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IN THE BEGINNING…
TAX ACCOUNTING FOR INSURANCE COMPANIES

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One of the key tasks insurance company tax departments have in carrying out their financial reporting obligations is managing the interplay of financial statement, or "book," accounting and tax accounting. An insurance company may have multiple reporting obligations, requiring different accounting rules depending upon the type of organization it is—e.g., a stock versus a mutual insurance company—and the intended recipient of the financial report—e.g., a shareholder or a state regulator. This piece discusses, among other things, the major reporting systems insurance companies are required to apply, the interplay between tax and book accounting, and a few of the more common differences among these accounting systems.

INSURANCE ACCOUNTING METHODS

The primary financial statement prepared by domestic insurance companies is intended for state insurance regulators. These regulators require insurance companies to prepare financial statements (referred to as the "annual statement" or "statutory annual statement" or "blank" or "statutory blank") under Statutory Accounting Principles (SAP). The filing submitted under SAP is prepared according to the guidelines of the National Association of Insurance Commissioners (the NAIC), the source of SAP. The type of statement any particular insurance company is required to file is based on industry segment.[1] These statements are highly structured, and all companies within a segment are required to follow the prescribed structure for that segment.

In addition to the required statutory annual statement, an insurance company that is publicly held will be required to prepare financial statements under Generally Accepted Accounting Principles (GAAP) for purposes of reporting to investors and shareholders. These companies will typically also utilize GAAP for purposes of internal reporting. While mutual insurance companies are not required to file GAAP statements, some mutual companies similarly prepare GAAP financials for internal reporting purposes.

If an insurance company is part of an international group headquartered outside of the United States, it may also be required to prepare financial statements in accordance with International Financial Reporting Standards (IFRS). SAP, GAAP, and IFRS financial statements and their methods represent the non-tax financial position or "books" of the company and are referred to as "book accounting" methods.

Insurance companies subject to tax in the United States are also required to report the results of their operations to the Internal Revenue Service (IRS). For this purpose, insurance companies are generally required to start with the same method of accounting for tax purposes as they use for statutory accounting purposes. Insurance companies must then make adjustments to account for differences in measurement and treatment of income and expense, or assets and liabilities, between the statutory accounting and federal income tax paradigms.

Typically, these differences are a matter of timing, i.e., when, or how quickly an item is recognized for SAP purposes relative to how it must be recognized for tax purposes. For example, SAP and the Internal Revenue Code (IRC) provide different rules with respect to the period of time over which some assets may be depreciated. The full cost of the asset will eventually be recognized under both methods, but the period of time over which the cost is recovered will differ under each method. This type of difference in timing would be characterized as a temporary difference.

It is also possible that an item may be recognized for book purposes, but never recognized for tax purposes. One example would be tax-exempt interest. This type of difference is referred to as a permanent difference.

STATUTORY ACCOUNTING VS. TAX ACCOUNTING

SAP focuses on the balance sheet, rather than the income statement, and emphasizes insurers' solvency and liquidity. SAP is developed in accordance with the concepts of

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consistency, recognition and conservatism. Tax accounting is governed by the rules and principles expressed in the IRC, Treasury regulations, case law, and administrative releases. As stated above, tax accounting often does not agree with book accounting. For example, the "all-events" test provides that:

> When all the events have occurred that establish the right of an accrual basis taxpayer to receive a determined or determinable amount, that amount must be accrued or recognized at that time. Where the right to receive income exists currently, the amount can be determined with reasonable accuracy, and the right to receive it isn't subject to a substantial restriction, the "all events" test is met.[2]

Hence, although an item may be accrued for book purposes, the subject amount is not recognized for tax purposes until specified conditions are satisfied.

The differences between accounting methods create "book-to-tax adjustments." The adjustments can increase or decrease what started as SAP (book) income, and they may produce either a temporary or a permanent difference. Further, the adjustments may affect either the current tax year or a later year. Not surprisingly, an adjustment in the current tax year is called a current adjustment. A book-to-tax adjustment that will impact a subsequent tax period is called a deferred adjustment. The accumulation of deferred tax items are called deferred tax assets or deferred tax liabilities, depending upon the direction of the temporary difference.

The following paragraphs highlight some of the differences between tax and annual statement accounting. Please note that the examples have been simplified for illustration purposes and other tax adjustments may also apply.

EXAMPLES OF PERMANENT DIFFERENCES BETWEEN BOOK AND TAX

While there are many permanent differences between book and tax, the list below represents many of the more common differences encountered by insurance companies:

- Tax exempt interest
- Dividends received deduction
- Federal income tax paid
- Tax, criminal and other penalties
- Meals and entertainment
- Lobbying expenses

EXAMPLES OF TEMPORARY DIFFERENCES BETWEEN BOOK AND TAX

For annual statement purposes, insurance companies are required to accrue certain expenses and losses in years in which they may not qualify as income tax deductions, or to recognize certain income items at different times. These include but are not limited to:

- Advance premiums
- Deferred and uncollected premiums
- Agents' debit balances
- Impairment of assets
- Reserve strengthening or weakening
- Policy acquisition expenses

One of the temporary differences most familiar to actuaries is the calculation of reserves. Eventually, every reserve will revert to zero once the obligations under the contract have been fulfilled. By governing the level of the reserve over the life of the policy for their respective methods, book and tax accounting affect how quickly profits emerge under each paradigm.

The table on page 13 illustrates the effects of several common permanent and temporary differences in calculating the book and tax net income of a life insurance company.

CONCLUSION

This piece has merely highlighted the existence of several types of accounting regimes that insurance companies must manage and discussed some of the many differences that exist between SAP (book) and tax accounting methods. It is important to understand these differences for purposes of both determining the correct amounts to include on a tax return, as well as how (or if) they may be reflected on a financial statement, be it SAP, GAAP, or some other required accounting methodology. ◄

Note: The views expressed are those of the author and do not necessarily reflect the views of Ernst & Young LLP.

	Year 1		Year 2		Year 3	
	SAP	Tax	SAP	Tax	SAP	Tax
Base income common to both accounting methods	10,000	10,000	11,000	11,000	9,000	9,000
Permanent Items						
Tax-exempt interest	300	0	500	0	400	0
Dividends received	200	60	300	90	150	45
Meals and entertainment	(150)	(75)	(150)	(75)	(150)	(75)
Tax penalty	0	0	(75)	0	0	0
Income after Permanent Items	**10,350**	**9,985**	**11,575**	**11,015**	**9,400**	**8,970**
Temporary Items						
Policy issued Y1, lapsed Y3	(100)	(90)	10	8	90	82
Policy acquisition costs for policy issued Y1	(60)	(3)	0	(6)	0	(6)
Income after all items	**10,190**	**9,892**	**11,585**	**11,017**	**9,490**	**9,046**

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END NOTES

1 Different company lines are represented by different color covers on printed annual statements. Life insurance companies file a light blue covered statement and life insurance/annuity separate accounts separately file a green covered annual statement. Examples of other business line colors include: property casualty (yellow), title (salmon), health (orange) and fraternal benefit societies (white).

2 IRC §451, Treasury Regulation (Treas. Reg.) §1.451-1(a), IRC §461(h)(4) and Treas. Reg. §1.461-1(a)(2).