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A CONVERSATION ABOUT IFRS

By Christian DesRochers, Peter H. Winslow and Craig Pichette

Editor's Note: *On June 30, 2010, the International Accounting Standards Board (IASB) released an Exposure Draft proposing a comprehensive accounting standard titled "Insurance Contracts." On Feb. 9, 2011, the Financial Accounting Standards Board (FASB) voted to work with the IASB to develop a single converged accounting standard for insurance contracts.*

This issue of TAXING TIMES *contains two articles related to the developing international accounting rules. In "IASB Exposure Draft on Insurance Contracts," Frederic Gelfond and Yvonne Fujimoto provide an overview of the Exposure Draft. The related article, "A Conversation about IFRS," provides a discussion of the potential tax policy implications of the emerging accounting standards.*

The Exposure Draft, which applies to all insurance contracts, identifies two models for the measurement of insurance liabilities: (1) an unearned premium approach for short duration (one-year) contracts and (2) a current fulfillment value approach for all other insurance contracts. The proposed measurement model uses four "building blocks" to measure an insurance liability:

- *Current estimates of future cash flows—probability weighted amounts the insurer expects to collect from premiums and pay out for claims, benefits and expenses, estimated using up-to-date information.*

- *Time value of money—an adjustment that uses an interest rate to convert future cash flows into current amounts.*

- *Risk adjustment—an assessment of the uncertainty about the amount of future cash flows.*

- *Residual margin—contract profit (reported over the life of the contract). The residual margin is an amount that eliminates the recognition of a gain at the inception of a contract (i.e., the present value of future cash inflows is greater than the present value of future outflows, including the risk adjustment). A loss at issue would be immediately recognized under the proposed model.*

After observing that, while many nonlife insurance contracts provide only insurance coverage, others "blend together several types of cash flows arising from various components that would, if issued as free-standing contracts, be subject to a variety of accounting treatments,"[1] the Exposure Draft proposes to unbundle certain elements of the contracts. In the Exposure Draft, unbundling refers to the bifurcation of a contract into components, separating insurance elements from investment elements.

On Sept. 1, 2010, FASB issued a discussion paper on valuation of insurance contracts and proposed a building block approach similar to the IASB Exposure Draft, but with a composite margin instead of the risk adjustment plus residual margin. The NAIC has appointed a Commissioner-level group to consider the future direction of statutory accounting in the context of changing GAAP and international accounting standards.

The IFRS Exposure Draft prompted over 200 comments. Major issues raised in these comments included:

- *Treatment of short-duration contracts,*
- *Residual versus composite margin and remeasurement of residual margin,*
- *Volatility in profits or loss, and*
- *Unbundling.*

Many of these key issues have potential income tax implications.

While the basis for tax reporting in the United States continues to follow statutory accounting, the new international accounting standards are likely to have significant implications for all insurers in the foreseeable future, which include tax. Prior issues of TAXING TIMES *have featured interdisciplinary dialogues on selected tax issues related to the change in statutory reserves to a principle-based approach. In this issue, we turn to the topic of fundamental accounting changes proposed under international financial reporting standards (IFRS). To think about some potential tax policy issues relative to IFRS, I have invited two experts in the field, Peter Winslow*

of Scribner, Hall & Thompson, LLP and Craig Pichette of KPMG, to join me in what I hope will be a thought-provoking discussion of the issues. The opinions expressed in this dialogue are solely those of the participants.

ACCOUNTANT, ACTUARY AND ATTORNEY DIALOGUE: A CONVERSATION ABOUT IFRS

Chris: The current life insurance tax model, which has been in place since 1984, can be characterized as a modified income model, which is based on statutory annual statement accounting modified for tax, including adjustments for tax reserves and deferred acquisition costs (DAC). However, in the past, different approaches have been used to tax life insurers, including the so-called three-phase system under the 1959 Act, and the free investment income tax base under the 1921 Revenue Act.

Most observers in both industry and government would generally agree that the 1984 Act has worked well over time. However, the increasing sophistication of insurance products, as well as the developments in both statutory, U.S. GAAP and IFRS accounting, have made it more difficult to reconcile various systems of book and tax accounting. For example, a key difference in the Exposure Draft method from the current tax system is that premiums are revenue for tax, which necessitates a reserve deduction, while the Exposure Draft method can be characterized as a "margins" approach to income. This leads to the question of whether the current modified statutory income approach is becoming obsolete and inevitably must be replaced, much the same way as the 1959 Act finally gave way to the 1984 Act. Peter, what do you think?

Peter: There are many pressures that already are testing the limits of the 1984 Act, including innovation in product development and the trend toward principle-based reserves (PBR). Up to this point, the 1984 Act has stood up relatively well to the challenges of product development; much better, in fact, than the 1959 Act did. This is because the drafters of the 1984 Act had the wisdom to foresee that new products would be developed and changes in reserve standards could occur. The 1984 Act drafters created dynamic tax reserve rules that adjust automatically when the NAIC or 26 states adopt new reserving standards. What the 1984 Act drafters did not foresee was that life insurance accounting standards could change more radically from a deterministic reserving regime to a principle-based approach.

Chris, getting back to your question, I would say that, if the NAIC were to adopt some version of the proposed IFRS Exposure Draft, almost certainly changes to the 1984 Act would be necessary. Although in theory the current Internal Revenue Code ("Code") provisions could continue to operate, the uncertainty in how they would apply precisely to particular products seemingly would be too great for the Internal Revenue Service (IRS) and industry to tolerate, and a tax law change would likely be inevitable. The more difficult question is whether the 1984 Act would have to change if the NAIC declines to adopt IFRS, and retains some version of the current statutory income approach—say principle-based reserves with a net premium reserve floor. In such a situation, the 1984 Act could continue to operate. The question then becomes: would the adoption of IFRS by the SEC create so much political pressure that an overhaul of the 1984 Act would be triggered? Any thoughts on this more difficult question, Craig?

Craig: I agree that adoption by the NAIC of an accounting model or reserve methodology as radically different from the current statutory and tax accounting model as the Exposure Draft may necessitate a legislative change. This is just a guess, but I do not believe that adoption of an accounting model like that in the IFRS or GAAP Exposure and Discussion Drafts would necessarily trigger tax legislation. We already have a tax accounting model based upon statutory accounting that recognizes income independently relative to the GAAP accounting model. The congressional reaction to these differences between statutory accounting and GAAP has basically been to put in place piecemeal solutions like DAC capitalization under section 848 rather than attempt to replace the entire accounting paradigm. I am inclined to think that this practice will continue absent a dramatic change in statutory accounting.

I think the real question may be what adoption of this accounting guidance indicates about the nature of the industry and its products. For instance, unbundling, which I am sure we will talk about later, is potentially a radical departure from the current statutory and tax accounting models. The question of how to unbundle, what, if anything, the results of unbundling will demonstrate, and how this will be interpreted by the various stakeholders in the tax system are all factors that could affect the potential for legislative action. At this point we do not know what, if anything, unbundling will demonstrate.

Peter: What do you think a legislative change triggered by the new accounting rules would look like?

CONTINUED ON **PAGE 28**

Craig: I see a problem: if you want to replace the current tax system for insurance, particularly life insurance, what do you replace it with? The current reserve alternatives, such as those in the Exposure Draft or principle-based reserves, may be problematic from a policy perspective. One of the fundamentals of our tax system is supposed to be the concept of "fairness," which is generally interpreted to mean that similarly situated taxpayers pay the same amount of tax. This objective is fairly easy to meet in the current tax system which prescribes, in great detail, virtually all of the assumptions, methods, etc. that are to be used in calculating income. While not everything is prescribed, the range of potential outcomes possible between taxpayers issuing similar life insurance contracts, for instance, is generally relatively narrow. The alternatives such as PBR or the model in the Exposure Draft have much greater degrees of judgment allowed and required, whether it be in choosing mortality assumptions, discount rates, policyholder behavior assumptions, or any number of other things. The result is a much greater range of potential outcomes and a system that is much more difficult for the tax authorities to manage and administer. It would seem to me that policymakers may have a choice between the current tax system, or something very much like it, and a set of alternatives that they may find unpalatable because it will be too difficult for them to regulate.

Lastly, the available alternatives also seem to produce more volatility than the current system which produces a relatively steady stream of income over time, primarily due to using dynamic assumptions. It is not clear to me why tax policymakers would prefer an accounting model that produces greater volatility and less predictability.

Peter: Your point on volatility is a good one and is a major concern of the non-tax commentators on the Exposure Draft. I assume that volatility in financial results would make it more difficult to price products. But, I am not so sure whether it would make matters better or worse if financial accounting has the volatility you are concerned with. At least for now, the tax regime generally remains on a deterministic basis.

I agree with you that the IRS and Congress have expressed concerns that similarly situated insurance companies should be taxed in the same manner when issuing similar products. But, that principle should not mean necessarily that their deductible tax reserves should be the same. It seems to me that allowing different reserve amounts based on actual experience is no different than two service providers that have different profit margins because of their different levels of expenses. No one would suggest that these service providers should accrue the same amount of expenses for tax purposes just because they are competitors that offer the same product. A level playing field is better maintained by attempting to bring taxable income more closely aligned with economic income for all companies, regardless of whether that principle yields different reserve amounts for similar products.

Chris: The Exposure Draft methodology uses "up-to-date" assumptions in computing insurance liabilities. This approach can be characterized as an "active" or "dynamic" valuation methodology, unlike the current tax model, which is a "passive" or "static" approach in which valuation assumptions do not generally change over the life of a policy once they are set. Current reserve methodologies, including principle-based reserves, are moving toward dynamic valuation approaches in which assumptions are changed periodically, often annually, to reflect changing market conditions. Even a deterministic system, which is based on a single assumption set, will result in increased volatility under a dynamic reserve system, as the effect of a change in assumptions is fully reflected in the year in which the change is made. However, the price of limiting volatility in a static system is that the valuation basis is always likely to be more or less obsolete, so increased volatility may simply be the reflection of the change in the underlying value of the liabilities. However, whether that is desirable for determining taxable income is a matter of opinion.

I would like to turn the conversation to the "margins" approach of the Exposure Draft and its possible application to the determination of taxable income. By its very nature, insurance is different from most commercial transactions because the income (premiums) is received before the service (claims) is rendered. As a consequence, any financial accounting system for insurance, whether statutory, GAAP or tax, must make an allowance for future claims and expenses beyond simply measuring current cash flows. For short duration contracts, this may be as simple as an unearned premium reserve, which recognizes net income over the policy duration. For longer duration contracts, this is the role of reserves. However, once a reserve system is introduced, the annual emergence of income under an insurance contract will be influenced by the reserves. This has always been a dilemma for taxing insurance companies. As I mentioned in the introduction, various systems have been used over time, based on some combination of actuarial

science, tax theory and projected tax revenue, not always in that order. However, fundamental to all approaches is the recognition that an allowance is needed so that increases in reserves, or investment income on reserves under an investment income-based tax, should be excluded from the tax base in determining the taxable income of a life insurance company.

In theory, the recognition of reserves can either be explicit, by recognizing premiums as income and allowing a deduction for reserves, or implicitly, through a "margins" approach similar to the classical three-factor dividend formula. The Exposure Draft approach, as well as the current FASB Draft, uses a sophisticated "margins-based" approach for the income statement. Under this method, premiums and claims are treated as balance sheet deposits received and repaid, and thus, do not appear on the income statement. Could a "margins-based" approach to taxable income, similar to the direction of IFRS, be workable for taxing life insurance companies?

Peter: I believe that the margins-based approach of IFRS brings into focus the tax policy considerations relating to the level of reserves that should be allowed in an appropriate income tax regime for life insurance companies.

In the 1959 Act, life insurance company taxable income, and its tax reserves component, generally were determined based on statutory income. Under this taxable income model the level of tax reserves was based on distributable statutory earnings. The concept is that life insurers should not be required to pay tax on profits unless and until they can distribute those profits to their owners. While this concept has not been accepted generally for other types of taxpayers, it could be considered appropriate for life insurers because they are required to hold surplus for the protection of policyholders. The argument is that, because of the social utility of life insurance, surplus should not have to be built-up with after-tax earnings until those earnings are available for distribution to shareholders.

In the 1984 Act (as amended in the 1987 Act), Congress departed from the distributable-statutory-earnings model, and attempted to measure tax reserves as the economic present value of future benefits (less the present value of future premiums). The 1984 Act, as amended, does this in a very crude way. Section 807(d) of the Code requires the reserve discount rate to be determined by a federally prescribed rate which is intended to result in a more realistic present value of future benefits. The 1984 Act does not eliminate all the conservatism in statutory reserves, however, to the extent that standard mortality tables and other statutory reserve assumptions include an implicit margin for adverse claim experience.

By making the margin in reserves explicit, IFRS highlights the fact that tax reserves under current law include elements of conservatism, and this may cause tax policymakers to consider whether the current law should be amended to limit the deduction to a more economic level of tax reserves. I expect that some tax professionals, even in the industry, would view "economic" tax reserves without a margin as the proper approach to achieve matching of premium income and reserve deductions because, in concept, both sides of the premium/claims equation essentially would be computed on a "fair market value" basis. But, I believe that this view is wrong. What this tax reserve model ignores is that the gross premium charged is not only based on the expected value of the liabilities, but includes a charge for assuming the risk of possible adverse experience. To the extent claims emerge as expected, the risk charge becomes the insurer's profit. Consequently, the effect of adopting the economic reserve (without margin) model for tax reserves would be that the insurer's entire anticipated profit for its long-term commitment would be included in taxable income up-front when the premium is received, rather than spread over the period the risk is extant and the premium is earned.

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It has been argued that insurance is no different from the situation where prepaid fees for services are required to be included in income before the services are performed and the fees are earned. But, insurance is different from products offered by other industries for two reasons. First, unlike the typical prepaid fees for services situation, an insurer's prepaid "income" is received long before the "services" are performed. Second, unlike the case of prepaid fees for services, an insurer's "services" are to pay cash in the form of claims. As a result, premiums have more characteristics of a deposit than prepaid service income in other types of businesses.

Chris: Funny that you should say that. In fact, a well-regarded insurance textbook from the 1930s, Maclean's *Life Insurance*,

CONTINUED ON **PAGE 30**

contains a statement echoing yours that "premiums received by life insurance companies are not income in the same sense as the income of an ordinary commercial corporation, but rather are deposits creating a liability and are comparable, for this purpose, to deposits in a bank." I could make an argument that a margin-based approach is conceptually a variation of the "excess interest" tax base used for insurance companies from 1921 to 1959. During this period the life insurance industry was taxed on its investment income "margin." That is, net investment income less required interest on reserves, *i.e.,* the interest "margin." I am not suggesting that Congress readopt the Revenue Act of 1921, but it does illustrate that there is a long-standing precedent in the field of life insurance taxation relative to a tax based on margins. However, at the time, it was characterized by E.E. Rhodes, as "a true income tax upon the only real source of income which life insurance companies have."[2] Rhodes also commented that, "While premiums paid under a contract are consideration for the contract, it does not follow that such premiums constitute income."[3] Given the precedent for a tax system for insurance companies where income is determined based on the emergence of margins, how would you define the taxable income of an insurer under an IFRS-based system?

Peter: I think a better approach than the present-value-of-benefits model for reserves is a tax system that attempts to spread the insurer's risk charge over the period to which the risk relates so that income is clearly reflected annually over the time the premium is earned. This is the basic approach of the IFRS Exposure Draft relating to accounting for insurance contracts. For this reason, I think that the IFRS proposal actually is a useful tool to support the basic argument that margin in reserves is necessary to clearly reflect income. An earlier IFRS proposal sought to measure the risk charge by a "current exit value" whereby the margin in reserves would be measured by the amount a third party would pay to assume the liabilities. The current Exposure Draft shifts the focus to the insurer and measures the margin by the amount the insurer would be willing to pay to have someone assume the liability. To the extent a gross premium is charged in excess of this basic margin, the Exposure Draft would require a residual margin to be amortized. FASB's Discussion Draft does the same thing in concept but combines the margin into a composite amount. The measure of the liability is dynamic in that it is adjusted periodically to reflect current experience. Thus, if claims experience is favorable, the margin is adjusted prospectively so that more profit is reported and conversely annual losses or smaller profits would emerge if claims experience is greater than expected.

In my view, this is a better answer from a tax policy standpoint because it results in a matching of premium income with claims and expenses, and profits and losses emerge as they are earned. The key difference in this approach from the present-value-of-benefits model for reserves is that it focuses on how much premium should be currently recognized in income, with the reserve acting as a deferral mechanism for appropriate annual income recognition. The approach does not focus exclusively on reserves purely as a measure of the expected liability.

Chris: One interesting aspect of the IFRS Exposure Draft is that it does not make distinctions about the type of insurance business, except for adjustments made for certain short-duration contracts. Typically, life insurance and property-casualty insurers have used different statutory, GAAP and tax accounting methods. However, the Exposure Draft does not differentiate by the type of business, so the principles outlined apply equally to both life insurance and property/casualty contracts, leading to the convergence of GAAP accounting methods. Peter, do you think this convergence could have tax policy implications?

Peter: I do. The IFRS Exposure Draft raises the question whether there is any good reason to retain current tax law's distinction between life and nonlife insurance companies. Historically, life and nonlife insurance companies have received different tax treatment based on their company-wide status. If more than half of the reserves of an insurance company are life insurance reserves as specially defined in section 816(b), the company is taxed as a life insurance company. This different treatment based on the status of the company generally follows the NAIC's approach to filing Annual Statements where the status of the company dictates the color of the financial statement that is filed. In the 1984 and 1986 Tax Acts many of the distinctions between life and nonlife companies were eliminated, particularly with respect to life insurance reserves. But, many differences still remain. The most important of these are probably the proration rules for tax-exempt income and the dividends-received deduction and limitations on consolidation and the use of nonlife losses. There are many other distinctions too.

The IFRS Exposure Draft generally applies the same rules for reserves regardless of the type of insurance company. There are special rules for short duration contracts (which many commentators believe should be expanded significantly), but essentially the same reserve standards apply across the board.

If the NAIC were to adopt some version of IFRS, presumably there no longer would be a need to have different types of Annual Statements. In that event, I think a reevaluation of current tax law with a view to eliminating the remaining differences between life and nonlife insurance companies would likely occur.

One way to look at IFRS is that the proposed reserve methodology is similar to how claim reserves are currently determined for many property/casualty lines of business with an explicit margin rather than an implicit margin built into the claim projection factors. That is, claim reserve estimates, as typically determined now, are periodically updated based on the most current information available with a margin added for moderately adverse conditions so that the reserves are "good and sufficient" for the actuarial certification. So, adoption of IFRS may not be a radical change for some property/casualty companies.

Chris: As used in the Exposure Draft, the term "unbundling" refers to the bifurcation of a contract into two components, one that is accounted for as an insurance contract under the "building block" approach and another that is accounted for as a financial instrument. The Exposure Draft requires unbundling of a component which is not "closely related" to the insurance coverage. While the term "closely related" is not explicitly defined in the Exposure Draft, examples of components that should be unbundled include: (1) an investment component reflecting an account balance that is credited with an explicit return where the credited rate is based on the performance of a specified pool of assets and all investment performance is passed to the policyholder; (2) embedded derivatives that would be separated from their host contract under IAS 39; and (3) goods and services not closely related to the insurance coverage. One argument for unbundling is that it maintains consistency between the deposit component of an insurance contract and a separate but otherwise identical financial instrument that is not a part of an insurance contract. However, the ACLI has pointed out, "unbundling of components would misrepresent the nature of the business and add undue complexity."[4] From a tax perspective, does unbundling complicate or simplify the reporting of income for life insurers?

Craig: Unbundling introduces a tremendous degree of complexity. Unbundling as defined in the Exposure Draft requires a company to determine which components are closely related to the insurance coverage. Then a company would have to separately report the pieces of the contract associated with each component.

From a tax policy standpoint, unbundling has many of the same issues that the Exposure Draft has generally. There is a tremendous degree of judgment that must be exercised in assessing what components are to be unbundled and what assets and liabilities and items of income and expense are associated with each component. One would expect that companies will reach different conclusions about unbundling. For instance, many of the comments on the Exposure Draft indicate that its examples of situations where unbundling is required actually are situations where the components are closely related. Thus, there is confusion and disagreement around this most fundamental point. While the users of financial statements may be able to evaluate a company's positions relating to unbundling and evaluate those decisions, I am concerned with how useful and administrable unbundling would be from a tax perspective. At least today the tax authorities are not equipped with the actuarial resources necessary to evaluate the decisions companies would make in this area. Even assuming that the taxing authorities did have the resources necessary, I would question whether a statute could be drafted that would allow taxpayers, the tax authorities and the courts to assess and determine when unbundling is correct with the degree of precision our tax system seems to require.

Chris: Another practical concern with unbundling is the characterization of the unbundled components of the contract. Under section 7702, the term "life insurance contract" means any contract which is a life insurance contract under the applicable law. The legislative history for section 7702 excludes from life insurance treatment "an insurance arrangement written as a combination of term insurance with an annuity contract or with a premium deposit fund," on the basis that "all elements of the contract are not treated under State law as providing a single integrated death benefit." Thus, tax law looks to the state law characterization of

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CONTINUED ON **PAGE 32**

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a contract as "a single, integrated life insurance contract" to determine the tax treatment.[5] If components of a contract are separated for accounting treatment, it could create some uncertainty related to the policyholder tax treatment, particularly if IFRS principles were extended to NAIC statutory accounting. However, as a practical matter, it may not be all that easy to separate the revenue and cost associated with the contract components.

I would like to bring the discussion to a close by thanking Peter and Craig for their thought-provoking comments. As Peter observed, the 1984 Act has held up well, but is increasingly under pressure to accommodate new product designs and the accompanying reserve requirements. Craig pointed out that this trend could continue as products evolve in response to the new accounting requirements. At the same time, a critical issue that must be confronted in any discussion on replacing the 1984 Act is what to replace it with. Peter suggested that a "margins" approach similar to that described in the Exposure Draft could be one way to proceed, through the development of a system in which taxable income follows the release of margins, recognizing revenue as the insurer performs under the contract. However, any change to a more dynamic valuation system would lead to increased volatility of income, as well as a lack of uniformity among taxpayers, neither of which is desirable in a tax accounting method. Unbundling may also have implications, but seems to need additional guidance to be performed consistently, which may also create issues in adapting IFRS to tax.

While our discussion may not have provided many answers, we hope that it added some insight to the potential tax consequences of the adoption of IFRS.

END NOTES

1 IASB, Basis for Conclusions Exposure Draft, Insurance Contracts, July 2010, 10.
2 Proceedings, 14th Annual Meeting of Life Insurance Presidents, New York, Dec. 9–10, 1920.
3 *Rhodes, EE "Income Taxes* Imposed upon Life Insurance Companies by the Revenue Act of 1921," *TASA*, XXIII (1922), 19.
4 Nov. 30, 2010 letter re; Insurance Contracts Exposure Draft, 13.
5 Staff of the Jt. Comm. on Tax'n, 98th Cong., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, 646–647 (Comm. Print 1984).