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FAS 96

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Panelists: CHARLES J. AUER*
 JAMES S. HAWKE
Recorder: DONALD P. MAVES

- o *Timing and measurement of deferred tax effects*
 - Deferred Acquisition Cost
 - Tax versus benefit reserve differences
 - Accelerated depreciation
 - Purchase GAAP reversals
 - January 1, 1987 fresh start amounts
- o *Alternative minimum tax considerations*
- o *Worksheets versus models*
- o *Small company effective tax rate -- average versus marginal*
- o *Consolidated returns*
 - Life/life
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 - 5 year waiting period
- o *Incorporating future tax strategies*

MR. EDWARD L. ROBBINS: Financial Accounting Standard (FAS) 96 has created many concerns and problems for the actuarial and accounting professions for the following reasons. First, FAS 96 is in a state of flux. For example, the implementation date has been postponed one year to the first quarter of 1990. Second, it deals with a very complex subject. We had a tough time recruiting experienced actuaries in this new and highly specialized area.

Because this is such a new topic, I think it would be worthwhile to give an introduction and background of FAS 96. Then Chuck Auer will cover related, but more abstruse, topics such as Alternative Minimum Tax (AMT) considerations, consolidated GAAP statements and consolidated tax returns, and purchase accounting considerations. Finally, Jim Hawke will give you some insights about what you can end up doing to your companies if you are not careful in the application of FAS 96. He will also cover the impact of certain GAAP and tax basis accrual items on companies' deferred tax liabilities.

Mandatory implementation is the first quarter of 1990. The FASB has changed the focus from the income statement to the balance sheet. What does that mean? The old requirement, APB 11, required the taxable income to match GAAP income. Thus, in the absence of permanent differences, you could multiply GAAP income times the current tax rate to get the tax expense. The deferred tax was simply the liability that forced that to happen. FAS 96, forces the balance sheet to be right and lets the chips fall where they may on the income statement.

What does that mean to get the balance sheet "right"? It means simply that, as of a valuation date, if there are differences between the tax basis assets and liabilities and the GAAP basis assets and liabilities, and if those differences will eventually reverse, you must determine what taxable income will be generated in future years by those reversals. In essence, you will have a set of "mini" tax returns for those future years. You must also pretend that those reversals will be the only taxable income that you will have in the future.

FAS 96 creates a fictional world with respect to the tax rate band that you might be in, with respect to the fact that you are not allowed to count future cash flows from existing business, and with respect to the fact that you are not allowed to count future new business.

* Mr. Auer, not a member of the Society, is a Partner of Peat Marwick Main and Company in Chicago, Illinois.

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In addition, FASB has created a new term known as "representationally faithful." That means that the process of establishing the deferred tax liability must be faithful to the current tax law, as if each future year's set of reversals were its own tax return.

If you are generating net deductible amounts, you may only use those amounts for carrying back or forward under the rules in the Internal Revenue Code. The future tax calculations must be done on both a regular tax and an AMT basis, with a minimum tax credit generated where appropriate. There are also limitations on the use of capital losses. Net long-term capital losses can only be taken against net long-term capital gains, not against ordinary income.

Thus, the actuary must project GAAP benefit reserves, deferred acquisition costs (DAC), deferred profit liabilities on front-loaded universal life (UL) and limited-pay life, and tax reserves.

If you live in an ideal world, the deferred tax formula collapses to a quite simple formula. FASB does not recognize the time value of money, and therefore the future taxes that arise from the scheduling are not discounted. Below is the formula, which I will call the aggregate approach, which results under ideal conditions:

$$TR (A_G - A_T) \text{ where } TR = \text{tax rate}$$

A_G equals net GAAP assets less liabilities, and A_T equals net tax basis assets less liabilities. This formula works if you will never have any future unusable net deductible amounts, if you will never be in AMT, if future tax rates are constant, and if certain other conditions hold. It is a slick formula that means that you would not have to do any projections or scheduling of future reversals.

However, most of us do not live in an ideal world, and, thus, we must perform the scheduling. When a company does this, it must do so with respect to every accrual item in its balance sheet. I find it helpful to start with the statutory balance sheet to be sure that I am accounting for everything. From there, I look at the statutory-to-GAAP adjustments, and then the statutory-to-tax adjustments to the extent possible using Schedule R of the tax return. Once these are completed, it is possible to go from GAAP basis to tax basis for FAS 96.

I would like to make a few remarks on modeling. For most stand-alone life companies, it is probably not necessary to do a lot of material work, because the DAC runoff overwhelms everything else. In the absence of extenuating circumstances, you are not too far off using the aggregate approach and simplified models. For a small life affiliate of a large property and casualty (P&C) company, modeling is quite important because of the heavy loss reserve discounting that the P&C operation is likely to have.

I want to show you a simple runoff example. Table 1 shows the cumulative temporary differences in the first column, and what those balances are projected to be for each of the next four years.

TABLE 1

Item	12/31/y Cumulative Temporary Differences	Projected in the Future			
		12/31/y+1	12/31/y+2	12/31/y+3	12/31/y+4
GAAP Assets (+)	600	450	300	150	0
Tax Basis Assets (-)	400	300	200	100	0
GAAP Liabilities (-)	300	225	150	75	0
Tax Basis Liabilities (+)	320	240	160	80	0
Net Total	220	165	110	55	0

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Note that each item must have the correct sign associated with it. For example, GAAP assets become a liability for deferred tax purposes, because the runoff produces an excess of taxable income over GAAP income. The net totals are then moved to the top of Table 2.

The last line of Table 2 contains merely the first differences of the column entries in the first line of the table. There is a reversal of \$55 each year, composed of the GAAP runoffs and the tax runoffs. Thus, there are future GAAP losses of \$75 each year, and future tax losses of \$20 each year.

TABLE 2

	<u>Total</u>	<u>y+1</u>	<u>y+2</u>	<u>y+3</u>	<u>y+4</u>
Net Total (from Table 1)	220	165	110	55	0
Future Income: GAAP Basis	<300>	<75>	<75>	<75>	<75>
Tax Basis	<80>	<20>	<20>	<20>	<20>
Excess	220	55	55	55	55

Now look at Table 3. GAAP losses are on the top line. I have assumed a 40% tax rate, which, when applied to the tax loss of \$20 from Table 2, produces a current tax of -- \$8 per year. Also, the 40% rate applied to the \$55 annual reversal on Table 2 produces \$22 of deferred tax in each year, for a total deferred tax of \$88. If you take the \$22 deferred tax liability that you could theoretically release, and add it to the current year tax of \$8, you get \$30. This is 40% of GAAP basis income, which is just as it should be.

TABLE 3

	<u>y+1</u>	<u>y+2</u>	<u>y+3</u>	<u>y+4</u>
(1) GAAP Basis Income	<75>	<75>	<75>	<75>
(2) Current Year Tax	<8>	<8>	<8>	<8>
(3) Release of Deferred Tax Liability	<22>	<22>	<22>	<20>
(4) Tax Expense	<30>	<30>	<30>	<30>
(5) Row (4)/Row (1)	40%	40%	40%	40%

MR. CHARLES J. AUER: For every client for whom I have worked on FAS 96, I have run into a different nuance. Therefore, I think that it will be useful to go through an actual FAS 96 calculation in its entirety, because in practice the actuaries usually do only certain parts, never seeing the full process. In these tables, for the scheduling process, parenthetical amounts are future deductible amounts, and nonparenthetical amounts are future income amounts.

Let us start by looking at Table 4. We have a parent company in this table. A subsidiary is shown in Table 5. This company is trying to convert to FAS 96 in 1988. In order to do that, it must determine the effect of the change at the beginning of the year. The effect of the change is then

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TABLE 4

Calculation of the Deferred Tax Asset/Liability

December 31, 1987

(\$000)

	<u>Total</u>	<u>1986</u>	<u>1987</u>	<u>1988</u>	<u>1989</u>	<u>1990</u>	<u>1991</u>	<u>1992</u>	<u>1993</u>
Taxable income - actual		12,672	7,420	--	--	--	--	--	--
Reversal of Temporary Differences - Sched. 2		--	--	(9,997)	5,922	(2,052)	(1,873)	3,921	2,945
Utilization of Loss Carryback		<u>(9,997)</u>	<u>(2,052)</u>	<u>9,997</u>	<u>(1,873)</u>	<u>2,052</u>	<u>1,873</u>	<u>--</u>	<u>--</u>
Net taxable amount		2,675	5,368	--	4,049	--	--	3,921	2,945
Effective tax rate		<u>43%</u>	<u>40%</u>	<u>34%</u>	<u>34%</u>	<u>34%</u>	<u>34%</u>	<u>34%</u>	<u>34%</u>
Tax at applicable rate		1,150	2,147	--	1,377	--	--	1,333	1,001
Actual tax before carryback		<u>(5,374)</u>	<u>(2,968)</u>	<u>--</u>	<u>--</u>	<u>--</u>	<u>--</u>	<u>--</u>	<u>--</u>
Net tax expense (benefit)		<u>5,559</u>	<u>(4,224)</u>	<u>(821)</u>	<u>1,377</u>	<u>--</u>	<u>--</u>	<u>1,333</u>	<u>1,001</u>
Deferred tax liability - FASB 96		5,559							
Deferred tax liability for Phase III tax - APB 23		<u>5,500</u>							
Total estimated deferred tax liability at December 31, 1987		<u>11,059</u>							
Deferred tax liability per December 31, 1987 financial statements		<u>22,843</u>							

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TABLE 4
CONTINUED

Calculation of the Deferred Tax Asset/Liability
December 31, 1987
(\$000)

	<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1997</u>	<u>1998</u>	<u>1999</u>	<u>2000</u>	<u>2001</u>	<u>2002</u>	<u>2003</u>	<u>Thereafter</u>	<u>Indefinite</u>
Taxable income - actual	--	--	--	--	--	--	--	--	--	--	--	--
Reversal of Temporary Differences - Sched. 2	2,556	2,360	1,062	734	742	269	148	254	321	840	10,963	(1,713)
Utilization of Loss Carryback	--	--	--	--	--	--	--	--	--	--	--	--
Net taxable amount	2,556	2,360	1,062	734	742	269	148	254	321	840	10,963	(1,713)
Effective tax rate	<u>34%</u>	<u>34%</u>	<u>34%</u>	<u>34%</u>	<u>34%</u>	<u>34%</u>	<u>34%</u>	<u>34%</u>	<u>34%</u>	<u>34%</u>	<u>34%</u>	--
Tax at applicable rate	869	802	361	250	252	91	50	86	109	286	3,727	(a)
Actual tax before carryback	--	--	--	--	--	--	--	--	--	--	--	--
Net tax expense (benefit)	<u>869</u>	<u>802</u>	<u>361</u>	<u>250</u>	<u>252</u>	<u>91</u>	<u>50</u>	<u>86</u>	<u>109</u>	<u>286</u>	<u>3,727</u>	--

(a) As loss is in the indefinite column, carryforward or carryback cannot be assumed and tax is \$0.

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TABLE 5

Schedule of Temporary Differences
(\$000)

<u>Assets</u>	<u>Reference</u>	<u>December 31, 1987</u>			<u>1988</u>	<u>1989</u>	<u>1990</u>	<u>1991</u>	<u>1992</u>	<u>1993</u>
		<u>GAAP Basis</u>	<u>Tax Basis</u>	<u>Difference</u>						
Fixed maturities	1	422,782	421,238	1,544	9	(8)	--	130	4	8
Equity securities	2	18,308	19,499	(1,191)	(1,191)	--	--	--	--	--
Mortgage loans	3	78,318	70,915	7,403	27	7,270	27	27	26	26
Real estate	4	15,006	14,494	512	8	8	8	8	8	8
Agents balances	5	2,343	3,538	(1,195)	(1,065)	(65)	(65)	--	--	--
COIA	6	15,971	23,372	(7,401)	(3,195)	(3,397)	(3,864)	(4,015)	1,697	725
DAC	6	34,157	--	34,157	3,172	2,726	2,482	2,269	2,037	1,847
Pension asset	7	630	--	630	--	--	--	--	--	--
Agency field force	10	--	595	(595)	(595)	--	--	--	--	--
Going concern	11	--	3,718	(3,718)	--	--	--	--	--	--
Other	12	10,736	10,773	(37)	(37)	--	--	--	--	--
<u>Liabilities</u>										
Benefit reserves	13	513,376	484,119	(29,257)	(12,927)	(4,097)	(2,873)	(2,065)	(1,438)	(770)
Resisted claim reserves	14	600	--	(600)	(300)	(300)	--	--	--	--
Unearned interest	17	586	--	(586)	(586)	--	--	--	--	--
Payable to reinsurers	19	247	8,775	8,528	<u>8,528</u>	--	--	--	--	--
Total -- GARCO					(8,161)	2,137	(4,285)	(3,646)	2,334	1,844
Total -- NFL					<u>(1,843)</u>	<u>3,787</u>	<u>2,233</u>	<u>1,774</u>	<u>1,586</u>	<u>1,101</u>
Grand total					<u>(10,004)</u>	<u>5,924</u>	<u>(2,052)</u>	<u>(1,872)</u>	<u>3,920</u>	<u>2,945</u>

Note: The assets and liabilities reflected on this schedule represent only those assets and liabilities for which temporary differences exist between the values reflected on the GAAP financial statements (GAAP basis) and the tax return (tax basis).

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TABLE 5
CONTINUED

Schedule of Temporary Differences
(\$000)

<u>Assets</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1997</u>	<u>1998</u>	<u>1999</u>	<u>2000</u>	<u>2001</u>	<u>2002</u>	<u>2003</u>	<u>Thereafter</u>	<u>Indefinite</u>
Fixed maturities	--	--	10	22	4	32	(102)	150	150	96	1,039	--
Equity securities	--	--	--	--	--	--	--	--	--	--	--	--
Mortgage loans	--	--	--	--	--	--	--	--	--	--	--	--
Real estate	7	7	7	7	--	--	--	--	--	--	--	436
Agents balances	--	--	--	--	--	--	--	--	--	--	--	--
COIA	627	543	469	406	351	304	263	227	197	170	1,090	--
DAC	1,707	1,492	1,202	812	529	494	515	534	548	577	11,214	--
Pension asset	--	--	--	--	--	--	--	--	--	--	--	630
Agency field force	--	--	--	--	--	--	--	--	--	--	--	--
Going concern	--	--	--	--	--	--	--	--	--	--	--	(3,718)
Other	--	--	--	--	--	--	--	--	--	--	--	--
 <u>Liabilities</u>												
Benefit reserves	(500)	(325)	(258)	(241)	(144)	(173)	(197)	(209)	(223)	(106)	(2,711)	--
Resisted claim reserves	--	--	--	--	--	--	--	--	--	--	--	--
Unearned interest	--	--	--	--	--	--	--	--	--	--	--	--
Payable to reinsurers	--	--	--	--	--	--	--	--	--	--	--	--
Total -- GARCO	1,841	1,717	1,430	1,006	740	657	479	702	672	737	10,632	(2,652)
Total -- NFL	715	642	(369)	(272)	1	(388)	(332)	(448)	(351)	103	331	939
Grand total	<u>2,556</u>	<u>2,359</u>	<u>1,061</u>	<u>734</u>	<u>741</u>	<u>269</u>	<u>147</u>	<u>254</u>	<u>321</u>	<u>840</u>	<u>10,963</u>	<u>(1,713)</u>

Note: The assets and liabilities on this schedule represent only those assets and liabilities for which temporary differences exist between the values reflected on the GAAP financial statements (GAAP basis) and the tax return (tax basis).

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run through income in the year of the change, in this case 1988, as a cumulative change in accounting method.

The first step is to inventory the items. On Table 5, there are both a GAAP basis balance sheet and a tax basis balance sheet. Of course, companies have no trouble producing a GAAP balance sheet. However, since there has never been a reason to have a tax basis balance sheet, most companies have some difficulty in producing one, especially if there have been acquisitions and intangible items.

Assuming that we have a tax basis balance sheet, when we compare it to the GAAP balance sheet, we can see the temporary differences. The second step is scheduling when those differences will reverse. This step is more art than science at this point, because there are differences of opinion as to how those differences should reverse. Little by little, FASB has been giving guidance in this area. Let us proceed item by item.

The first asset line is fixed maturities, or bonds. The biggest difference usually is bond discount, which is not taxable currently, so one would expect book basis to be greater than tax basis. Thus, we would have future non-bracketed amounts, which are income. Note that there are bracketed amounts in years 1989 and 2000. This is unusual and is probably due to some purchase accounting considerations. Otherwise, this is typical of what to expect. One question that we run into frequently is what to do about bond accretion. For scheduling purposes, FASB has said that new differences are not to be created. So one simply schedules the reversal in the year that the bond is expected to be sold or matured. This is FASB's "drop-dead" theory of accounting, in that one never makes or loses money in the future.

Next are equity securities. This company has probably written its book value down to market, but has not done so for tax purposes. The company has decided that the loss will be taken in 1988. This will probably be a capital loss in 1988, if and when it occurs, and typically should be scheduled separately, because capital losses cannot be used to offset ordinary income. This is a fine point that has been ignored in this example, but should be included in actual practice.

Mortgage loans appear odd in this example. There is probably some mortgage discount here that this company knows will reverse in 1989, but it is not obvious why that should be. It could be due to purchase accounting.

For real estate, the difference most likely arose from accelerated depreciation. However, if you look at the last column on the right, you see that part of the reversal occurs in the "Indefinite" time frame. This is probably the land under the home office building, which the company has no intention of ever selling. The present value of the tax would approach zero. However, as Ed pointed out, the time value of money is not taken into account in this process.

Agents' balances probably have a reserve set up against them for book purposes, but not for tax, most of which difference reverses in 1988.

The next line, COIA, is cost of insurance acquired. In this example, COIA has a larger tax basis than book basis, which is not necessarily the way it will always happen. Perhaps this is an older block of business acquired in the days when Section 818(c) gave a big boost to the value of the insurance. The difference continues to accelerate through 1991, after which it starts to reverse.

DAC, of course, has a zero tax basis. This is an item that the actuaries will most likely be called upon to schedule.

The pension asset is another gift from the FASB -- FAS 87. Will this asset ever be realized? One way to handle it is to put it in the "Indefinite" column, as this company has done. Another way is to schedule out the differences, assuming that one can estimate when the book pension expenses will occur.

For some reason, this company believes that "Agency field force" is deductible. It could be that this is the result of an acquisition, but typically this item would not be seen in this process.

For some reason, this company carved out an intangible asset, not in the books, but in the tax return, called "Going concern." I do not know why this was done, as this item is not currently

deductible. This asset is really goodwill for tax purposes. I would be inclined to not even schedule it.

Let us move down to the liabilities. The first item, "Benefit Reserves," is another one that the actuaries most likely will be called upon to schedule. "Resisted claim reserves" is self-explanatory, "Unearned interest" is a typical Schedule R item, which reverses in one year. The last liability item is probably surplus relief that this company granted.

That takes care of the parent company's scheduling. Let us move now to Table 5 to look at the subsidiary, as it has a few items that are treated differently from the parent.

Its "mortgage loans" look more normal than the parent's loans, although they have a higher tax basis than book basis, which is unusual. Probably what has happened is that the subsidiary wrote down some of its mortgages for bookkeeping purposes but was not able to take a tax deduction at the time.

"COIA" is different than in the parent. The subsidiary has no tax basis for COIA. There are two ways that this can happen. Either the company has written it all off already for tax purposes, or it never did a step-up transaction to get a tax basis in the COIA. It is probably the latter, perhaps related to purchase accounting.

"Foreign exchange" was put in the "Indefinite" column because the subsidiary has no idea when that income will ever be received.

Moving down to the liabilities, the "Benefit reserves" look relatively normal, except for what happens in 1988, 1989, and 1990, when the temporary differences are growing.

The "Provision for policyholder dividends" looks odd to me. Typically the tax basis is close to zero. Here it is not.

The subsidiary has set up a "Moving expense accrual" for bookkeeping purposes, which is not deductible currently, but will become deductible for this company in 1988.

That concludes the inventory and scheduling part of the process. In the "Grand total" line at the bottom of Table 4, all the items are totaled for both the parent and the subsidiary, and then those totals are placed in the second line of the schedule on Table 6. Again, the positive totals are income, and the parenthetical totals are deductible items or losses.

Ed said that, under FAS 96, we pretend that we are filing tax returns for all future years. This is what we are doing in Table 6. On the line labeled "Utilization of Loss Carryback," the 1988 loss is carried back to 1986, the 1990 loss is carried back to 1987, and the 1991 loss is carried back to 1989. After 1991, there are no loss carrybacks. Since there are no carryforwards, the process is completed, and thus all that remains is to calculate the tax liability for each year at the appropriate rate.

We see that the tax would have been \$1.2 million in 1986, \$2.1 million in 1987, and so on into the future. Add those up for all years, and then compare the result to the taxes that actually occurred before this process took place. In this case, this company had roughly \$8.3 million of actual tax for 1986 and 1987, which, when compared to the sum of the tax liabilities from the scheduling process, results in \$5.6 million of future tax expense. This is the amount that this company would ultimately owe if it collected every asset and paid out every liability exactly as it was scheduled.

One additional difficulty in this example is that the company also had accrued a deferred tax liability of \$5.5 million for Phase III. This amount is added to the FAS 96 liability just established to give a total estimated deferred tax liability of \$11.1 million at December 31, 1987.

That is what the deferred liability would have been if this company had been on FAS 96 all along. Of course, through 1987 the company would have been using APB 11, and on this basis the liability was \$22.8 million. Thus, the difference of \$11.7 million is the cumulative catchup, or change in accounting method, that would run through the 1988 income statement. This is the initial scheduling, and this company would have to schedule the differences at the end of 1988 and thereafter.

PANEL DISCUSSION

TABLE 6

Schedule of Temporary Differences

(\$000)

Assets	Reference	December 31, 1987			1988	1989	1990	1991	1992	1993
		GAAP Basis	Tax Basis	Difference						
Fixed maturities	1	157,061	153,477	3,584	6	211	(11)	(49)	(16)	119
Equity securities	2	11,745	13,382	(1,637)	(1,637)	--	--	--	--	--
Mortgage loans	3	132,681	137,842	(5,161)	(1,298)	(1,066)	(870)	(706)	(259)	(454)
Real estate	4	5,149	5,089	60	--	--	--	--	60	--
COIA	6	14,847	--	14,847	2,002	1,760	1,551	1,370	1,214	1,079
DAC	6	10,353	--	10,353	1,233	1,675	1,122	984	868	768
Pension asset	7	845	--	845	--	--	--	--	--	--
Foreign exchange	8	(589)	(683)	94	--	--	--	--	--	--
Surplus relief	9	9	(859)	868	145	145	145	145	145	143
Other	12	2,224	1,218	1,006	58	245	217	198	183	92
Liabilities										
Benefit reserves	13	313,580	301,447	(12,133)	1,114	821	82	(163)	(605)	(612)
Resisted claims	14	300	--	(300)	(300)	--	--	--	--	--
A & H claims	15	594	574	(20)	(4)	(4)	(3)	(3)	(3)	(3)
Provision for P/H Div.	16	1,008	2,573	1,565	1,565	--	--	--	--	--
Unearned interest	17	1,811	--	(1,811)	(1,811)	--	--	--	--	--
Moving expense accrual	18	2,500	--	(2,500)	(2,500)	--	--	--	--	--
Other	20	<u>1,169</u>	<u>717</u>	<u>(452)</u>	<u>(416)</u>	<u>(1)</u>	<u>(1)</u>	<u>(1)</u>	<u>(1)</u>	<u>(32)</u>
Total NFL		<u>13,363</u>	<u>4,155</u>	<u>9,208</u>	<u>(1,843)</u>	<u>3,786</u>	<u>2,232</u>	<u>1,775</u>	<u>1,586</u>	<u>1,100</u>

Note: The assets and liabilities reflected on this schedule represent only those assets and liabilities for which temporary differences exist between the values reflected on the GAAP financial statements (GAAP) basis and the tax return (tax basis).

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TABLE 6
CONTINUED

Schedule of Temporary Differences
(\$000)

	<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1997</u>	<u>1998</u>	<u>1999</u>	<u>2000</u>	<u>2001</u>	<u>2002</u>	<u>2003</u>	<u>Thereafter</u>	<u>Indefinite</u>
Fixed maturities	263	309	(21)	179	276	(41)	63	36	136	299	1,825	--
Equity securities	--	--	--	--	--	--	--	--	--	--	--	--
Mortgage loans	(359)	(149)	--	--	--	--	--	--	--	--	--	--
Real estate	--	--	--	--	--	--	--	--	--	--	--	--
COIA	962	860	455	485	420	363	314	272	235	203	1,302	--
DAC	695	646	366	269	248	219	188	160	137	121	654	--
Pension asset	--	--	--	--	--	--	--	--	--	--	--	845
Foreign exchange	--	--	--	--	--	--	--	--	--	--	--	94
Surplus relief	--	--	--	--	--	--	--	--	--	--	--	--
Other	7	6	--	--	--	--	--	--	--	--	--	--
<u>Liabilities</u>												
Benefit reserves	(852)	(1,029)	(1,169)	(1,205)	(943)	(928)	(896)	(916)	(861)	(520)	(3,451)	--
Resisted claims	--	--	--	--	--	--	--	--	--	--	--	--
A & H claims	--	--	--	--	--	--	--	--	--	--	--	--
Provision for P/H Div.	--	--	--	--	--	--	--	--	--	--	--	--
Unearned interest	--	--	--	--	--	--	--	--	--	--	--	--
Moving expense accrual	--	--	--	--	--	--	--	--	--	--	--	--
Other	--	--	--	--	--	--	--	--	--	--	--	--
Total NFL	<u>716</u>	<u>643</u>	<u>(369)</u>	<u>(272)</u>	<u>1</u>	<u>(387)</u>	<u>(331)</u>	<u>(448)</u>	<u>(353)</u>	<u>103</u>	<u>330</u>	<u>939</u>

Note: The assets and liabilities reflected on this schedule represent only those assets and liabilities for which temporary differences exist between the values reflected on the GAAP financial statements (GAAP basis) and the tax return (tax basis).

PANEL DISCUSSION

As Ed mentioned, you must convert to FAS 96 by the first quarter of 1990. However, any company that waits that long to start the process may have trouble, because these kinds of processes take a fair amount of time to do.

MR. CHARLES D. FRIEDSTAT: In your example with the cumulative catchup of \$11.7 million, do you put it all through the first quarter income, or do you spread it out over the four quarters of the year?

MR. AUER: It would depend on when you adopted FAS 96. If you adopted it in the fourth quarter of 1988, you would have to restate the first, second, and third quarters of 1988.

This is the scheduling that is done under the regular tax system. Note that there are future taxable amounts, or zero, in all future years under this system, in my example. The AMT is going to be roughly the same series of numbers, and thus the tax will be the greater of 34% (the regular tax) or 20% (AMT tax) -- or 34%. The only thing that may affect that result could occur after 1989, when we must use the Adjusted Current Earnings (ACE) approach. We must then calculate DAC for AMT purposes, which may complicate things. However, I cannot see how it changes the answer, because these scheduling processes fully account for the DAC in the regular tax. Also, there is a fresh start on the DAC as of January 1, 1990, which would also tend to reduce AMT. In the cases on which I have worked, AMT considerations have not arisen in any meaningful way. I am coming to the conclusion that AMT should not be a problem, especially before 1990.

MR. ROBBINS: Assume that a company's only temporary difference is DAC. Under AMT, starting in 1990, there would then be no temporary differences.

MR. AUER: That is correct. The book and tax basis would be the same.

MR. ROBBINS: Therefore, that company would have no AMT income on these schedules.

MR. AUER: It would have regular taxable income only. It seems that AMT will just not apply in the scheduling process.

I want to talk a little about tax planning strategies. FASB requires that such strategies be prudent, be feasible, be within the discretion of management, and not involve significant costs. A strategy is not elective, it is mandatory. If it meets the tests, it must be used. The reason for this is to prevent the management or manipulation of tax benefits under FAS 96.

When FAS 96 was published, many people believed that reinsurance would be a viable strategy. We are convinced that reinsurance is not a viable strategy for life insurance companies, because, if the strategy is tax motivated, Internal Revenue Code Section 845 allows the federal government to set the strategy aside. It is almost a Catch 22. There may be room for reinsurance as a qualified strategy, but not very often.

MR. JAMES S. HAWKE: I will focus on the temporary differences particular to the actuary's concern -- the DAC and the excess of GAAP benefit reserve over tax reserve.

You can view these as a single book versus tax balance sheet difference if the net GAAP reserve (benefit reserve less DAC) is set against the tax reserve, but it is sometimes clearer to isolate the two sides of the balance sheet: 1) The DAC creates taxable temporary difference reversals as amortization is projected, and 2) the excess of GAAP benefit reserve over tax reserves creates deductible temporary difference reversals as it is amortized.

Many of us have wanted to race to the conclusion that the deferred tax contribution of these actuarial elements is just:

$$(\text{DAC} - \text{excess reserve}) * (\text{tax rate})$$

Unfortunately this does not always prove to be true under FAS 96 due to the limitation on carryforwards and carrybacks. Current tax law limits are 15 years for carryforwards and 3 years for carrybacks.

FAS 96 calls for a projection of temporary difference reversals which, in our case, boils down to a projection of the reserves on our in-force block (the prohibition on consideration of events yet to

FAS 96

occur precludes inclusion of new business). We will see that several types of businesses can produce future net deductible temporary difference reversals which cannot be carried back or forward to offset taxable amounts.

The end result in such a case would be that the deferred tax liability will end up higher than the expected value -- the net difference at the valuation date times the tax rate.

Problems with the simplified formula can also arise due to graduated rates, the small company deduction, and the AMT. Similarly, these problems may be offset by non-reserve temporary difference reversals or by consolidation offsets.

The case studies I have all utilize "actuarial" projections, i.e., assumptions have been made as to mortality, lapse, etc., and calculations similar to a model office or profit test projection have been made. The resulting DAC amortization pattern has then been set against the runoff of excess reserve (GAAP over tax) to obtain the net temporary difference reversals.

Graph 1 shows a back loaded UL contract with reserve and DAC balances captured at the end of the first policy year. Excess reserves run off at the fifteenth policy year coincident with the end of the surrender charge period. You can see that we have some net deductible temporary difference reversals in years 9 through 15.

The cause can be seen on Graph 2 -- the tax reserve is quickly overtaken by the cash value so that the excess reserve is just the surrender charge. This grows for a few years and then is graded off at policy year 15 on this particular product.

The grading is steep enough to overwhelm the amortization of DAC during this period of time, so that net deductible reversals are created. The period of net deductible reversals occurs when more excess reserve is released than DAC is amortized.

The severity of the problem will depend on plan specifics as to surrender charges, capitalization, and gross profit pattern. Nevertheless, every back loaded UL product my company has sold has shown some degree of the problem.

Graph 3 isolates the pattern of net temporary difference reversals. Now we can look at the carryforward carryback process.

On Graph 4, the first net deductible amount, year 9, offsets the taxable amount in year 6 and a piece of year 7.

On Graph 5, the year 10 deductible reversal is carried back to years 7 and 8. This ends the carryback possibilities since year 11 is too far from year 5. From here on we are limited to carryforwards.

Year 11 offsets years 16 through 21, shown on Graph 6.

Finally, on Graph 7, years 12 through 15 are offset against taxable amounts out to year 30, but not fully due to the fifteen-year limitation.

In this case the simplified calculation would yield:

$$\text{Deferred Tax Liability} = (651 - 332) * .34 = 108$$

The FAS 96 approach yields 128 due to the loss of a portion of the excess reserve credit. The "effective" tax rate appears to be 40%, rather than 34%, in that the deferred tax liability is 40% of the net temporary difference at the valuation date.

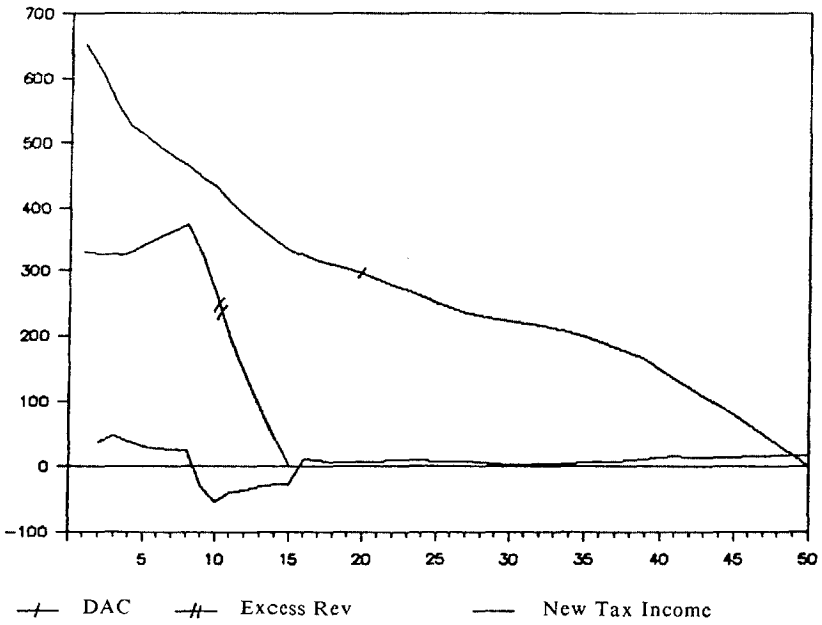
This is just one year of issue, but the problem remains until very near the end of the surrender charge period. In fact, it gets worse before getting better. The effective tax rate for six years of issue, 1983 through 1988, in the case of my company is 42%.

Again, this sort of problem may be offset by other blocks of business or by non-reserve temporary differences.

PANEL DISCUSSION

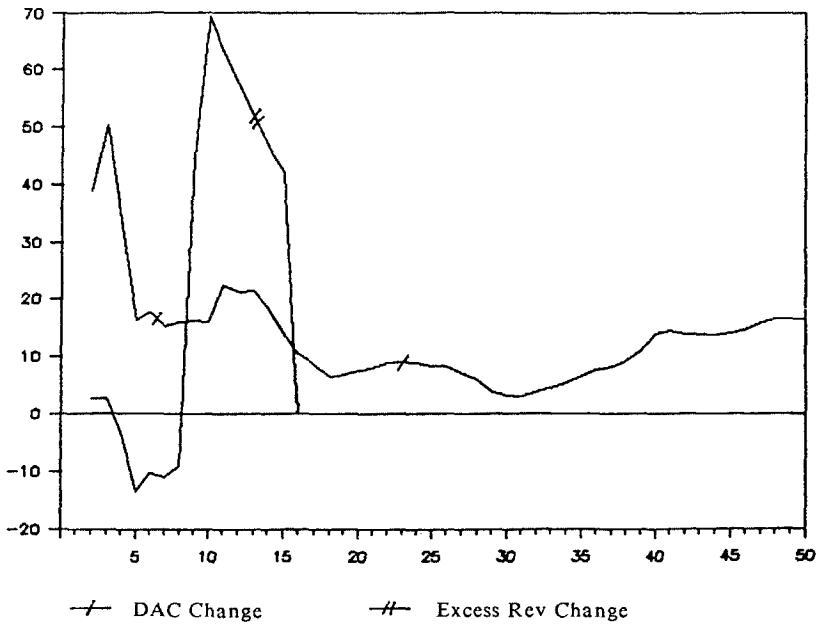
GRAPH 1

Back Load Universal Life



FAS 96
GRAPH 2

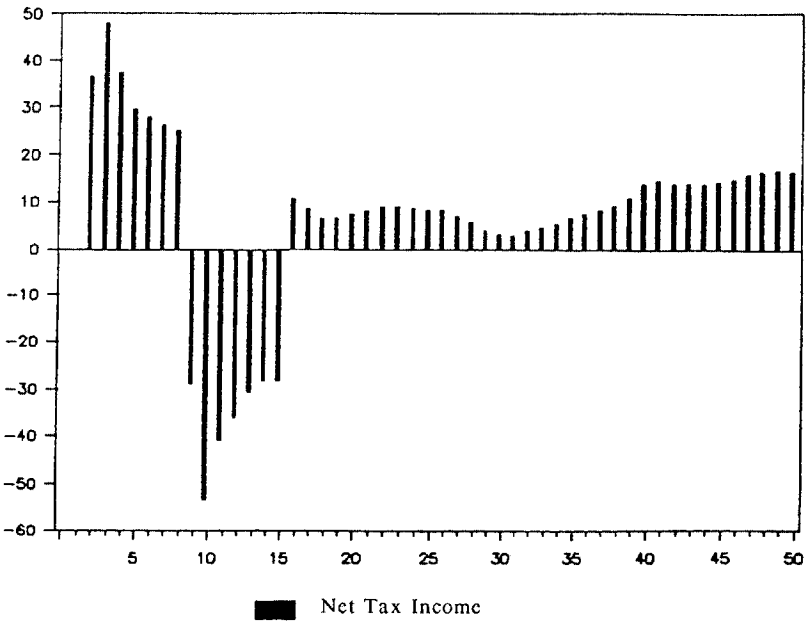
Back Load Universal Life



PANEL DISCUSSION

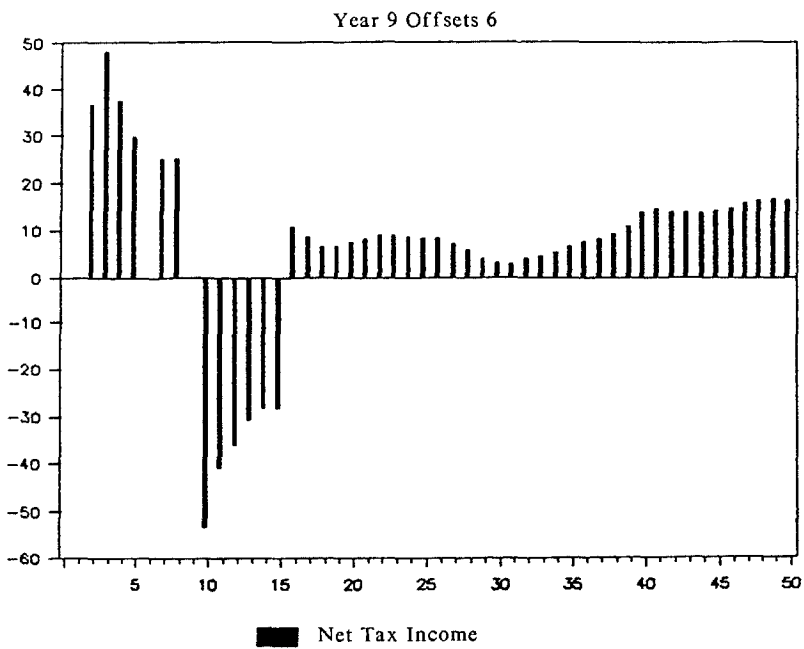
GRAPH 3

Back Load Universal Life



FAS 96
GRAPH 4

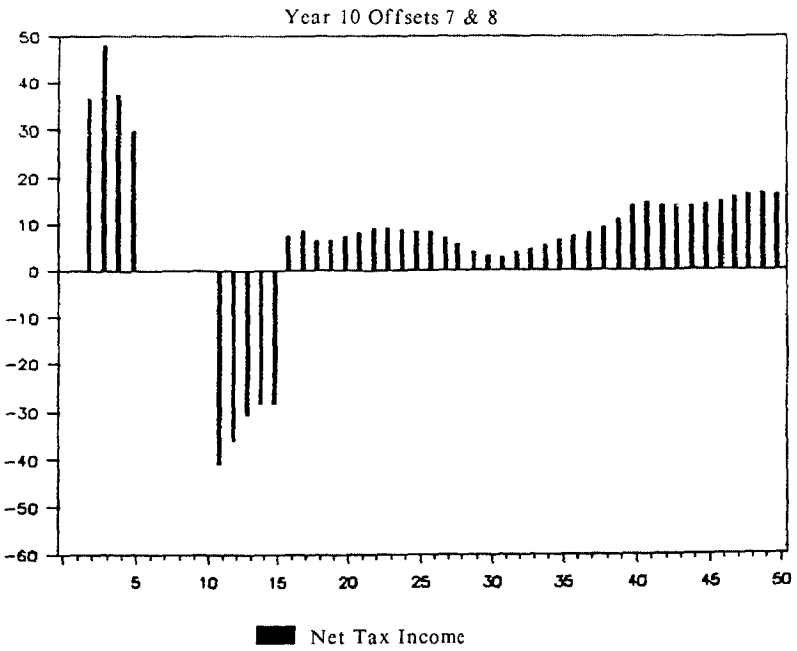
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PANEL DISCUSSION

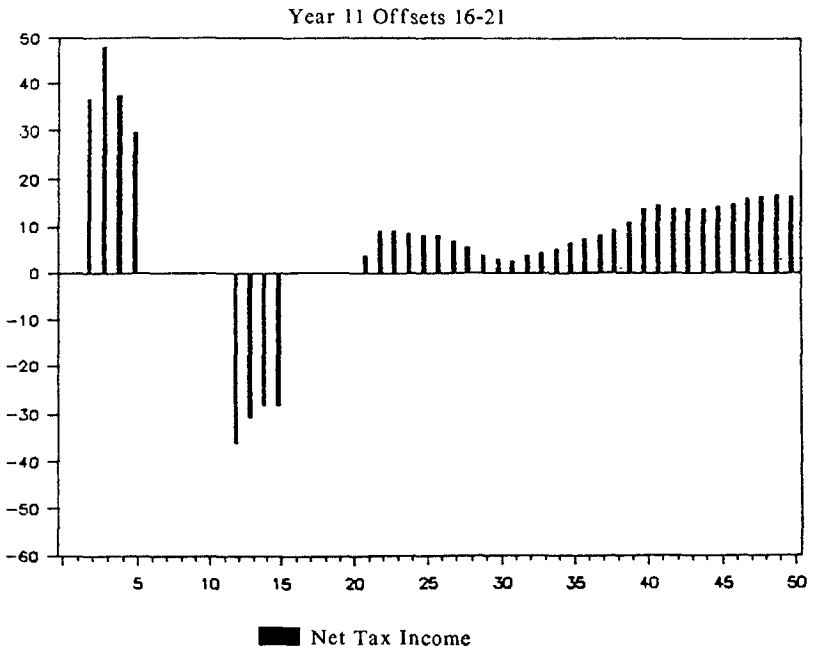
GRAPH 5

Back Load Universal Life



FAS 96
GRAPH 6

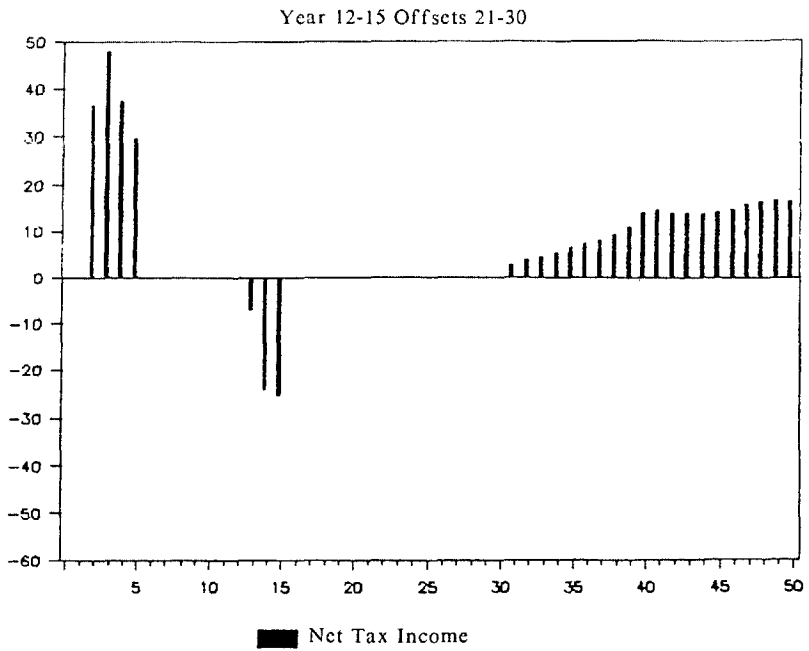
Back Load Universal Life



PANEL DISCUSSION

GRAPH 7

Back Load Universal Life



FAS 96

Graph 8 illustrates a deferred annuity plan showing the same type of problem, for the same reason. The plan is back loaded and tax reserves equal the cash value. Excess reserve is again equal to the surrender charge, and as these are graded off in policy years 1 through 6, net deductible reversals are created in years 4 through 6.

Graph 9 isolates the stream of net taxable temporary difference reversals.

Graph 10 presents the end result after allowable carrybacks and carryforwards. We are left with one year of sizeable net deductible reversals such that the effective tax rate appears to be 55%, rather than the desired 34%. Again, this is just one year of issues captured at the end of the first policy year, so eventually a better pattern would develop if sales continue.

A front loaded UL contract is on Graph 11, with DAC, excess reserves, and net temporary differences projected from the end of the first policy year. You can see that no net deductible reversals emerge.

For this product, the tax and GAAP reserves are equal to the cash value. Under FAS 97 we have the additional reserve for unearned revenue arising from the front end load, and this becomes an excess reserve when compared to the tax basis. However, the DAC contains a mirror image of the reserve for unearned revenue so long as capitalization exceeds the front end load. Because of this, DAC amortization will always exceed excess reserve releases. This product is well-behaved for deferred tax calculation purposes.

In the area of traditional products, I have seen only the following problem case -- a limited pay contract with substandard or guaranteed issue type mortality and sizeable profit margins, such as some pre-need funeral contracts. This case is illustrated on Graph 12.

Under FAS 97, the reserving treatment would probably go like this: 1) benefit reserves according to FAS 60, 2) DAC amortized per FAS 60 over the premium period, and 3) the additional reserve for unearned revenue would be established so as to cause profit to emerge as a level amount per thousand in-force.

If the mortality basis is high enough, and the profit margins are large, the combined GAAP reserve may exceed the tax reserve at the end of the premium period -- when DAC is fully amortized.

This is the worst case scenario under FAS 96 in that a sizeable excess reserve remains after DAC is gone.

On Graph 13, you see the long tail of net deductible reversals, of which only a very few can be carried back. In this case the effective tax rate appears to be 102%. The deferred tax liability actually exceeds the net temporary difference at the valuation date due to loss of most excess reserve credit.

In the case of my company, despite big problems with back loaded UL and deferred annuities, it appears that consolidation offsets afforded by our parent will just about cover us. I hope that the same proves true for you, and that our talk will help warn you of the hurdles that may appear in your path.

MR. ROBBINS: What options does a company have with respect to taking capital gains and losses as a tax planning strategy?

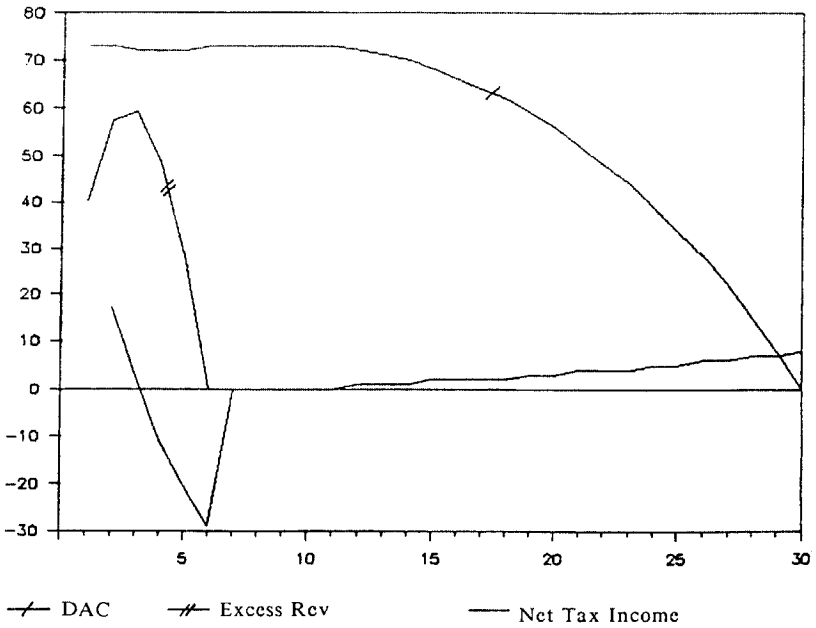
MR. AUER: The options are probably unlimited, as long as the strategy meets the FASB requirements. For example, if there is a capital loss that is expiring, any appreciation in the portfolio that would spawn a taxable amount should be taken, provided it does not involve an inordinate cost. Paying a brokerage fee to sell a stock should not be a problem.

MR. ROBBINS: What items cause the most difficulty in trying to put together a tax-basis balance sheet?

MR. AUER: A prime example is Ginnie Maes. It may be difficult to determine the tax basis on any single one of those issues, and approximation methods may have to be used.

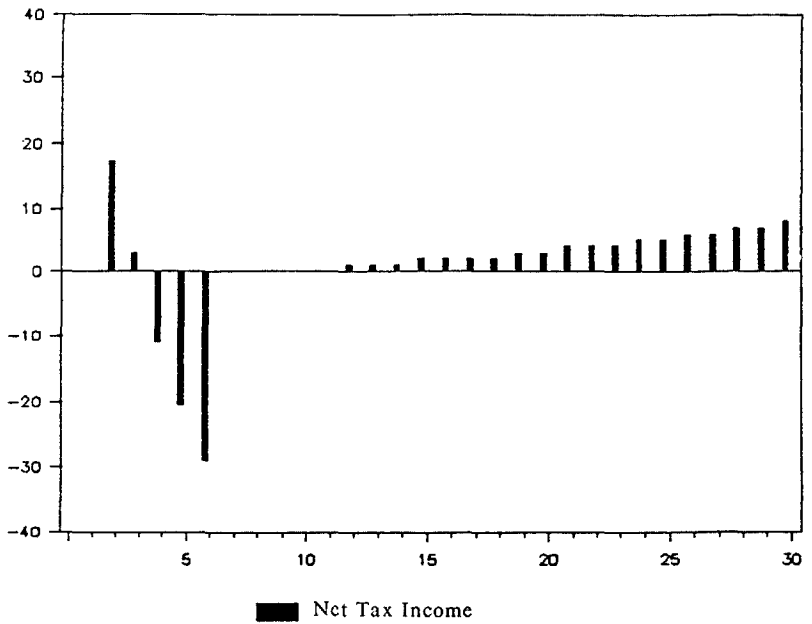
PANEL DISCUSSION
 GRAPH 8

Deferred Annuity



FAS 96
GRAPH 9

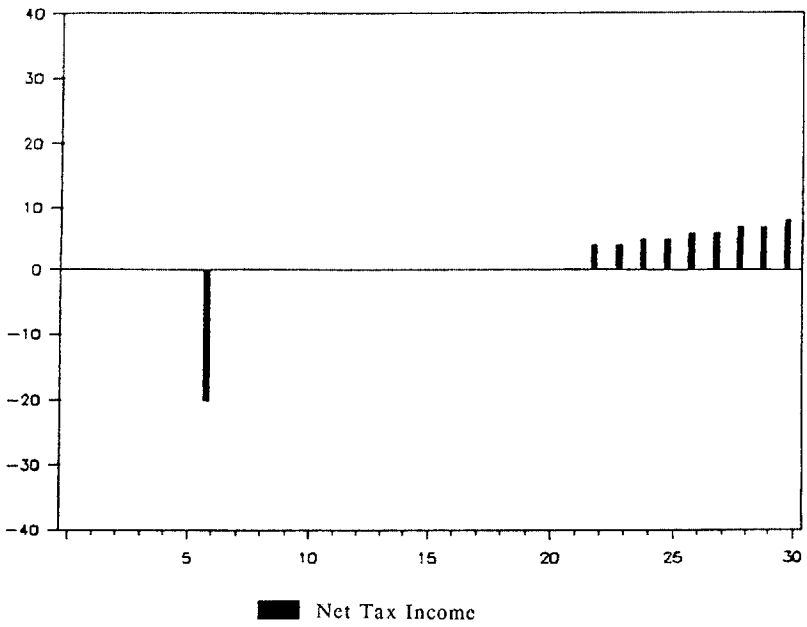
Deferred Annuity



PANEL DISCUSSION

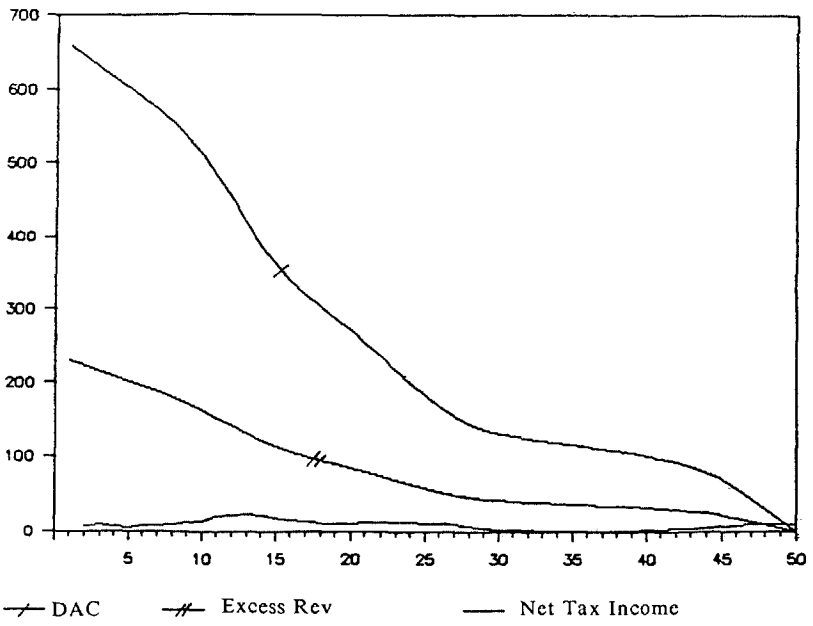
GRAPH 10

Deferred Annuity



FAS 96
GRAPH 11

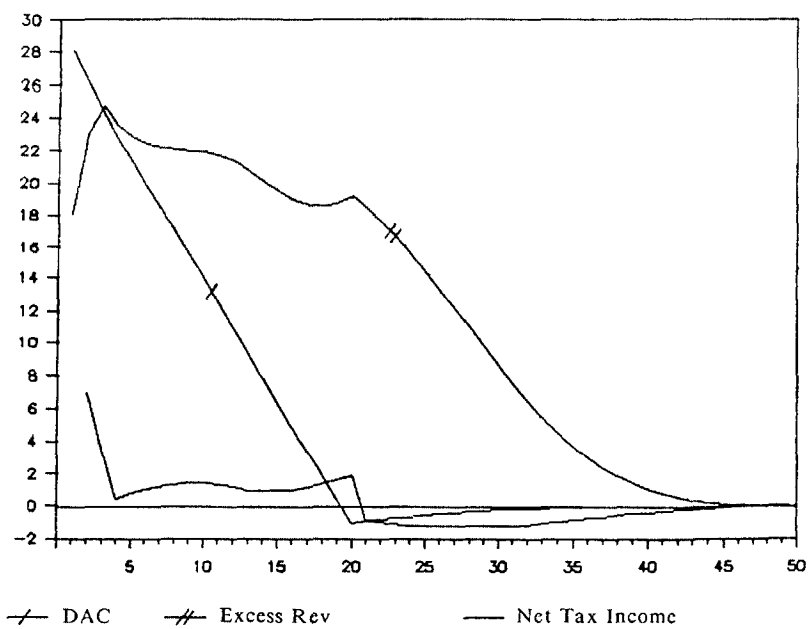
Front Load Universal Life



PANEL DISCUSSION

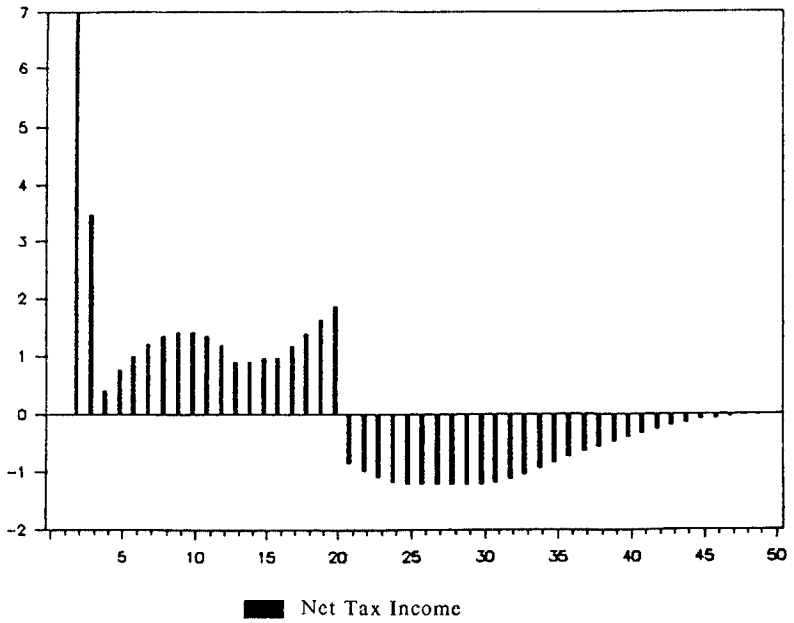
GRAPH 12

Limited Pay Life



FAS 96
GRAPH 13

Limited Pay Life



PANEL DISCUSSION

Another problem is acquisitions. The records needed to determine the tax basis of the assets acquired may just not exist. There is no good way to come up with the numbers.

MR. ROBBINS: In modeling FAS 96, how far out must the projections be carried?

MR. HAWKE: Theoretically, you should carry them out to the end of the benefit period. I am not sure if there are options as to when to cut off the projections. You should discuss that with your auditors.

MR. ROBBINS: I think that actuaries must take the projections out farther than they have done in traditional projections, partly because of the lack of interest discounting. A reversal is just as important thirty years from now as it is currently. Therefore, your horizons must be somewhat longer for this work.

MR. HAWKE: If a company did not have problems with its products, it seems that it would only need to project until its other temporary differences reverse. For example, if the only items beyond a certain point were DAC and excess reserves, and you could establish that those items would result in future taxable amounts, you could cut the projection off then.

MR. WILLIAM A. KLING: I have two questions. The first one deals with open tax issues. Suppose that a company is in appellate on some major issue that affects taxable income for a prior year. Also suppose that the company is unsure of whether it will win the case, and what the effect on taxable income will be. Does FAS 96 provide any guidance on what to assume? The second question deals with the conditions that must exist in order to use the simplified approach. Is there a source for that information, or is this merely common knowledge?

MR. ROBBINS: I will answer the second question. If you merely sum up the future reversals, that is what it becomes.

MR. AUER: There is no particular guidance on simplification. The FASB staff meets weekly to discuss FAS 96, and last month it issued an implementation booklet. I do not think that we will see any major changes to FAS 96. FASB may address the shortcut method, because many people are asking about it. The obvious shortcut application occurs if there would only be future taxable amounts. However, if there is any chance that there could be a deductible amount anywhere, the shortcut method will not work.

With respect to the first question, the only advice I can give is to project what you think the outcome is going to be, and use that as a best guess.

MR. PAUL A. HEKMAN: You said that the projections should not include future new business. What about projection of premiums on existing business? Does it make a difference if the premiums are fixed or flexible?

MR. ROBBINS: FAS 96 does not refer to that specifically, but looking at the history of the interpretations, I believe that the DAC and the benefit reserves must depend on "best estimate" assumptions of cash flows. Everything that I have read indicates that you must assume a reasonable pattern of future cash flows.

In a related item, a while ago there was a statement that increases in DAC would not be permitted. That was a tentative position that was eventually revoked.

MR. KERMIT L. COX: In regard to projections of health insurance, what are company practices with respect to claims incurred after the valuation date, but related to the closed block of business?

MR. ROBBINS: I do not believe that such claims can be taken into consideration.

MR. AUER: You must assume that whatever claims are on the books are correct. You cannot assume that the company will pay out more in claims than what is on the books.

MR. ROBBINS: My opinion is that you cannot assume future incurred claims by setting them up in claim reserves.