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SSAP 10R—ADMITTANCE OF DEFERRED INCOME TAXES MODIFIED IN 2009

By Thomas Barber and Kelly Brucato

On Dec. 7, 2009, a revised version of the admitted deferred tax asset ("DTA") guidance emerged when, after careful consideration and much debate, the National Association of Insurance Commissioners ("NAIC") passed Statement of Statutory Accounting Principles No. 10R, *Income Taxes - Revised, A Temporary Replacement of SSAP No. 10* ("SSAP 10R") in a 33-22 vote.

SSAP 10R supersedes Statement of Statutory Accounting Principles No. 10, *Income Taxes* ("SSAP 10") and the new provisions set forth in this accounting principle are effective for year-end 2009 statutory financial statements. If elected, they provide, where appropriate, the ability to admit additional DTAs by increasing the projected realization period from one to three years along with increasing the statutory surplus limitation from 10 percent to 15 percent, provided the entity exceeds certain risk based capital ("RBC") thresholds. SSAP 10R also makes explicit and gives definition to the implicit valuation allowance of SSAP 10,[1] and increases transparency through its expanded disclosure requirements for all entities (regardless of whether electing the expanded recognition provisions).

HISTORICAL BACKGROUND: STATUTORY DEFERRED INCOME TAX

Statutory deferred income tax accounting has been around for a relatively short period of time compared to generally accepted accounting principles ("GAAP"). Effective Jan. 1, 2001, statutory deferred income taxes were introduced with the adoption of SSAP 10.[2] In contrast, the deferred income tax concept for GAAP accounting was first introduced in 1967 and has gone through a number of changes over the years to get to the current rules within Accounting Standards Codification ("ASC") topic 740, "*Income Taxes*" (ASC 740).[3]

In general, SSAP 10 follows the main principles of FAS 109 regarding the measurement of deferred income taxes. Generally, DTAs and deferred tax liabilities ("DTLs") are the result of a difference between the tax basis of an asset or a liability and its corresponding basis in the statement of financial position if that difference will result in taxable or deductible amounts in some future year(s). However, differences between SSAP 10 and FAS 109 exist. One major difference is the methodology of determining the amount of the DTAs that will be recognized. FAS 109 requires a valuation allowance for reducing gross DTAs if it is *more likely than not* that some or all of the DTAs will not be realized in the future, which is determined through a qualitative review. On the other hand, SSAP 10 primarily employs an admitted asset test for restricting gross DTAs, which is mechanical in nature.

The SSAP 10 admittance test attempts to follow the general rules within statutory accounting principles, whereby assets are not admitted on the balance sheet if they have "economic value other than those which can be used to fulfill policyholder obligations, or those assets which are unavailable due to encumbrances or other third party interests should not be recognized on the balance sheet…".[4] However, under SSAP 10, DTAs are generally subject to a double restriction on admissibility; a one-year reversal test while also being subject to a possible limitation based upon 10 percent of statutory surplus. While the replacement of the FAS 109 valuation allowance concept with the realization criteria employed in the DTA admittance tests is intended to ensure that an entity's surplus is conservatively measured,[5] many professionals feel that the rules for recognizing gross DTAs under SSAP 10 are overly conservative.

SSAP 10R—IN GENERAL

SSAP 10R, as passed by the NAIC, makes a number of significant changes to the provisions for deferred income taxes. Among the changes is an explicit valuation allowance concept, consistent with FAS 109, to be applied to gross DTAs before the admitted asset test is applied, and an election to expand the admitted asset test if certain RBC thresholds are met. In addition, the provisions include additional emphasis on the character of income (ordinary vs. capital) both as to admittance and in the disclosure. The new provisions of SSAP 10R became effective as of Dec. 31, 2009. Any change in admitted DTAs due to the new provisions of SSAP 10R is considered a change in accounting principle effective Dec. 31, 2009.

SSAP 10R is a temporary replacement of SSAP 10 as SSAP 10R expires after 2010. If no additional guidance is adopted by the end of 2010, SSAP 10 will be reinstated effective Jan. 1, 2011. The NAIC's Statutory Accounting Principles Working Group ("SAPWG") announced, in the spring of 2010, the formation of the DTA Subgroup whose goal it is to have a long-term solution on the accounting for deferred income taxes and admissibility for the first quarter of 2011 since SSAP 10R sunsets at the end of 2010.

VALUATION ALLOWANCE CONCEPT

One of the changes included in SSAP 10R is the addition of an explicit valuation allowance concept. This provision requires a reduction of an entity's gross DTAs if it is *more likely than not* (greater than 50 percent chance) that some portion (or all) of the gross DTAs will not be realized (the reduced amount is a new term referred to as the "adjusted gross deferred tax asset"). The statutory valuation allowance is determined in accordance with FAS 109, paragraphs 20-25 and will have to be evaluated on a company-by-company basis. Future realization of the tax benefit depends on the existence of sufficient taxable income, of the appropriate character (ordinary income vs. capital gain), within the applicable tax law carry-forward period.[6]

There are additional factors to consider in determining whether a statutory valuation allowance is needed, including tax planning strategies; the expected emergence of future earnings; and other various future events. SSAP 10R also requires that both negative and positive evidence be considered in determining whether a valuation allowance is needed; similar to FAS 109. Once a valuation allowance methodology is developed, the methodology needs to be applied on a consistent basis.

EXPANDED ADMITTANCE TEST

The "adjusted gross DTA" is used as the starting point for the admissibility test under SSAP 10R. Thus, instead of using the total gross DTAs, the admissibility test under SSAP 10R paragraphs 10a, 10b and 10c and new paragraph 10e is applied against the "adjusted gross DTA." New paragraph 10e expands the realization period over which DTAs are projected to be realized to better match the IRS loss carry-back rules; not exceeding three years. The expanded rules are elective, and only apply to companies who are subject to the RBC rules or who are required to file an RBC report with their state of domicile.[7] A company may use the expanded admittance rules only if their RBC level, determined after computing the admitted DTA's under paragraph 10a through 10c, is above the maximum RBC level where an action level could occur (250 percent for life and fraternal entities; 300 percent for property/casualty ("P&C") entities and health entities), or, for companies subject to a RBC trend test, where the RBC level exceeds the RBC trend test. As a result, this election could produce potential volatility in results and may reduce comparability within the industry. Accordingly, the additional DTA admitted as a result of this election will be reflected separately in the financial statement (*see* below).

Admittance Test under SSAP 10

By way of background, the admitted asset test under SSAP 10 determines the admissible DTA as the sum of items identified in paragraphs 10a-c:

10a) Federal income taxes paid in prior years that can be recovered through loss carrybacks for existing temporary differences that reverse by the end of the subsequent calendar year (one year reversal).

10b) The lesser of:

i) The amount of remaining adjusted gross DTAs, after the 10a test., expected to be realized within one year of the balance sheet date (one year reversal) or

ii) Ten percent of adjusted statutory capital [as adjusted – *e.g.,* removing DTAs, goodwill] and surplus as required to be shown on the statutory balance sheet of the reporting entity for its most recently filed statement (annual or quarterly);

10c) The amount of remaining adjusted gross DTAs, after the 10a and 10b tests that can be offset against existing gross DTLs.

If elected, the expansion under 10e allows for additional admissibility of DTAs by:

10e.i) Increasing the ability to admit DTAs by means of a deemed loss carryback of reversing temporary differences from one year (paragraph 10a) to the number of years the IRS permits a carryback, not to exceed three years. Thus life insurers can uti-

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lize a three-year reversal timeframe while nonlife insurers are limited to a two year-reversal period. Note that any potential future increases in loss carrybacks similar to the recent special five-year carryback provisions, would only benefit nonlife insurers.

10e.ii(a) Extending the reversal of temporary difference period from one year (paragraph 10.b.i) to three years in the future realization test, and

10e.ii(b) Increasing the surplus limitation from 10 percent (paragraph 10.b.ii) to 15 percent.

The admitted DTA calculated under the new 10e test (after taking into account the valuation allowance) is then compared with the aggregate admitted DTAs allowed under revised paragraphs 10a, 10b and 10c (after taking into account the valuation allowance). Any excess of 10e over the sum of revised paragraphs 10a through 10c admitted DTAs is reported separately on the face of the statutory financial statement as follows:

1. *Aggregate write-ins for gains and losses in surplus* in the change in Capital and Surplus Account (beginning in 2010), and
2. *Aggregate write-in for special surplus funds* on the Balance Sheet

For life companies, there is also a 5 percent RBC charge on the additional admitted DTA permitted by SSAP 10R under paragraph 10.e. These reporting changes were adopted as a temporary measure for year-end 2009 only.

The calculation of the expanded admitted DTA under new paragraph 10e is detailed and creates significant additional reporting requirements. In addition, the extension of the reversal patterns to three years also expands the need to develop consistent forecasts of taxable income for three years. If a company qualifies and elects to utilize the additional admittance available under 10e, the RBC calculation will, for the first time, require auditor review.

RISK BASED CAPITAL

At the request of the SAPWG, the NAIC's Capital Adequacy Task Force reviewed whether a RBC charge for any additional admittance of deferred taxes under SSAP 10R was appropriate. Two proposals were drafted and adopted during the Dec. 17, 2009 conference call of the Capital Adequacy Task Force: 1) an additional DTA sensitivity test and 2) a DTA charge to life companies RBC. The NAIC's proposed sensitivity test calculation removes the impact of the expanded admitted DTA from the RBC calculation in determining whether an insurance company has met the 300 percent P&C and 250 percent life RBC ratio in SSAP 10R. [Further, the NAIC has proposed that for life insurance companies, the admitted DTA will have a 1 percent RBC charge. Currently, the P&C RBC formula contains a 5 percent charge [before covariance – more like 1 percent], which at this point would also apply to the expanded admitted DTA. For life companies, there is also a 5 percent RBC charge on the additional admitted DTA permitted by SSAP 10R under paragraph 10.e. These reporting changes were adopted as a temporary measure for year-end 2009 only.

CONSIDERATION OF CHARACTER: ORDINARY VS. CAPITAL

The new provisions under SSAP 10R reinforce that the income character of DTAs and DTLs (*i.e.,* ordinary vs. capital) must be considered when applying the admissibility test of SSAP 10R. SSAP 10R, paragraphs 10.c and 10e.iii states that offsetting adjusted gross DTAs with existing gross DTLs will be permitted only to the extent that "offsetting would be permitted in the tax return under existing enacted federal income tax laws and regulations." While the character of income items was already a factor required to be considered for admitting DTAs under SSAP 10 (*see* SSAP 10 Q&As 4.4 and 4.7), the new provisions emphasize this point. This character emphasis also pertains to the additional disclosure requirements (discussed below).

CHANGE IN ACCOUNTING PRINCIPLE

Revisions to the admitted DTA as a result of implementation of SSAP 10R are considered a change in accounting principle effective Dec. 31, 2009. Given that SSAP 10R is effective as of Dec. 31, 2009 any company admitting any additional DTAs as a result will have to perform both the SSAP 10 and the SSAP 10R admissibility tests to determine the amount to be reported as a change in accounting principle. This amount is reflected in the statutory annual statement in changes in Capital and Surplus Account in the line *Cumulative effect of changes in accounting principles*.

ADDITIONAL/EXPANDED FOOTNOTE DISCLOSURES

Paragraphs 17, 18 and 20 of SSAP 10R identify new and expanded items of disclosure. The total of gross, adjusted gross, admitted and nonadmitted DTAs and DTLs are required to be disclosed and reported by their tax character (ordinary vs. capital). In addition, the results obtained under each step of the SSAP 10R admissibility test (*i.e.,* the results of paragraph 10a through 10e) are required to be disclosed, by tax character, including the RBC level used in paragraph 10d, if elected. Additional disclosure is also required if the company has elected to admit additional DTAs pursuant to new paragraph 10e and whether the current-period election differs from the prior reporting period. Furthermore, SSAP 10R requires new disclosures on an entity's valuation allowance. These should follow the GAAP prescribed disclosure format for valuation allowances and include the valuation allowance balance; the net change during the year in the total valuation allowance; and adjustments to the beginning-of-the-year valuation allowance because of a change in circumstances that causes a change in judgment about the realizability of the related DTA in future years.

CONCLUSION

SSAP 10R was issued with provisions intended to more appropriately and consistently recognize DTAs for eligible companies, currently restrained by the mechanical limitations of SSAP 10, which "better depicts the true economic condition of the insurer in the statutory financial statements."[8] In its evolution, safeguards were built in to SSAP 10R's RBC threshold that must be satisfied for a company to be eligible for the additional admittance. The American Council of Life Insurers' Chief Actuary Paul Graham, stated that "With this improvement, insurers can have greater access to capital and credit, which is essential to serving current and future policyholders. Just as consumers must demonstrate strong financials to qualify for a loan, life insurers must demonstrate strong financials in order to have access to capital and credit from financial markets,"[9]

Although SSAP 10R is effective as of Dec. 31, 2009, it sunsets after Dec. 31, 2010. As a result, this subject will continue to be under review during 2010, as regulators work on a long-term solution. The SAPWG issued a data call in May 2010 (responses were due June 2010) which requested insurance companies provide their 2008 and 2009 year-end deferred tax data. An interim meeting of the SAPWG was held on July 27, 2010 which discussed the results of the data call, discussed DTA's and the SAPWG received a technical education session from the industry, the American Institute of CPAs and the American Academy of Actuaries. The education sessions covered DTA's and reversals, Accounting and Audits of Deferred Taxes and Deferred Taxes in RBC formulas. There was a low response to the data call and the responses contained numerous errors. The information obtained from this data call and points discussed in the meeting will be utilized by the SAPWG to help determine the appropriate statutory accounting admission guidance for deferred tax assets. The SAPWG plans to expose a recommendation based on its findings and have it voted on in August. If the recommendation is passed it will be subject to a vote in October by the Financial Condition (E) Committee and the Executive Committee as well as the Plenary. While SSAP 10R is a step in the right direction, it is hoped that during 2010 the ongoing review by the SAPWG will give rise to a practical solution for determining the level of admitted DTAs that even more accurately reflects their value.

Authors' Note *— Following the submission of this article, at the NAIC National Summer Meeting, the SAPWG met on August 14, 2010. At this meeting, the SAPWG DTA subgroup exposed a one-year extension of the Dec. 31, 2010 sunset provision in SSAP 10R and additional disclosures on tax planning strategies for a two week comment period ending Aug. 27, 2010.*

END NOTES

1. SSAP 10 Q&A 4.10 does contain an implicit valuation allowance whereby gross DTAs will be reduced if it is more likely than not that the future benefit will not be realized. The SSAP 10 Q&A is not included in SSAP 10R. SSAP 10 continues to provide this Q&A, however, the Q&A does not incorporate the SSAP 10R revisions.
2. Prior to 2001 only current income tax was accounted for under statutory accounting rules.
3. Formerly known as Statement of Financial Accounting Standards No. 109 ("FAS 109"). For purposes of this article, ASC 740 will be referred to as FAS 109.
4. Statement of Statutory Accounting Principles No. 4, "*Assets and Nonadmitted Assets,*" paragraph 3.
5. Statutory Issue Paper No. 83, "*Accounting for Income Taxes,*" paragraph 25.d.
6. The statutory valuation allowance is used strictly to calculate the "adjusted gross deferred tax asset" and is not reflected as a separate reserve within the statutory financial statements.
7. Companies such as title and mortgage insurance and financial guaranty companies, who are not subject to RBC rules, cannot utilize the expanded admittance rules under 10e.
8. NAIC News release, "*NAIC Adopts Accounting Change,*" Dec. 7, 2009.
9. BestWire news release, *NAIC Accounting Changes to Save Life Insurers $11 Billion,*" Dec. 8, 2009.

Thomas Barber is a managing director, Insurance Tax Services with LECG and may be reached at *tbarber@lecg.com.*

Kelly Brucato is a senior manager, Insurance Tax Services with LECG and may be reached at *kbrucato@lecg.com.*