Senate Finance Committee

Business Income Tax Reform Working Group

The Federal Income Taxation and Financial Regulation of Property and Casualty Insurance Companies

April 14, 2015

Executive Summary

- The property & casualty ("P&C") insurance industry pays approximately $300 billion in claims annually, covering businesses and individuals.
- A P&C insurer's gross income is composed of two elements --- underwriting income and investment income. Because P&C insurers cover major catastrophes, the industry's income is volatile.
- Unlike most businesses, insurers receive premiums first, and then record expenses. In order to ensure that they will have adequate funds to meet policyholder claims, insurers establish reserves for losses incurred and related expenses using actuarial estimates of the value of claims for the policy period. The deduction of reserves during the year in which premiums are received is essential to accurate measurement of an insurer's income.
- Insurers are regulated by the states for financial solvency, investments, rate-setting, market conduct practices, and the resolution of insolvencies. In recognition that insurers are governed by regulatory accounting ("statutory accounting" or "SAP"), Congress has declared that regulatory accounting forms the basis for tax accounting. In tax reform, it is essential to maintain the link between tax accounting and regulatory accounting.
- Insurer investments are subject to detailed regulation which is designed to ensure that investments are sufficiently liquid to allow companies to satisfy

unexpected large losses. P&C insurers hold more than $325 billion in state and local bonds, making the P&C insurance industry one of the largest holders of municipal securities.

- Tax Reform: The industry recognizes the importance of tax reform to ensuring the growth and competitiveness of the American economy. We welcome the opportunity to work with the Congress in developing changes to the Code that ensure policyholder protection, fairness, and administrative simplicity. A detailed analysis of specific elements necessary to maintain the efficient operation of this industry is given below. Key elements include:
    - Continue Conformity with Statutory Accounting
    - Maintain Deductibility of Loss Reserves
    - Maintain Current Approach to Municipal Bond Interest ("Proration")
    - Make Permanent the Exception for Certain Active Financing Income and the Look-through Treatment of Payments Between Related Controlled Foreign Corporations / Modernize AFE to Reflect Insurance Company Operations
    - Index Small P&C Insurers
    - Broaden or Maintain Capital Loss Rules for P&C Insurers
    - Repeal the Life/Non-Life Consolidation Rule
    - Preserve Net Operating Loss Carrybacks

Introduction

The American Insurance Association ("AIA"), the National Association of Mutual Insurance Companies ("NAMIC"), the Property Casualty Insurers Association of America ("PCI"), and the Reinsurance Association of America ("RAA") (collectively the "Trades") represent the great majority of insurance companies underwriting property and casualty insurance throughout the United States. P&C lines of business include personal lines such as homeowners and automobile insurance and commercial lines written for businesses and other organizations, such as workers' compensation, commercial general liability, commercial property and business interruption, product

liability, surety and fidelity. Members of the trades are domiciled in virtually every state and range from small insurers writing one line of P&C business in a single state or region, to multinational insurers writing essentially all P&C lines of insurance throughout the U.S. and globally. The P&C insurance industry is comprised of approximately 2,600 domestic companies and an additional 791 licensed foreign P&C insurers.[1] By all economic measures, the U.S. P&C insurance industry is healthy, vibrant and highly competitive and makes important contributions to the U.S. economy:

- The P&C insurance industry serves the economically vital functions of assuming the liability, property and casualty risks of U.S. businesses and consumers, pooling these risks and distributing them among all insureds, thereby allowing businesses and consumers to profitably engage in commerce.

- The P&C insurance industry pays out approximately $300 billion annually in policy claims.[2]

- P&C insurers provided $733.1 billion to businesses in 2014 to fund research, innovation, expansion and other opportunities through their investments in corporate stocks and bonds. The total insurance industry holds corporate stock and bond investments of $4.9 trillion.[3]

- P&C insurers are a major source of capital for state and local government in the United States, investing $326.5 billion in municipal bonds in 2014, which helps to fund the construction of schools, roads, health care facilities, and a variety of other public projects. Insurers also purchase general obligation bonds used to finance ongoing government operations.[4]

[1] National Association of Insurance Commissioners, 2013 Insurance Department Resources Report, 2014 edition.
[2] Average industry all-lines incurred losses ($298 billion) calculated using SNL Financial data over five-year period from 2009-2013.
[3] Board of Governors of the Federal Reserve System, as of 3Q 2014

[4] *Id.*

- The insurance industry, including P&C, life and health, and related activities, employs more than 2.1 million people, accounting for about 28 percent of the workforce in the U.S. financial activities sector.[5]

- The insurance industry, including P&C, life, and health, paid $17.4 billion in premium taxes in 2013, in addition to a wide range of other state and local taxes and assessments. The premium tax, imposed on a base of gross underwriting receipts, provides a predictable (and generally growing) revenue source for states that is paid regardless of an insurer's profitability.[6]

As the Business Income Tax Reform Working Group moves forward with considering tax reform proposals for United States Senate, we believe that it is critically important to understand the business and regulatory challenges that P&C insurers face to properly understand how P&C insurers are currently taxed.

<u>The Business of P&C Insurance</u>

A P&C insurer's gross income is composed of two elements: underwriting income and investment income. Underwriting income consists of premiums, net of acquisition costs (*e.g.* agents' commissions, advertising expenses, state premium taxes) minus estimates of reserves needed to cover losses incurred, related claims settlement expenses, and any reinsurance purchased. Investment income consists of income from securities, net of brokerage costs, investment advisory fees, and, in rare instances, securities losses. Because the industry must be prepared to meet sudden demands for payment when catastrophes occur, investments typically maintain a high proportion of corporate and municipal bonds, which can be readily liquidated.

[5] U.S. Bureau of Labor Statistics, 2013
[6] U.S. Census Bureau, all insurance sectors

P&C insurers purchase investments to manage the liquidity needs of their entire portfolio of insurance risks. Investment managers regularly evaluate the cash flow necessary to meet their ongoing claim obligations from less volatile lines of business (*e.g.* personal lines, such as auto and homeowners) while also maintaining a substantial cushion of short duration, liquid investment to meet the uncertain demands of potential catastrophe losses. The remaining cash inflows are invested in longer duration investments to maximize the insurer's overall investment returns.

Because P&C insurers cover major catastrophes, their profitability is volatile. For example, P&C industry catastrophe losses in the U.S. swung from $35 billion in 2012 to $12.9 billion in 2013.[7]

The Role of the State Regulatory System

The McCarran-Ferguson Act, approved by Congress in 1945, preserves the states' role as the primary regulators of the business of insurance. State regulators oversee virtually every aspect of insurance operations, including financial solvency, investments, rate setting, market conduct practices, and the resolution of insolvencies. As insurance is a promise that the insurer will make a payment in the event that a covered loss occurs in the future, solvency monitoring, including the maintenance of consistent financial standards, is the most important aspect of state regulation.

Critical to solvency regulation is the use of solvency-based accounting practices, sound investment practices, and requirements for establishing adequate reserves. Each of these requirements is essential for ensuring the ability of insurance companies to meet their future obligations, and the strength of the system is evidenced by the long history of financial stability and resilience of the P&C industry.

To promote sound, uniform standards, the National Association of Insurance Commissioners ("NAIC") develops model laws and regulations dealing with all aspects of insurance regulation. For example, the NAIC developed risk-based capital standards

[7] Insurance Information Institute, http://www.iii.org/fact-statistic/catastrophes-us (last visited April 14, 2015). A "catastrophe" is defined as an event with $25 million or more in losses.

("RBC") for life, P&C, and health insurers, and an accreditation program – the Financial Standards and Accreditation Program – to improve uniformity in state regulation. In addition, the NAIC codified Statutory Accounting Principles ("SAP") in order to establish a more comprehensive and consistent accounting and reporting system to enhance policyholder protection.

Annual Statement and Statutory Accounting Principles

All states require insurance companies operating in the United States to file an annual financial statement with the state regulator ("Annual Statement") using SAP. The Securities and Exchange Commission requires publicly traded insurers to report on the basis of generally accepted accounting principles ("GAAP"), and insurers also may provide GAAP financial statements to investors, lenders, and other business constituents.

The important difference between GAAP and SAP is the purpose of each system. One of the primary objectives of GAAP accounting is to provide financial information to enable investors to make informed decisions regarding their investments. In contrast, the primary objective of SAP reporting is to ensure that insurers remain solvent and, thus, SAP accounting seeks to measure the liquidation value of an insurance company. The liquidation value provides the appropriate measure of an insurer's ability to pay claims as they become due, and is an essential metric by which insurance regulators monitor solvency. Under SAP, insurer value excludes, in whole or in part, non-liquid and intangible assets, such as goodwill, receivables more than 90 days past due, EDP equipment and capitalized software, deferred acquisition costs (expensed immediately), deferred tax assets (partially recognized), and investments that do not comply with statutory restrictions. Amounts in excess of the statutory valuation requirements are excluded as nonadmitted assets.

State insurance regulators have found that the different purposes of SAP and GAAP make GAAP ill-suited for the purpose of assessing an insurer's solvency, and its ability to pay claims and meet financial obligations. Therefore, state insurance regulators

codified SAP in all states as the preferred approach for insurance regulation.

The SAP-based Annual Statement contains far more comprehensive financial information than normal GAAP financial statements. For example, in addition to a balance sheet, income statement and cash flow statement, the Annual Statement contains many comprehensive schedules including investments and reinsurance details, and an extensive schedule showing the history of how company loss reserve estimates have developed over time.

Virtually all insurers are required to have their annual statutory financial statements audited by an independent certified public accountant.

Regulation of Insurer Investments

As compared to manufacturing and other general corporations, insurers hold a far higher percentage of their assets in securities, municipal bonds, mortgages, and other investments. This is because an insurer's primary business involves holding and investing funds received from policyholders to pay current and future claims and expenses. An insurer must invest those funds until they are used to pay claims. It is critical to solvency that an insurer invests funds in diverse, reasonably liquid, high-quality assets.

States have detailed investment laws that specify which types of assets domestic insurers may hold, expectations regarding how insurer portfolios are selected, and limitations on which investments receive regulatory credit. These laws also include diversification requirements that prescribe limits on the amounts of each type of asset and limits on the amount of investments in a single issuer that an insurer may hold. SAP also includes the concept of "admitted assets," which are intended to be readily convertible into cash in order to pay claims. Generally, the limits in state investment laws provide that, to the extent a company's investments exceed the limits, they are "nonadmitted" and the company cannot take credit for them on the Annual Statement's balance sheet.

Finally, companies must value their investments in accordance with NAIC's Accounting Practices and Procedures Manual, which requires that securities be valued according to the rules of the NAIC's Securities Valuation Office and that other invested assets be valued according to specific rules that reflect their availability to meet policyholder obligations.

Loss Reserves

Unlike most businesses, which generally make upfront expenditures and earn income in the future, insurance companies receive advance payments in the form of premiums in exchange for the promise to pay any covered losses that will occur in the future. As accepting premiums obligates insurers to pay losses on future claims, insurance companies record liabilities (*i.e.* reserves) as soon as losses are incurred by policyholders. , Under SAP accounting principles, a loss is incurred when the event giving rise to the liability occurs (i.e., a car accident), and P&C insurers may not establish a loss reserve before the underlying loss event occurs. Loss reserves consist of case reserves – estimates of the cost of reported claims – and reserves for losses that have been incurred but not reported ("IBNR"), which are estimates of losses, based on historic experience, that have occurred during the policy term but will be reported after the end of the policy term. Both case reserves and IBNR estimates are prepared by professional actuaries, based on their experience and expertise, methodologies, judgment, knowledge of the insurer's business, claims history of the insurer and/or industry, trends, and environmental factors.

Since loss and loss expense reserves are by far the largest liabilities on an insurer's balance sheet, it is critical that they be sufficient. Consequently, the Annual Statement requires nearly all P&C insurers to include a statement of the opinion of a qualified actuary as to whether the company's loss and loss adjustment expense reserves make a "reasonable provision" for the company's future claim and expense obligations.

It is important to note that insurers do not have an incentive to over-estimate loss reserves. Overstating loss reserves would make an insurance company appear less

financially secure to investors, rating agencies, and, most importantly, state regulators. As state regulators' primary concern is insurer solvency, overstating loss reserves would increase state regulatory scrutiny, and in particular, the potential for mandated rate increases in lines subject to rate regulation.[8] Loss reserves are not discretionary funds that are available to the company for other business uses, but rather amounts insurers are required to pay to policyholders. For this reason, overstating loss reserves often would require a company to divert capital from higher-return investments supporting capital into the lower-return investments that support loss reserves. Reserve levels can also impact commissions payable to brokers, management compensation, and other constituents. Thus, there are compelling regulatory and business reasons for insurers to estimate reasonable – not excessive – loss reserves.

Taxation of P&C Insurance Companies

Understanding the significance and structure of insurance regulatory requirements, including statutory accounting, investment laws and reserve requirements, is essential to appreciating the complexities of insurance taxation and the value of conformity between tax and regulatory accounting.

The tax treatment of P&C insurance companies is contained in Subchapter L of the Internal Revenue Code. From the earliest days of the federal income tax system, the Annual Statement has been the starting point for taxing insurance companies. The principle of "conformity" with the Annual Statement underlies the federal income tax system for P&C insurance companies. Thus, the Internal Revenue Code expressly relies on the P&C insurer's Annual Statement. IRC § 832(b)(1)(A) provides that a P&C insurer's gross income (*i.e.* underwriting and investment income) must be "computed on the basis of the underwriting and investment exhibit of the annual statement approved by the [NAIC]." *See also* IRC §§ 832(b)(6), 846(b)(1).

[8] Some state insurance regulators engage in rate regulation, which is designed to ensure that premium rates are adequate to support estimated losses. If estimated losses increase, those regulators could require insurers to raise rates in order to be adequately capitalized. Since the insurance business is highly competitive, insurers who are forced to raise rates may be placed at a competitive disadvantage.

In general, P&C insurers calculate gross income – net underwriting profit (or loss) and its net investment income (or loss) – using SAP principles. However, the Tax Code departs from statutory accounting in that it requires that loss reserves be reported on a discounted basis.[9] Prior to 1986, the statutory accounting treatment of loss reserves was mirrored in the federal tax treatment. The Tax Reform Act of 1986 ("1986 Act") required insurers to discount their loss reserves for federal tax purposes. Discounting loss reserves has the effect of deferring deductions for incurred losses, accelerating taxable income and income tax payments, and has produced significant revenue for the federal government.

The accounting and tax treatment of insurers reflects the fundamental difference between insurance companies and other financial institutions – insurers receive premiums up-front and pay losses and related expenses later while most other businesses incur their expenses up-front and sell their products and services later. From a SAP standpoint, a P&C insurer cannot treat premium income as its own until it is clear that these amounts are not needed to pay losses and expenses. Taxing premium income as received without deducting reserves for unpaid losses would distort income by overstating income in year of the policy, and understating income in later years when losses under the policy are paid.

Given the inextricable link between solvency regulation and insurance company economic income, it is imperative that the link between regulatory-based accounting and reserve requirements and federal income tax treatment be maintained. With this in mind, the trades believe the following principles must guide Congress as it considers tax changes affecting the P&C insurance industry.

[9] There is a narrow exception to the rule prohibiting discounting for the payment of claims that are fixed and determinable over the remaining settlement period of the contract, e.g., workers compensation and structured settlements.

Tax Reform

We appreciate the importance of tax reform to ensuring the growth and competiveness of the American economy. We welcome the opportunity to work with the Committee on this landmark legislation.

As we consider fundamental tax reform, our organizations are guided by three important policy principles: policyholder protection, fairness, and simplicity. Specifically, we support tax policy that safeguards the financial security of policyholders. We support taxation that is fair and proportional across all industries. Finally, we support proposals that simplify tax laws and reduce the cost of tax compliance.

We urge the Committee to ensure that any reform proposal that affects the P&C industry should:

Continue Conformity with Statutory Accounting

The basic components of insurance company taxable income are taken from the Annual Statement and based on statutory accounting. Continued reliance on statutory accounting and the Annual Statement is essential for proper measurement of insurance company income taxable income.

Maintain Deductibility of Loss Reserves

Deduction of loss reserves is essential to properly account for the front-loaded nature of P&C premium receipts, the back-loaded nature of P&C expenses, and to ensure that funds are available to meet claims. The matching principle requires the alignment of income and expenses and the deductibility of loss reserves is essential to achieve this balance and ensure availability of funds to meet claims obligations. To ensure fairness and support the goal of financial soundness and solvency, deductions should conform to statutory accounting principles and the reserving requirements approved by state insurance regulators. Since 1986 Congress has provided for loss reserve discounting, which has had the effect of front-loading insurers' income and eroding Annual Statement conformity. Any attempt to increase discounting would magnify these

effects.

Maintain Current Approach to Municipal Bond Interest (Proration)

P&C insurers hold more than $325 billion in state and local bonds, making the P&C insurance industry one of the largest holders of municipal securities. The tax-exempt nature of these securities, together with their stability and liquidity, makes them an attractive investment for P&C insurers. However, unlike other taxpayers, P&C insurers are not entitled to exclude 100 percent of interest earned on state and local bonds from income. Since 1986, P&C insurers have been required to include in income 15 percent of the interest received on otherwise “tax-exempt” bonds. Any attempt to increase the taxable percentage would discourage P&C insurers from investing in state and local bonds, and, at the same time, increase the borrowing costs of state and municipal governments.

Make Permanent the Exception for Certain Active Financing Income and the Look-through Treatment of Payments Between Related Controlled Foreign Corporations / Modernize AFE to Reflect Insurance Company Operations

The “Active Financing” rule of Subpart F allows foreign insurance subsidiaries to defer investment income received as part of active insurance operations in the same manner as other active businesses. The look-through rule allows dividends, interest, rents, and royalties to be paid between affiliated foreign subsidiaries without giving rise to Subpart F income in the United States.

The active financing rule serves the important policy purpose of fairness because it enables foreign insurance subsidiaries of US companies to better compete in foreign markets. Unless the broader concept of deferral were eliminated for all industries, eliminating only the active financing exception would place foreign insurance subsidiaries of US companies at a substantial competitive disadvantage.

Although non-insurance companies may have the option to repatriate earnings at will, that option is not necessarily available to insurance companies. Insurance companies doing business in non-US jurisdictions are required by foreign regulators to maintain a

certain amount of earnings or capital in the local country to support obligations to policyholders. Imposing current tax on earnings that are not available for repatriation would run counter to the fundamental principle that income should be subject to tax only when realized.

Briefly, we would support revising the definition of a "Qualified Insurance Company" to be consistent with normal business structures used in multinational insurance and reinsurance businesses; and recognizing that any one time tax on foreign accumulated earnings of insurance companies should not apply to income subject to local restrictions on earnings available for repatriation.

Index Small P&C Insurer Election

IRC § 831(b) currently allows small P&C insurers writing less than $1.2 million annually to choose their preferred tax treatment – net investment income or corporate income taxation. Primarily, this was done to maintain and promote insurance availability and affordability in the rural and small town locales in each state. It was also created as the Farm Mutuals generally write in a limited operating territory and thus increases the potential catastrophic loss. Being small also meant that accumulation of capital (surplus) was secondary to protection and service. Additionally, the size of the companies meant that they would be unable to raise capital from any other source. The threshold should be indexed for inflation to continue to allow these mutuals to provide additional surplus and cash flow.

Broadens or Maintains Capital Loss Rules for P&C Insurers

Tax code provisions permit P&C insurance companies to deduct capital losses against ordinary income to fund operating cash deficits. The provision allows capital losses to be turned into "abnormal losses" and to fund operating cash deficits with sales of capital assets to allow insurers to meet the cyclical demands of policyholder claims.

Repeal the Life-Non-Life Consolidation Rule

Obsolete rules prohibit life insurance companies from fully consolidating taxable income with companies that are not life insurers creating enormous complexity and distorting

economic income. Existing consolidation rules unnecessarily restrain the movement of capital between life and non-life insurance operations. The policy justification for prohibition on consolidation no longer exists and this rule should be repealed. Furthermore, IRS regulations in this area have expanded the scope of the provisions far beyond congressional intent with rigid income computations for subgroups.

Preserve Net Operating Loss Carrybacks

P&C insurers are subject to periodic large catastrophe losses, which create the situation in which insurers paying claims have more allowable tax deductions than taxable income. As a result, the insurer has a Net Operating Loss (“NOL”). Under current law, an NOL incurred in one taxable year may be carried back to the two taxable years preceding the taxable year of such loss and carried forward to the 20 taxable years following the taxable year of the loss.

Utilizing a carry back to recoup previously paid taxes, creates an immediate cash infusion and provides direct access to the capital needed to address losses and meet policyholder claims. The ability to carry back net operating losses addresses the cyclicality of P&C losses by providing a means to average years with catastrophic years and good and bad years within the underwriting cycle. As such, the value of a net operating loss carry back exceeds the value of a carry forward. Congress should reject any attempt to reduce the current net operating loss carry back period for P&C insurance companies.

Advertising

P&C insurers currently are taxed on twenty percent of their unearned premiums as a proxy for capitalizing certain “premium acquisition expenses,” such as advertising expenses, even though such expenses otherwise would be immediately deductible. As a result of this special treatment, a substantial portion of the advertising expense of P&C companies is effectively deferred under current law. Any proposals to change the general deductibility of advertising expenses should designed so that the change does not unfairly burden the advertising activities of P&C insurance companies relative to other industries.

Conclusion

The very nature of the P&C insurance industry and its approach to risk and investment differentiate it from other financial services. Insurance inherently differs from other financial products and services in that it provides a promise of future financial protection, which makes solvency and consumer protection paramount and requires actuarial estimation of future losses to determine current income.

As Congress moves forward with comprehensive tax reform for the first time in almost three decades, it is imperative that policy makers understand the business of P&C insurance, its fundamental differences from other financial services sectors, and the tax provisions uniquely applicable to the P&C industry. The P&C industry is integral to the vitality of the economy. The cyclical nature of P&C insurance and the significance of the statutory accounting system make the industry unique in the reform discussion process, and members of Congress should be aware of the consequences for American consumers of changes to current tax policy.

The industry welcomes the opportunity to work with the Congress in developing a modern and efficient tax code. We look forward to working with the Senate Finance Committee in the development of changes to the Code that ensure policyholder protection, fairness, and administrative simplicity.

Contact List

David Pearce
Vice President --- Tax Policy
American Insurance Association
dpearce@aiadc.org

Irica Solomon
Vice President, Federal & Political Affairs
National Association of Mutual Insurance Companies
isolomon@namic.org

Dwaune Dupree
Counsel Financial Policy
Property Casualty Insurers Association of America
dwaune.dupree@pciaa.net

Joseph Sieverling
Senior Vice President and Director of Financial Services
Reinsurance Association of America
Sieverling@reinsurance.org