

Corpfin, Mod 9: Taxes

Jacob: If income is negative, is the tax liability zero or negative?

Rachel: When we evaluate a project, negative income offsets positive income. Suppose an insurer sells 1,000 personal auto insurance policies. Ten policies have losses of \$5,000 apiece and the other 90 policies have gains of \$1,000 apiece. The after-tax income is

$$10 \times (-\$5,000) \times (1 - 35\%) + 90 \times (+\$1,000) \times (1 - 35\%) = \$26,000$$

Jacob: Does this apply to cohorts as well?

Rachel: Yes. An insurer expects to lose money the first year on a cohort of new business and to recoup the loss in renewal years. The first year loss on one cohort offsets gains on other cohorts.

Jacob: What if the insurer loses money in total? For example, what if Hurricane Katrina causes a net loss for the insurer?

Rachel: The loss may be carried back to the previous two years to offset taxable income in those years; the IRS gives a tax refund.

Jacob: What if the insurer lost money in the previous two years as well?

Rachel: The loss is carried forward and can offset income in future years. One shows a deferred tax asset in GAAP or statutory accounting statements.