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STATEMENT OF

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BEFORE THE

SENATE FINANCE COMMITTEE

ON

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

Mr. Chairman and Members of the Committee:

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

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

The Loss Reserve Deduction

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

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

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

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

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

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

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

Allocation of Acquisition Costs

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

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

<u>Protection Against Loss Account</u>

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

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

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

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

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

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

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

TABLE 1

Estimates of Additional Revenues for the Property/Casualty Insurance Industry From Discounting Reserves For Calendar Years 1980-1982

($000,000 omitted)

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

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

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

TABLE 2

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

($000,000 omitted)

	Percent of Publicly Held Tax-Exempt Securities	Tax-Exempts as a Percent of Admitted Assets	Tax Exempt Income	Gross Investment Income	Dividends Excluded	Exempt Income to Gross Income (Percent)	Divid Exclu to Gr Incom (Perc
1975	14.9%	34.1%	$1,730	$3,347	$1,082	51.7%	32
1976	16.2	33.6	1,951	3,857	1,025	50.6	26
1977	18.8	39.2	2,411	6,230	1,326	38.7	21
1978	21.6	42.6	3,148	7,750	1,438	40.6	18
1979	22.7	42.3	3,937	9,787	2,278	40.2	23
1980	22.7	41.2	4,669	11.667	2,531	40.0	21
1981	21.7	40.2	5,415	13,938	2,622	38.9	18

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

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

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

TABLE 3

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

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

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

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