RAA Issue Briefs on P&C Insurance Taxation

Introduction

Property-casualty insurance companies provide protection against losses by individuals and businesses, including individual lines such as automobile and homeowners, and commercial lines such as product liability, professional malpractice, commercial general liability, environmental liability, and workers' compensation. Because the industry covers natural catastrophes such as hurricanes and earthquakes, its financial results have been highly volatile. The industry is regulated by state insurance departments, which have coordinated regulation and oversight through the National Association of Insurance Commissioners ("NAIC"). The Federal Insurance Office also monitors industry developments.

This description of the industry's tax provisions focuses upon the basic tax rules governing property-casualty insurance companies, the definition of insurance, and anti-abuse rules governing reinsurance. Because property-casualty insurance and reinsurance are global businesses, it includes a survey of the rules governing foreign operations of U.S. insurance companies and U.S. insurance operations of foreign insurers.

Taxation of Property & Casualty Insurance Companies

Property-casualty insurance and reinsurance companies are taxed upon their total income, composed of premium or "underwriting" income and investment income, computed on the basis of the Annual Statement approved by the National Association of Insurance Commissioners.1 Taxable income consists of net underwriting income plus net investment income.2 A company's tax liability may be offset by any credits, such as the foreign tax credit, allowed all corporations. Insurance companies are taxed as corporations; they are never treated as pass-through entities.3

To compute net underwriting income, insurance companies compute gross premiums written, then deduct reserves established for losses incurred during the year, and expenses (such as advertising costs and agents' commissions).4 An insurance company also deducts from underwriting income any return premiums and any premiums paid for reinsurance,5 and will include in loss reserves (and therefore in income) any amounts recovered from reinsurance.6 Property-casualty companies are allowed the ordinary and necessary business expense deductions allowed all corporations.7

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1 Internal Revenue Code of 1986, Section 832(a) and (b)(1) (hereafter, the "Code.")
2 Code Section 832(a).
3 Treas. Reg. §301.7701-2(b)(4).
4 Code Section 832(b)(3) and (4).
5 Code Section 832(b)(4).
6 Code Section 832(b)(5).
7 Code Section 832(c).
Underwriting income is based on "earned" premiums, meaning that portion of the premium covering a time period for which coverage has been provided. Any premiums received relating to a future period are part of the "uneearned" premium reserve, which is deductible from gross premiums in computing taxable income. For example, if an insurer receives an annual premium in July covering a full year, one-half of the premium will be included in earned premiums (part of taxable income) for the year. The remaining half will be allocated to the unearned premium reserve (representing the six months for which insurance coverage has not yet been provided) and deducted from gross premiums. The unearned premium reserve represents amounts that must be returned to the policyholder in the event of cancellation. However, the Internal Revenue Code allows a deduction for only 80 per cent of the increase in the unearned premium reserve for the taxable year. In the Tax Reform Act of 1986, Congress required that 20 percent of the unearned premium reserve be taxable currently, since it represents the allocable portion of expenses incurred in generating the unearned premiums.\(^8\)

Loss reserves take into account both claims received and an estimate of claims incurred during the year that have been incurred but not reported ("IBNR"), as well as related claims handling expenses, called "loss adjustment expenses" ("LAE").\(^9\) Losses reserves are computed on the basis of the statutory method of accounting, used by state regulators, which permits estimates of the ultimate payment for the insured loss plus related loss adjustment expenses, to be taken in the year in which the loss event occurred.\(^10\) Unlike other businesses, insurance companies collect premiums before their expenses are known.\(^11\) To protect policyholders and to accurately reflect income, insurance companies are required by regulators to create reserves for the future payment of claims and loss adjustment expenses. Estimates of claims and loss adjustment expenses are based upon an adjustor's evaluation of the individual loss, as well as aggregate statistics gathered by the insurer, taking into account trends in various reserve components, such as court awards, inflation, or medical expenses.

Statutory accounting achieves a proper matching of income and expenses by including income and expenses in the year in which the loss occurred. In later years, loss reserves may be increased as the company's experience shows that actual settlement costs will be greater than expected. If settlement costs are actually lower than projected by early estimates, unused amounts in the reserves are moved into taxable income.

To reflect the time value of money, the full value reserves shown on the NAIC Annual Statement\(^12\) were discounted by the Tax Reform Act of 1986. The reserves are discounted using an interest rate and claims payment pattern set by the Internal Revenue Service (IRS) annually.\(^13\) In the alternative, a company may use its own claims payment patterns and interest rates, but, in practice, the majority of companies use the factors

\(^8\) Code Section 832(b)(4).
\(^9\) Code Section 832(b)(5).
\(^10\) Code Section 832(b)(1)(A).
\(^12\) Reserves shown on the Annual Statement are sometimes shown as discounted, particularly the worker's compensation reserves.
\(^13\) Code Section 832(b)(5)(A)(ii) and Section 846.
published by the IRS each year. IRS regulations require that reserves must be "a fair and reasonable estimate of the amount that the company will be required to pay," and the IRS requires extensive supporting documentation to justify the reserve deduction when insurers are audited.

Until 1986, insurers were allowed a full deduction for increases in reserves, in accordance with statutory accounting rules. The full deduction was permitted even though the reserves were funded in part from tax-exempt interest on municipal bonds and dividends subject to the dividends received deduction. The Tax Reform Act of 1986 added a "proration" rule that requires that 15% of the sum of tax-exempt interest and the amounts excluded under the dividends received deduction to be offset against the reserve deduction, so that these "prorated amounts" actually reduce the reserve deduction. An exception was created for dividends received from a wholly owned subsidiary.

If an insurer expects to receive "salvage" (for example, the amount received for an automobile that has been totally destroyed, but can still be sold for scrap) or payments as a result of claims subrogation rights (for example, the insurer pursues the insured's right to collect damages from a party that caused an injury), it must reduce its reserve deduction by the estimated salvage and subrogation amounts, computed on a discounted basis.

Investment income includes dividends, rents, and royalties as well as taxable interest from bonds and other securities, and tax-exempt income from state and local bonds. Expenses related to investment income, such as brokerage commissions and advisory fees, are deducted to compute net investment income. Capital gains included in investment income are taxed at ordinary rates. Like all other corporations, insurers may deduct dividends received from investments and affiliated corporations (the "dividends received deduction").

An insurer or reinsurer is allowed to use Net Operating Losses ("NOL") in the same manner as all other corporations. A NOL may be carried back two years and carried forward twenty years. The Code allows a 10 year carryback period for any portion of the NOL attributable to a product liability loss, liabilities arising from a federal or state law (such as environmental liabilities under "Superfund"), or tort liabilities of a taxpayer.

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14 Treas. Regs. Section 1.832-4(b) provides, "These losses must be stated in amounts which, based upon the facts in each case and the company's experience with similar cases, represent a fair and reasonable estimate of the amount the company will be required to pay."
15 Code Section 832(b)(5)(B).
16 Code Section 832(b)(5)(A)(i)
17 Code Section 243.
18 Code Section 172(b).
19 Code Section 172(f).
Definition of an Insurance Company

For 2004 and later years, an insurance company is defined as any company whose business during the year is 50% or more the issuance of insurance or annuity contracts, or the reinsurance of risks underwritten by insurance companies.\(^{20}\) Property-casualty insurance companies are organized as either stock or mutual insurance companies. An insurance company can be taxable only as a corporation; it can never be a pass-through entity.\(^{21}\)

Definition of Insurance and Reinsurance

Although there is no statutory definition of insurance for property-casualty purposes, the standards for qualification as true insurance are well developed in case law. Drawing upon the landmark case of Helvering v. Le Gierse, 312 U.S. 531 (1941), the Tax Court developed a three-step analysis to determine whether insurance exists in captive arrangements: "presence of insurance risk," "risk shifting and risk distributing," and "whether the arrangement would be considered 'insurance' in its commonly accepted sense." Sears, Roebuck & Co. v. Commissioner, 96 T.C. 61 (1991), as modified, 96. T.C. 671 (1991); The Harper Group v. Commissioner, 96 T.C. 45 (1991); AMERCO v. Commissioner, 96 T.C. 18 (1991). In addition, a contract must represent an insurance risk, rather than an investment risk.\(^{22}\) Finally, there must be a transfer of substantial risk; if the risk transferred is virtually the same as the amount of the premium, or the contract includes features that limit the amount of risk or delay the timing of payments, the contract will not qualify as insurance.\(^{23}\)

The determination whether a contract qualifies as true insurance or reinsurance is essential to determine the tax treatment of the premium by both the company transferring reinsurance and the company assuming the reinsurance. In some instances, it may also determine whether the company qualifies as an insurance company. So long as the contract satisfies the requirements for insurance, the ceding company deducts the premium paid for reinsurance coverage, and the assuming reinsurer includes the reinsurance premium in its premium income. Reinsurance claims payments ("recoveries") are included in "losses incurred" by the ceding company, and deducted by the reinsurer.

If the contract does not qualify as insurance, it will be treated as a deposit or loan, and no deduction will be allowed in the year of transfer for the reinsurance premiums. Amounts returned to the ceding company will be treated as return of capital, and the

\(^{20}\) Code Section 831(c) adopts the Section 816(a) definition of an insurance company. A life insurance company is any company whose life insurance reserves plus unearned premiums and unpaid losses on noncancellable life, accident or health policies not included in life reserves are greater than 50% of total reserves. A "non life" or property-casualty insurer is one that does not meet the 50% threshold.


\(^{22}\) Commissioner v. Treganowan, 183 F.2d 288, 290-91 (2d Cir. 1950). Allied Fidelity Corp. v. Commissioner, 572 F.2d 1190 (7th Cir. 1978).

reinsurer will not be allowed a deduction for the amounts paid, unless they represent interest on the deposit --- a much less favorable treatment for tax purposes.

**Rules Governing Tax Treatment of Reinsurance**

In the 1986 Tax Reform Act, Congress adopted Section 845, which grants the IRS authority to reallocate or recharacterize income, deductions or credits in connection with reinsurance contracts if it finds there is tax avoidance or evasion. The standards for an adjustment vary slightly for independent third parties and for related parties. To adjust the tax treatment of reinsurance between unrelated parties, the IRS must find that the contract has a “significant tax avoidance effect.” To adjust the tax treatment of reinsurance between related parties, the IRS must find that the adjustment is “necessary to reflect the proper amount, source, or character” of the taxable income. The IRS has relied upon this authority to order adjustments in a number of cases reported in Private Letter Rulings and Technical Advice Memoranda.

**International Operations of U.S. Insurance Companies**

U.S. insurance companies operating abroad are taxable on net insurance income from their foreign operations, including both underwriting income and investment income. Generally, U.S. multinational corporations are allowed to defer income until repatriated to the U.S. However, the U.S. has adopted anti-deferral rules requiring the immediate inclusion of income, whether or not repatriated, for certain types of income, including insurance income under “Subpart F” of the Code. Under Subpart F, U.S. parent companies would be taxable currently on income earned by foreign insurance subsidiaries from underwriting risks located outside their country of incorporation, whether or not received --- if it were not for the Active Financing Exception which permits deferral of underwriting and investment income earned in the active conduct of an insurance business until repatriated to the U.S. The Subpart F rules never permit deferral of income from coverage of U.S. risks.

The Active Financing Exception, first adopted in 1998, is only a temporary measure that requires Congressional action to extend it annually, or, where possible, every two years, most recently by the American Taxpayer Relief Act (H.R. 8) for 2012 and 2013. The seamless extension or permanent adoption of this provision is considered crucial to ensuring that U.S. companies with foreign operations can compete in foreign insurance markets.

Income of a foreign insurer is taxable under the Subpart F insurance income rules if more than 25 percent of the foreign company’s shares (by vote or value) are owned by 10% or more U.S. shareholders, a term that includes individuals, corporations, or partnerships.

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24 Code Sections 953 and 954.
25 Code Sections 953(c) and 954(i).
26 Code Sections 957(a) and 953(c)(1)(B). Unlike the ordinary “U.S. shareholder” definition in Section 951(b) which requires that a U.S. shareholder must own 10% or more of the value of the company’s
Subpart F insurance income is computed by using U.S. property-casualty insurance tax rules, which means that the reserves are subject to discounting according to U.S. tables prescribed by the IRS, the 20% reduction of the unearned premium reserve and 15% proration rules. U.S. insurers may compute the Subpart F income of their foreign subsidiaries using foreign reserves, if they receive a ruling from the IRS approving the use of foreign reserves (but the foreign subsidiary will still be subject to the 20% reduction of the unearned premium reserve and the 15% proration rule).

**U.S. Operations of Foreign Insurance Companies**

Insurance, and particularly reinsurance, is a global business, and many foreign insurers and reinsurers have established U.S. platforms to market their products. The predominant form is a U.S. company, which is taxed in the same way as other U.S. insurance companies. In other words, the U.S. insurer owned by a foreign parent is taxed as described in the first section, above.

Insurers, like all other U.S. companies with foreign parents, are subject to limits on the interest deduction for loans made to the U.S. subsidiary by the foreign parent (the “earnings stripping rules” of Code Section 163(j)). In general, a U.S. insurer can not deduct interest paid to a foreign affiliate that exceeds 50 per cent of the corporation’s adjusted taxable income. The earnings stripping rules do not apply if the ratio of debt to equity in the corporation does not exceed 1.5 to 1.

In some cases, a foreign insurance company may establish a branch, rather than a corporate subsidiary, in the U.S. The U.S. branch is taxable on income attributable to its U.S. insurance operations, as described above, with two major exceptions --- the minimum tax on net investment income and the branch profits tax. Under this provision, the U.S. subsidiary is taxed on its actual net investment income or the minimum net investment income as prescribed by the Internal Revenue Code, whichever is greater. The minimum net investment income is computed by multiplying the “required U.S. assets” for the U.S. branch by the domestic investment yield calculated by the Internal Revenue Service annually. The U.S. branch may elect to use its worldwide investment yield, in the alternative. A Canadian insurer successfully challenged the minimum tax on net investment income as a violation of the U.S. – Canada tax treaty, so Canadian subsidiaries are generally relieved of liability for the tax. *Northwest Life Assurance Company of Canada v. Comm ′ r*, 107 T.C. 363 (Dec. 12, 1996). In addition, the branch is subject to the branch profits tax, unless waived by a tax treaty. The branch profits tax imposes a 30 per cent tax on the U.S. branch’s “dividend equivalent amount” --- the amount of the branch’s U.S. earnings and profits adjusted for any increases or decreases in U.S. equity. Because the combined tax rate on a U.S. branch’s net insurance income stock to bring Subpart F into play, under Section 953(c), the insurer will come under the Subpart F rules if a U.S. shareholder owns any amount of stock (unless related parties own less than 20% of the stock and related party insurance accounts for less than 20% of the company’s insurance income). The purpose of the lower threshold in Section 953 was to bring related party insurance income of captive insurance companies within the Subpart F rules.
would exceed 50 per cent, foreign insurers have typically operated in the U.S. in corporate form, rather than branch form.

**Federal Excise Tax on Insurance Placed with Foreign Insurers**

As a matter of sound risk management, insurance companies, both primary companies and reinsurers, reinsure a portion of their business. Reinsurance is used to allow a company to transfer risks that fall outside its underwriting parameters without turning away producers, to mitigate the volatility inherent in the property-casualty insurance business, to provide additional underwriting capacity, and to protect against catastrophic losses that could jeopardize the company's solvency. Reinsurance is an essential tool to manage capital efficiently and permits global insurance groups to obtain cash when it is needed quickly.

The U.S. places an excise tax on insurance and reinsurance placed with a foreign company not admitted to do business in the U.S.\(^{27}\) The tax is placed on the insurance or reinsurance premium on a gross basis (without any deduction for brokerage commissions or other expenses) at the rate of 4 per cent for property-casualty insurance, and 1 per cent for life insurance and all types of reinsurance. The tax is ordinarily collected by the last U.S. person transferring the insurance or reinsurance premium, typically a broker. The FET is waived in many U.S. tax treaties with European countries. However, it is not waived in tax treaties with countries, such as Bermuda and Barbados, which have no income tax.

\(^{27}\) Code Section 4371.