PCI

Property Casualty Insurers
Association of America

Advocacy. Leadership. Results.

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The Honorable Dave Camp
Chairman, Ways and Means Committee
United States House of Representatives
341 Cannon House Office Building
Washington, D.C. 20515

The Honorable Sander M. Levin
Ranking Member, Ways and Means Committee
United States House of Representatives
1236 Longworth House Office Building
Washington, D.C. 20515

Dear Chairman Camp and Ranking Member Levin:

On behalf of the Property Casualty Insurers Association of America ("PCI"), thank you for the opportunity to present PCI's views regarding certain federal tax issues that may come before the 113th Congress.

PCI promotes and protects the viability of a competitive private insurance market for the benefit of consumers and insurers. PCI is composed of more than 1,000 member companies, representing the broadest cross section of insurers of any national trade association. PCI members write more than $190 billion in annual premium, 40 percent of the nation's property-casualty insurance. Member companies write 46 percent of the U.S. automobile insurance market, 32 percent of the homeowners market, 38 percent of the commercial property and liability market, and 41 percent of the private workers compensation market.

PCI supports tax policy that safeguards the public interest and the financial security of both the insurance industry and policyholders. PCI supports taxation that is fair and proportional across all industries and which promotes a level playing field for all companies within the property-casualty insurance industry. PCI supports policies that simplify tax laws and reduce the cost of tax compliance.

As Congress takes up the issue of broad tax reform, PCI urges Congress to:

- Maintain conformity between regulatory accounting and the tax code for insurers.
- Maintain a level playing field across industries for income earned abroad.
- Retain the existing rules for carrybacks and carryovers of losses and credits.
- Maintain the deductibility of interest expense.
- Grandfather existing municipal bonds.

<u>1. Maintain conformity between regulatory accounting and the tax code for insurers.</u>

The Internal Revenue Code expressly adopts regulatory accounting for property-casualty insurers (commonly called "statutory" accounting) as the basis for determining taxable income. Section 832 of the Code provides that insurance company gross income includes "underwriting income . . . computed on the basis of the underwriting . . . exhibit of the annual statement approved by the National Association of Insurance Commissioners." Underwriting income is defined as premiums earned minus losses incurred and expenses incurred. Under section 846 of the Code, losses incurred are determined by reference to the "unpaid losses" shown on the insurer's NAIC Annual Statement. These unpaid losses are aggregate estimates of amounts insurers will pay in the future for events that have occurred in the past, based on the insurer's experience.

The Code provisions applicable to property-casualty insurers were adopted almost verbatim from the Annual Statement in use in 1921 when the predecessor of Code section 832 was first enacted. The courts have confirmed that Congress intended to defer to Annual Statement accounting in determining what constitutes a "loss" in computing taxable underwriting income. *State Farm Mut. Auto. Ins. Co. v. Commissioner*, 698 F.3d

357 (7th Cir. 2012); *Sears, Roebuck & Co. v. Commissioner*, 972 F.2d 858 (7th Cir. 1992); *American International Group, Inc. v. United States*, 38 Fed. Cl. 274 (Ct. Fed. Cl. 1997).

PCI opposes any change to the historic system of Annual Statement conformity. Affirming, and strengthening, the principle of conformity would serve the tax reform goals of increasing simplicity and reducing controversy.

2. Maintain a level playing field across industries for income earned abroad.

Income earned by non-U.S. subsidiaries of a U.S. company is generally not taxed until the income is brought back to the U.S. (this concept is referred to as "deferral"). However, "Subpart F" of the Code contains certain exceptions to this general rule for various forms of passive or portable income. A U.S. company that owns non-U.S. subsidiaries with significant passive income (e.g., investment income) is subject to current U.S. taxation on that income whether or not the income is brought back to the U.S.

Insurance companies earn significant amounts of investment income through the collection of insurance premiums and the investment of these premiums to pay claims in the future. Local regulation of insurance companies typically requires local presence, employees, and capital (including invested assets). For an insurance company, earning investment income is part of the company's active business. In order to assure consistent treatment for insurance company investment income, and other active non-insurance income, Subpart F treats active insurance operations in the same manner as other active businesses, resulting in deferred taxation of income from active insurance operations. This provision, referred to as the "active financing" rule, is on the list of so-called "extenders" that Congress periodically restores retroactively. PCI supports the "active financing" provision as a way of maintaining a level playing field across industries. Non-insurance companies are able to structure their foreign operations to facilitate redeployment of foreign earnings or excess capital between foreign subsidiaries without incurring U.S. tax on the earnings (maintaining the deferral and avoiding Subpart F). This is accomplished through the use of various tax elections and legal entity structures ("check the box" election, LLCs, branch structures). These tax elections and entity structures are generally not available to insurance companies, but the same result can be achieved through a special "Look Thru" exception to the Subpart F rules. This Look Thru exception is on the list of so-called "extenders" that Congress periodically restores retroactively. PCI supports this exception as a way of maintaining a level playing field across industries.

In recent tax reform discussions, proposals have been discussed that would tax earnings of foreign subsidiaries that have not been repatriated. Such proposals are based on the idea that the U.S. parent company has the option to either repatriate earnings, or not, and may choose not to for tax reasons. These proposals do not take into account that foreign insurance companies are different; they are required by local regulators to maintain a certain amount of earnings or capital in the local country to support the insurer's obligations to policyholders. PCI opposes any provision that imposes a tax on such earnings to the extent these earnings relate to local regulatory capital and accordingly are not available to be distributed to U.S. shareholders.

3. Retain the existing rules for carrybacks and carryovers of losses and credits.

A corporation that incurs a net loss from operations (a "net operating loss") in one tax year is permitted to carry those losses back to prior years or forward to future years. A corporation that realizes losses from investments ("capital losses") is permitted to carry those losses back to prior years or forward to future years, albeit to a lesser extent. Similarly, if a corporation pays the alternative minimum tax ("AMT") for one tax year, this payment is treated as a credit (i.e., prepaid tax) that may be carried forward indefinitely. The foreign tax credit and other credits are also subject to a system of carrybacks and carryovers when these items cannot be used in the year they arise.

PCI supports retention of the existing rules relating to carryovers and carrybacks of losses and credits. Property and casualty insurers, unlike other businesses, experience periodic changes in profitability known as the "underwriting cycle." It has been observed that the underwriting cycle is approximately three years (i.e., three profitable years followed by three unprofitable years). The ability to carry losses forward and back to offset income earned in other years helps stabilize property-casualty insurers' taxable income over a period of years, and tax refunds from loss carrybacks provide increased liquidity to pay claims in years of heavy property losses from natural catastrophes (tornadoes, hurricanes, earthquakes, etc.).

In recent tax reform discussions, the possibility of eliminating the corporate AMT has been discussed. Property-casualty insurers have significant AMT credit carryovers. If the corporate AMT is eliminated, PCI supports creating a mechanism for property-casualty insurers to continue using their existing AMT credit carryovers in future years.

4. <u>Maintain the deductibility of interest expense</u>.

President Obama and prominent members of Congress have identified a lower corporate income tax rate as an important policy objective to help make the United States a more attractive place for businesses to invest and locate. There is little agreement, however, on how to pay for a lower corporate income tax rate.

Corporate taxpayers are currently permitted to deduct amounts incurred as interest expense. Recent tax reform discussions have included the suggestion that the deductibility of interest expense should be limited.

Interest expense has been viewed as a legitimate business expense since the inception of the corporate income tax. PCI opposes any new limits on the deductibility of interest expense.

The interest expense deduction for property-casualty insurers should generally continue under the current law rule, where a forbidden purpose (i.e., to "purchase or carry" tax-exempt obligations) must be shown in order for interest expense to be disallowed.

5. <u>Grandfather existing municipal bonds.</u>

Income earned on certain municipal bonds is exempt from federal income tax. This rule is designed to enable municipalities to issue debt at interest rates lower than corporate debt.

In recent tax reform discussions, it has been stated that "everything is on the table," including taxing municipal bond income. According to a recent CRS report, there are three primary types of proposals—capping the preference, eliminating the preference, and changing the preference to a direct issuer subsidy. These three types can be seen in the following proposals: The President's FY 2013 budget proposal would include partial elimination of the tax preference by capping the preference at the 28% marginal tax rate. The Simpson-Bowles deficit reduction plan proposes complete elimination of the tax preference. The Congressional Budget Office "Revenue Options" report proposes changing the tax exclusion for investors to a direct tax subsidy to issuers. The direction of broader tax reform will likely dictate which modifications, if any, are made to the tax treatment of state and local government debt.

Property and casualty insurers are significant investors in municipal bonds. Any change to the taxation of municipal bonds must take into account the settled expectations of investors with respect to existing bonds, and should apply only to bonds issued after enactment.

Again, PCI and its members are grateful to you for your consideration of PCI's views, and we look forward to the opportunity to discuss these important issues with you as Congress considers tax reform proposals.

Sincerely,

Nat Wienecke

Nathaniel F. Wienecke