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MEMORANDUM

Re: Joint Committee Staff's Proposal Would Extend
I.R.C. § 265 Pro-rata Disallowance to P&C Insurers

From: Peter H. Winslow
Samuel A. Mitchell

Date: January 28, 2005

The staff of the Joint Committee on Taxation has released a Report on Options to Improve Tax Compliance and Reform Tax Expenditures (JCS-02-05). The staff report contains a proposal to extend the financial institution pro-rata interest disallowance rule under I.R.C. § 265(b) to property and casualty insurers, in lieu of the current 15% proration rule under I.R.C. § 832(b)(5)(B). The pro-rata disallowance rule, which currently applies only to financial institutions, disallows the portion of interest expense allocable to tax-exempt interest, based on the ratio of the adjusted basis of the financial institution's tax-exempt obligations (except for bonds of qualified small issuers) to the adjusted basis of all its assets. Other taxpayers currently are subject to I.R.C. § 265(a), under which interest is not disallowed unless the debt proceeds are traceable to tax exempts or unless the debt was incurred with the intent to purchase or carry tax exempts.

The Joint Committee staff proposal, scored as a \$1.2 billion revenue raiser over 10 years, would repeal the proration rule, and, in its place, extend I.R.C. § 265(b) to property and casualty insurers. Although it does not appear that the wearing-off of loss reserves would be subject to the pro-rata disallowance (e.g., because it is not "interest"), there is a danger that it could be so treated as details of the proposal are legislatively developed. Additionally, the proposed interest disallowance rule would account for the untaxed portion of dividends received and inside build-up in insurance contracts. The report also contains a separate proposal (scored as a \$700 million revenue raiser) to extend the pro-rata disallowance rule to all other taxpayers, with the exception

of life insurance companies. None of the proposals would apply to life insurance companies, which already are subject to a significant tax-exempt income limitation rule.

Similar pro-rata interest disallowance proposals for property and casualty insurers have been rejected in the past as a result of pressure from state and local governments. Given the current deficit environment, the proposal may have a better chance of enactment this time. The Joint Committee staff report, moreover, recognizes that the proposal would raise the cost of borrowing for state and local governments, but expresses the opinion that their cost of borrowing should be driven by free-market forces.

The proposal effectively would eliminate the tracing requirement under the current purchase-or-carry regime in I.R.C. § 265(a), and this could have a significant effect on property and casualty insurance borrowing. The property and casualty industry has traditionally been allowed under the purchase-or-carry regime to incur debt in order to capitalize down-stream insurance companies that hold tax exempts. The Joint Committee staff's proposal, as we understand it, would impose an interest disallowance on such arrangements.

Importantly, however, note that the proposals would grandfather all existing bonds held as of the time of enactment.

Please call us if you have questions.