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# NAIC ADOPTS SSAP NO. 101—INCOME TAXES

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The National Association of Insurance Commissioners ("NAIC") Statutory Accounting Principles Working Group ("SAPWG") issued a revised exposure draft of Statement of Statutory Accounting Principles ("SSAP") No. 101 on July 27, 2011. The revised exposure draft passed the SAPWG by a vote of 10 to 2 and subsequently passed the Financial Condition E Committee with only one "No" vote. SSAP No. 101 is the new standard which replaces the current temporary guidance set forth under SSAP No. 10R, which expires on Dec. 31, 2011.

Statutory accounting for income taxes has been the subject of considerable debate since the financial crisis began in 2008. Prior to the financial crisis, SSAP No. 10, the original codified SSAP standard for accounting for income taxes, remained relatively unchanged from its adoption in 2001. However, beginning in 2008, various states granted insurance companies permitted practices in determining the amount of deferred tax assets ("DTAs") they would be allowed to admit on their statutory annual statements. These practices generally allowed for greater admitted DTAs to be recorded on statutory annual statements than the initially allowed practices under SSAP No. 10.

Due to the increasing use and variety of permitted practices being applied under SSAP No. 10, and to address the apparent needs that resulted in such variation, the regulators proposed a temporary standard of accounting for income taxes under SSAP No. 10R. In particular, the accounting standard under SSAP No. 10R offered companies the ability to make an accounting election to increase the DTA realization or reversal period to three years, with a 15 percent capital and surplus limit. This reflected a change from the original SSAP No. 10 principles, which required a one-year DTA realization period, with a 10 percent capital and surplus limit.

The election was only available to property and casualty, health, and life insurance companies that met certain risk-based capital thresholds. Neither mortgage guarantee nor title insurance companies were eligible for the election under SSAP No. 10R as they are not subject to a risk-based capital threshold. The election was originally effective for 2009 and 2010 and was subsequently extended through December 2011.

While SSAP No. 101 maintains some of the changes found in SSAP 10R, including the possibility of a three-year DTA reversal period and a 15 percent surplus limit, it includes significant changes in statutory reporting for income taxes. Among the more noteworthy changes proposed in SSAP No. 101 are its provisions relating to tax contingency reserves, DTA admissibility and required disclosures. Some highlights of these changes are summarized below.

## TAX CONTINGENCY RESERVES

Companies that are required to prepare financial statements under generally accepted accounting principles, or GAAP, are required to satisfy certain criteria in order to record the tax benefits, or the amount of tax benefits, associated with "uncertain tax positions." The rules, formerly known as Financial Interpretation No. 48, are contained in Accounting Standards Codification ("ASC") No. 740. Although SSAP No. 101 does not formally adopt the GAAP principles under ASC No. 740, it has significantly reduced the threshold for which recording a tax contingency reserve may be required.

More precisely, SSAP No. 101 replaces the standard set forth under SSAP No. 5, which required tax contingencies to be recorded using a *probable* and *reasonably estimated* criteria, with the standard under SSAP No. 5R, which requires tax contingencies to be recorded using a *more-likely-than-not* and *reasonably estimated* criteria.

In measuring the amount of the contingency reserve, the company must utilize management's best estimate. If the estimated tax loss contingency is greater than 50 percent of the original benefit recorded, a contingency reserve must be recorded in an amount equal to the full benefit recorded by the entity. Moreover, in conducting an analysis with respect to a given tax position, it must be presumed that the tax position will be examined by the taxing authority, and that the taxing authority will have full knowledge of the relevant facts.

Finally, tax contingency reserves related to timing items are not required to be "grossed up" unless an event has occurred that has given rise to a potential adjustment being issued by the taxing authority.

As a result of the reduced threshold and other changes relating to tax contingency reserves, insurance companies may need to reevaluate their tax positions to determine if SSAP No. 101 would require any adjustments to be made with respect to their current tax positions.

## DEFERRED TAX ASSET ADMISSIBILITY

The DTA admissibility test under SSAP No. 101 is an area that garnered much public discussion. The impact of the changes noted below may require companies to examine their current accounting procedures to determine if any of the changes may impact the company's processes that are currently in place. These changes include:

- Repeal of the elective admissibility relief under SSAP No. 10R, which allowed a three-year reversal pattern of DTAs and a 15 percent surplus limitation if certain risk-based capital criteria were met. This repeal was replaced with a mandatory graduated admissibility calculation, as discussed below.

- Repeal of the requirement that the additional surplus resulting from the SSAP No. 10R election be held as appropriated surplus, not eligible for declaring dividends in certain states.

- Requirement that a statutory valuation allowance reduce gross assets recorded in the company's annual statement rather than being treated as a non-admitted asset.

- Formal adoption of the use of tax planning strategies in the determination of statutory valuation allowances and admissibility of DTAs consistent with ASC 740. This adoption helps bridge the gap between principles explicitly noted in ASC 740 and SSAP No. 101. Specifically, these principles include a requirement that tax planning strategies utilized must be prudent and feasible.

The DTA admissibility calculation under SSAP No. 101 is similar in principle and mechanics to the earlier tests under SSAP No. 10 and 10R. SSAP No. 101 takes a three-step approach, similar to the approach SSAP 10 paragraph 10(a), (b) and (c) outlines. SSAP No. 101, however, attempts to provide a greater admitted DTA for sufficiently capitalized entities, while addressing solvency concerns the SAPWG sought to deal with in SSAP No. 10R.

The three-step admissibility test allows an entity to admit DTAs that can be realized through recouping prior taxes paid, reducing future taxes expected to be paid, or offsetting future taxable income recorded as a deferred tax liability ("DTL"). These three steps are discussed in further detail below.

**Step 1**

Step 1 sets forth the test for admitting DTAs that can be carried back to taxes paid in prior years, similar to SSAP No. 10 paragraph 10(a). Due to the different carryback rules for certain entities and DTAs, there are a few items to take into consideration when admitting DTAs under Step 1. For example:

- The test requires consideration of a maximum three-year reversal pattern of DTAs.
- A DTA is admissible only to the extent taxes can be recovered in a time frame consistent with Internal Revenue Code carryback provisions. This will require entities to take into consideration the character of the DTAs reversing (ordinary vs. capital) as well as the carryback period allowed under the tax law.
- Consideration of a risk-based capital limitation is not needed
- Taxes deemed to be paid under step one of the admissibility test should include tax contingency accruals along with income taxes paid in prior year determinations.

**Step 2**

Step 2 of the admissibility test is also similar to SSAP No. 10 paragraph 10(b). Step 2 allows for the admissibility of reversing DTAs not admitted under Step 1, but only to the extent such amounts can be realized in future years and do not exceed a surplus limitation percentage. The surplus limitation percentage and the years in which DTAs may be realized are regulated by a solvency ratio developed by the SAPWG.

The solvency ratio is based on the entity's Authorized Control Level ("ACL") risk-based capital ("RBC") percentage, excluding any DTAs. This ratio is referred to as the "ExDTA ACL RBC" ratio in SSAP No. 101. The result is then mea-

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sured against the industry table set forth below. Admissibility limits are either zero years and 0 percent of adjusted surplus, one year and 10 percent of adjusted surplus, or three years and 15 percent of adjusted surplus.

Realization Threshold Limitation Table—RBC Reporting Entities

| ExDTA ACL RBC | Realized Years | Surplus Limitation |
|---|---|---|
| Greater than 300% | 3 years | 15% |
| 200% – 300% | 1 year | 10% |
| Less than 200% | 0 years | 0% |

Unlike SSAP No. 10R, financial/mortgage guaranty entities and other non-RBC reporting entities (e.g., title insurance entities) may be allowed an additional admitted DTA to the extent certain capital metrics are met. Additional realization threshold tables are noted under SSAP No. 101 for these entities. For financial/mortgage guaranty entities, the ratio of surplus (excluding DTAs) over policyholder and contingency reserves is used to calculate the admissibility limits. Other non-RBC reporting entities use the ratio of adjusted gross DTA (after valuation allowances) over capital and surplus as the metric for admissibility limits. Each type of entity is similarly allowed a three-year/15 percent, one-year/10 percent or 0-year/0 percent admissibility under Step 2, as follows:

Realization Threshold Limitation Table—Financial Guaranty or Mortgage Guaranty Non-RBC Reporting Entities

| ExDTA Surplus/Policyholders and Contingency Reserves (%) | Realized Years | Surplus Limitation |
|---|---|---|
| Greater than 115% | 3 years | 15% |
| 100% – 115% | 1 year | 10% |
| Less than 100% | 0 years | 0% |

Realization Threshold Limitation Table—Other Non-RBC Reporting Entities (Predominantly Title Insurance)

| Adjusted Gross DTA/Adjusted Capital & Surplus (%) | Realized Years | Surplus Limitation |
|---|---|---|
| 0 – 50% | 3 years | 15% |
| 51% – 75% | 1 year | 10% |
| Greater than 75% | 0 years | 0% |

**Step 3**

Step 3 of the SSAP 101 test allows for the admissibility of any remaining DTAs to the extent DTLs are available to offset the DTA. This is similar to SSAP No. 10R paragraph (c).

This step requires consideration of the character of the DTAs and DTLs. In this regard, it is consistent with tax law, which, for example, does not allow ordinary DTLs to offset capital DTAs.

SSAP 101 also provides that a reporting entity shall consider the reversal pattern of temporary differences. This consideration only requires a scheduling exercise if scheduling is needed for valuation allowance purposes and, as a result, should be consistent with the mechanics for determining any statutory valuation allowance which occurs prior to performing the admissibility test.

## DISCLOSURES

Unlike what occurred with respect to the adoption of SSAP No. 10R, SSAP No. 101 does not include significant changes to the income tax footnote disclosures. The regulators determined to keep the enhanced disclosure under SSAP No. 10R, with only a few additional disclosures being required.

Under SSAP No. 101, companies will now be required to disclose whether any benefits being recognized as a result of tax planning strategies are related to reinsurance transactions. This disclosure is in addition to the current tax planning disclosure required under SSAP 10R.

In addition, a new disclosure will be required that identifies any tax contingency reserve with respect to which it is deemed

to be reasonably possible that the total liability will significantly increase within 12 months of the reporting period. The reporting entity will need to disclose an estimate of the range or a statement that a range cannot be made.

## CONCLUSION

SSAP No. 101 has many characteristics of the prior accounting principles for income taxes for insurance companies. However, there are many intricacies and steps that will need to be considered.

So, although the issuance of SSAP No. 101 ends a period of uncertainty relating to statutory accounting for income taxes, there is still uncertainty as to how SSAP No. 101 will affect each entity's specific fact pattern. To assist in the transition to the new standard, the NAIC has indicated a revised SSAP No. 10 Questions and Answers will be updated for the new SSAP No. 101 guidance. It is also anticipated that the NAIC will draft an Issue Paper discussing the rationale and bases for its conclusions under SSAP No. 101.

Nevertheless, financial reporting departments will need to be cognizant of the potential changes as they begin their financial reporting and internal control processes for 2012.



END NOTES

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