[JOINT COMMITTEE PRINT]

BACKGROUND ON THE TAX TREATMENT OF PROPERTY AND CASUALTY INSURANCE COMPANIES

SCHEDULED FOR A HEARING

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ON

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PREPARED BY THE STAFF

OF THE

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INTRODUCTION

The Senate Committee on Finance has scheduled a hearing on June 13, 1983, on the tax treatment of property and casualty insurance companies. This pamphlet, prepared in connection with the hearing, provides information on the property and casualty insurance industry and the taxation of such companies.

The first part of the pamphlet is general background on property and casualty insurance. Part two discusses State regulation of property and casualty insurance companies. Part three provides a description of present law tax treatment of such companies as well as a discussion of tax issues. Part four provides information and data on the various types of private property and casualty insurance. Finally, the Appendix presents statistical material on the property and casualty insurance industry.

I. BACKGROUND INFORMATION ON PROPERTY AND CASUALTY INSURANCE

The theory of insurance

The purpose of property and casualty insurance [1] (and all insurance, generally) is to pool the probable cost of the same types of risks of loss over a large number of insured persons (whether individuals or businesses). As a result, each insured person will contribute a premium payment each year to the pool, and the total annual contributions should equal the total payments for damage, plus necessary operating costs of the insurance company.

In developing its insurance pool, an insurance company will classify all the relevant possible events into categories that have as many common characteristics as can be identified. The company will identify the population that may be affected by the type of loss and determine from historical experience the proportion of the population anticipated to be affected by the loss in any annual period. Both the value of the property involved and the amount of potential damage will be estimated as part of the process. From this information, the average annual probability of the loss and the amount of the loss will be computed and an insurance premium determined to cover the estimated payments. In a perfect situation, the insured persons transfer their risks to the pool in exchange for payment of a premium. The insurance company provides a service to the insured persons in collecting, holding, investing, and disbursing payments, and ideally the company bears no financial risk.

It is important that the insurer be able to determine some pattern of experience over a large number of insured persons. In the absence of such experience, a distribution of the risks with a central tendency cannot be developed, and actuaries will not have a probability distribution on which to base a premium rate structure.

A common textbook illustration should help clarify the insurance concept. In determining the annual probability of damage to a house by fire, statistics would be collected on the incidence of fires in houses of comparable value, age, construction and location. Thus, if in a sample of 100,000 houses of comparable status 100 have burned, the probability of fire in a house is 100 divided by 100,000 or 0.1 percent. The amount of loss would be $5 billion, if the entire sample of houses (each valued at $50,000) were to be destroyed completely. However, if the 100 houses in which the fires are assumed to occur experience damage at an average cost of $20,000 to repair, the probable value of fire losses annually would be $2 million. The probability of the value of $1 of loss is $2 million divided by $5 billion or 0.04 percent. This is the equivalent of 4

[1] Under more current terminology, this may also be referred to as property and liability insurance.

cents per $100 of the cost per house to repair fire damage, or $8 for each house. Generally, an insurance company would price fire insurance for houses so that the premiums received over a five-year period would be sufficient to meet payments to insured persons and cover company costs related to this kind of insurance.

The company's objective is to estimate its payments over this period so accurately that there is an exact balance of receipts and disbursements. In that perfect case, insurance companies would be simply providing a service to the insured persons and not bearing any financial risk. Perfection, however, is not achieved, and insurance companies bear financial risks that extend into the future, because the estimates may be uncertain, new theories of liabilities may develop under the law, inflation may increase the amount of any loss, or investment earnings may fall short of expectations.

Characteristics of the industry

Property and casualty insurance companies in 1981 held more than $212 billion in assets which were invested primarily in tax-exempt and taxable bonds and common stock. Premium receipts were $93 billion in that year. Property and casualty companies directly employed 475,900 persons in 1981, about 25 percent of 1.9 million persons employed in all phases of the insurance industry.

Worldwide premium volume (outside of Eastern European Bloc countries) was about $435 billion in 1980. The United States share of the world insurance market is the greatest among all countries at 43.6 percent of the worldwide volume in 1980, which is greater than the combined premium volume of the next 8 largest insurance-writing countries.

In the United States, more than 41 percent of property and casualty insurance covers automobile liability and physical damage. A dominating portion of this insurance (82 percent) covers private passenger automobiles. Workers' compensation is the next major line of property and casualty insurance at 14.7 percent, and home and farm owners multiple peril insurance is the third largest category at 11.5 percent of the total. Other lines of property and casualty insurance include inland ocean marine coverage, commercial multiple peril, surety and fidelity, burglary and theft, crop and hail, boiler and machinery, glass, aircraft, accident and health, and liability and property damage nuclear insurance.

From 1977 to 1981, net income before taxes of the property and casualty insurance companies varied between $6.9 and $8.6 billion. Average annual rates of return in those years declined from 21.0 percent in 1977 to 11.9 percent in 1981. (The annual rates of return were calculated as net income after taxes as a percent of net worth.) During the last 10 years (1972-81), the average annual rate of return in the property and casualty industry was 13.04 percent, but the annual rates of return varied between 4.0 and 21.0 percent; the standard (i.e., average annual) deviation from the 10-year average was (plus or minus) 5.48 percent. In other industries which had higher or lower 10-year average annual rates of return, the highest standard deviation was less than 3 percent.

II. STATE REGULATION OF PROPERTY AND CASUALTY INSURANCE COMPANIES

Generally, insurance is regulated by the States to protect the public interest. The nature of insurance generally requires an advance premium payment to the insurance company for a service which is to be performed essentially in the future. It is important that the insurer be able financially to carry out its contract when a loss occurs, which involves careful scrutiny of the adequacy of premiums collected, the evaluation of assets and liabilities, and the investment of assets.

Experience has borne out the general need for regulation of insurance companies. Before the adoption of State regulatory statutes, large sums of money were lost by policyholders because of the poor business judgment or dishonesty of those in control of the companies. In other cases, competition among companies and agents drove rates (premiums) down to a level at which the company's reserves were inadequate to meet its liabilities. However, today all State legislatures have enacted insurance regulatory statutes, and each has established an Office of the Insurance Commissioner. The insurance commissioners, through their national organization, the National Association of Insurance Commissioners (NAIC), have achieved a degree of uniformity in insurance laws and regulations. State regulations are now extensive, including rules governing the establishment of new companies and the examinations for persons seeking to become insurance agents and brokers.

States also regulate premium rates and often determine how they are set. Laws require that rates be adequate, reasonable, and not unfairly discriminatory. All States, however, do not follow the same practice with respect to rate setting. Generally, State rating laws may be divided into four categories: (1) under *prior approval*, the insurance department must approve both rate level and form before any filing change or use may occur; (2) under *modified prior approval*, rate level adjustments (based on experience data) may be filed and used immediately, although more fundamental changes, in rate form, require prior approval; (3) under *file and use* rules, a company must file any new or modified rates, but the company does not have to wait for approval before putting them into effect; if a commissioner disapproves the rates within a reasonable period of time, the prior rates must be reinstated; (4) under *open competition* laws, neither rate filing nor prior approval is required; several States have adopted this procedure, and regulatory attention has turned to company solvency and equity.

Several States also regulate the type of investments that an insurance company may make in order to provide for company solvency and liquidity. In such States, a property and casualty insurance company chartered by the State is required to invest an

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amount equal to minimum capital requirements in Federal, State, or local government bonds, or bonds or notes secured by mortgages or deeds of trust on improved, unencumbered real estate. Asset amounts equal to 50 percent of unearned premium and unpaid loss reserves also must be invested in restricted securities of similar high quality. In such States, companies chartered by other States or foreign countries usually are required to carry investments of the same class as those required for State chartered companies.

The excess funds of every domestic company above capital stock and reserve liabilities (referred to as "surplus") may be invested in securities (described above), or in the common stock of any solvent company incorporated in the U.S., or any real estate for which there is legal authorization. Generally, not more than 10 percent of the assets may be invested in any one corporation.

Liability reserves must be established for unpaid losses and unearned premiums. Unpaid losses include provisions for claims that have been incurred but not reported, as well as for claims about which there is specific knowledge. The ultimate cost of each claim is not always known precisely, and various estimating procedures have been created to estimate the needed reserves. Unearned premiums represent the amount of premiums that has been paid or collected in advance but which are allocable to the period of protection that remains in the future. Reserves for unearned premiums are computed generally on the basis of gross premiums and do not take into account any deduction for expenses already incurred or paid. The effect of this computation is to reduce the stated amount of surplus and, thus, may limit the ability of a company to underwrite new business.

III. TAXATION OF PROPERTY AND CASUALTY INSURANCE COMPANIES

A. Overview

1. Historical background

A company whose primary and predominant business activity during the taxable year is the issuance of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies is taxed under specific provisions of the Code which are applicable solely to insurance companies. [2] Insurance companies have generally been classified into four groups for tax purposes: (1) life insurance companies; (2) mutual insurance companies other than life, and certain marine insurance companies and other than certain fire or flood insurance companies; (3) insurance companies (other than life or mutual), mutual marine insurance companies, and certain mutual fire or flood insurance companies; and (4) insurance companies that are exempt from tax under section 501(c) of the Code, such as fraternal beneficiary societies, voluntary employees' beneficiary associations, local benevolent life and mutual associations, and certain mutual insurance companies other than life or marine.

The tax provisions relating to life insurance establish an essentially free-standing set of rules for the computation of life insurance company taxable income. These provisions are beyond the scope of this discussion.[3] Likewise, tax-exempt insurance companies (category (4)), generally, will not be discussed in this pamphlet. Any further references to insurance companies in this document will be to property and casualty (nonlife) insurance companies, unless specifically stated otherwise.

Stock property and casualty insurers have been subject to virtually the same tax rules since 1921. Gross income of these companies includes underwriting income, investment income, and gains and losses (to the extent deductible by other corporations) from sales of assets. Special rules have been added defining the underwriting income of these companies. Under these rules, inclusion of income is deferred until premiums are "earned" and losses are allowed as deductions on the basis of estimates as to their occurrence and their amount.

Before 1942, most mutual property and casualty insurers were exempt from taxation. Mutual insurers that were not exempt from taxation were taxed in the same manner as corporations, with certain special deductions. From 1942 through 1962, a formula ap-

[2] Treas. Reg. § 1.801-3(a)(1) defines an insurance company.

[3] For background on the taxation of life insurance companies and their products, see Joint Committee staff pamphlet, "Background on the Taxation of Life Insurance Companies and Their Products" (JCS-11-83), May 5, 1983.

proach to the taxation of mutual insurance companies did not take underwriting income or loss into account. Generally, the tax of these companies was the higher of (1) a tax at regular corporate rates on net investment income or (2) a tax of one percent of gross investment income and net premium income reduced by tax-exempt interest and policyholder dividends. Capital gains were not included in this calculation.

Since 1963, the tax treatment of mutual insurance companies has been similar to the treatment of stock insurance companies (*i.e.*, companies listed in category (3), above) but mutual insurance companies have been allowed to defer tax on a portion of their underwriting income.

2. Stock insurance companies other than life

Stock companies are subject to tax under rules similar to those applicable to ordinary corporations, although this result is accomplished through two special provisions in the Code which override the general corporate taxation provisions.[4] The primary difference between the taxation of a property and casualty insurer and other taxpayers is in the timing of the inclusion of underwriting income and the allowance of deductions. Rather than following the generally applicable Federal tax accounting rules, the taxation of insurance companies generally follows State insurance department accounting rules.[5] Thus, the Annual Statement filed with State regulatory authorities is the governing standard for determining the timing of taxable income.

Although the courts have described property and casualty companies as accrual method taxpayers, there are significant exceptions to the accrual rules. For example, under the usual rules, income must be accrued when all events have occurred that determine the right to income and the amount of income can reasonably be ascertained, or, if earlier, when the income is received and is subject to the recipient's control. Property and casualty insurance premiums, however, are included in income only as earned and not when payment is received. Generally, unearned premiums are those amounts which cover the cost of carrying the insurance risk for the period for which the premiums have been paid in advance. Thus, in comparison to other taxpayers, property and casualty insurers may recognize income at a later time.

Expenses are deductible by accrual method taxpayers when all events have occurred that fix the fact of liability and the amount of liability can reasonably be ascertained. Insurers, however, may deduct estimated losses and expenses on the occurrence of an insured event, even though the liability is not fixed or determinable and may be contested by the insurer. Also, whether an insured event has occurred may be estimated on the basis of the same statistical population and distribution that provides the basis for insurance. Finally, insurers are permitted to deduct acquisition expenses such as agents' commissions and premium taxes in the year

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[4] I.R.C. secs. 831 and 832.

[5] Compare *Western Casualty and Surety Co.* v. *Commissioner*, 571 F.2d 514 (10th Cir. 1978), aff'g, 65 T.C. 894 (1976), and footnote 24 in *Commissioner* v. *Standard Life & Accident Insurance Co.*, 433 U.S. 148, 161 (1977).

a policy is issued rather than over the term of the policy or the expected life of the policy and renewals.[6]

3. Mutual property and casualty companies

Since 1962, the taxation of mutual property and casualty insurance companies has been similar to that of stock companies with two major distinctions. First, certain mutual companies are permitted to defer a portion of underwriting income, which is accumulated in an account called the Protection Against Loss (PAL) account. This account does not represent an actual reserve established by the company on its books or a specific allocation of assets to be held as protection against losses. Generally, these deductions do not result in a permanent deferral (see item B.4. below). Second, certain small mutuals are exempt from income tax or are taxed only on investment income.

The case law and Internal Revenue Service rulings have identified the following criteria as indicative of mutuality:

(a) there is common equitable ownership of the company by its members;

(b) the policyholders have the right to be members to the exclusion of others and to choose the management;

(c) the company's sole business purpose is to furnish insurance substantially at cost; and

(d) the members have the right to the return of premiums which are in excess of the amount needed to pay losses and expenses.[7]

Mutuals are classified into three categories depending upon the amounts of their gross receipts. Mutual companies with gross receipts not in excess of $150,000 are tax-exempt (Code sec. 501(c)(15)). Companies whose gross receipts exceed $150,000 but do not exceed $500,000 are "small mutuals" and may be taxed solely on investment income. This provision does not apply to any mutual company that elects to be taxed on total income or that has a balance in its PAL account. Additionally, small mutuals which are subject to tax because their gross receipts exceed $150,000 may claim the benefit of a special rule which phases in the regular tax on investment income as gross receipts increase from $150,000 to $250,000. Companies whose gross receipts exceed $500,000 are ordinary mutuals taxed on both investment and underwriting income.[8]

In determining the amount of gross receipts for purposes of classifying a mutual, gross premiums and gross investment income are included, but capital gains are not. Gross premiums represent the total of premiums received (including premiums received for reinsurance) without reduction for premiums paid for reinsurance ceded, return premiums, or any other similar item.

Like stock companies, ordinary mutuals generally are subject to the regular corporate income tax rates. Mutuals whose taxable income does not exceed $12,000 pay a lower tax. No tax is imposed on the first $6,000 of taxable income, and a tax of 30 percent is im-

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[6] See Rev. Rul. 70-552, 1970-2 C.B. 141, and Rev. Rul. 82-69, 1982—1 C.B. 102.

[7] Rev. Rul. 74-196, 1974-1 C.B. 140.

[8] Also, organizations called reciprocal underwriters or interinsurers generally are taxed as mutual insurance companies, subject to special rules (see Code sec. 826).

posed on the next $6,000 of taxable income. For small mutual companies which are taxable on investment income, no tax is imposed on the first $3,000 of taxable investment income, and a tax of 30 percent is imposed on taxable investment income between $3,000 and $6,000.

A small mutual may elect to be taxed on both its underwriting and investment income. This election is advantageous if the company experiences underwriting losses that could offset investment income in computing total taxable income. The election, once made, continues to apply to future years unless the Secretary of the Treasury approves a revocation upon a company's showing that continuation of the election causes an undue burden or hardship. If the mutual company's gross receipts fall below $150,000 in a future year so that the company would be exempt from tax under the rules for mutuals, the election to be taxed on both underwriting and investment income is automatically terminated.

B. Discussion of Issue Areas

1. Definition of insurance

In general

Despite the special provisions (subchapter L) for taxing insurance companies and other provisions that recognize insurance transactions, the Code does not contain a definition of "insurance." The question "what is insurance?" has been considered by several courts (including the Supreme Court), but there is still no "definitive" definition.

Under the Supreme Court decision of *Helvering* v. *LeGierse*, 312 U.S. 531 (1941), it has been commonly understood that "risk-shifting" and "risk-distribution" are essentials of a contract of insurance. Likewise, a transaction is one of insurance only if it involves an actual "insurance risk" when it is executed. The concept of risk-shifting refers to the fact that a risk of loss is shifted from the individual insured to the insurer (and the insurance pool managed by the insurer). For example, under a fire insurance policy, the property owner's risk of loss from a fire (and the resulting damage costs) is shifted from the owner to the insurance company to the extent that the insurance proceeds from the contract will reimburse the owner for that loss. The concept of risk-distribution might be considered fundamental to the very theory of insurance, which relies on the law of large numbers. That is, within a group of a large number of individual insureds who share a similar type of risk of loss, only a certain number will actually suffer the loss within any defined period of time. When a loss is suffered by any insured, each individual insured, through the payment of premiums, makes a contribution toward indemnifying the loss suffered. Despite the language in the *LeGierse* case, a more recent decision has raised the question of whether risk-shifting is still required in order to validate an insurance transaction. (See *Consumer Life Insurance Company* v. *U.S.*, 430 U.S. 725 (1977), in which the Supreme Court found that, although there was no significant risk-shifting, a transaction was valid reinsurance.)

Retroactive liability coverage

The question of what constitutes insurance may have broad practical significance in many areas. Consider the situation of retroactive liability coverage under which a policyholder obtains insurance against a particular risk after the event of the risk has occurred. When the loss event (such as a fire) has already occurred, and both parties know it has occurred, one might question whether any shifting has occurred because the risk or possibility of loss has already become a certainty. Under such retroactive liability coverage, an actual loss is being shifted rather than merely a risk of loss. The uncertainties remaining are the final determination of the size of the loss and the time of payment.

Ordinarily, the size of the loss is not an "event" that would be thought to involve an insurance risk. Focusing only on the economic realities of the transaction, the only "risk" assumed by the insurer under the retroactive contract seems to be an investment risk; that is, will the insurer earn a sufficient amount on the premium dollars charged (taking into account any tax savings generated by the transactiion) to pay the face amount of the policy some time in the future? The investment risk can be broken into two elements: (1) whether the company will earn the rate of return on the premium dollars that it anticipates; and (2) whether the company will have sufficient funds accumulated by the time it has to pay the claims. The first element of the investment risk is not unlike that assumed by a bank under any interest obligation. The second element, because it involves a timing risk, might be considered more similar to an insurable risk.

The investment risk assumed under the retroactive liability coverage might be compared to that risk assumed by a seller of a 10-year callable bond. In negotiating the price with the purchaser, the seller will take into account the rate of return for the bond and when the bond might be redeemed by the corporate issuer. Does the risk assumed by the bond seller constitute an "insurance risk?" Although investment risk has been recognized as an element of an insurance contract, the Supreme Court has said that "the assumption of an investment risk can not by itself create an insurance provision under the Federal definition."[9]

If retroactive liability coverage is insurance, the tax accounting for such a transaction can make the contract profitable. The policyholder, in a business context, is entitled to an immediate deduction for a premium, which has been discounted at interest, taking into consideration the fact that the actual claims will be paid over a long period of time. At the same time, the insurance company selling the contract recognizes the liability for the accrued claims on an undiscounted basis. Arguably, then, the transaction takes advantage of what might be viewed as a mismatching of income and deductions, as between two unrelated taxpayers and for a single taxpayer.

[9] *S.E.C. v. United Benefit Life Insurance Co.*, 387 U.S. 202, 211 (1967). Also, *Helvering v. Le-Gierse*, 312 U.S. 531, 542 (1941).

Captive Insurance Companies

The question of what is insurance also is central to an analysis of self-insurance plans and consideration of whether there can be valid insurance transactions between economically related parties. Generally, taxpayers are not allowed deductions for anticipated expenses or losses unless the liability is fixed and the amount reasonably estimated. Thus, although most types of insurance premium payments are deductible if they are incurred in connection with the taxpayer's trade or business, amounts that are added to a self-insurance fund or account are not deductible. Aside from the fact that amounts set aside as self-insurance "premiums" are not paid or incurred, self-insurance is not considered insurance because there is no economic shifting or distribution of the risk "insured." Instead of merely setting aside "premiums" within a company, a subsidiary might be formed as an insurance company to provide the insurance protection for the parent company. But such "captive insurance companies" may be viewed as highly evolved self-insurance arrangements.

Specifically, the Internal Revenue Service has ruled that the "insurance premiums" paid by a domestic corporation and its domestic subsidiaries to the parent's wholly owned foreign "insurance" subsidiary are not deductible if the "insurance" subsidiary does not also insure risks of insureds outside its own corporate family. The Service concluded that because the insureds and the "insurance" subsidiary (though separate corporate entities) represent one economic family, those who bear the ultimate economic burden of the loss are the same persons who suffer the loss. Thus, the required risk-shifting and risk-distribution of a valid insurance transaction are missing.[10] This position of the Service was favorably cited by the Ninth Circuit in *Carnation Co. v. United States.*, 640 F.2d. 1010 (9th Cir. 1981), *cert. denied*, 454 U.S. 965.

In contrast, the Service has also ruled that amounts paid by a domestic petroleum corporation to a foreign insurance company that provided insurance against certain petroleum industry risks only for its 31 unrelated shareholders and their subsidiaries and affiliates were deductible as insurance premiums. In addition to the fact that the 31 shareholders/insureds of the insurance company were unrelated, the ruling indicated that no one owned a controlling interest and no one's risk coverage could exceed 5 percent of the total risks insured. The ruling concluded that such an arrangement allowed the economic risk of loss to be shifted and distributed among the shareholders who comprised the insured group so that it constituted insurance.[11]

Although the Service has indicated what is an invalid "captive insurance arrangement" as well as what is a valid insurance arrangement, questions still remain. For example, how many unrelated shareholders/insureds are necessary in order to have sufficient risk-shifting and risk-distribution? Is the number of insureds important if the number of risk exposures is large? How much risk from unrelated insureds must a wholly owned captive insurance

[10] Rev. Rul. 77-316, 1977-2 C.B. 53.
[11] Rev. Rul 78-338, 1978-2 C.B. 107

company assume in order to provide a valid insurance arrangement in which members of its own economic family can participate? Must the premium structure charged unrelated insureds generally contribute to the funding adequacy for potential claims arising from contracts with related insureds in order for there to be the risk-shifting and risk-distribution essential for a valid insurance arrangement? Can there ever be a valid insurance arrangement between economically related parties? Whatever the rules are, do the same rules apply for reinsurance transactions between related parties? Thus far, the definition of insurance developed by the case law has not answered these questions.

Definitional problems with nontraditional "insurance" products

Finally, the definition of insurance is pertinent in areas that are outside the traditional insurance business. For example, consider the sale of "telephone maintenance insurance." For an annual fee, a company may contract to replace or repair telephone equipment that is not purchased from and serviced by the public telephone company. The risk of loss connected with a breakdown in telephone equipment is shifted from the buyer of the contract to the seller and is distributed among other buyers of similar contracts through the fee paid. Is this insurance or merely a contract to perform services? The company may be able to predict the occurrence of a certain number of repair calls per year based on its experience, and so may charge its customers accordingly. This pricing procedure is similar to the actuarial computations used by an insurance company selling traditional products. Unlike other taxpayers, insurance companies are allowed to estimate and recognize future contingent liabilities under current tax law. Should companies selling product maintenance contracts be treated as insurance companies for tax purposes? Or must an insurance company for tax purposes be licensed as such under State law? Should companies that sell nontraditional "insurance" products—such as service contracts, warranties, sureties, and tax audit insurance—be able to avail themselves of the special taxing provisions generally available to insurance companies?

2. Reserves

Property and casualty insurance companies, generally, do not maintain reserve accounts per se. However, two of the special rules relating to the computation of underwriting gain or loss for a property and casualty company have the effect of creating reserves. These are the rules relating to unearned premiums and unpaid losses.

In the computation of earned premiums, insurers deduct from gross premiums the difference between the current and prior year's unearned premiums, that is, the net unearned premiums for the current year. The Internal Revenue Service has defined unearned premiums as those amounts that cover the cost of carrying the insurance risk for the period for which the premium has been paid in advance and that are maintained for the purposes of maturing and liquidating, either by payment as they are earned or reinsurance

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with other companies, future unaccrued and contingent claims arising under the contract.[12]

Property and casualty insurers are permitted a deduction for losses incurred and expenses incurred during the taxable year in computing their underwriting income. Losses incurred are computed as the sum of losses paid (with appropriate adjustments for salvage and reinsurance recoverable) and the net increase (or decrease) in unpaid losses. The amount of unpaid losses which may be claimed is the amount which, at the close of the taxable year (based on the facts in each case and the company's experience in similar cases) represents a fair and reasonable estimate of the amount the company will be required to pay. The effect of this provision is to allow property and casualty insurers to claim deductions for reported losses, incurred but not reported (IBNR) losses, and resisted or contested losses.[13] A contingency reserve for events yet to occur remains nondeductible. The usual practice is for a company to determine its liability based on experience as a percentage of an element of underwriting, such as premiums in force. However, the estimates of unpaid losses must be reasonable.

The allowance of a deduction for unpaid losses of a property or liability insurer differs from the treatment of other taxpayers in two important respects. First, insurers may estimate not only the amount of liabilities they have incurred but also the existence of the liability itself. That is, the company need not know that losses have occurred with respect to any particular contract before claiming a reserve deduction based on its reasonable (generally experience-based) estimate of its liability for these losses. Second, the company's ability to deduct an unpaid loss is not diminished by its decision to contest the liability. An ordinary accrual method taxpayer, generally, may not deduct the amount of a contested liability. The net effect of these differences generally is to permit insurers to accelerate the deduction of losses claimed relative to the timing of those deductions under the generally applicable rules.

In the case of loss reserves or any accrual of liabilities far in advance of their expected satisfaction, the time value of the deduction may be significant. For example, in a theoretical world, one would want, within a single accounting period, to match perfectly the income and the deductions associated with a particular activity. The accrual method of accounting and the reserve for unpaid losses attempt to accomplish the matching. However, if the time between the recognition of the income and the actual payment of the related expenses is too long, the accrual method and the unpaid loss reserve provisions could result in an understatement of a taxpayer's economic income.

For example, assume an insurer insures a risk for which it expects to pay a claim of $150 on the fourth anniversary of the insurance contract. If the insurer wants a $10 profit after expenses of $2 on the transaction and assumes a 10-percent earnings rate in its investments, it will charge $114.50. That is $102.50 which is the present value of $150 discounted over four years at 10 percent plus

[12] Rev. Rul. 67-225, 1967-2 C.B. 238, revoked by Rev. Rul. 73-302, 1973-2 C.B. 220, with respect to retrospective rate credit reserves.
[13] Rev. Rul. 70-643, 1970-2 C.B. 141.

$12 for profit and expenses. The deduction of $150 for estimated liabilities without discounting to present values can result in a tax loss of $37.50 ($114.50 premium—$2 expenses—$150 loss reserve), assuming the loss estimate is correct. Thus, the company has economic income of $10 and a tax loss of $37.50, which will shelter the investment earnings necessary to increase the amount on hand to $150 when paid. The above discussion implies that the tax effect of reserves for unpaid losses is most dramatic (1) if the losses are not be paid in fact until a much later date, (as in the case of malpractice insurance claims) or (2) when insurance accounting rules are used to accelerate, in effect, loss deductions of other noninsurance taxpayers (see the prior discussion on retroactive liability coverage).

3. Amortization of acquisition expenses

Under present law, ordinary and necessary business expenses paid or incurred in carrying on a trade or business are deductible. However, outside the insurance area, expenditures made in acquiring or creating an asset with a useful life that extends beyond the taxable year normally must be capitalized or amortized over the useful life of the asset or a specified statutory period.

Property and casualty insurance companies use the annual statement filed with State regulatory authorities as the basis for computing the underwriting and investment components of gross income (Code sec. 832 (b)(1)(a)). State insurance departments require acquisition expenses to be charged currently against income, even though the related premium income is deferred over the policy term. These expenses of property and casualty insurers are attributable to underwriting activities and primarily include agents' commissions, but also include such items as field supervisors' costs, premium taxes, and insurance board and rate bureau costs. The Internal Revenue Service has ruled that acquisition expenses of insurance policies are deducted as incurred because this treatment is consistent with the accrual method of accounting that insurers follow.[14]

This tax treatment could be questioned if these acquisition expenses are compared to the expenses of acquiring a capital asset. Generally, acquisition expenses of a property or liability insurance contract can be attributed directly to the insurance contract to which they relate. Also, the useful life of the contract is fixed and determinable. Thus, should the entire amount of the acquisition expense of an insurance policy be deductible currently? An alternative view, however, would be that acquisition expenses of an insurance policy are related to the sale of a service rather than the sale of a contract. These "sales costs" could then be deductible currently because they do not relate to an asset having a life extending beyond the taxable year but relate instead to the present income of the company.

[14] Rev. Rul. 70-552, 1970-2 C.B. 141, and Rev. Rul. 82-69,1982-C.B. 102.

4. Protection against loss (PAL) accounts

The major distinction between the taxation of stock property and casualty companies and ordinary mutual property and casualty companies is the PAL account that is available to the mutual companies. The PAL provisions are designed to provide mutuals with protection against catastrophic losses. If a stock insurer has extraordinary losses or needs to provide for growth, it has access to the capital market. Unlike stock companies, mutuals have no stock and, thus, have no paid-in capital or shareholder surplus. Congress recognized this essential difference between stock and mutual insurers and enacted the PAL provision to alleviate this disadvantage. In the life insurance area, this distinction between stock and mutual companies led to a different conclusion, which was that stock companies need a deferral mechanism to compete effectively with mutuals because stock companies do not have access to redundant premium charges. This different conclusion may not be inconsistent; the longer term and investment features of life insurance products allow mutual life insurance companies to charge, and retain for a longer period, a proportionately larger redundant premium than is possible with short-term property and casualty coverage.

The PAL account deduction does not represent an actual reserve established by the company on its books or a specific allocation of assets to be held as protection against losses. Rather, the PAL account is a set of income tax adjustments which, in effect, accomplish a forward averaging of underwriting income. In general, mutual companies are allowed to defer recognition of all or a portion of their underwriting income when they have taxable underwriting income. Some or all of this deferred portion is later recognized if the company had underwriting losses (which offset the income) or more than five consecutive years of underwriting gains. After an addition to the PAL account has been set aside for five years and has not been used to offset losses, the then unused balance is withdrawn from the PAL account and included in taxable income, except for a statutorily defined amount that remains as a cushion for future losses.

For the typical mutual company, the PAL account does not result in a permanent nonrecognition of the deferred income. Thus, PAL account deductions are qualitatively different from the deferral provided for under the life insurance company tax rules (the policyholder's surplus account) which is rarely recaptured.

There are three allowable additions to the PAL account that represent deductions for the current year. These three additions are amounts equal to (1) one percent of losses incurred, (2) 25 percent of underwriting gain, and (3) a further percentage of underwriting gain equal to the extent to which the percentage of premiums for concentrated windstorm, flood and similar risks during the year exceeds 40 percent of all premiums earned. The three additions to the PAL account are recorded separately because the point at which each is restored to income is based on different determinations. For purposes of the PAL additions, underwriting gain is defined as statutory underwriting income for tax purposes computed without the

PAL deduction. The one percent is calculated on losses incurred as shown in the annual statement and tax returns.

The amounts that may be deducted and added to the PAL account in a year are limited in two ways. First, the excess of any current addition over the current year's statutory underwriting gain for the year (before the PAL additions) must be subtracted. Thus, the increase in the PAL account for any year cannot exceed that year's underwriting gain. Second, current year additions are, in effect, subject to a limitation so that the PAL account may not exceed the greater of 10 percent of the total current year's earned premiums reduced by policyholder dividends or the balance in the PAL account at the end of the preceding year. Before this limitation is applied, the PAL account will be reduced by the amount of any current underwriting loss that exceeds taxable investment income and by the amount of any unused loss deduction carryovers. Also, immediately before applying the limitation, the PAL account is reduced by any amounts added to the account in the fifth preceding year if they have not been previously subtracted.

If a company fails to retain its status as a mutual, it must include in taxable income for the preceding year the entire balance in the PAL account by amending its return. In addition, a company may elect to subtract the entire PAL account and include it in income. However, this election is rarely made. The effect of the PAL account is to enlarge the available surplus of a mutual property and casualty insurance company and, thus, may be viewed as a kind of contingency reserve.

5. Consolidation of insurance companies

In general

Under present law, an affiliated group of corporations may elect to file a consolidated income tax return. An affiliated group means one or more chains of "includible corporations" connected by stock ownership with a common parent corporation, provided certain percentage of ownership tests are met. Generally, property and casualty insurance companies have always been permitted to file a consolidated return with noninsurance companies. However, prior to 1981, life insurance companies were not otherwise treated as "includible corporations" that could be consolidated with other companies, although special rules permitted two or more domestic life insurance companies to be treated as an affiliated group. Beginning in 1981, a common parent corporation could elect to treat life insurance companies as "includible corporations", subject to certain limitations. Thus, a property and casualty insurance company may now be consolidated with a life insurance company as well as noninsurance companies.

It has been suggested that the affiliation of property and casualty insurance companies, life insurance companies, and other companies may provide unintended tax benefits. Two sorts of concerns with respect to consolidation can be identified. First, some question the consolidation of income producing companies with companies that have tax losses. If, however, the activities conducted in the two businesses could be conducted in a single entity with the same aggregate tax result, then consolidation should not be objectionable. Second, some question the consolidation of companies which are permitted or required to use special accounting or tax computation rules. For example, should a company that is not eligible for reserve treatment because it has only a small amount of insurance business qualify for that treatment by segregating the insurance business into a subsidiary that can file a consolidated return with the parent? These concerns generally arise because insurance companies conduct a business that differs substantially from other companies and, thus, are taxed differently.[15]

Consolidation of property and casualty insurance companies with life insurance companies

The consolidation of property and casualty insurance companies and life insurance companies raises questions concerning the point at which, in the computation of separate taxable income, consolidation should occur. This is especially important with respect to the consolidation of life companies within the group. For example, life insurance companies are required to calculate both taxable investment income and gain or loss from operations. However, property and casualty insurance companies are not required to make this distinction in the computation of taxable income. Thus, a fundamental question in the consolidation of property and casualty insurance companies and life insurance companies is the extent to which the timing of the computation of consolidated taxable income may distort the taxable income and gain or loss from operations of life insurance companies.

Two timing rules have been suggested with respect to the consolidation of life and nonlife companies: (a) the phase-by-phase approach and (b) the bottom line approach. Under the phase-by-phase approach, the taxable investment income bases and the gain from operation bases of life companies first must be aggregated to arrive at consolidated life company amounts and then these aggregate tax bases (taxable investment income and gain from operations) are combined to arrive at a taxable income for the consolidated life companies within the group.[16] Under the bottom line approach to computing consolidated taxable income, each member of an affiliated group (whether a life or nonlife company) compute is its taxable income as if it is filing a separate return. The taxable income determined for each component member of the affiliated group is then consolidated by adding the separate company taxable income bases.[17]

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[15] Potential tax benefits are available to other includible groups of corporations in which some members of the group are provided special tax benefits that are not available to other members of the group. For example, a savings and loan association may be eligible for a bad debt deduction and consolidate with a nonfinancial institution whereas if the entity were one company, it may fail the statutory test for classification as a savings and loan association and therefore not be eligible for the bad debt deduction.

[16] The Internal Revenue Service has proposed a modified phase-by-phase approach to apply to a life insurance subgroup of a consolidation of life and nonlife companies. Under this method, consolidated amounts would be determined by aggregating separate amounts for each member in a life subgroup and a consolidated limitation would apply whenever a deduction is limited by an amount or percentage of an amount.

[17] It has been suggested that the bottom line approach presents the most consistent treatment between life and nonlife companies while creating only a minimal distortion of the life insurance company rules relating to taxable income. Proponents of this approach point out that the general rules relating to consolidation use such an approach to compute separate corporate taxable income. The Tax Equity and Fiscal Responsibility Act of 1982 contained a provision that permits life insurance companies to use the bottom line approach for a two-year period.

Intercompany reinsurance agreements

Reinsurance involves the process of providing insurance coverage to an insurer that has previously assumed a risk. Thus, in order to reduce exposure to loss for a particular risk, an insurer will use reinsurance to pass all or a portion of the risk to another insurer. Case law and Internal Revenue Service rulings relating to reinsurance have established that, in order to be effective for Federal income tax purposes, reinsurance must, in fact, involve a shifting of risk and there must be an independent business reason for the reinsurance (but see *Consumer Life Insurance Company* v. *U.S.*, 430 U.S. 725 (1977)).

Despite the requirement that reinsurance involve risk-shifting and a valid business purpose, significant tax benefits can be derived by reinsuring, because the transaction may alter the timing of income and deductions. For example, if a direct writer has an unused loss carryover that would expire in a taxable year, the direct writer may reinsure a portion of its risks. This reinsurance serves to accelerate the direct writer's income on the reinsured risks, thereby utilizing a tax benefit that would otherwise be lost.

In situations in which property and casualty insurance companies and life insurance companies are consolidated, these tax benefits may be even greater. For example, the rules relating to the consolidation of affiliated companies place two limitations on the amount of nonlife insurance company losses that can be applied against the income of the life insurance company members of the group. However, both life insurance companies and property and casualty insurance companies issue group health and accident insurance. By reinsuring in a year in which the nonlife members will have losses in excess of the limitations, the nonlife members accelerate income to offset those losses. Therefore, a property and casualty insurer could use reinsurance of certain accident and health policies effectively to pass its losses to the life insurance company notwithstanding the limitation on losses for nonlife companies that may be taken into account against life insurance taxable income.[18]

Availability of tax credits to offset the income of an affiliated company

In general, the rules relating to the consolidation of affiliated companies place two limitations on the amount of nonlife insurance company losses that may be applied against the income of life insurance company members. These limitations apply only to the amount of nonlife losses that may offset life company income. Losses incurred by the life members can offset the income of nonlife members without limitation.

[18] Similarly, a life insurance company member of an affiliated group may reinsure accident and health insurance business with a property and casualty company to shift a deduction for retrospective rate credits to the property and casualty company. Retrospective rate credits are basically refunds for premiums previously paid, determined under a formula that considers the policyholder's loss experience. The Internal Revenue Service has taken the position that these retrospective rate credits must be treated as dividends to policyholders if they depend on the experience of the company. However, the deduction for policyholder dividends (when combined with two special deductions) for life insurance companies is subject to a limitation. No similar limitation applies to property and casualty insurance companies. Thus, the use of reinsurance can provide an opportunity for life members of an affiliated group to avoid the general limitation that may be applicable to policyholder dividends.

In addition, there is no statutory limitation on the extent to which tax credits available to one member of an affiliated group may be used to offset the tax on income of the group as a whole. Given the limitation on losses that can be used to offset life company taxable income, an argument could be made that the unlimited availability of tax credits provides an unintended tax benefit.

6. Tax-exempt investment income

As of December 31, 1981, an estimated $85.3 billion was invested by property and casualty companies in tax-exempt bonds (approximately 47 percent of their total investments). Because of this relatively large investment in tax-exempt bonds, it may be helpful, in evaluating the tax burden of property and casualty companies, to focus on how the tax rules applicable to these companies encourage such large investments.

In general, present law provides taxpayers with certain deductions from gross income. However, in cases in which taxpayers invest in tax-exempt obligations, two rules apply that may limit the otherwise allowable deductions. These rules disallow deductions relating to (1) expenses allocable to one or more classes of tax-exempt income and (2) interest on indebtedness incurred or continued to purchase or carry tax-exempt obligations.

(1) *Expenses allocable to one or more classes of exempt income.*—Generally, present law permits a deduction for any expense that is an ordinary and necessary trade or business expense or for any expense of an individual taxpayer relating to the production of income. However, no deduction is allowed for a) expenses that are allocable to one or more classes of tax-exempt income other than interest income and b) expenses of an individual taxpayer relating to the production of income that are allocable to one or more classes of of tax-exempt interest income.

Under present law, there is no similar provision that applies to expenses allocable to tax-exempt interest income of taxpayers engaged in a trade or business, including property and casualty insurance companies. Thus, property and casualty companies are permitted deductions under present law for amounts which are paid out of tax -exempt income.

(2) *Interest on indebtedness incurred or continued to purchase tax-exempt obligations.*—Present law generally allows as a deduction all interest paid or accrued within the taxable year on indebtedness. However, no deduction is allowed for interest incurred or continued to purchase or carry obligations the interest on which is wholly exempt from Federal income tax. The Internal Revenue Service and the courts have consistently interpreted the law to disallow an interest deduction only upon a showing that a taxpayer incurred or continued indebtedness for *the purpose of* acquiring or holding tax-exempt obligations. Thus, if no independent business or personal purpose exists for acquiring or continuing debt, and when there is a sufficiently direct connection between the indebtedness and the acquisition or holding of tax-exempt obligations, a deduction has been disallowed. Thus, the Congress has recognized that a taxpayer should not receive a deduction for interest that relates to a tax-exempt investment.

In practice this provision is difficult to apply for two reasons: (1) it is often difficult to trace a particular debt to the purchase or carrying of a tax-exempt bond, given the fungibility of money; and (2) there are often business reasons for acquiring a debt which make the disallowance provision inapplicable. For example, a long-standing Service position, supported by the legislative history, states that the deduction disallowance provision has no application to interest paid on indebtedness represented by deposits in banks received in the general business of banking, even though a substantial amount of these deposits are invested in tax-exempt obligations. This position apparently is premised upon the fact that the debt represented by the deposits was incurred because of the banks' obligation to accept deposits, not to acquire or purchase tax-exempt bonds. The effect of this interpretation has be to allow banks to significantly reduce their Federal income taxes.

In the case of property and casualty insurance companies investing primarily in tax-exempt obligations, it can be argued that part of the unearned premium income or estimates of unpaid losses of the company that are essentially deductible reserves are analogous to debt. For example, the deduction for estimates of unpaid losses recognizes that an insurance company has a fixed and determinable liability (debt) for the claims of policyholders. However, until a claim is actually paid, the insurer may use the amounts for investments (including tax-exempt investments).

Because property and casualty insurance companies invest substantial amounts in tax-exempt bonds, the argument can be made that at least a portion of the funds used to acquire the tax-exempt bonds comes from the companies deductible reserves. Under this analysis, some portion of the expenses of property and casualty insurance companies should be disallowed because of their investments in tax-exempt bonds.

7. Use of foreign insurance companies for additional tax benefits

Income tax

Foreign corporations generally are subject to U.S. tax only on certain U.S. source income and on income that is effectively connected with a trade or business conducted in the United States. Income that a foreign corporation receives from insurance premiums is generally subject to U.S. income tax only if it is effectively connected with the recipient's trade or business in the United States (see Rev. Rul. 80-222, 1980-1 C.B. 211). Investment income of a foreign corporation is subject to U.S. income tax if it is either (1) from U.S. sources or (2) effectively connected with a U.S. trade or business, such as investment income that a foreign corporation engaged in a U.S. business earns on premiums paid to cover U.S. risks.

Whether a foreign corporation is engaged in a U.S. trade or business in a taxable year is largely a question of fact. In general, foreign insurance companies that insure U.S. risks may be able to arrange their affairs so as not to engage in a U.S. business. A foreign corporation not engaged in U.S. business in a taxable year is not subject to U.S. income tax on underwriting income, and it is not subject to U.S. tax on foreign source investment income earned on premiums paid to cover U.S. risks in that taxable year.

Excise tax

In general, insurance or reinsurance of U.S. casualty risks by foreign insurance companies that are not subject to U.S. income tax because they are not engaged in business in the United States is subject to an excise tax. The rate of this tax is four cents on each dollar of premium for insurance, and one cent on each dollar of premium for reinsurance. Any party to the transaction is liable for payment of this tax, but in practice the tax is collected from the U.S. party that actually pays over the premiums to a foreign person. Certain U.S. income tax treaties, including those with France and the United Kingdom, waive this excise tax in certain circumstances for insurance companies resident in the treaty partner. The U.S. model treaty waives this tax also. Although the model and the French treaty do not waive the tax when the foreign insurer reinsures with a third-country insurer that is not subject to a treaty exemption, the treaty with the United Kingdom waives the tax even in that event.

Taxpayers may take the position that since the Service does not now recognize that "captive insurance companies" provide insurance protection, payments to captives are not premiums subject to the excise tax. However, taxpayers could not consistently deduct payments to a "captive insurance company" as premiums while treating the payments as exempt from the excise tax on the ground that they are not premiums. Moreover, even if these payments are not subject to the excise tax on premiums, they could be subject to U.S. income tax.

Taxation of U.S. shareholders of foreign corporations

The foreign source income of a foreign corporation that is not effectively connected with a U.S. business is generally subject to U.S. income tax only if and when it is actually remitted as a dividend to U.S. shareholders. However, under the Subpart F provisions of the Code, income from certain tax haven type activities conducted by corporations controlled by U.S. shareholders is includible in the gross income of the U.S. shareholders and currently taxed to them (subject to the foreign tax credit). The income taxed under Subpart F generally includes investment income such as dividends and interest, and income from the insurance of U.S. risks. One purpose of this rule is to prevent U.S. persons from shifting underwriting income to tax-haven subsidiaries. Income earned on premiums paid to cover U.S. risks is also currently taxable to the U.S. shareholders of a controlled foreign corporation.

In general, underwriting income of a foreign corporation from the insurance of foreign assets is not subject to U.S. taxation, either at the corporate level or the U.S. shareholder level. However, income of a controlled foreign corporation from the insurance of oil assets located without the United States is subject to current taxation under Subpart F if the controlled foreign corporation or a related party has substantial oil or gas extraction income. A U.S. corporation (or its foreign affiliates) may therefore generally insure foreign non-oil assets with a "captive insurance company" in a tax haven. Some foreign countries may allow a deduction under their income tax laws for this kind of payment.

In general, a controlled foreign corporation (one whose shareholders are subject to Subpart F) is one more than 50 percent of whose voting power is owned by "U.S. shareholders" (defined as U.S. persons owning 10 percent or more of the corporation's voting power). A special rule for insurance income expands the definition of controlled foreign corporation for Subpart F purposes to include certain foreign corporations of which more than 25 percent (rather than the standard 50 percent) of the voting power is owned by U.S. shareholders if more than 75 percent of gross premiums are attributable to U.S. risks.

If ten or fewer unrelated U.S. persons own equal voting interests in a foreign corporation 5 percent or more of whose insurance premiums received cover U.S. risks, they will be subject to Subpart F, and the Subpart F income will be includible in their gross income. Such income, however, will be foreign source income that may allow the U.S. persons to credit other foreign taxes. In general, the United States limits the foreign tax credit on the basis of total foreign source income. In some cases, a taxpayer's foreign tax credits cannot be used (and may be forever lost) if the taxpayer does not have sufficient foreign source income. Generation of foreign source income through Subpart F could enable the taxpayer to use increased foreign tax credits.

If eleven unrelated U.S. persons own equal voting in a foreign corporation, Subpart F does not apply, because there is no "U.S. shareholder" owning ten percent or more of the foreign corporation's voting power. In that case, the U.S. owners generally pay no U.S. tax on the foreign corporation's earnings unless and until it pays a dividend. When the foreign corporation pays a dividend, however, that dividend may be foreign source income that enables the shareholders to use increased foreign tax credits. Until payment of a dividend, such an insurance company located in a tax haven may be able to accumulate investment income and underwriting income free of tax (other than gross withholding or excise taxes imposed by the country of source of the income).

IV. TYPES OF PRIVATE PROPERTY AND CASUALTY INSURANCE

A. General Background

Total net premiums paid to property and casualty insurance companies have increased from about $15 billion in 1960 to almost $100 billion in 1981, an increase of more than 6-1/2 times. All kinds of property and casualty insurance is covered, and limited amounts of all accident and health insurance coverage (up to $3.6 billion in 1981) are included in these totals. Subtracting accident and health premium payments reduces the annual totals by small amounts, but the scale of increase—7 times from 1960 to 1981—remains considerable.

TOTAL NET PREMIUMS WRITTEN BY PROPERTY AND CASUALTY INSURANCE COMPANIES, 1960–81

[In millions]

Year	Accident and health	All other	Total
1960	$1,358	$13,615	$14,973
1965	1,644	18,420	20,063
1970	1,909	30,958	32,867
1975	1,820	48,146	49,967
1976	2,120	58,693	60,813
1977	2,317	70,080	72,397
1978	2,628	79,062	81,690
1979	3,179	86,943	90,123
1980	3,291	92,389	95,569
1981	3,585	95,690	99,276

Source: "Insurance Facts," 1982–83 edition.

The percentage distribution among the major lines of property and casualty insurance in 1972 and 1981 is shown in the next table. Two categories of auto insurance predominate, exceeding 40 percent in both years, even though the percentage of auto liability insurance declined by 1981. The absolute amount of premiums paid increased during that period, as can be seen in the preceding table. Major proportionate increases in coverage have taken place in workers' compensation and home and farm owners multiple peril policies.

PERCENTAGE DISTRIBUTION OF MAJOR INSURANCE LINES [1] 1972 and 1981

Line	Percent of all lines	
	1981	1972
Auto liability [2]	24.6	29.6
Auto physical damage [2]	16.9	16.8
Workers' compensation	14.7	10.7
Homeowners/farmowners multiple peril	11.5	8.8
Other liability (includes medical malpractice)	7.4	6.7
Commercial multiple peril	6.9	5.4
Fire and allied	4.9	8.9
All other	13.1	13.1
Total	100.0	100.0

[1] Excludes Lloyd's organizations.

[2] Includes commercial and private passenger autos because 1972 data cannot be disaggregated. Between 1973 and 1981 private passenger auto liability decreased from 22.7 to 19.8 percent and commercial auto liability from 5.5 to 4.8 percent. Private passenger auto physical damage increased from 14 to 14.2 percent and commercial auto physical damage from 2.6 to 2.7 percent.

Source: Calculated from Best's Aggregates and Averages, 1982, by American Insurance Association

B. Fire Insurance

The standard fire insurance policy generally provides insurance against direct loss by fire and lightning. In addition, the insured may obtain protection against loss of income while damage is being repaired, extra expenses involved in getting a business back in operation after a fire, and the cost of housing a family after its house has burned. Fire insurance companies also provide protection against such perils as earthquake, explosion, riot, rain and smoke among other perils, in the same insurance contract.

Amounts paid (i.e., premiums written) for fire and allied insurance are shown in the following table. Amounts paid doubled between 1960 and 1981.

PREMIUMS WRITTEN FOR FIRE AND ALLIED INSURANCE, 1960–81

[In millions]

Year	Fire	Allied—Lines [1]
1960	$1,667	$739
1965	1,548	667
1970	2,199	948
1975	2,510	1,181
1976	2,811	1,291
1977	2,993	1,422
1978	3,223	1,462

PREMIUMS WRITTEN FOR FIRE AND ALLIED INSURANCE, 1960–81—Continued

[In millions]

Year	Fire	Allied—Lines [1]
1979	3,247	1,534
1980	3,210	1,574
1981	3,193	1,624

[1] Covers a wide variety of perils, including windstorm, riot, explosion, sprinkler leakage, water damage and earthquakes.

Source: "Insurance Facts," 1982–83 edition.

C. Ocean and Inland Marine Insurance

Marine insurance is the oldest branch of the insurance business. While there is a great variety of marine insurance coverages, a common factor embodied in each is that property covered under marine insurance involves an element of transportation, or, at least, that the property is capable of being transported. Ocean or wet marine insurance primarily is concerned with water-borne commerce, and inland or dry marine insurance covers transportation and related risks on land.

Ocean navigation and trade involves three major interests: the cargo, the hull, and the freight, i.e., the costs charged or incurred for transporting the cargo in the hull from place to place. Inland marine insurance is an extension from ocean marine insurance to cover the shipment for the entire voyage from the shipper to the addressee. Forms of inland transportation cover railroad, airplane, coastwise steamer, motor transport, parcel post, registered mail and first class mail. In addition to transportation forms, inland marine insurance also covers bridges and tunnels as well as personal effects, personal property, jewelry, furs, fine arts and many others. The amounts paid for insurance coverage (premiums written) has increased sixfold from 1960 to 1981, from $381 million to $2.4 billion.

PREMIUMS WRITTEN FOR ISLAND AND OCEAN MARINE INSURANCE, 1960–81

[In millions]

Year	Inland Marine	Ocean Marine
1960	$381	$230
1965	489	262
1970	81	465
1975	1,266	861
1977	1,584	953
1978	1,867	1,000

PREMIUMS WRITTEN FOR ISLAND AND OCEAN MARINE INSURANCE, 1960–81—CONTINUED

[In millions]

Year	Inland Marine	Ocean Marine
1979	2,061	1,009
1980	2,291	1,065
1981	2,428	1127

Source: "Insurance Facts," 1982–83 edition.

The growth in ocean marine insurance during the same period has been almost as great as for inland marine insurance, or from $230 million in 1960 to $1.1 billion in 1981. The growth reflects increased international trade as well as growth in ownership of pleasure craft along coastal and inland waterways.

D. Casualty Insurance

General casualty insurance

Casualty insurance is based on the law of negligence, under which everyone is obligated to be so careful that no member of the public is caused to suffer bodily injury or property damage (which includes loss of income). Liability insurance coverage extends to the payment of damages that arise from civil liabilities. Most business policies are restricted to bodily injury and property damage caused by accident. Personal liability insurance provides protection for the insured against liability that may be incurred in personal activities, as distinguished from business activity.

Business and professional persons tend now to purchase general liability insurance. Sharp increases in the number of lawsuits and the average size of claims in recent years, particularly against physicians, other professional people, and product manufacturers have generated interest in general liability insurance. Liability coverage is included in both commercial and homeowners package (or umbrella) policies. The table below shows general liability premiums written for the past two decades. Medical malpractice premiums have been included in the totals, to permit valid historical comparisons even though also shown separately below.

PREMIUMS WRITTEN FOR GENERAL LIABILITY INSURANCE, 1960–81

[In millions]

Year	Amounts
1960	$963
1965	1,137
1970	2,140
1975	3,981
1977	6,794
1978	7,706
1979	7,817
1980	7,690

Year	Amounts
1981	7,385

Source: "Insurance Facts," 1982–83 edition.

Medical malpractice insurance

A proliferation of insurance claims and lawsuits against hospitals, doctors and other medical practitioners has generated a heavy demand for medical malpractice insurance in recent years. Medical malpractice premiums written increased by 4.9 percent from 1980 to 1981, and by 49 percent from 1975 to 1981.

PREMIUMS WRITTEN FOR MEDICAL MALPRACTICE, 1975–81

[In millions]

Year	Amounts
1975	$895
1976	1,133
1977	1,194
1978	1,216
1979	1,204
1980	1,276
1981	1,338

Source: "Insurance Facts," 1982–83 edition.

Automobile insurance

Personal injury and property damage involving automobiles generate large economic losses, often beyond the personal ability of drivers and owners to cover. Insurance protection for others is generalized throughout the country. In some States, minimum coverage through insurance or some other form of security is mandatory, and bad risks (i.e., drivers with a high probability of recurrent accidents) often are covered through special arrangements.

The tables below provide information on the amount of premiums written (i.e., amounts paid for insurance coverage) for both auto liability insurance and auto physical damage insurance.

PREMIUMS WRITTEN FOR AUTO LIABILITY INSURANCE, 1956–81

[In millions]

Year	All autos
1956	$2,684
1960	3,883
1965	5,424
1970	8,958

	Private Passengers [1]	Commercials [1]
1972	$9,070	$2,306
1975	10,775	2,539
1976	12,899	3,152
1977	14,998	3,830
1978	16,048	4,335
1979	17,385	4,717

	Private Passengers [1]	Commercials [1]
1980	18,590	4,729
1981	19,650	4,745

PREMIUMS WRITTEN FOR AUTO PHYSICAL DAMAGE INSURANCE 1956–81

[In millions]

Year	All autos
1956	$1,613
1960	1,994
1965	2,861
1970	4,824

	Private Passenger [1]	Commercial [1]
1972	$5,502	$1,052
1975	6,386	1,237
1976	7,987	1,578
1977	9,582	1,939
1978	10,541	2,294
1979	11,909	2,628
1980	13,086	2,747
1981	14,034	2,714

[1] Totals were not broken into these categories prior to 1972.

Source: "Insurance Facts," 1982–83 edition.

There are many other types of property or casualty insurance written to protect businesses and individuals. The kinds of coverage provided include business interruption insurance, personal business interruption insurance, boiler and other pressure vessels and associated piping, machinery, glass, surety bonding, crime (burglary, kidnap, ransom—for example), title insurance and commercial credit insurance. Each of these groups also include detailed variations that are made available to suit the insured person's requirements. There also is insurance against losses resulting from nuclear accidents. Table 5 in the Appendix shows the amounts of premiums paid for many of these individual types of insurance, 1978-1981.

E. Workers' Compensation

Workers' compensation is a form of social insurance although it is coverage provided to a private employer for compensation of employees who are injured on the job. In contrast, almost all other forms of social insurance are offered by the Federal Government.

The responsibility of an employer for the safety and well-being of its employees while at work has well-established legal precedents. Presently, all States have workers' compensation laws.

Under workers' compensation, an injured employee is guaranteed the payment of a level of benefits. Payment is prompt and does not involve litigation. The employer is able to estimate in advance the probable costs of injury to the workforce while at work. Generally, four types of benefits may be provided under workers' compensation: medical (including also surgical, nursing and hospital benefits, income replacement, death and survivor's benefits), and rehabilitation.

The amount of premiums paid (written) for workers' compensation from 1960-1981 is shown below. This premium volume has increased tenfold over that period and has quadrupled since 1970.

PREMIUMS WRITTEN FOR WORKERS' COMPENSATION INSURANCE, 1960–81

[In millions]

Year	Amounts
1960	$1,419
1965	2,042
1970	3,492
1975	6,186
1977	9,261
1978	11,300
1979	13,164
1980	14,238
1981	14,616

Source: "Insurance Facts," 1982–83 edition.

APPENDIX

STATISTICAL MATERIAL RELATING TO THE PROPERTY AND CASUALTY INSURANCE INDUSTRY

The five tables in this Appendix provide some general information about the property and casualty insurance industry and some comparisons of this industry with other industries.

Assets and premiums of property, casualty and life insurance companies

In table 1, assets and premium receipts of life and property and casualty companies in 1977 through 1981 are shown. Generally, both types of insurance companies receive close to the same amounts in premium receipts but life insurance company assets are two and one-half times as large as those of property and casualty companies.

Table 1.—Comparison of Assets and Premium Receipts of Property and Casualty and Life Insurance Companies, 1977-81

[In billions of dollars]

Year	Assets		Premium receipts	
	Property and casualty	Life	Property and casualty	Life
1977	126.6	351.7	72.4	72.3
1978	149.1	389.9	81.7	78.8
1979	174.2	432.3	90.1	84.9
1980	197.7	479.2	95.6	94.2
1981	212.3	525.8	99.3	107.7

Source: "Insurance Facts," 1982-83 edition; "Statistical Profile of the Casualty Insurance Industry;" 1983; "Life Insurance Fact Book," 1982.

Income of property and casualty insurers

Operating, investment, and combined income of property and casualty companies is presented in table 2 for selected years from 1957 through 1981. Combined income and investment income in those years have been positive. Underwriting often has been a net loss but has been offset by investment income to produce positive combined income.

Table 2.—Income of Property and Casualty Insurers, Selected Years, 1957–1987

[In millions of dollars]

Year	Gross underwriting gain or loss	Policyholder dividends	Net underwriting gain or loss	Investment income	Combined income, before taxes
1957	−130	279	−409	580	171
1960	462	313	150	768	918
1965	−352	357	−710	1,132	422
1970	78	504	−426	2,005	1,579
1975	−3,594	633	−4,227	4,150	77
1976	−1,559	630	−2,189	4,806	2,617
1977	1,926	815	1,112	5,816	6,928
1978	2,548	1,252	1,296	7,290	8,586
1979	24	1,324	−1,301	9,279	7,978
1980	−1,712	1,622	−3,334	11,063	7,730
1981	−4,464	1,824	−6,288	13,248	6,961

Source: "Insurance Facts," 1982-83 edition.

Rates of return of property and casualty insurers and certain other industries

Average annual rates of return of the property and casualty insurance industry and several other industries are shown in table 3. The data cover each year in the period from 1972 through 1981, and the table also shows the average rate of return and standard deviation for 3 ten-year periods: 1972-1981; 1962-1971; and 1952-1961. The standard deviations of the property and casualty insurance industry are greater than those for any other industry group shown in the table and the average rates of return are lower for 10-year periods.

Table 3.—Average Annual Rates Return: Net Income After Taxes as Percent of Net Worth, Selected Industries, 1972–81

Year	Property and casualty insurance	Public utilities	Commercial banks	Services	Manufacturing	All industries
1972	13.7	10.3	10.5	12.1	12.1	10.5
1973	9.4	10.6	11.0	12.9	14.9	12.0
1974	5.9	10.4	10.7	13.5	15.2	12.5
1975	4.0	11.0	10.3	15.0	12.6	11.5
1976	11.3	11.5	11.5	18.1	15.0	13.3
1977	21.0	12.1	11.8	18.3	14.8	13.8
1978	20.9	12.1	12.9	19.2	16.0	14.6
1979	17.8	13.0	13.9	19.1	18.3	16.4
1980	14.5	12.6	13.7	19.2	16.4	14.9
1981	11.9	13.8	15.4	20.9	15.5	14.5
Mean: 1972–81	13.04	11.74	12.17	16.83	15.08	13.4
(Std. deviation)	(5.48)	(1.22)	(1.63)	(2.98)	(1.68)	(1.70)
Mean: 1962–71	4.95	10.59	9.41	13.06	12.24	10.01
(Std. deviation)	(2.57)	(0.32)	(0.70)	(2.36)	(1.3)	(0.7)
Mean: 1952–61	5.35	9.63	8.62	11.04	12.08	10.14
(Std. deviation)	(1.88)	(0.33)	(0.89)	(1.32)	(1.58)	(1.01)

Source: "Insurance Facts," 1982–83 edition.

Investments of property and casualty insurance companies

The distribution of assets among general types of investments by companies in the property and casualty industry are shown in table 4 for three selected years. Tax-exempt bonds, taxable bonds, and common stock, in that order, have been the major forms of investment.

Table 4.—Distribution of Invested Assets of property and Casualty Companies December 31, 1975, 1978, and 1981

[Amounts in millions of dollars]

Type of investment	1975		1978		1981	
	Amount	Percent	Amount	Percent	Amount	Percent
Tax-exempt bonds	33,397	42	63,487	49	85,335	47
Taxable bonds	19,648	25	35,498	27	45,122	25
Common stock	20,220	25	20,876	16	32,540	18
Preferred stock	3,039	4	4,511	4	8,645	5
Mortgages and real estate	1,770	2	2,174	2	4,004	2
Other	1,971	2	3,012	2	4,456	3
Total	80,044	100	129,559	100	180,102	100

Source: "Statistical Profile of Casualty Insurance Industry," April 1983.

Premiums paid for different types of property and casualty insurance

The amounts of premiums paid (written premiums) for 20 different lines of property and casualty insurance in 1978, 1979, 1980 and 1981 are shown in table 5. The list is virtually all-inclusive.

TABLE 5.—PREMIUMS PAID FOR DIFFERENT TYPES OF PROPERTY AND CASUALTY INSURANCE, 1978–81

[In millions of dollars]

Type of insurance	1978	1979	1980	1981
Automobile:				
Liability:				
Personal	16,048	17,385	18,590	19,650
Commercial	4,335	4,717	4,729	4,745
Property:				
Personal	10,541	11,909	13,086	14,034
Commercial	2,294	2,628	2,747	2,714
Multiple perils:				
Homeowners	7,792	8,792	9,821	10,780
Commercial	5,830	6,667	6,885	6,870
Farmowners	434	519	555	620
Fire insurance and allied lines	4,675	4,781	4,784	4,817
Burglary and theft	133	140	136	128
Inland marine	1,867	2,061	2,291	2,428
Ocean marine	1,000	1,009	1,065	1,127
Glass	35	33	32	31
General liability (nonauto)	7,706	7,817	7,690	7,385
Medical malpractice	1,216	1,204	1,276	1,338
Workers' compensation	11,300	13,164	14,238	14,616
Surety and fidelity	1,076	1,155	1,248	1,351
Boiler and machinery	256	283	293	298
Crop-hail	351	396	417	504
Nuclear:				
Liability	19	20	23	28
Property	31	40	61	74

Source: "Insurance Facts," 1982–83 edition.

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