk-free nature of the underlying insurance obligations by using a rate that approximates a risk-free interest rate, such as the Federal mid-term rate used today.

Averaging Period

A 24-month average is less stable than the current 60-month average, introducing increased volatility to a P/C insurer's recognition of its long-term contractual obligations.

In particular, in a rising interest rate scenario the discount rate may vary widely from an insurer's portfolio return, because insurance companies typically hold securities to maturity. P/C insurance companies will not be able to react to the markets quickly enough to maintain investments that match the required discount rate under H.R. 1.

Default Risk

As discussed earlier, the appropriate rate to use to discount loss reserves is a risk-free rate. If that is not done, though, it is critical to recognize both sides of what is sometimes referred to as the *risk/reward trade-off*—generally speaking, bonds that have a higher risk that the issuer will default on the debt will provide a higher rate of return to the investor to compensate for that risk.

As an example, assume that an investor can choose between two one-year bonds with a face value of 100:

- A U.S. Treasury bond, offering an interest rate of 1%, with no expected risk of default.
- A corporate bond offering an interest rate of 2%. The investor estimates a 1% chance that the corporation will default on the debt, and if it does, the investor expects to receive 50% of what he is owed.

The following table demonstrates that the 2% interest rate offered on the corporate bond is only part of the story. Once we reflect the fact that the investor earns the higher interest rate *because he is taking on risk of default*, the expected annual return of the corporate bond in the example is only 1.49%. If loss reserve discounting is based on an interest rate that is not risk-free, that rate must be reduced to account for the greater likelihood that the issuer of the bond will default.

	U.S. Treasury Bond	**Corporate Bond**
Value at end of year if no default	101	102
Likelihood of default	**0%**	**1%**
Amount that can be recovered if default occurs	n/a	50%
Value at end of year if default occurs	n/a	50% x 102 = 51
Weighted average value at end of year	100% x 101 **= 101**	(99% x 102) + (1% x 51) **= 101.49**
Expected annual return reflecting default risk	**1%**	**1.49%** *not 2%*

Taxation of P/C Insurance Companies under Current Law—Proration

Tax-Preferred Income—Proration

For all taxpayers other than insurance companies, if the taxpayer earns income on a municipal bond, that income is *tax-exempt*—not included in taxable income. Similarly, for other corporate taxpayers, if the corporation receives dividends on stock it owns in another corporation, the holder of the stock can deduct a portion of the dividends received, which reduces multiple layers of corporate taxation on the same income.

These tax benefits are not free, though. Market forces drive the prices of taxable and tax-exempt bonds so that the *after-tax* yields are the same on bonds that are otherwise identical, as shown in the example below.

Assume a non-insurance corporation is deciding which of two ten-year bonds to purchase. One is a corporate bond with an investment yield of 5%. The other is a municipal bond. Both bonds have the same risk of default. The purchaser's income tax rate is 35%.

In an ideal market, the investment yield on the municipal bond would be 3.25%, so that the two bonds are equivalent on an after-tax basis:

	Corporate Bond	**Municipal Bond**
Investment income per $100	$5.00	$3.25
Tax rate	35%	0%
Tax on investment income	$1.75	$0.00
After-tax income	**$3.25**	**$3.25**

Insurance companies have limitations on the favorable treatment normally available to corporations that receive tax-exempt and dividend income:

- Since the 1986 Tax Reform Act, these amounts have been *prorated*—divided into a portion that the insurance company may treat as described above and a portion that it must include in taxable income.
- For P/C insurance companies, 15% of the otherwise tax-exempt investment income and of the dividends-received deduction must be included in ordinary taxable income.

P/C vs. Life Insurance Company Proration

During the development of the 1986 Tax Reform Act, because of the differences in the nature of P/C insurance and life insurance, Congress chose a simplified, easily administrable approach of applying a flat 15% proration factor to all P/C insurance companies, rather than attempting to trace the actual tax-preferred income as in life insurance companies.

The Business Case for Municipal Bonds

Despite the fact that proration limits the tax benefits, the insurance industry is still a major player in the municipal bond market. The decision is driven by many non-tax business considerations, such as:

- **Quality**—Because of the long-term contractual guarantees an insurance company makes to its policyholders, it must be confident that the institutions it invests in are strong enough financially to make interest and principal payments and provide cash flow for the insurer to use to pay claims. Many municipalities have higher credit ratings than an average corporation.
- **Duration**—Municipal bonds also tend to be available with longer durations than many corporate bonds, enabling insurers to match assets with their long-term liabilities.
- **Capital**—Insurance companies are subject to a *risk-based capital* regime for regulatory purposes, which requires an amount of capital for each investment, based on factors that vary depending on the risk of the asset. Because municipal bonds tend to have better credit ratings, they require less capital.

Proposed Changes to Proration for P/C Insurance Companies under the Camp Bill

The proposal in H.R. 1 for P/C insurance company proration is to:

- Replace the fixed 15% proration factor with the ratio of the average adjusted basis of the company's tax-preferred assets to the average adjusted basis of all its assets, computed on an annual basis

There are a number of issues with this proposal, detailed below:

- **Distortion**—The example below demonstrates the effect of the proposal for a hypothetical company holding $1,000 of assets with varying proportions invested in tax-exempt bonds. It is clear that H.R. 1 distorts the effect of proration—even with no change to the total level of assets or reserves, the portion of a P/C insurance company's tax-exempt income that would be treated as taxable increases exponentially as it holds more of its assets in tax-exempt bonds.

(a)	(b)	(c)	(d)	(e)	(f)	(g)
		= (b) x 5%	= (c) x 15%	$= \frac{(d)}{(c)}$	$= \frac{(b)}{(a)} \times (c)$	$= \frac{(f)}{(c)}$
			Current Law		**Camp Proposal**	
Average adjusted basis of total assets	Average adjusted basis of tax-exempt ("TE") bonds	Income on TE bonds (at 5%)	TE income subject to tax (15% of TE income)	Percent of TE income subject to tax	TE income subject to tax (TE asset ratio x TE income)	Percent of TE income subject to tax
1,000	100	5	0.75	**15%**	0.50	**10%**
1,000	200	10	1.50	**15%**	2	**20%**
1,000	400	20	3	**15%**	8	**40%**
1,000	800	40	6	**15%**	32	**80%**

- **Effects on municipal bond market**—Because of these distortive effects, H.R. 1 would likely discourage P/C insurers from investing in tax-exempt securities, potentially disrupting the municipal bond market where the insurance industry in total holds over 14% of the market.[3]
- **Unnecessary complexity**—The proposal in H.R. 1 would create practical concerns for both insurers and the IRS.
  - Because the proration factor would change from year to year, investment managers would not be able to reliably compare the after-tax investment yield of assets available for purchase.
  - Every time an asset (whether tax-exempt or not) is acquired or disposed of, the tax-preferred asset ratio changes, altering the after-tax yield of the other assets in the insurer's portfolio.
  - Between the numerous open technical questions about the determination of the average adjusted basis, and the sheer volume of transactions and calculations that must be maintained on an ongoing basis, companies and the IRS alike would face a significant administrative burden as well as the potential for increased tax controversy.

Overall, the changes to P/C insurance company proration introduced in H.R. 1 would create undue complexity in compliance and examination, while distorting the investment management decisions of P/C insurance companies.

[3] NAIC, Capital Markets Special Report, April 2016, http://www.naic.org/capital_markets_archive/160419.htm (accessed 5/26/2016).

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