This paper has briefly explored the subject of federal income taxes in the hope of stimulating investigations into this important area of insurance company operations. In the final analysis, net income is the sum of underwriting profit, investment income and taxes, and the latter may be the most important *controllable* factor in maximizing income.

DISCUSSION BY M. STANLEY HUGHEY

The very nature of the property and liability insurance industry involves the collection of dollars in the form of advance premium payments, the payment of losses that occur under the insured exposure as they are settled, and the payment of the related expenses of doing business as they fall due. Therefore, at any given time a property and liability insurance company has funds it is holding to make these various payments, as well as the equity funds which its stockholders (or mutual policyholders) have made available to guarantee financial performance.

The wise investment of these funds is an important element in the successful operation of a property and liability insurance company, and there are a number of important considerations to be taken into account:

1. Invested funds should provide security and protect a satisfactory surplus margin. Insurance companies above all else provide security and the investment program must be planned to provide that security.

2. Sufficient cash and liquid funds should be maintained at all times to meet liabilities which are due to be paid in the immediate future. The extremes are reflected in the "liquidation theory" where investments are maintained in such fashion that the company could orderly liquidate all liabilities if it stopped writing business, and the so-called "cash flow" theory where investments are planned on the basis that premium income would continue to flow at about the same level and losses and other expenses could be paid out of current premium receipts. In any given company some of the logic underlying both theories can be helpful in developing the best individual investment program.

Evaluating property and liability insurance company liabilities:

• Unearned premium reserves involve prepaid expenses, expenses falling

due over a reasonably short period of time, and potential loss payments and reserves.

- Loss reserves can be thought of in three categories — short term, payable immediately or within a relatively few months; interim, payable in perhaps two to four years; and long term, with very long payout periods.
- Other liabilities are normally short term.

To the extent these reserves call for immediately available funds to meet the short term liabilities falling due, the investment program should provide for such funds in cash or other liquid assets.

3. Protection against inflation should be provided for longer term loss reserves. Particularly in the auto, compensation and liability lines, long tail claims can remain open many years, with some of the settlement factors relating closely to inflation affected elements. In an overall inflationary economy it is desirable to tie some of the longer term loss reserves to investments which will provide some protection against inflation.

4. Underwriting results and surplus position should be recognized in planning investments. A company which is operating with a satisfactory underwriting margin and with a relatively large capital and surplus in relation to exposure can be more aggressive in its investment program than a company which has a thin underwriting margin (or underwriting loss) and a high exposure in relation it its capital and surplus.

5. All legal limitations should be carefully observed. Most state statutes spell out certain restrictions on property and liability insurance company investments, and while the regulations are normally very much in keeping with a sound investment program, it is clearly prudent to make certain that all investments are within whatever legal requirements are applicable.

6. Investment return after taxes should be maximized. Because of the normally higher yields on taxable securities, a property and liability company should strive to balance any underwriting loss with taxable income. Any investment income not needed to offset underwriting loss can normally be more profitably concentrated in tax-exempt and tax-sheltered securities.

All of these considerations can be important in any particular situation and usually they are closely interrelated. Mr. Beckman has concentrated on the last of these, exploring how to maximize investment return after taxes. He is to be commended for his needed and useful summary of the federal tax code as it relates to Stock Fire and Casualty Insurance Companies. His examples of the way net income after tax is affected by the different mixes of taxable investment income, tax-exempt investment income and underwriting loss are both interesting and illuminating.

As Mr. Beckman implies in his conclusions, the investment goal from a tax standpoint is to have taxable income exactly offset any underwriting loss, assuming the current situation where after tax return on tax-exempt and tax-sheltered investments is higher than the after tax return on taxable investments. Recognizing that the tax considerations may be affected by the other considerations commented on above, there is still room for substantial benefits from careful investment planning.

In considering the wide field of investment planning, several points should be emphasized:

- While it is most difficult to predict the key ingredient of the underwriting result for any given year, it is not unreasonable to predict the planned and approximate underwriting result over a period of say five years. With the carryforward and carryback provisions in the tax law, it should be possible to plan for tax-exempt and tax-sheltered investment income which minimizes taxes on the average, and gains the benefit of the tax-free income over several years even though any one year produces an unbalanced result.
- While not completely flexible, the timing of capital gains and losses is subject to some control. Therefore, with careful planning and by making full use of capital gain and loss carry forward and carry back provisions, the use of capital gains to offset ordinary losses can be minimized.
- Similarly, with a minimum of planning, a company operating in a normal range of underwriting results will have enough taxable income to make use of the dividend credit.
- While there are minor variations, mutual property and liability insurance companies are generally subject to the same Federal Income Taxes as stock property and liability companies so that the same general principles apply. However, Federal Income Taxes on both

stock and mutual life insurance companies are very much different and call for a completely different approach to tax planning.

- In Exhibit VI Mr. Beckman has compared the results with differing rates of yield on tax-exempt income. However, as a practical matter investment yield on tax-exempts tends to fluctuate in approximately parallel fashion to the investment yield on taxable securities so that these very sharp variations do not have to be dealt with very often.
- In commenting on tax-exempt investments, Mr. Beckman has concentrated his discussion on municipal bonds which are completely tax free. However, not to be overlooked as tax-sheltered investments are:

1. sound stocks which over a period of years (and assuming that they can be liquidated at the capital gains rate) should yield a net after tax return in the 6-7% range, and
2. real estate investments which due to the depreciation allowance can yield a net after tax return in the 7-8% range (perhaps more in an inflationary economy.)

Mr. Beckman's paper tackles head-on some of the tax ramifications of investment income and suggests some of the possibilities for improving net after tax results. Investment income has not been given the full consideration it deserves by the actuarial profession and it is to be hoped that others will continue to explore the multiple relationships that make up a sound program of investment planning. This is an area which holds promise for a significant professional contribution and, just as importantly, for a significant contribution toward improved company and industry profitability.

DISCUSSION BY J. W. MACGINNITIE

Mr. Beckman has done an excellent job of summarizing the impact of Federal Income Taxes on property/casualty insurance companies and the various factors that influence the total tax liability.

The major variable to which the paper is addressed is the relative amounts of taxable and tax-exempt investment income. In many companies this is the variable over which management has the greatest control and widest latitude of choice. For companies who have both the need and the resources, a more sophisticated approach to tax planning is possible.