Report to the Congress on Property and Casualty Insurance Company Taxation

Department of the Treasury
April 1991

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DEPARTMENT OF THE TREASURY
WASHINGTON

ASSISTANT SECRETARY

April 1991

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
U.S. House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

Section 1025 of Public Law 99-514, the Tax Reform Act of 1986, directs the Secretary of the Treasury or his delegate to conduct a study of (1) the treatment of policyholder dividends by mutual property and casualty insurance companies, (2) the treatment of property and casualty insurance companies under the minimum tax, and (3) the operation and effect of, and revenue raised by, the property and casualty insurance tax provisions of the Tax Reform Act of 1986. Pursuant to that directive, I hereby submit this "Report to the Congress on Property and Casualty Insurance Company Taxation."

I am sending a similar letter to Representative Bill Archer.

Sincerely,

Kenneth W. Gideon
Assistant Secretary
(Tax Policy)

Enclosure

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CHAPTER 1. INTRODUCTION AND SUMMARY

The Tax Reform Act of 1986 (Public Law 99-514) (the 1986 Act) changed substantially the taxation of corporate income by reducing the top corporate tax rate from 46 percent to 34 percent, broadening the corporate income tax base, and adopting an alternative minimum tax. In addition to those general changes, the 1986 Act contained specific provisions that changed the taxation of property and casualty insurance companies. In order to monitor the effect of the specific provisions on property and casualty insurance companies, the Congress required the Treasury Department to study the property and casualty insurance tax provisions and to examine whether the revenue targets projected for the provisions were met.[1]

The 1986 Act also required the Treasury Department to study the tax treatment of policyholder dividends paid by property and casualty insurance companies. Under present law, mutual and stock property and casualty insurance companies may deduct dividends and similar distributions paid to their policyholders, but stock property and casualty insurance companies may not deduct dividends paid to shareholders. The Congress recognized that it may be appropriate, as in the case of life insurance companies, to treat a portion of the policyholder dividends of mutual property and casualty insurance companies as a distribution of earnings on equity of the company. However, the Congress also recognized that the rule that applies this concept to life insurance companies is both controversial and complex. Thus, the 1986 Act required the Treasury Department to study the tax treatment of policyholder dividends paid by mutual property and casualty insurance companies before the life insurance company rule or similar rule is considered for property and casualty insurers.

This report responds to the Congressional mandate contained in the 1986 Act. The principal findings and conclusions of this report are the following:

- The 1986 Act changes in the taxation of property and casualty insurance companies increased liabilities for the regular tax for calendar year 1987 by approximately the estimated amount ($1.5 billion). It was not possible to calculate the effect of the alternative minimum tax (AMT) on property and casualty insurance companies, because tax return data generally contain AMT information only on a consolidated basis.

- Although the specific property and casualty insurance company tax provisions were either over- or underestimated, estimating errors were largely offsetting. These errors are related largely to the difficulty in forecasting taxpayers' responses to the significant changes enacted under the 1986 Act and to limitations in the available data.

- The Treasury Department recommends that Congress not extend a limitation on the deduction for policyholder dividends to property and casualty insurers because the conceptual basis for such a limitation is flawed. The "prepayment" analysis shows that mutual company policyholder dividends should be fully deductible to provide equal corporate-level tax treatment of equity-like returns to mutual and stock company investors.

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[1] Appendix 1 contains the requirement for this study.

CHAPTER 2. THE TAX REFORM ACT OF 1986

2.1 Introduction

The Tax Reform Act of 1986 (the 1986 Act) changed substantially the taxation of corporations and their shareholders. The 1986 Act adopted base-broadening measures designed to increase the overall level of corporate income taxes, while at the same time reducing the maximum corporate tax rate from 46 percent to 34 percent. The corporate base broadening was accomplished primarily by limiting depreciation deductions, reducing the dividends received deduction, enacting the corporate alternative minimum tax, and adopting important changes in accounting rules. The 1986 Act also repealed the investment tax credit. In addition to the general base-broadening measures that affect the tax liabilities of all companies, the 1986 Act included several provisions that specifically affected the measurement of taxable income of property and casualty insurance companies.

This chapter provides background for the evaluation of the revenue effects of the changes in the 1986 Act on property and casualty insurance companies contained in Chapter 3. The chapter describes in detail the 1986 Act's changes in the taxation of property and casualty insurance companies (Section 2.2). The chapter also includes a detailed discussion of the alternative minimum tax (Section 2.3). The tax changes described in this chapter became effective for taxable years beginning after December 31, 1986.

2.2 Changes in Property and Casualty Insurance Company Taxation

The 1986 Act changed the taxation of property and casualty insurance companies by requiring: (1) discounting of unpaid losses; (2) the inclusion in income of 20 percent of unearned premiums; (3) prorating of tax-exempt income; (4) repeal of the protection against loss account (PAL) for mutual property and casualty insurers; and (5) adoption of a single deduction for all small companies. These provisions are discussed below.

Discounting of Unpaid Losses

Under tax rules prior to the 1986 Act, property and casualty insurance companies were allowed a deduction for losses paid during the taxable year and for the net increase (from year-end to year-end) in losses incurred but unpaid (unpaid losses) and for loss adjustment expenses (LAE). Unpaid losses were reduced (and the reduction included in taxable income) when future losses were actually paid. For tax purposes, unpaid losses and LAE were calculated on a nominal (undiscounted) basis, that is, without reference to the fact that the present value of future liabilities (unpaid losses) is less than their nominal value. The net effect of this tax treatment allowed property and casualty insurance companies a current deduction for future costs. This deduction effectively understated a property and casualty insurance company's income by the difference between the nominal value and the present value of the company's liability to pay its unpaid loss claims.

This change was intended to correct the prior overstatement of the true economic value of the insured loss. Without discounting, the longer the period between the claim and the actual payment, the greater the overstatement. Since prior law failed to reflect the time value of money, it permitted companies to understate their income.[5]

Inclusion in Income of 20 Percent of Unearned Premiums

The underwriting income of a property and casualty insurance company begins with earned premiums. Prior to the 1986 Act, in determining premiums earned, the increase in unearned premiums shown on the NAIC annual statement was deductible from gross income. However, expenses incurred, including acquisition expenses attributable to unearned premiums, were currently deductible. As a result, prior law mismatched income and expenses by permitting a deferral of an undiscounted portion of unearned premium income while allowing a current deduction for the associated costs of earning the deferred income.

The 1986 Act reduced the current deduction for the increase in unearned premiums, which has the same effect as denying current deductibility for a portion of the premium acquisition expenses.[6] The 1986 Act generally required property and casualty insurance companies to reduce their deduction for unearned premiums by 20 percent, which was deemed to represent the expenses incurred in generating the unearned premiums.[7] The Act also provided for the inclusion in income of 20 percent of unearned premiums outstanding prior to January 1, 1987.[8]

Prorating of Tax-Exempt Income

Prior to the 1986 Act, property and casualty insurance companies were subject to a tax on investment income which generally included interest, dividends, and rents. However, a property and casualty insurance company that included tax-exempt interest in income was allowed to deduct this interest. Property and casualty insurance companies were also allowed deductions for dividends received.

These companies were also taxed on their underwriting income which consisted of premiums earned reduced by losses (and expenses) incurred. The deduction for losses incurred generally reflected the losses paid during the year plus any increase in losses incurred but unpaid. No reduction in the deduction for unpaid losses was required to take account of the fact that deductible increases in unpaid losses could be funded with tax-exempt income.

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[5] See The General Explanation, pages 601 and 602.

[6] See The General Explanation, page 595.

[7] The 1986 Act generally required the deduction for unearned premiums for insuring bonds to be reduced by 10 percent.

[8] For bond insurance, the inclusion factor for the six years is 10 percent.

special provisions that lowered their tax liabilities. Mutual property and casualty insurance companies with gross receipts exceeding $1,110,000 were generally taxed like other corporations. There were no special tax provisions for small stock companies.

The 1986 Act repealed these rules and, in their place, exempted net written premiums or direct written premiums from tax for mutual and stock property and casualty insurance companies with less than $350,000 of net written premiums or direct written premiums (whichever is greater). The 1986 Act also allowed property and casualty insurance companies with net or direct written premiums (whichever is greater) between $350,000 and $1,200,000 to elect to be taxed only on investment income.[13]

These changes were intended to simplify the prior law rules applying to certain small and ordinary mutual companies. The changes also eliminated the distinction between small mutual and other companies by extending the benefits to all eligible companies, whether stock or mutual.[14]

2.3 Corporate Alternative Minimum Tax

In general, under prior law, corporations paid a minimum tax of 15 percent on certain tax preferences, to the extent that the aggregate amount of these preferences exceeded the greater of the regular corporate income tax or $10,000. This tax was paid in addition to the corporation's regular tax. The items treated as tax preferences included accelerated depreciation in excess of straight line depreciation; percentage depletion in excess of basis; a portion of net capital gains; and excess bad debt reserves of financial institutions.

The purpose of the minimum tax was to ensure that no taxpayer with substantial economic income could avoid significant tax liability by using exclusions, deductions, and credits. Congress concluded, however, that the prior minimum tax was inadequate because it was not designed to define a comprehensive income tax base. Moreover, since many important tax preferences were not included or were defined narrowly, Congress concluded that even with the add-on minimum tax, corporations were not being taxed on their economic income. Congress also concluded that the goal of taxing corporations with substantial economic income could not be achieved by broadening the list of tax preferences and wanted to ensure that whenever companies publicly reported earnings they would pay some tax for the year.

In order to address these perceived deficiencies in the corporate minimum tax, the 1986 Act repealed the existing minimum tax and created a new minimum tax for corporations known as the alternative minimum tax (AMT). The AMT was designed to ensure that in each taxable year the taxpayer generally must pay a significant tax on an amount more nearly approximating economic

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[13] To determine net and direct written premiums for the purpose of these tests, premiums of affiliated companies generally must be taken into account.

[14] See The General Explanation, page 620.

For taxable years beginning after 1989, the book income adjustment is replaced by the ACE adjustment. The ACE adjustment is equal to 75 percent of the amount by which the adjusted current earnings of a corporation exceed unadjusted AMTI, i.e., AMTI determined without regard to the ACE adjustment and the AMT net operating loss deduction. If unadjusted AMTI exceeds ACE then AMTI is reduced by 75 percent of the difference. However, this reduction is limited to the aggregate amount by which AMTI has been increased by the ACE adjustment in prior years. Generally, ACE is the corporation's unadjusted AMTI increased by items includable in computing earnings and profits but excluded from unadjusted AMTI and items deductible in determining unadjusted AMTI but not deductible in determining earnings and profits. ACE also includes various rules governing the treatment of specific items.

CHAPTER 3. EFFECT OF THE TAX REFORM ACT OF 1986 ON TAX LIABILITIES

3.1 Introduction

At the time of the 1986 Act, the specific property and casualty insurance tax changes were estimated to increase regular tax receipts by $7.5 billion between fiscal years 1987 and 1991.[1] In order to monitor the effect of these provisions and the alternative minimum tax (AMT) on property and casualty insurers, Congress required the Treasury Department to study the regular and minimum tax and to examine whether the revenue targets projected for the property and casualty insurance company tax provisions were met.

This chapter presents the results of the Treasury Department's analysis of the effect of the property and casualty insurance company tax provisions on regular tax liabilities for calendar year 1987. It compares the increase in tax liabilities in 1987 attributable to the 1986 Act's property and casualty insurance tax provisions with estimates made when tax reform was enacted. It reconciles the difference between changes in actual tax liabilities for 1987 and the estimates and discusses reasons for the differences.

This chapter also examines minimum tax information provided on consolidated tax returns filed by property and casualty insurance companies and their affiliates.[2] It is not possible to compare actual AMT liabilities to an AMT revenue estimate for property and casualty companies, because AMT receipts were not estimated separately for each industry when tax reform was enacted.

3.2 Revenue Estimates Prepared in 1986

Revenue estimates associated with changes in tax legislation are measures of the differences between expected tax revenues under the new law and the amount that would have been collected in the absence of the change in law. However, only the actual collections after the tax law change are observable. The collections that would have occurred in the absence of the change in law are not observable. Thus, it is never possible to know with certainty the actual revenue effect of enacted legislation, because only one of the two amounts required to determine that revenue effect is directly observable.

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[1] The revenue effect for the property and casualty insurance company provisions excludes the effect of the 1986 Act's changes in the taxation of Blue Cross-Blue Shield companies. The revenue effect from changes affecting these companies was reported separately and included in the total for life insurance companies.

[2] Regular and minimum tax liabilities and related information for 1987 are based on a sample of 1987 tax returns filed by property and casualty insurance companies and companies filing consolidated tax returns with property and casualty insurance companies. Appendix 2 contains a description of the sample of tax returns used in this report.

Another difficulty is that measures of income differ for tax and financial accounting purposes. For example, annual statement rules allow a deduction for the nominal increase in unpaid losses of property and casualty insurers, whereas the tax rules limit the deduction to the change in discounted unpaid losses. Thus, the use of annual statement data requires adjustments to account for these differences and such adjustments are a potential source of error.

Consolidation rules differ for annual statement and tax reporting. Annual statement reporting rules do not allow consolidation with non-property and casualty insurance companies, whereas tax rules generally allow such consolidation. As a result, annual statements lack reliable data on net operating losses (NOLs) and current losses of companies filing consolidated tax returns with property and casualty insurance companies. These amounts were estimated from tax return data.

In addition, special rules for consolidation between life insurance and nonlife companies can limit the amount of revenue from the property and casualty insurance company changes. The rules limit the losses of a property and casualty insurance company that can be used to offset life insurance company income to the lesser of 35 percent of life insurance income or 35 percent of the property and casualty insurance company losses. Because of these limitations, it is possible that the 1986 Act's changes could have no current effect on consolidated taxable income.

The 1986 Act contained six changes in property and casualty insurance taxation.[4] The Act required:

(1) discounting of unpaid losses;

(2) the inclusion of 20 percent of the annual increase in unearned premiums in taxable income (10 percent for bond insurance);

(3) the inclusion of 20 percent of the 1986 year-end unearned premiums in taxable income (10 percent for bond insurance income) over the six year period beginning in 1987;

(4) a reduction in deductions for losses by a specified proportion of tax-exempt interest and dividends received (the proration rule);

(5) repeal of protection against loss (PAL) accounts; and

(6) adoption of a single tax rule for small property and casualty insurance companies.

Table 3.1 contains the revenue estimates made at the time of 1986 Act for the six provisions described above. The Treasury Department and the Joint Committee on Taxation (JCT) estimated that the provisions would increase regular tax receipts by $7.5 billion between fiscal years 1987 and 1991.

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[4] These changes are discussed in Chapter 2.

Approximately 41 percent of the revenue was estimated to result from the unpaid loss discounting change. The temporary and permanent unearned premium changes were expected to account for 29 percent and 17 percent of the revenue increase, respectively. The proration rule and PAL account changes were expected to account for 11 and 4 percent of the revenue increase, respectively. The small company changes were estimated to lower the total revenue gain by approximately 2 percent.

The revenue estimates for the property and casualty insurance company provisions were calculated after taking into account corporate tax rate reductions. Since the estimates sought to determine the amount of receipts that would result from the property and casualty insurance company tax changes, they take into account losses, NOLs, and credits of all companies filing consolidated returns with property and casualty insurance companies.

The revenue estimates exclude the effect of the property and casualty insurance company tax provisions on corporate minimum tax receipts. These effects were included in the estimate of total corporate minimum tax receipts which were reported separately by Treasury and the JCT.

3.3 Impact of the Property and Casualty Insurance Tax Provisions on Regular Tax Liabilities: 1987

When tax reform was enacted, the Treasury Department estimated that the change in calendar year liabilities for the regular tax attributable to the property and casualty insurance company provisions would be $1.5 billion for calendar year 1987. Table 3.2 shows that the actual changes in liabilities nearly equaled the estimate ($1.5 billion). Although the actual change in liabilities for certain provisions differed substantially from the estimate, these differences were largely offsetting.

Actual tax liabilities attributable to the 1986 Act's changes were $1,472 million for calendar year 1987, about $63 million (4 percent) lower than the $1,535 million of estimated liabilities. Table 3.2 compares actual and estimated changes in liabilities for each provision for calendar year 1987. The unpaid loss discounting provision and proration rule increased liabilities by a larger amount than estimated. The unearned premium changes and the PAL account change increased liabilities by less than estimated, and the small company change provision reduced liabilities by a smaller amount than anticipated.

Reconciliation of Actual and Estimated Receipts

Table 3.3 reconciles the actual and estimated effects of the discounting of unpaid loss discounting, the proration rule for tax-exempt income, and the temporary and permanent changes in the deduction for unearned premiums on taxable income and tax after credits. These provisions were estimated using a detailed computer model. The PAL account and small company changes were projected separately and are also discussed below.

Table 3.3

Reconciliation of Actual and Estimated Effect of Selected Property and Casualty Insurance Company Tax Reform Provisions on Changes in Taxable Income, Losses, Tax Credits, and Tax After Credits: Calendar Year 1987
($ millions)

	Actual Effect (1)	Estimated Effect (2)	Difference (1) - (2)
Change in:			
Taxable income (before current losses and NOLs) attributable to			
1. Discounting of unpaid losses	6,213	3,515	2,698
2. Inclusion in income of 20 percent unearned premiums	916	1,978	-1,062
3. Inclusion in income of 20 percent of beginning of year unearned premiums	2,134	2,198	-64
4. Proration rule	397	95	302
Total	9,661	7,786	1,875
Current losses and NOLs	4,861	3,845	1,016
Taxable income after NOLs and current losses	4,800	3,941	859
Tax before tax credits	1,800	1,462	338
Tax credits	328	0	328
Tax after tax credits	1,472	1,462	10

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Note: Details may not add to totals because of rounding.

Table 3.4

Net Written Premiums for Schedule P and O Lines: 1978-89

Year	Schedule P Lines: Faster Payout Lines: Auto Liability	Schedule P Lines: Faster Payout Lines: Multiple Peril Lines	Schedule P Lines: Slower Payout Lines: Other Liability	Schedule P Lines: Slower Payout Lines: Workers Compensation	Schedule P Lines: Slower Payout Lines: Medical Malpractice	All Schedule P Lines	Schedule O Lines
			($ millions)				
1978	20,383	14,057	6,490	11,300	1,216	53,446	25,293
1979	22,102	15,977	6,612	13,164	1,204	59,060	27,857
1980	23,319	17,261	6,415	14,238	1,276	62,508	31,221
1981	24,395	18,269	6,046	14,616	1,338	64,666	32,800
1982	26,226	19,425	5,668	13,945	1,490	66,756	35,249
1983	28,080	20,496	5,679	14,005	1,568	69,829	37,140
1984	30,217	22,229	6,479	15,107	1,775	75,807	38,832
1985	36,087	26,933	11,544	17,048	2,769	94,380	38,267
1986	44,081	32,241	19,365	20,431	3,492	119,609	46,335
1987	49,205	34,774	20,874	23,429	4,004	132,285	56,240
1988	52,520	35,636	19,077	26,135	4,028	137,397	62,242
1989	56,024	36,084	18,434	28,241	4,278	143,061	63,181
			Growth Rates (percent)				
1979	8	14	2	16	(1)	11	10
1980	6	8	(3)	8	6	6	12
1981	5	6	(6)	3	5	3	5
1982	8	6	(6)	(5)	11	3	7
1983	7	6	0	0	5	5	5
1984	8	8	14	8	13	9	5
1985	19	21	78	13	56	25	(1)
1986	22	20	68	20	26	27	21
1987	12	8	8	15	15	11	21
1988	7	2	(9)	12	1	4	11
1989	7	1	(3)	8	6	4	2

Source: A.M. Best Company, Aggregates and Averages, Property and Casualty 1984-89 Editions.

Table 3.5

Net Written Premiums and Unearned Premiums for Property and Casualty Insurance Companies: 1973-89

Year	Net Written Premiums ($ millions)	Change in Net Written Premiums (percent)	Unearned Premiums ($ millions)	Change in Unearned Premiums (percent)
1973	42,480		18,944	
1974	45,152	6.3	19,881	4.9
1975	49,967	10.7	21,529	8.3
1976	60,959	22.0	24,850	15.4
1977	73,030	19.8	28,387	14.2
1978	82,341	12.7	31,375	10.5
1979	91,359	11.0	34,585	10.2
1980	96,556	5.7	36,446	5.4
1981	100,294	3.9	37,816	3.8
1982	104,038	3.7	40,126	6.1
1983	109,247	5.0	42,302	5.4
1984	118,591	8.6	45,832	8.3
1985	144,860	22.2	56,850	24.0
1986	176,993	22.2	67,374	18.5
1987	193,689	9.4	72,302	7.3
1988	197,885	2.2	76,831	6.3
1989	220,620	11.5	79,941	4.0

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Source: A.M. Best, Aggregates and Averages, Property and Casualty, 1975-90 Editions.

3.4 Alternative Minimum Tax Liabilities for Property and Casualty Insurance Company Consolidated Returns: 1987

This section presents information on minimum tax liabilities of property and casualty insurance companies and companies in other industries that file consolidated returns with property and casualty insurance companies. Because minimum tax liabilities are determined on a consolidated basis, it was not possible to estimate the minimum tax liability attributable to companies in the property and casualty insurance industry. Data from tax returns generally included only the information needed to compute minimum tax liabilities on a consolidated basis, such as minimum tax adjustments, preferences, and NOLs. Moreover, it is not possible to compare estimated receipts for the property and casualty insurance companies with actual liabilities because only aggregate corporate minimum tax receipts were estimated for the 1986 Act.

The minimum tax liabilities for property and casualty insurance companies and affiliated companies were $175 million for 1987 (Table 3.6). Approximately 32 percent of the property and casualty insurance companies' consolidated tax returns in the sample had minimum tax liabilities.

Table 3.6 provides information on the composition of the alternative minimum (AMT) tax base by tax status of the consolidated returns. Companies that paid only the minimum tax (and no regular tax due to the property and casualty insurance company changes) owed approximately $115 million. Generally, these companies had no regular tax liability because NOLs offset the increase in taxable income before NOLs attributable to the property and casualty insurance companies tax changes. Because the use of NOLs to offset alternative minimum taxable income is limited, these companies paid AMT. The minimum tax paid by these companies is largely attributable to the book income preference, which accounted for 64 percent of the minimum tax base before NOLs.

Returns in the sample that paid both regular tax and minimum tax paid $60 million in alternative minimum tax. Generally these companies paid the minimum tax because NOLs reduced regular tax liability below minimum tax liability, but were insufficient to eliminate regular tax liability. Approximately 55 percent percent of the consolidated returns in the sample paid only regular tax. For these companies, the tax effect of the larger minimum tax base was more than offset by lower minimum tax rate.

The remaining 13 percent of returns in the sample with no minimum tax had no regular tax liability attributable to the property and casualty insurance company tax changes. Most of these companies were not taxable because current losses before NOLs more than offset minimum tax preferences. Some companies that paid no taxes due to the property and casualty insurance company tax changes filed consolidated returns with life insurance companies and paid tax on their life insurance income.

3.5 Conclusion

The actual increase in regular tax liabilities for calendar year 1987 for the property and casualty insurance company tax provisions nearly equaled the amounts estimated at the time of the 1986 Act. The specific provisions, however, were either over- or underestimated. These errors are related largely to the significance of the changes enacted under the Tax Reform Act of 1986 and to limitations in the available data, particularly with respect to NOLs and credits. Estimating errors were largely offsetting, so that the aggregate estimated change in liabilities for the property and casualty insurance tax provisions nearly equaled the actual change in liabilities for 1987.

CHAPTER 4. THE TAX TREATMENT OF POLICYHOLDER DIVIDENDS PAID BY INSURANCE COMPANIES

4.1 Introduction

Under present law, mutual and stock insurance companies generally are allowed to deduct dividends and similar distributions paid to their policyholders. These distributions are included in the income of the recipient only after the full amount of premiums paid has been recovered (unless the policyholder deducted the premiums). Dividends paid to individual shareholders by stock insurance companies are not deductible by the company and are included in the income of the shareholder.[1]

An exception to the general rule that provides for deductibility of policyholder dividends paid arises for mutual life insurance companies. Under the Deficit Reduction Act of 1984 (the 1984 Act) mutual life insurance companies must reduce the deduction for policyholder dividends paid.[2] Congress enacted this limitation because it believed that a portion of the policyholder dividends paid by mutual life insurance companies is a distribution of corporate earnings to the policyholders as owners. Absent such a limitation on the deduction for policyholder dividends, it was argued, mutual life insurance companies would be provided a tax advantage because stock life insurance companies cannot deduct amounts paid to their shareholders as dividends.

Although Congress significantly overhauled the tax treatment of property and casualty insurance companies under the Tax Reform Act of 1986 (the 1986 Act), it did not extend the application of a limitation on the deductibility of policyholder dividends to mutual property and casualty insurance companies. Congress recognized that the limitation on the deduction for policyholder dividends as applied to life insurance companies has been both complex and controversial.[3] Thus, the 1986 Act required the Treasury Department to study the tax treatment of policyholder dividends paid by mutual property and casualty insurance companies before a limitation on the deductibility of policyholder dividends or other approach is considered for such insurers.

The appropriate tax treatment of policyholder dividends is problematic because in the insurance industry customers (policyholders) often also participate as owners or part owners of the business, since they provide capital to the business that earns income. A major difficulty in taxing the income of mutual and stock insurance companies is that the total income of companies selling "participating" policies cannot be identified directly. A "participating" policy is one through

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[1] See generally, Sections 808(a)(2), 832(c)(11), 72(e)(5)(c), 301(c) of the Internal Revenue Code.

[2] See Internal Revenue Code Section 809.

[3] Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, May 4, 1987, p. 621.

4.2 Policyholder-Level Taxation of Policyholder Dividends Paid by Property and Casualty Insurance Companies

Policyholders enjoy a tax advantage at the investor level because returns to capital contained in policyholder dividends generally are excluded from taxable income but shareholders' dividends are taxed when received (and stock appreciation is taxed when the stock is sold). This tax advantage accrues to participating policies issued by both stock and mutual insurance companies.

An exception to the policyholder-level tax advantage occurs when the policyholder is a business rather than an individual. Businesses are permitted to deduct premiums paid, but include fully in taxable income policyholder dividends received.[5] To the extent that a portion of premiums represents an equity-like contribution through a redundant premium, the current deduction of the redundant premium and the later inclusion in income of policyholder dividends is equivalent in present value to the absence of a deduction for share purchases and the exclusion from income of shareholder dividends received by corporations.[6] Thus, policyholder equity generally has no policyholder-level tax advantage over shareholder equity when the policyholder is a business. The following sections examine data on policyholder dividends paid by property and casualty insurers for business and personal coverage.

4.2.1 Policyholder Dividends By Line of Business

Data on policyholder dividends for property and casualty insurance companies by line of business for 1989 show that most policyholder dividends were paid on workers' compensation policies, which are sold primarily to businesses (Table 4.1). Property and casualty insurance companies paid 63 percent of policyholder dividends in the workers' compensation line, 17 percent in the personal auto lines, and 20 percent in all other lines. For the workers' compensation line, policyholder dividends were 6 percent of premiums. Policyholder dividends as a percent of premiums were 2.3 percent or less for all other lines.

Table 4.2 shows the breakdown of policyholder dividends for stock and mutual property and casualty insurance companies by line of business for 1989. Policyholder dividends in the workers' compensation line predominate for both stock and mutual property and casualty insurance companies.

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[5] See generally Internal Revenue Code Sections 162, 61, and 63.

[6] Equity investments in a mutual company and in a stock company are not fully equivalent because up to thirty percent of shareholder dividends received by corporations are taxable. See Internal Revenue Code Section 243.

Table 4.2

Policyholder Dividends and Premiums Earned for Stock and Mutual
Property and Casualty Insurance Companies by Line of Business: 1989

	Stock Companies					Mutual Companies				
	Policyholder Dividends		Premiums Earned		Dividends/	Policyholder Dividends		Premiums Earned		Dividends/
	Amount ($ millions)	Percent of Total	Amount ($ millions)	Percent of Total	Premiums (percent)	Amount ($ millions)	Percent of total	Amount ($ millions)	Percent of Total	Premiums (percent)
Fire	5.0	0.4	2,903.6	2.3	0.2	12.9	0.9	1,772.1	2.2	0.7
Allied Lines	2.9	0.2	1,396.9	1.1	0.2	7.4	0.5	657.9	0.8	1.1
Farmowners Multi Peril	0.0	0.0	332.8	0.3	0.0	7.9	0.6	589.9	0.7	1.3
Homeowners Multi Peril	1.6	0.1	8,192.5	6.5	0.0	81.4	5.6	9,157.3	11.4	0.9
Commercial Multi Peril	47.0	3.7	12,682.6	10.1	0.4	17.3	1.2	4,719.6	5.9	0.4
Ocean Marine	0.0	0.0	1,075.9	0.9	0.0	3.7	0.3	146.5	0.2	2.5
Inland Marine	0.4	0.0	3,234.9	2.6	0.0	9.3	0.6	1,089.1	1.4	0.9
Financial Guaranty	0.0	0.0	343.1	0.3	0.0	0.0	0.0	7.8	0.0	0.0
Medical Malpractice	9.0	0.7	2,106.9	1.7	0.4	86.1	6.0	2,115.8	2.6	4.1
Earthquake	0.0	0.0	190.6	0.2	0.0	1.8	0.1	169.4	0.2	1.1
Group Accident & Health	0.0	0.0	1,202.5	1.0	0.0	0.0	0.0	1,537.1	1.9	0.0
Credit Accident & Health	0.0	0.0	207.9	0.2	0.0	0.0	0.0	35.1	0.0	0.0
Other Accident & Health	0.0	0.0	541.8	0.4	0.0	0.1	0.0	990.4	1.2	0.0
Workers' Compensation	1,065.6	84.0	19,773.1	15.7	5.4	649.6	45.0	8,295.9	10.3	7.8
Other Liability	30.7	2.4	15,549.5	12.3	0.2	55.7	3.9	2,973.1	3.7	1.9
Auto Liab. (Private)	7.9	0.6	19,037.2	15.1	0.0	259.3	18.0	24,036.7	29.9	1.1
Auto Liab. (Commercial)	58.5	4.6	8,889.8	7.1	0.7	50.1	3.5	3,044.9	3.8	1.6
Auto Damage (Private)	4.4	0.3	13,196.5	10.5	0.0	193.1	13.4	16,200.9	20.2	1.2
Auto Damage (Commercial)	22.9	1.8	3,962.0	3.1	0.6	4.8	0.3	1,234.3	1.5	0.4
Aircraft	0.0	0.0	503.7	0.4	0.0	0.0	0.0	80.0	0.1	0.0
Fidelity	0.7	0.1	817.4	0.6	0.1	0.0	0.0	124.7	0.2	0.0
Surety	10.3	0.8	1,527.2	1.2	0.7	0.2	0.0	166.4	0.2	0.1
Glass	0.3	0.0	16.8	0.0	1.6	0.0	0.0	4.4	0.0	0.2
Burglary and Theft	1.5	0.1	81.1	0.1	1.8	0.1	0.0	22.3	0.0	0.3
Boiler and Machinery	0.4	0.0	404.6	0.3	0.1	0.5	0.0	216.8	0.3	0.2
Credit	0.0	0.0	889.6	0.7	0.0	0.0	0.0	9.5	0.0	0.0
International	0.0	0.0	111.2	0.1	0.0	0.0	0.0	59.0	0.1	0.0
Reinsurance (A,B,C, & D)	0.1	0.0	6,281.2	5.0	0.0	1.1	0.1	781.9	1.0	0.1
Write-ins	0.1	0.0	530.5	0.4	0.0	1.4	0.1	19.5	0.0	7.3
Total	1,269.3	100.0	125,983.6	100.0	1.0	1,443.8	100.0	80,258.6	100.0	1.8

Department of the Treasury
Office of Tax Analysis

April 1991

Source: A. M. Best Company

Table 4.3

Policyholder Dividends and Premiums Earned for Property and Casualty Insurance Companies for Personal and Commercial Coverage: 1989

	Policyholder Dividends		Premiums Earned		Dividends/ Premiums (percent)
	Amount ($ millions)	Percent of Total	Amount ($ millions)	Percent of Total	
Total Personal Lines:	547.7	20.2	89,821.1	43.6	0.6
Homeowners MP	83.0	3.1	17,349.7	8.4	0.5
Auto Liab (Priv.)	267.2	9.8	43,073.9	20.9	0.6
Auto Phys (Priv.)	197.5	7.3	29,397.4	14.3	0.7
Total Commercial Lines:	2,165.4	79.8	116,421.1	56.4	1.9
Workers' Comp	1,715.1	63.2	28,069.0	13.6	6.1
Other	450.3	16.6	88,352.1	42.8	0.5
Total All Lines	2,713.1	100.0	206,242.2	100.0	1.3

Department of the Treasury
Office of Tax Analysis

April 1991

Source: A. M. Best Company

The data presented in Tables 4.3 and 4.4 include both companies that paid policyholder dividends and those that did not. As a result, the average ratio of policyholder dividends to premiums understates the average for companies that actually paid such dividends. Table 4.5 provides data on policyholder dividends and premiums for companies that paid policyholder dividends, i.e., it excludes companies that did not pay policyholder dividends for the particular line of business. Table 4.5 shows that policyholder dividends for personal coverage averaged 2 percent for mutual companies that paid such dividends, compared with 0.2 percent for stock companies. For mutual companies policyholder dividends as a percent of premiums for personal coverage varies by line of business. Policyholder dividends as a percent of premiums were more than twice as large for homeowners multiple peril than for the personal auto lines for mutual companies that actually paid policyholder dividends for those lines.

Industry representatives argue that, if policyholder dividends for personal coverage contain an element of return on equity that confer a tax advantage, they would be significant and paid primarily by mutual companies.[8] Table 4.3 shows that policyholder dividends for personal coverage are less than one percent of premiums. However, mutual companies account for virtually all policyholder dividends for personal coverage and pay them at a higher rate than stock companies (Table 4.4). Approximately 7.6 percent of the mutual companies that wrote business in the personal lines paid policyholder dividends for personal coverage, compared with 2.5 percent of stock companies (Table 4.6). Thus, these data provide some support for the industry view that policyholder dividends are small relative to premiums and are paid by a relatively small fraction of companies that provide personal coverage.

Industry representatives also note that the ratio of policyholder dividends to premiums varies among personal lines and policyholders, and suggest that policyholder dividends reflect a firm's circumstances in a particular market.[9] If mutual company policyholder dividends are a return on equity, it is argued, they would be paid proportionately to all policyholders, as is the case with respect to dividends paid to shareholders of the same class of stock.[10]

However, differences in the rate at which policyholder dividends are paid among lines of business may reflect differences in the degree of risk. In addition, differences in the rate at which policyholder dividends are paid may reflect the fact that policyholder dividends are not a precise measure of the returns that a participating policyholder receives on his equity interest.

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[8] Letter to Kenneth Gideon, Assistant Secretary for Tax Policy, Treasury Department, from Alliance of American Insurers, National Association of Independent Insurers and National Association of Mutual Insurance Companies, May 31, 1990.

[9] Ibid, p. 7.

[10] Alliance of American Insurers, National Association of Independent Insurers, and National Association of Mutual Insurance Companies, Report Concerning Taxation of Mutual and Stock Property and Casualty Insurers, p. 10.

Table 4.6

Number and Percent of Property and Casualty Insurance Companies that Paid Policyholder Dividends for Personal Coverage: 1989

	Stock Companies		Mutual Companies		Total	
	Number	Percent	Number	Percent	Number	Percent
Total Personal Lines:	17	2.5	33	7.6	50	4.5
Homeowners MP	5	0.7	26	6.0	31	2.8
Auto liability (private)	12	1.8	19	4.4	31	2.8
Auto physical (private)	11	1.6	19	4.4	30	2.7

Department of the Treasury
Office of Tax Analysis

April 1991

Source: A. M. Best Company

premiums it receives. Thus, policyholder dividends contain an policyholder-level advantage with respect to any investment-like element for participating policies of both mutual and stock companies.[13]

The duration of an insurance contract may also affect whether the investment-like return is paid in the form of policyholder dividends or premium adjustments. Life insurance industry representatives point out that life insurance companies may set premiums over a period of years and reflect favorable experience through policyholder dividends, while property and casualty insurers may reflect favorable experience by periodically resetting premiums.[14]

Property and casualty insurance industry representatives also note that unlike many life insurance policies, property and casualty policies do not generate a cash surrender value. Thus, it is argued that the purchaser of property and casualty insurance is purchasing insurance and is not making an investment.[15] Although cash value policies are likely to contain larger investment returns, short-term policies also earn investment-like returns since property and casualty insurers invest the premiums they receive. Thus, policyholder dividends may provide a policyholder-level advantage with respect to this investment return, regardless of whether the policy has a cash surrender value.

Finally, it is argued that property and casualty insurance is riskier than life insurance, because property and casualty insurance companies cannot measure the magnitude of their risks with as much precision. Life insurance policies pay the face amount of the policy when the insured dies and life insurers are able to predict the occurrence of death accurately for members of large groups of individuals. Property and casualty insurers do not know whether a particular policy will produce a loss, the number of losses that will occur with respect to the policy, or the amount of the loss.[16] Whether property and casualty insurance is riskier than life insurance is beyond the scope of this report. Nevertheless, if the industry's argument is accepted, one likely outcome is that the expected return on equity will be larger to compensate investors for the greater risk.

4.4 Summary and Conclusion

The Treasury Department recommends that Congress not extend a limitation on the deduction for policyholder dividends to property and casualty insurance companies because the conceptual basis for

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[13] Emil M. Sunley, Op. Cit., p. 33.

[14] Letter to Kenneth W. Gideon, Assistant Secretary (Tax Policy), Department of the Treasury, from Theodore R. Groom and Matthew J. Zinn, dated August 8, 1990.

[15] Letter to Kenneth W. Gideon, Assistant Secretary (Tax Policy), Department of the Treasury from Donald C. Alexander, April 3, 1990.

[16] Alliance of American Insurers, National Association of Independent Insurers, and National Association of Mutual Insurance Companies, Report Concerning Taxation of Mutual and Stock Property and Casualty Insurers, p. 14-17.

APPENDIX 1 - REQUIREMENT FOR THE REPORT

The Tax Reform Act of 1986 (P.L. 99-514) contains the following reporting requirement:

"Sec. 1025. STUDY OF THE TREATMENT OF PROPERTY AND CASUALTY INSURANCE COMPANIES.

The Secretary of the Treasury or his delegate shall conduct a study of--

(1) the treatment of policyholder dividends by mutual property and casualty insurance companies,

(2) the treatment of property and casualty insurance companies under the minimum tax, and

(3) the operation and effect of, and revenue raised by, the amendments made by this subtitle.

Not later than January 1, 1989, such Secretary shall submit to the Committee on Ways and Means of the House of Representatives, the Committee on Finance of the Senate, and the Joint Committee on Taxation, the results of such study, together with such recommendations as he determines to be appropriate. The Secretary of the Treasury shall have authority to require the furnishing of such information as may be necessary to carry out the purposes of this section."

Section 11831 of the Omnibus Budget Reconciliation Act of 1990 (P.L. 101-508) extended the date for filing this study to January 1, 1992.

APPENDIX 2 - DESCRIPTION OF THE SAMPLE AND METHODOLOGY

The Sample and Sample Weights

The estimates of actual 1987 tax liabilities are based on data from a sample of tax returns of the largest property and casualty insurance companies. The sample consisted of 96 of the 100 largest, as measured by net written premiums, affiliated property and casualty insurance company groups. For many company groups, some property and casualty insurance companies in the group filed separate tax returns so the data collection process involved the assembly of data from multiple tax returns. Much of the data needed for the study came from an IRS corporate SOI data tape and a special IRS data project. The Treasury Department obtained additional data required for the study from the companies.

The sample companies had approximately 85.5 percent of net written premiums for the industry in 1987. The estimates of regular and minimum taxes for the companies not in the sample were calculated by multiplying the average of tax to net premiums written for the sample companies by the difference between net written premiums for the industry and net written premiums for the sample companies. If the ratio between tax and premiums is invariant with respect to the level of premiums, these ratio estimates (and therefore the tax estimates for the missing companies) are unbiased. The invariance condition was tested by comparing the ratio of the top 50 companies to the rest of the sample. It was not possible, at the 95 percent confidence level, to reject the hypothesis of invariance.

Data Checking and Error Resolution Procedures

The internal consistency of data items required for the computation of the changes in taxable income were tested and data errors corrected. For example, in some cases the consistency testing resulted in the detection of incorrectly transcribed Schedule E and F data from the 1120PC form, which was used to determine the potential effect of the discounting, prorationing, and unearned premium reserve changes on the company's taxable income. In these cases, copies of tax returns were used to correct the underlying data transcription problems. Net written premiums from each company group were compared to net written premiums for the company group Best Company data tapes were used to determine company groups which filed multiple 1120PC tax returns. Supplemental tax data were collected from such companies when preliminary available data were determined to be insufficient. When data on undiscounted reserves were not reported on tax returns, the undiscounted reserve data were obtained from Best Co. data tapes.

Computation Procedures

Tax return data from the sample companies were used to estimate the maximum potential increase in taxable income attributable to the 1986 Act provisions. For each tax return, the actual effect of the provisions on the taxable income shown on the return was also determined. The actual effect

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