Report to the Congress on Property and Casualty Insurance Company Taxation

Department of the Treasury
April 1991

DEPARTMENT OF THE TREASURY
WASHINGTON

ASSISTANT SECRETARY

April 1991

The Honorable Lloyd Bentsen
Chairman
Committee on Finance
United States Senate
Washington, D.C. 20510

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 Senator Bob Packwood.

Sincerely,

Kenneth W. Gideon

Kenneth W. Gideon
Assistant Secretary
(Tax Policy)

Enclosure

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."

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Sincerely,

Kenneth W. Gideon
Assistant Secretary
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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.

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

- The prepayment analysis does not address the problem that investment returns to certain policyholders of mutual and stock insurance companies may enjoy a policyholder-level advantage because policyholder dividends are not generally taxable income to policyholders but dividends are taxable income to shareholders. An exception to this policyholder-level advantage arises when the policyholder is a business rather than an individual. Businesses deduct premiums paid but include policyholder dividends in income.

- While the disparity in the treatment of policyholders and shareholders at the individual level could justify a corporate-level proxy tax on the equity-like returns contained in policyholder dividends, this disparity is considerably smaller for property and casualty insurance companies than for life insurance companies. Policyholder dividends paid by property and casualty insurers are substantially less and are paid primarily to business policyholders. The imposition of a proxy tax would impose a compliance burden but would have a modest revenue yield. Therefore, the Treasury Department does not recommend the imposition of a proxy tax at this time.

The remainder of this report is organized as follows. Chapter 2 describes prior tax law and the changes in property and casualty insurance taxation and the alternative minimum tax under the 1986 Act. Chapter 3 examines the effects of the property and casualty insurance company provisions enacted under the 1986 Act on tax liabilities of property and casualty insurance companies for calendar year 1987. Chapter 4 evaluates the tax treatment of policyholder dividends paid by insurance companies and presents the Treasury Department's recommendation with respect to policyholder dividends paid by property and casualty insurance companies.

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.

The 1986 Act continued to allow the current deduction of unpaid losses and loss adjustment expenses. However, the Act required that such amounts be calculated as the discounted value of unpaid losses as defined by section 846 of the Internal Revenue Code. The discounting of unpaid losses generally reduces the current tax deduction for unpaid losses. The 1986 Act required the Secretary of the Treasury to calculate discount factors annually for each line of business shown on annual statements filed with the National Association of Insurance Commissioners (NAIC) using certain interest rate and loss payment patterns.[1] These factors are used by companies to determine their deduction for unpaid losses.[2]

The rules outlined in The General Explanation of the Tax Reform Act of 1986 call for relatively slower loss payment pattern assumptions for the five lines of business included in Schedule P of the annual statement -- auto liability, other liability, workers' compensation, medical malpractice, and multiple peril -- than the relatively fast loss payment assumptions of the lines of business contained in Schedule O.[3] The discounting rules specify maximum loss payment periods of 15 years for the unpaid losses of the Schedule P lines and 3 years for unpaid losses of Schedule O lines. The General Explanation also indicates that loss payment patterns used for the calculation of discount factors for each line of business are to be redetermined every five years.

In each loss payment pattern determination year, loss payment patterns for each line of business are generally assumed to follow loss payment patterns based on the most recently published aggregate loss payment data illustrated in examples in The General Explanation.[4] Discount rate factors for unpaid losses in various future years are then calculated for the losses incurred each year using the determined loss payment patterns and the statutory interest rate for discounting. For any calendar year, the interest rate to be used for discounting is the average of the Federal mid-term interest rates in the 60 months preceding the beginning of the year, as illustrated in The General Explanation. The discounting rules were generally expected to have a relatively greater effect in reducing unpaid losses -- and the associated tax deductions -- for Schedule P lines because of the longer loss payment patterns for these lines.

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[1] The details are contained in Joint Committee on Taxation, The General Explanation of the Tax Reform Act of 1986 (May 4, 1987), pages 600 - 618.

[2] Schedules in the annual statements show loss payment patterns for the unpaid losses of each accident year shown on the schedules, e.g., the schedules show the amount of loss incurred in certain prior years but unpaid at the beginning of the current year as well the amount of these losses that are paid during the current year for each line of property and casualty insurance business.

[3] Under certain circumstances companies may also elect to use their historical experience for determining discount factors.

[4] Beginning in 1989, the NAIC annual statements combine Schedule O and P into Schedule P.

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.

The 1986 Act reduced the deduction of property and casualty insurance companies for losses incurred by 15 percent of the insurer's: (1) tax-exempt interest income, and (2) dividends received deduction.[9] This tax change is often referred to as prorating of tax-exempt income.

Protection Against Loss Account

Prior to the 1986 Act, mutual property and casualty insurance companies were permitted deductions for contributions to protection against loss (PAL) tax accounts. The intent of the PAL provision was to provide mutual companies with a source of capital in the event of a catastrophic loss, since mutual companies, unlike stock companies, are unable to raise capital in capital markets.

The amount of the deduction was generally one percent of the underwriting losses incurred for the year plus 25 percent of the underwriting income, plus certain windstorm and other losses.[10] In general, contributions to PAL accounts were taken into income over a 5 year period. The PAL account thus produced a 5 year deferral of certain mutual company underwriting income. However, PAL account rules required the reduction of PAL balances for each dollar of NOLs used to offset current taxable income. Subractions from PAL account balances increased taxable income, dollar for dollar, until the PAL account balance was zero.

The 1986 Act repealed the deduction for contributions to PAL account balances. Congress believed that the deduction for contributions to the PAL account was not serving its intended purpose principally because the PAL account provided the greatest benefit where least needed, i.e., for mutual companies with current taxable income that could benefit from deferral.[11]

Small company provisions

Under prior tax law, mutual property and casualty insurance companies with less than $150,000 in gross receipts were exempt from tax. Mutual companies with gross receipts from $150,000 to $500,000 could generally elect to be taxed only on investment income.[12] Mutual property and casualty insurance companies with gross receipts between $500,000 and $1,110,000 generally benefited from

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[9] The 1986 Act also requires inclusion in income of any excess of the required reduction in the deduction for discounted unpaid losses over the increase in discounted unpaid losses. These changes do not apply to the income from stock or obligations acquired before August 8, 1986.

[10] Additions to PAL accounts were zero for companies for which the sum of investment income and underwriting income was negative.

[11] See The General Explanation, pages 618 and 619.

[12] In addition, companies that elected to be taxed on investment income could benefit from a special rule which phased in regular tax on investment income as gross receipts increased from $150,000 to $250,000.

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.

income. In addition, the Act addressed the concern that companies that reported substantial earnings paid no tax. It required that corporations include in the AMT tax base an adjustment based on financial statement income reported by the taxpayer pursuant to public reporting requirements or in disclosures made for non-tax reasons to regulators, shareholders, or creditors. This "book income adjustment" was required for taxable years beginning in 1987 through 1989. For taxable years beginning after 1989, the book income adjustment is replaced by an adjustment based on a broad, but statutorily defined, measure of economic income known as adjusted current earnings (ACE).

Generally, the tax base for the corporate AMT is the corporation's taxable income, increased by tax preferences for the year and adjusted in a manner designed to negate the deferral of income or acceleration of deductions resulting from the regular tax treatment of certain items. The resulting amount of alternative minimum taxable income (AMTI), reduced by an exemption amount, is subject to a 20 percent tax rate. The exemption amount is $40,000, reduced by 25 percent of the amount by which AMTI exceeds $150,000. The amount of minimum tax liability so determined may then be offset partially by the minimum tax foreign tax credit, and to a limited extent by investment tax credit carryovers. A corporation is effectively required to pay the higher of the AMT or the regular tax for the taxable year.[15]

The computation of corporate AMTI is a two-step process. First, taxable income is adjusted to reflect specific statutory adjustments and preferences. Second, the resulting amount of AMTI is adjusted further to take into account the book income adjustment for taxable years beginning in 1987 through 1989, or the ACE adjustment for taxable years beginning after 1989.

The more significant adjustments and preferences include those related to accelerated depreciation, depletion, intangible drilling costs, mining exploration and development costs, long-term contracts, installment sales, tax-exempt interest, and charitable contributions. The adjustment for the net book income of corporations is computed by increasing AMTI by 50 percent of the amount by which the net book income of a corporation exceeds unadjusted AMTI, i.e., AMTI determined without regard to the book income adjustment or the AMT net operating loss deduction.[16] The net book income for this purpose generally is the net book income shown on a taxpayer's applicable financial statement.

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[15] Technically the regular tax continues to be imposed, and the excess of the tentative minimum tax over the regular tax is added on. Corporations are allowed a minimum tax credit to the extent the excess of the AMT over the regular tax is attributable to preferences or adjustments involving the timing of a deduction or income inclusion. This credit is allowed as a reduction of regular tax liability of the taxpayer in any subsequent taxable year, but may not be used to reduce regular tax below AMT for the subsequent year.

[16] The amount of the AMT net operating loss for any taxable year generally is equal to the amount by which the deductions allowed in computing AMTI for the taxable year (other than the deduction for carryovers to the taxable year of AMT net operating losses) exceed the gross income includable in AMTI for the taxable year. In computing AMTI, NOLs available for reducing AMTI are limited to 90 percent of AMTI before NOLs.

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.

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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.

Estimates of the effect of tax law changes require estimates of both the base level of collections (i.e., estimates of collection levels that would have occurred absent the change in law) and the effect of the change in law on that base. The estimates of the property and casualty insurance company tax changes of the 1986 Act were the result of this two-stage estimating process. Comparisons of the initial revenue estimates of a change in tax law with subsequent estimates of the actual effects (the subject of this chapter) are complicated by the need to disentangle the effect of the change in law, changes in the baseline forecast, and interactions between the two.

Estimating the revenue effects of proposed tax legislation requires accurate forecasts of many different factors, including the following: (1) the level of economic activity, including both the macro-economic national forecast and the market share of the particular economic activity affected; (2) the taxpayer's economic situation, including types of products sold, portfolio choice, and form of organization; (3) the effect of specific changes in the tax law on particular taxpayers' economic situations independent of behavioral changes; and (4) the taxpayers' reaction to the tax law changes. If these factors are misspecified or forecasted incorrectly, estimated receipts will differ from actual collections.

Forecasts of these factors for the revenue estimates for the property and casualty insurance company tax provisions were generally based on historical data from annual financial statements filed with the National Association of Insurance Commissioners and tax returns.[3] These data were difficult to use as the basis for forecasting for two reasons. First, the Tax Reform Act of 1986 significantly changed income taxation and the rules that apply specifically to property and casualty insurance companies. These changes were likely to affect historical relationships among financial variables and trends in financial data. Second, the available data from annual financial statements and tax returns define the property and casualty insurance industry differently, and use different rules to measure income and to consolidate affiliated companies. Moreover, the available corporate tax return data were outdated.

The potential misclassification of property and casualty insurance companies in the available data sources is a possible source of estimating errors. For regulatory purposes, companies are classified as life or property and casualty insurance companies based upon the type of charter for which they originally applied. However, because of the legal definitions of life insurance companies and property and casualty insurance companies for Federal income tax purposes, some companies chartered as life insurance companies file property and casualty insurance tax returns (1120PC) and some companies chartered as property and casualty insurance companies file life insurance tax returns (1120L). Thus, the use of annual statement data may misclassify certain companies for Federal income tax purposes. Moreover, the tax return data from the IRS Statistics of Income (SOI) program may misclassify some property and casualty insurance companies because consolidated tax returns are classified by industry group based on the industry group from which the largest percentage of total receipts is derived.

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[3] Annual statement data are compiled by A.M. Best Co.

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.

Table 3.1

Revenue Estimates for the Property and Casualty Insurance Company Tax Provisions
Under the 1986 Act
($ millions)

Provision	Fiscal Years					
	1987	1988	1989	1990	1991	Total
Treasury Estimates:						
Discounting of unpaid losses	374	667	757	714	566	3,078
Changes in unearned premiums:						
Inclusion in income of 20 percent unearned premiums	230	318	255	234	245	1,282
Unearned premiums for outstanding balances	254	432	469	512	495	2,162
Proration rule	19	74	156	258	358	865
Repeal of PAL account	58	76	68	44	24	270
Adoption of small company provision	-14	-33	-27	-25	-24	-123
Total	921	1,534	1,678	1,737	1,664	7,534
Joint Committee on Taxation Estimates:						
Total	871	1,454	1,636	1,745	1,842	7,548

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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.

<u>Reconciliation of Actual and Estimated Receipts</u>

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 3.2

Comparison of Actual and Estimated Changes in Tax Liabilities from the Property and Casualty Insurance Company Provisions under the 1986 Act: Calendar Year 1987*

	Actual Change in Liabilities ($ millions) (1)	Estimated Change in Liabilities ($ millions) (2)	Difference (1) - (2) ($ millions) (3)	Actual Share of Total (percent) (4)	Estimated Share of Total (percent) (5)
Discounting of unpaid losses	947	623	324	64	41
Changes in unearned premiums:					
Inclusion in income of 20 percent unearned premiums	139	383	-244	9	25
Unearned premiums for outstanding balances	324	423	-99	22	28
Proration rule	60	32	28	4	2
Repeal of PAL account	1	97	-96	0	6
Small company provision	**	-23	23	0	-1
Total	1,472	1,535	-63	100	100

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* Excludes the minimum tax. Details may not add to totals because of rounding.

**Less than $1 million revenue loss.

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 3.3 shows that the change in taxable income before current losses and NOLs attributable to unpaid loss discounting, the changes in the unearned premium deduction, and the proration rule were underestimated by $1.9 billion. However, the use of NOLs and current losses were underestimated by $1.0 billion and tax credits were underestimated by $0.3 billion. The underestimate of the change in taxable income was largely offset by the underestimates of the changes in the use of NOLs, current losses, and tax credits. These effects are discussed in detail below.

Discounting of unpaid loss

The impact on taxable income of the requirement to discount unpaid losses was underestimated by $2.7 billion (Table 3.3). This underestimate resulted from errors in the forecasts of the growth in undiscounted unpaid losses and loss expenses and the impact of discounting on the tax deduction for these amounts.

The estimated change in undiscounted unpaid losses was $31.8 billion compared to the actual change of $33.8 billion. Growth rates for unpaid losses have varied considerably over time and thus are difficult to predict. The model estimated that the 1987 discounting calculations would reduce the tax deduction for the increase in unpaid losses to 88.9 percent of its undiscounted value. The actual reduction factor was 81.6 percent.

The discounting factors in the model were based on 1984 loss payment patterns and distribution of losses between various lines of business. The actual discounting factors were based on the 1987 distribution of unpaid losses by line of business and 1985 loss payment time patterns, both of which resulted in a general lengthening of the time distribution of loss payments relative to the loss payment patterns implicit in the model's calculations. Typically, the Multiple Peril and Auto Liability lines of business have relatively short payout patterns compared to the Workers' Compensation, Medical Malpractice, and Other Liability lines of business. Table 3.4 shows that net written premium growth for the shorter payout lines generally exceeded the growth for the longer payout lines in the years preceding 1984 (the most current year for which annual statement data was available at the time the estimates were made).[5] From 1985 through 1987, premium growth was generally more rapid for lines of business with longer loss payout periods. Table 3.4 also shows that Schedule O lines, which generally have faster loss payment patterns, had smaller average growth rates than the Schedule P lines in 1985 and 1986.

Longer loss payment patterns result in greater discounting of unpaid losses and therefore a smaller tax deduction. In addition, the discount rate assumed by the model was 7.0 percent compared to the actual discount rate of 7.2 percent. Higher discount rates reduce the discounted value of future losses and thus reduce the deduction for discounted unpaid losses. Further, the discounting

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[5] Premium information by line of business in the table is limited to lines of business for which Schedule P Annual Statement information was available in 1987. The impact of discounting is generally greatest for these lines since the discounting calculation rules for Schedule P lines assume losses are paid out over longer periods of time than other (e.g., Schedule O) categories of unpaid losses.

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.

computations may have overestimated the value of the election under Section 846(e) of the Internal Revenue Code that allowed some companies to use their own loss payment patterns to compute discount factors by line of business rather than published IRS discount factors. All these factors contributed to underestimating the effect of the rules requiring the discounting of unpaid losses.

Unearned Premium Changes

The effect on taxable income of including 20 percent of the increase in the unearned premiums was overestimated by $1.1 billion (Table 3.3). Historically, growth rates in unearned premiums have varied greatly from year to year, closely tracking the growth in net written premiums (Table 3.5). The model used aggregate net written premium growth rate assumptions to estimate the change in unearned premiums. For 1987, a net written premium growth of 15 percent was assumed while the actual premium growth was 9 percent. This difference accounts for most of the overestimate.

The estimate for the effect on taxable income of including 20 percent of 1986 end of year unearned premiums in taxable income ratably over the next six years was underestimated by $64 million. Estimates of 1987 unearned premium levels were based on estimates of average net written premium growth rates. Annual premium growth rates are more variable (Table 3.5).

Proration Rule

The model underestimated the effect on taxable income of the proration rule -- including 15 percent of certain previously tax-exempt income in taxable income -- by $0.2 billion (Table 3.3).[6] Property and casualty company purchases of tax-exempt bonds increased in response to the 1986 Act changes. Interest income from tax-exempt bonds declined from $6.4 billion to $6.3 billion from 1984 to 1985, and then grew to $7.3 billion in 1986 and $9.1 billion in 1987.[7] The discounting and unearned premium changes caused some property and casualty companies to be regular taxpayers. The general lowering of tax rates reduced the spread between taxable and tax-exempt bonds. The combined impact of these changes provided incentives for purchases of tax-exempt bonds by property and casualty companies. Most of the underestimate of the proration rule on taxable income is explained by the underestimate of the impact of the 1986 Act changes on the purchase of tax-exempt bonds by property and casualty companies. The remainder is attributable to underestimates of tax-exempt bond yields and the dividends that were subject to the proration rule.

NOLs and Current Losses Used

The increase in the use of NOLs and current losses was underestimated by $1.0 billion. The estimates of NOLs and losses underestimated the use of losses of consolidated affiliates and NOLs to

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[6] The income from tax-exempt bonds purchased after August 7, 1986, and the tax deductible portion of dividends received on stock purchased after August 7, 1986, were subject to proration.

[7] A. M. Best Co., Best's Aggregates and Averages, Property-Casualty, 1985-88 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.

offset increases in the income of property and casualty insurance companies resulting from the 1986 Act changes to the property and casualty insurance company tax rules. This error resulted from lags in the availability of tax return data combined with tax reporting conventions and data limitations, particularly about current losses of companies in other industries filing consolidated returns with property and casualty insurance companies.

Tax Credits

The use of tax credits was underestimated by $0.3 billion. This estimating error resulted primarily from data limitations related to the definition of the industry for SOI tax statistics (discussed above). Many of the credits used against the income of property and casualty insurance companies were earned by companies in other industries filing consolidated returns with property and casualty insurance companies. The SOI tax statistics include these credits in the totals for other industries. Some of the credits used were investment tax credit (ITC) carry-overs from 1986, the year the ITC was repealed.

PAL Account and Small Company Changes

In addition to the four tax changes discussed above, the 1986 Act repealed PAL accounts, which allowed mutual property and casualty insurance companies to defer tax on a portion of their income. It also liberalized the rules that exempted some small property and casualty insurance companies from tax and allowed others to elect to exclude their underwriting income from taxable income. The 1987 calendar year estimates for the repeal of PAL accounts and the small company changes were $97 million and -$23 million, respectively. Based upon the data from the sample of tax returns in the SOI corporate tax data base for 1987, it appears that the combined effect of these provisions on liabilities was $1 million.[8]

Since reliable data on the magnitude and distribution of NOLs were unavailable at the time estimates for these provisions were made, the estimates exaggerated the revenue loss attributable to these special tax deferral and tax reduction measures in pre-tax reform periods. Thus, the revenue increase from the repeal of PAL accounts was overestimated. The overestimates of revenue effects of the repeal of the PAL accounts and the changes in small company provisions were also largely attributable to underestimates of available NOLs. PAL account balances and the associated tax deferral are reduced dollar for dollar by NOLs used. In addition, the larger exclusion for small companies did not reduce revenues by the amount estimated because the use of NOLs by such companies was underestimated.

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[8] The SOI corporate data base was used to evaluate actual receipts for these provisions, because companies in the special sample (described in Appendix 2) had minimal PAL balances and generally had net or direct written premiums that exceeded the small company thresholds.

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

Table 3.6

Alternative Minimum Tax Base and Liabilities
by Tax Status of Companies Filing P&C Consolidated Tax Returns*
($ millions)

	Minimum Tax Paid; No Regular Tax From P&C Tax Changes	Minimum Tax Paid; Regular Tax From P&C Tax Changes	No Minimum Tax Paid; Regular Tax From P&C Tax Changes	No Minimum Tax Paid; No Regular Tax From P&C Tax Changes
Regular taxable income before NOLs	1,192	1,785	15,287	177
Minimum tax adjustments	730	39	220	6
Minimum tax preferences **	119	42	117	29
Book income preference	3,615	744	1,418	469
Minimum tax base before NOLs	5,656	2,610	17,042	681
Alternative tax NOLs	3,892	846	3,949	734
Exemptions	***	***	***	***
Alternative minimum taxable income	1,764	1,764	13,093	402
Tentative minimum tax	353	353	2,619	80
AMT foreign tax credit	220	34	492	2
Tentative minimum tax	133	319	2,127	78
Income tax before credits Minus foreign tax credit****	8	259	4,383	112
Alternative minimum tax	115	60	0	0
Percent of companies	24	8	55	13

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* Details may not add to totals because of rounding.

** Excludes book income preference.

*** Less than $1 million.

**** Includes regular tax on income not attributable to the property and casualty company tax changes.

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.

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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.

which a policyholder effectively buys not only insurance protection, but also an equity-like interest in the insurance company. The return that a participating policyholder may receive on the equity interest is difficult to identify or measure because the return can be received in many forms, including increased policyholder dividends, reduced premiums, or increased amounts credited to policy cash values. Further, policyholder dividends may blend together many elements, including price reductions, interest payments (reflecting the companies' use of any redundant premiums between receipt and repayment), repayment of the policyholder's investment principal, and equity-like returns. Not all of these items are appropriately taxed at the corporate level. Moreover, the identification and measurement of equity-like returns to participating policyholders is even more difficult in the case of stock companies because these policyholders share the equity risk with stock company shareholders.

The 1984 Act required the Treasury Department to study the effects of the Act's life insurance tax provisions, including the tax treatment of life insurance company policyholder dividends. The Treasury Department's Final Report to the Congress on Life Insurance Company Taxation (the Final Report) included an evaluation of the limitation on the deduction for policyholder dividends paid by mutual life insurance companies and concluded that the limitation is conceptually flawed.[4] This conclusion relies to a large extent on the "prepayment analysis," which shows that under certain assumptions the full deductibility of policyholder dividends does not confer a tax advantage on mutual life insurance companies.

According to the prepayment analysis, a limitation on the deduction for policyholder dividends is unnecessary because any deduction of corporate earnings through mutual company policyholder dividends is exactly offset by the additional tax due from mutual companies when they raise capital through premiums by selling participating insurance policies. Stock companies, in contrast, are not required to include in income capital contributions of their shareholders. Under the prepayment analysis, a tax on paid-in capital combined with the full deductibility of the return to contributors (policyholder dividends) provides the same after-tax return at the company level and the same tax to the government in present value as the exclusion of paid-in capital combined with no deduction for dividends paid to shareholders. Since the prepayment analysis shows that the conceptual basis for a limitation on the deduction for policyholder dividends for mutual life insurance companies is flawed, extending this approach to mutual property and casualty insurance companies is inappropriate.

The prepayment analysis does not address the problem that policyholders enjoy a tax advantage at the investor level. The following section discusses the policyholder-level tax advantage and evaluates its significance for investors in property and casualty insurance companies.

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[4] See the Department of the Treasury, Final Report to the Congress on Life Insurance Company Taxation, (August 1989), Chapter 5. A study by the General Accounting Office also reached this conclusion. See United States General Accounting Office, Allocation of Taxes Within the Life Insurance Industry (October 1989).

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 4.1

Policyholders Dividends and Premiums Earned for
Property and Casualty Insurance Companies by Line of Business: 1989

	Policyholder Dividends		Premiums Earned		Dividends/ Premiums (percent)
	Amount ($ millions)	Percent of Total	Amount ($ millions)	Percent of Total	
Fire	17.8	0.7	4,675.7	2.3	0.4
Allied Lines	10.4	0.4	2,054.8	1.0	0.5
Farmowners Multi Peril	7.9	0.3	922.7	0.4	0.9
Homeowners Multi Peril	83.0	3.1	17,349.7	8.4	0.5
Commercial Multi Peril	64.3	2.4	17,402.2	8.4	0.4
Ocean Marine	3.7	0.1	1,222.5	0.6	0.3
Inland Marine	9.7	0.4	4,324.1	2.1	0.2
Financial Guaranty	0.0	0.0	351.0	0.2	0.0
Medical Malpractice	95.1	3.5	4,222.7	2.0	2.3
Earthquake	1.8	0.1	360.1	0.2	0.5
Group Accident & Health	0.0	0.0	2,739.6	1.3	0.0
Credit Accident & Health	0.0	0.0	243.0	0.1	0.0
Other Accident & Health	0.1	0.0	1,532.2	0.7	0.0
Workers' Compensation	1,715.1	63.2	28,069.0	13.6	6.1
Other Liability	86.3	3.2	18,522.6	9.0	0.5
Auto Liab. (Private)	267.2	9.8	43,073.9	20.9	0.6
Auto Liab. (Commercial)	108.6	4.0	11,934.7	5.8	0.9
Auto Damage (Private)	197.5	7.3	29,397.4	14.3	0.7
Auto Damage (Commercial)	27.8	1.0	5,196.3	2.5	0.5
Aircraft	0.0	0.0	583.7	0.3	0.0
Fidelity	0.8	0.0	942.1	0.5	0.1
Surety	10.6	0.4	1,693.6	0.8	0.6
Glass	0.3	0.0	21.2	0.0	1.3
Burglary and Theft	1.5	0.1	103.3	0.1	1.5
Boiler and Machinery	0.9	0.0	621.4	0.3	0.1
Credit	0.0	0.0	899.0	0.4	0.0
International	0.0	0.0	170.3	0.1	0.0
Reinsurance (A,B,C, & D)	1.2	0.0	7,063.1	3.4	0.0
Write-ins	1.5	0.1	550.0	0.3	0.3
Total	2,713.1	100.0	206,242.2	100.0	1.3

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Source: A. M. Best Company

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	Percent	Amount	Percent	Premiums	Amount	Percent	Amount	Percent	Premiums
	($ millions)	of Total	($ millions)	of Total	(percent)	($ millions)	of total	($ millions)	of Total	(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

The workers' compensation line accounted for 84 percent of policyholder dividends paid by stock companies and 45 percent of policyholder dividends paid by mutual companies. For mutual companies, private auto lines accounted for 31 percent of policyholder dividends. On average, mutual companies pay more policyholder dividends as a percent of premiums than stock companies. The ratio of policyholder dividends to premiums in 1989 was 1.8 percent and 1.0 percent for mutual companies and stock companies, respectively.

Associations representing the property and casualty insurance industry (both stock and mutual companies) argue that the importance of policyholder dividends in the workers' compensation line reflects a form of price competition in a regulated market. Base rates for workers' compensation coverage are established by state law and insurers generally are prevented from charging less than the base rates without regulatory approval. Policyholder dividends provide a mechanism for reducing the effective price of a workers' compensation contract because insurers are prevented from adjusting premiums when the contract is sold. Thus, it is argued that policyholder dividends are the result of price competition and are not return on equity.[7]

The extent to which policyholder dividends comprise price rebates, returns on equity, or return of capital cannot be determined with available data. As noted above, however, the prepayment analysis shows that when policyholders are businesses, as appears to be the case for workers' compensation policyholders, the present tax treatment of policyholder dividends does not confer a policyholder-level tax advantage. The lines of business for which a policyholder-level tax advantage may be relevant are the personal lines.

4.2.2 Policyholder Dividends for Personal Coverage

It is not possible to measure precisely policyholder dividends for personal coverage, because the available data on policyholder dividends generally do not distinguish between personal and commercial lines of insurance business. The exceptions are homeowners multiple peril, private passenger auto liability, and private passenger physical damage, which are identified personal lines. However, other lines that may be viewed as primarily commercial include some personal coverage, such as accident and health, fire, and allied lines. Thus, the data for homeowners multiple peril and the personal auto lines provide an indication of the importance of policyholder dividends for personal coverage.

Table 4.3 shows that policyholder dividends for the three lines of business that are primarily personal (homeowners multiple peril and the private auto lines) were $548 million in 1989, or 20 percent of total policyholder dividends paid by property and casualty insurers. Table 4.4 shows that mutual companies paid $534 million in policyholder dividends for personal coverage (97 percent of the industry total) compared with $14 million for stock companies (3 percent of the industry total). Policyholder dividends for personal coverage averaged 1.1 percent of premiums for mutual companies and were insignificant for stock companies.

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[7] 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 (January 8, 1990), pp. 8-9.

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/
	Amount ($ millions)	Percent of Total	Amount ($ millions)	Percent of Total	Premiums (percent)
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

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Source: A. M. Best Company

Table 4.4

Policyholder Dividends and Net Written Premiums for Stock and Mutual Property and Casualty Insurance Companies for Personal and Commercial Coverage: 1989

	Stock Companies					Mutual Companies				
	Policyholder Dividends		Net Written Premiums			Policyholder Dividends		Net Written Premiums		
	Amount ($ millions)	Percent of Total	Amount ($ millions)	Percent of Total	Dividends/ Premiums	Amount ($ millions)	Percent of total	Amount ($ millions)	Percent of Total	Dividends/ Premiums
Total Personal Lines:	13.9	1.1	40,718.4	32.2	0.0	533.8	37.0	50,514.6	61.6	1.1
Homeowners MP	1.6	0.1	8,261.5	6.5	0.0	81.4	5.6	9,409.4	11.5	0.9
Auto Liab (Priv.)	7.9	0.6	19,302.8	15.3	0.0	259.3	18.0	24,673.7	30.1	1.1
Auto Phys (Priv.)	4.4	0.3	13,154.0	10.4	0.0	193.1	13.4	16,431.4	20.1	1.2
Total Commercial Lines:	1,255.4	98.9	85,721.7	67.8	1.5	910.0	63.0	31,433.3	38.4	2.9
Workers' Comp	1,065.6	84.0	19,738.3	15.6	5.4	649.6	45.0	8,503.1	10.4	7.6
Other	189.8	15.0	65,983.4	52.2	0.3	260.5	18.0	22,930.2	28.0	1.1
Total All Lines	1,269.3	100.0	126,440.1	100.0	1.0	1,443.8	100.0	81,947.9	100.0	1.8

Source:

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 4.5

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

	Stock Companies					Mutual Companies				
	Policyholder Dividends		Premiums Earned		Dividends/ Premiums (percent)	Policyholder Dividends		Premiums Earned		Dividends/ Premiums (percent)
	Amount ($ millions)	Percent of Total	Amount ($ millions)	Percent of Total		Amount ($ millions)	Percent of total	Amount ($ millions)	Percent of Total	
Total Personal Lines:	13.9	1.1	6,317.8	6.2	0.2	533.8	37.0	24,727.6	36.8	2.2
Homeowners MP	1.6	0.1	880.3	0.9	0.2	81.4	5.6	1,574.2	2.3	5.2
Auto Liab (Priv.)	7.9	0.6	3,490.9	3.4	0.2	259.3	18.0	13,969.7	20.8	1.9
Auto Phys (Priv.)	4.4	0.3	1,946.6	1.9	0.2	193.1	13.4	9,183.7	13.7	2.1
Total Commercial Lines:	1,255.4	98.9	95,916.9	93.8	1.3	910.0	63.0	42,532.9	63.2	2.1
Workers' Comp	1,065.6	84.0	19,137.5	18.7	5.6	649.6	45.0	8,007.1	11.9	8.1
Other	189.8	15.0	76,779.3	75.1	0.2	260.5	18.0	34,525.8	51.3	0.8
Total All Lines	1,269.3	100.0	102,234.6	100.0	1.2	1,443.8	100.0	67,260.5	100.0	2.1

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Source: A. M. Best Company

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

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Office of Tax Analysis

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Source: A. M. Best Company

As discussed in the previous section, policyholder dividends may blend together price reductions, interest payments, and equity-like returns. Moreover, equity returns for participating policyholders may be received in a variety of ways, such as through reduced premiums. However, to the extent that policyholders change insurers, it is less likely that equity-like returns would be paid in the form of reduced premiums. Both the extent to which policyholder dividends contain equity returns and equity returns are received in other forms are impossible to determine empirically.

4.3 Arguments Relating to Differences between Property and Casualty Insurance and Life Insurance

Representatives of the property and casualty insurance industry also argue that a limitation on policyholder dividends should not be imposed on property and casualty insurers because property and casualty insurance differs from life insurance in several respects.

First, representatives of the property and casualty insurance industry contend that the resemblance that a mutual company policyholder bears to an owner is closer with a life insurance policy than with a property and casualty insurance policy. Because life insurance policies generally are longer-term commitments based on relatively predictable mortality rates, they may be more closely tied to the company's investment performance. In contrast, property and casualty policies are short-term contracts often for more highly variable risks. Whereas certain life insurance policies are held for many years, property and casualty insurance coverage tends to have a short duration, such as six-months to one year. Thus, it is argued that a property and casualty insurance policyholder's relationship only weakly resembles a traditional ownership relationship.[11]

Although property and casualty insurance contracts are short-term, the extent to which policyholders renew their policies with the same company and thus are affiliated with their property and casualty insurance company for long periods is unclear. The duration of property and casualty contracts may not accurately reflect either the duration of the relationship between the policyholder and the insurance company or the closeness of that relationship to a traditional ownership interest.

Representatives of the property and casualty insurance industry argue that property and casualty insurance policyholders are unlikely to receive an investment-like return during the term of the policy because the policies are short term.[12] This argument more appropriately addresses the amount and form of payment of any investment-like return. Policyholder dividends for short-duration contracts contain an investment-like return because the insurance company invests the redundant

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[11] See Emil M. Sunley, Federal Income Taxation of Mutual and Stock Property/Casualty Insurance Companies (November 28, 1988), pp. 31-2.

[12] 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. 17.

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.

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. According to the prepayment analysis a tax on paid-in capital combined with a full deduction of dividends to policyholders is equivalent in present value terms to the exclusion of capital contributions combined with no deduction for dividends to shareholders.

The prepayment analysis does not address the problem that returns to participating policyholders of mutual and stock insurance companies may enjoy a policyholder-level advantage because policyholder dividends are not taxable income to policyholders but dividends are taxable to shareholders. An exception to this policyholder-level advantage arises when the policyholder is a business rather than an individual. Since businesses deduct premiums paid but include policyholder dividends in income, a policyholder-level tax advantage generally does not arise between conventional equity and policyholder equity.

Data on policyholder dividends paid by property and casualty insurers show that most policyholder dividends are paid in the workers' compensation line. Since workers' compensation policies are purchased primarily by businesses, it is unlikely that a significant policyholder-level tax advantage arises with respect to policyholder dividends on these policies. However, a policyholder-level tax advantage arises with respect to the investment-like return contained in policyholder dividends for personal coverage, such as the homeowners multiple peril and the personal auto lines of business.

Current law generally does not tax the equity-like income of participating policyholders of life insurance companies or property and casualty insurance companies at the individual level. This problem is not limited to mutual company policyholders, since both stock and mutual companies issue participating policies. The disparity in the treatment of policyholders and shareholders at the individual level could justify a corporate-level tax on the equity return contained in policyholder dividends as a proxy for the absent individual-level tax. However, as an empirical matter, this disparity is considerably smaller for investors in property and casualty insurance companies than for life insurance companies because the amount of policyholder dividends paid by property and casualty insurers is substantially smaller than that paid by life insurers and policyholder dividends paid by property and casualty insurers are paid primarily to business policyholders. Since the imposition of a proxy tax on property and casualty insurance companies would impose a compliance burden but would have modest revenue yield, the Treasury Department does not recommend a proxy tax at this time.

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 could be less than the potential effect if the property and casualty insurance company or any of the consolidated companies had current losses or NOLs that offset the impact of the property and casualty insurance company tax changes. In determining the actual effect of the property and casualty insurance company changes on the income shown on consolidated tax returns, the 35 percent rule for life-nonlife consolidated returns was taken into account. This rule limits the use of nonlife losses against life income to the minimum of 35 percent of eligible nonlife losses or 35 percent of life insurance subgroup income. For several companies in the sample, consolidated taxable income was solely attributable to life subgroup income and the use of nonlife losses was constrained by life subgroup income. For such companies, consolidated taxable income and tax was unchanged by the 1986 Act provisions even though the tax changes reduced the nonlife losses of the companies.

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