Post Election Recap: Assessing the Impact of Tax Reform on Insurance Companies

Budget deficits, the national debt, and a path forward remain divisive issues in US politics. Among the most controversial facets of these debates are the various tax reform proposals that have been raised in recent years by congressional committees, through budget proposals, and by various third party NGO's (Non-Governmental Organizations)and lobbying organizations. All agree that the current system is bloated, unevenly enforced, and full of special interest loopholes and exceptions, but building a consensus for sweeping reform has proved difficult (to vastly understate the matter).

Many Property & Casualty insurance companies make tax-exempt municipal bonds a key component of an after-tax focused investment strategy. This paper will discuss some of the recently proposed reforms that would impact the relative attractiveness of these investments, and what they would mean for insurer portfolios. While handicapping the odds of any particular proposal being passed is challenging at this point (especially with split control of the White House and Congress), we believe that insurers should have familiarity with a variety of possible reforms to avoid any surprises.

Proposal No. 1: Lower the Corporate Tax Rate

The first and simplest proposal is simply to *lower corporate taxes*. The U.S. is notorious for charging one of the highest corporate tax rates among developed economies (a top rate of 35%, versus an European Union (EU) average of 21% and a Chinese rate of 25%), and for years large U.S. companies have employed elaborate schemes with colorful nicknames like the "Double Irish" or the "Dutch Sandwich" to shift profits to low-tax foreign jurisdictions. Household names like Apple, Microsoft, and GE have become (in) famous for keeping massive amounts of cash abroad to keep away from the IRS' hands. Apple has gone so far as to issue bonds to raise domestic cash despite having the highest offshore cash balance of any U.S. company.

In recent months, "tax inversions" have become a hot topic in financial news, namely cross-border mergers and acquisitions substantially motivated by the desire to avoid the 35% US rate. While various legislative attempts have been made to combat these strategies, the result has been an unwieldy arms race between large corporations and the IRS. However, there are signs that a bipartisan agreement is forming that the best way to solve this issue is to bring the U.S. tax rate in line with foreign jurisdictions and thereby remove the incentive to earn and hold profits abroad. While some object that the benefits of lower corporate taxes would accrue mainly to wealthy stockholders, incentivizing companies to move their operations and capital back onshore should benefit all levels of society.

If the top corporate income tax rate were reduced to 25-28%, the most important effect for municipal bond investors would be to reduce the yield "boost" that these bonds receive relative to taxable alternatives.

This concept is best illustrated through an example: For a 35% taxpayer, after accounting for all tax effects (including the 15% proration of tax-exempt income) a tax-exempt bond's nominal yield must be "grossed up" by a factor of 1.4577 to match the amount of pre-tax yield a comparable taxable bond would have to produce to achieve the same after-tax yield.

$1 of Taxable Income = $0.65 After-Tax Income

$1 of Tax-Exempt Income = $0.9475 After-Tax Income (net of 15% proration)

$0.9475 / $0.65 ≈ 1.4577

At a 25% tax rate, this factor would only be 1.2833. Therefore, a tax-exempt bond that offers an attractive yield relative to, say, AA corporate bonds at a 35% tax rate, might not look as appealing at a 25% rate unless the price fell (and the yield rose) to compensate, which is what we would expect to happen. This could result in unrealized losses for holders of tax-exempt bonds, but because the price movements would be driven by tax considerations rather than credit deterioration, this should not discourage investors from continuing to hold these bonds in expectation of receiving full interest and principal.

Proposal No. 2: Cap Municipal Income Tax Exemption

The municipal income tax exemption cap has been on the agenda for several years in President Obama's proposed budgets, including the most recent one (for Fiscal Year 2015), though, it has never actually been enacted. This would cap the amount of tax that could be exempted on municipal bond income at 28%, so that 35% taxpayers would still be fully taxable on 7% of this income (presumably this calculation would be separate from the 15% proration mentioned previously). Like the first proposal, this would reduce the "gross-up" factor applied to tax-exempt yields when comparing them to taxable alternatives, this time lowering it to 1.4200. Once again, this would most likely lead to a price adjustment downward across the municipal bond market (albeit a smaller one), to adjust yields to a level where they could compete with comparable taxable bonds. It could also expand the investor base for these bonds, as currently only taxpayers in the highest brackets can obtain the maximum benefit from the tax exemption, but at a capped 28% exemption individuals and companies in some of the lower brackets could invest in them on an equal footing. This could increase market liquidity and support price stability.

Proposal No.3: Eliminate the AMT and Change the 15% Proration of Tax-Exempt Income for Property & Casualty Insurers

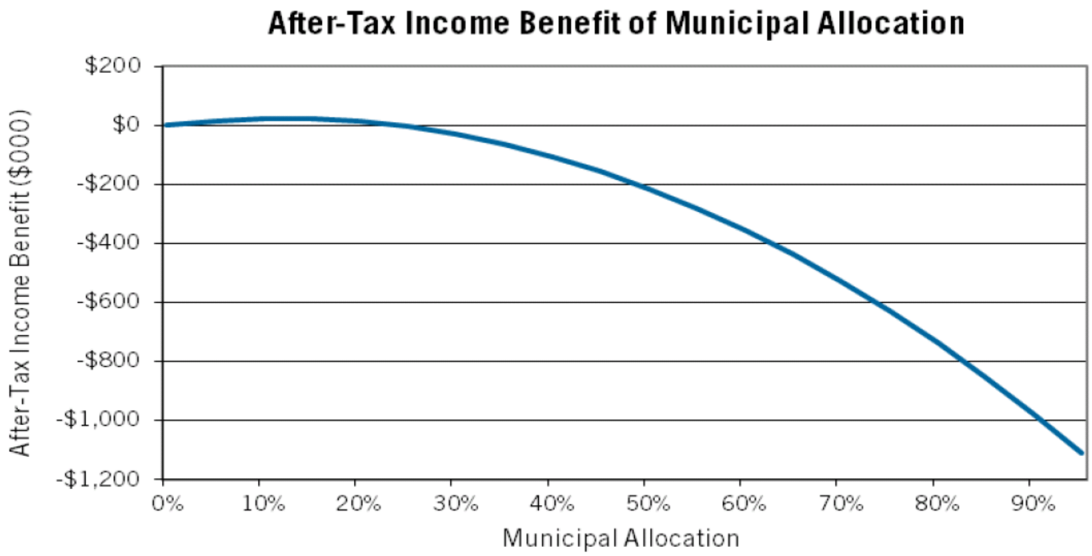
This is a pair of reforms contemplated in the Tax Reform Act of 2014. The first is the elimination of the Alternative Minimum Tax (AMT), a separate method of calculating a taxpayer's annual tax liability designed to limit the extent to which tax-management strategies (like investing in tax-exempt bonds) can reduce that liability. Traditionally, the AMT has been an important factor limiting the quantity of tax-exempt bonds an insurer holds, as holding too many and falling into the AMT results in sub-optimal after-tax income.

With the AMT restriction removed, insurers could theoretically invest heavily in municipal bonds and significantly reduce their tax liability. However, there's another part of the law designed to prevent that scenario: a change to the 15% proration of tax-exempt income for P&C insurers. Under the new law instead of adding a flat 15% of this income back into the taxable bucket, the percentage would be equal to the value of tax-exempt bonds held divided by total assets. So, the more municipals held, the larger the share of their income that becomes taxable. This creates a very interesting dynamic, where tax-exempts become more attractive to insurers with low allocations and less attractive to insurers with higher allocations. Market yields on these bonds are likely to move in response (P&C insurers are major players in the municipal bond market), but it's hard to predict exactly how given the opposing forces created. Over time this policy would likely homogenize insurers' tax-exempt allocations to within a fairly narrow range (perhaps 10% - 20%), with significant penalties in the form of higher taxes for going above this range, or foregone yield for going below it. For illustration, below is a table of the gross-up factors that insurers would assume for different municipal allocations under this plan:

Tax-Exempt Allocation (%)	Gross-up Factor	Grossed-up Yield Assuming 2.5% Nominal Yield
5	1.5115	3.7788
10	1.4846	3.7115
15	1.4577	3.6442
20	1.4308	3.5769
25	1.4038	3.5096
30	1.3769	3.4423
35	1.3500	3.3750
40	1.3231	3.3077
45	1.2962	3.2404
50	1.2692	3.1731

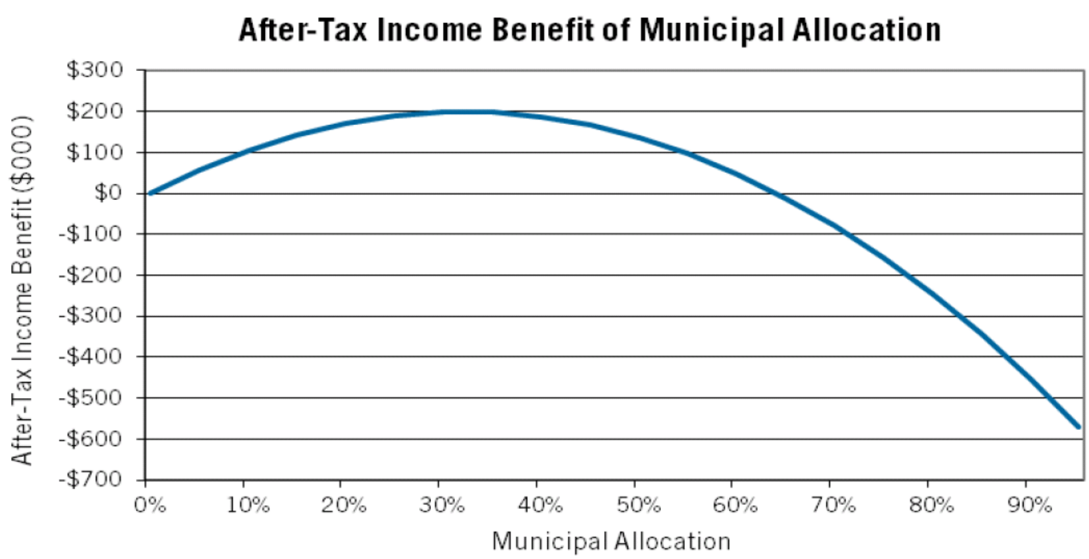
Source: AAM

Under this system, the optimal allocation to tax-exempts for an insurer would be driven mainly by the prevailing relationship between taxable and tax-exempt yields in the marketplace (This is already true to some extent, but under the current system it's usually safe to assume that the relationship will mean-revert over time as most investors are using the same gross-up factor based on a 35% tax rate, which would not be the case under the new rules). For example, assuming some representative underwriting metrics for a hypothetical P&C insurer, and given constant taxable and tax-exempt nominal yields of 3.2% and 2.3%, respectively, total income is maximized at about 10% tax-exempts under the new system:



Source: AAM

Keeping the same assumptions, but raising the nominal tax-exempt yield to 2.7%, produces an optimal allocation of 30% tax-exempts, representing a much larger incremental income contribution as well:



Source: AAM

In both of these cases, the incremental benefit of tax-exempts declines sharply after a certain point, as the after-tax yield gross-up factor shrinks and the yield advantage relative to taxables disappears.

Summary

In the aftermath of the recent midterm elections, tax reform is likely to be back on the legislative agenda as part of a larger fiscal reform debate. While the outcome is uncertain, a survey of the most prominent proposals from recent years can give us a sense of where this debate may lead, and the implications for insurance investors in tax-exempt municipal bonds. We will continue to follow political developments touching on this issue, and will be proactive with further communications and, if necessary, make strategic adjustments to portfolios, as the situation clarifies.

Contact Us

AAM has developed a proprietary dynamic tax model which includes modules to analyze potential tax reform changes and their impact on an insurers' recommended allocation range between taxable and tax-exempt securities. Please contact your AAM representative to run a complimentary tax modeling exercise for your company.

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