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RECENT DEVELOPMENTS IN STATUTORY DEFERRED TAX ACCOUNTING GUIDANCE FOR LIFE INSURERS

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The article “NAIC Adopts SSAP 101—Income Taxes” by Richard Burness and Steven Sutcliffe in the February 2012 edition of *TAXING TIMES* gave an excellent description of the basic components of SSAP 101. In this article we attempt to emphasize deferred tax issues that actuaries should find insightful. Since year-end 2009, statutory admitted deferred income tax assets have amounted to between 11 percent and 12 percent of statutory surplus industry-wide.¹ This demonstrates that deferred income taxes are an important component of statutory capital. An understanding of the corresponding statutory guidance and the impact of deferred taxes on surplus is important to actuaries charged with managing statutory capital, designing and evaluating insurance products, computing statutory and tax reserves, and performing actuarial projections.

The National Association of Insurance Commissioners [“NAIC”] recently adopted Statement of Statutory Accounting Principles [“SSAP”] No. 101 *Income Taxes a Replacement of SSAP No. 10R and SSAP No. 10*. SSAP 101 was initially exposed in the spring of 2011. Industry representatives had several meetings with the Statutory Accounting Principles Working Group through the summer of 2011. A revised version was re-exposed in August of 2011 and was adopted in the fall of 2011. SSAP 101 is effective on Jan. 1, 2012.

This article will provide a discussion of the theoretical basis of deferred income tax accounting (accounting for actuaries), an overview of the current statutory accounting rules governing income tax accounting under SSAP 101, and some examples of the effects of SSAP 101’s admissibility test on regulatory capital. The discussion will include the various deferred tax “corridors” in which a company can find itself, and the boundaries of those corridors.

INTRODUCTION AND BACKGROUND

The concept of deferred taxes has long been recognized as a necessary refinement to the financial balance sheet. Without

recognition of deferred taxes, there is no manifestation in the balance sheet of differences in the recognition of statutory and taxable income. Take for example a simplistic fact pattern as follows, for a policy issued at the end of year 1:

Premium income	\$120.00
Statutory policy reserve	100.00
Tax basis reserve	90.00

Without accounting for deferred income taxes, the company is relatively “inefficient,” with a higher effective tax rate than the marginal tax rate. To wit:

Item No.	Item	Amount	Comments
(1)	Statutory income	\$20.00	
(2)	Taxable income	30.00	
(3)	Tax (at 35%)	10.50	
(4)	Effective tax rate	52.50%	[(3)/(1)]

Assume that the policy terminates in year 2, before another premium is paid, with a net surrender value of \$85.00. The effective tax rate in year 2 is very low, offsetting the high effective tax rate in year 1:

Item No.	Item	Amount	Comments
(1)	Statutory income	\$15.00	Financial reserve released less surrender value paid
(2)	Taxable income	5.00	Tax reserve released minus surrender value paid
(3)	Tax (at 35%)	1.75	
(4)	Effective tax rate	11.67%	[(3)/(1)]

Full recognition of deferred taxes normalizes the tax rate over time. Thus, the impact of recognition of deferred income taxes (without regard to the statutory limitations described below) can be seen by adding the deferred tax asset [“DTA”], equal to

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35 percent of the \$10 difference between financial statement reserves and tax reserves, or \$3.50.

Now the result for year 1 is as follows:

Item No.	Item	Amount	Comments
(1)	Statutory income	\$20.00	
(2)	Current taxable income	30.00	
(3)	Current tax expense (@35%)	10.50	
(4)	Change in deferred tax	(3.50)	Establish DTA
(5)	Total tax expense	7.00	[(3) + (4)]
(6)	Effective tax rate	35.00%	[(5)/(1)]

The year 2 equivalent result would then appear as follows:

Item No.	Item	Amount	Comments
(1)	Statutory income	\$15.00	Financial reserve released less surrender value paid
(2)	Current taxable income	5.00	Tax reserve released minus surrender value paid
(3)	Current tax expense (@35%)	1.75	
(4)	Change in deferred tax	3.50	Release DTA
(5)	Total tax expense	5.25	[(3)+(4)]
(6)	Effective tax rate	35.00%	[(5)/(1)]

In such a situation, deferred taxes serve as the instrument that normalizes the tax expense over time by reflecting in the financial statements the current and future impacts of taxes resulting from current operations. The key concept in deferred taxes is that of a “temporary difference,” *i.e.*, the difference between the financial statement basis and the tax basis in an asset or liability that will reverse in the future. In the above example, at the end of year 1, the statutory basis in the policy reserve is \$100 while the tax basis in the reserve is \$90 due to different rules governing the computation of the required reserve. This difference will “reverse” over time (ultimately, the amount expensed in the financial statements and deducted for income tax purposes will be the amount paid the policyholder), and the difference is thus “temporary.” Conceptually,

deferred income tax accounting provides financial statement recognition of the future financial benefits or detriments associated with differences in timing in the recognition of income or expense between financial statements and tax returns.

Deferred tax accounting can become rather complex. The accounting models for income taxes adopted for most bases of accounting, *e.g.*, U.S. Generally Accepted Accounting Principles [“U.S. GAAP”] and International Financial Reporting Standards [“IFRS”] are what can be characterized as “full” deferred tax accounting models. That is, generally, all deferred tax assets and liabilities are recognized unless specifically excepted, with asset recognition limited in some cases in which it cannot be demonstrated that the asset will be recovered; what U.S. GAAP refers to as a “valuation allowance.” The statutory accounting rules also provide a valuation allowance and, as described below, further limit recognition of deferred taxes. The balance of this article will discuss these statutory accounting rules and their evolution over time. Also note that the change in deferred taxes is reflected in the income statement for U.S. GAAP and IFRS purposes. For statutory purposes, the change in deferred taxes is reflected directly in surplus.

In this article we will limit our discussion to those deferred tax assets and liabilities that emanate from single entity temporary differences. Deferred tax aspects of tax sharing agreements between legal entities, foreign taxes, the small life insurance company deduction, and tax credits, among other items, will not be discussed.

SSAP 101 GENERAL REQUIREMENTS

This Statement is effective on Jan. 1, 2012. In addition to guidance on current taxes (not the subject of this Article) it provides new guidance for admissibility of DTAs and DTLs and replaces SSAP 10 and SSAP 10R.

SSAP 101 retains, with modification, the basic three step admissibility criteria of SSAP 10R, renumbering them paragraphs 11 (a), (b) and (c):

- Paragraph 11(a) allows a DTA to be admitted to the extent that temporary differences that reverse within the IRS tax loss carryback provisions, not to exceed a three-year period, can be carried back to recover taxes paid in prior years.
- Paragraph 11(b) provides that a DTA can be admitted to the extent that temporary differences that reverse within

a three-year period can recover taxes to be paid within that period, after application of paragraph 11(a) and subject to certain RBC limits described below.

- Paragraph 11(c) provides that additional DTAs can be admitted to the extent that they can be offset against DTLs.

Significant changes from SSAP 10R include the following:

- The framework for which set of thresholds (percent of Adjusted Surplus and the length of the reversal period) to use for a legal entity changed from a legal entity election (subject to an adequate RBC ratio) in SSAP 10R, paragraph 10(b) to the following framework in SSAP 101, paragraph 11(b):²

ACLRBC ³ Ratio	Reversal Period	Percent of Adj. Surplus
Above 300%	3 years	15%
200% to 300%	1 year	10%
Under 200%	0 years	0%

- The surplus values for the “percent of surplus” threshold were changed from the immediate prior reported Adjusted Surplus to the current date Adjusted Surplus.
- The threshold for recognition of income tax contingencies was changed from “probable” to “more likely than not.”

Note that the admitted asset calculated under SSAP 101 paragraph 11(a) is not subject to the ACLRBC ratio.

Also, SSAP 101 adds numerous disclosure requirements to the deferred tax process. One element of disclosure concerns Tax Planning Strategies (SSAP 101, paragraphs 13 through 15). In particular, paragraph 22(f) requires disclosure for:

The impact of tax-planning strategies on the determination of adjusted gross DTAs and the determination of net admitted DTAs, by percentage and by tax character,⁴ and whether the tax-planning strategies include the use of reinsurance-related tax planning strategies.

ANALYSIS OF THE IMPACT OF CHANGES IN DEFERRED TAXES ON COMPANIES IN DIFFERENT DEFERRED TAX POSITIONS

A life insurance company’s deferred tax asset or liability position can have a significant impact on its tax planning. Below are various examples of how tax planning can impact both a company’s current tax position and its surplus. For simplicity,

assume that the character of DTAs and DTLs matches (such that there would be no issues with offsetting DTAs with DTLs due to character or other limitations), that the company has a sufficient ACLRBC ratio to use the three-year/15 percent limitation described above, and that there is sufficient tax paid within the carryback period or projected to be paid within the three-year reversal period to admit all temporary differences that reverse within the three-year period allowed under paragraphs 11(a) and (b).

Company A:

(a) Adjusted Gross DTAs	100
(b) DTAs Admitted through SSAP 101 parags. 11(a) and 11(b)	30
(c) DTLs	(50)
(d) Net Admitted DTA/(DTL) as reported	30
(e) Nonadmitted DTAs	20

Note that the nonadmitted DTA before application of the gross DTLs is equal to 70 (*i.e.*, 100-30). That number is greater than the gross DTL of 50, thus reducing the nonadmitted DTA from 70 to 20. Since that nonadmitted DTA is still a positive value, it does not affect line (b), and thus line (d) remains equal to line (b), at 30.

Company A represents the typical life insurance company. It has a net DTA of \$50 (*i.e.*, [(a) – (c)] before application of SSAP 101 admissibility criteria. Life insurance companies typically have DTAs because the tax law applicable to life insurance companies generally results in deferring deductions or accelerating income relative to statutory accounting. The principal examples of this are capitalization of policy acquisition expenses, limitations on deductions for life insurance reserves, and deferral of deductions for accrued expenses such as deferred compensation or pension obligations. However, DTLs can arise from unrealized gains and statutory accrual of bond discount, among other cases.

The company is able to admit \$30 of DTAs through paragraphs 11(a) and (b) and an additional \$50 under paragraph 11(c). The key component of the calculation is the amount of temporary differences that reverse within three years and may be admitted under paragraphs 11(a) and (b). A company in such a position generally has two alternative means of increasing surplus:

A life insurance company’s deferred tax asset or liability position can have a significant impact on its tax planning.

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1. Review the estimates of DTAs that reverse within three years and consider possible tax planning strategies related to this timing. For instance, while some DTA reversals, such as reversal of policy acquisition expenses capitalized under Internal Revenue Code section 848, are mechanical in nature, others involve estimates and judgments that can be refined as better or additional information becomes available. In addition, SSAP 101 allows for consideration of all tax planning strategies, and the use of those that are prudent and feasible to accelerate the reversal of temporary differences.
2. Generate DTLs. Certain transactions decrease current tax expense. The resulting increase in DTLs generally may be offset by unutilized DTAs for a net increase in surplus equal to the reduction in current tax expense. Put differently, in this example, a company could generate \$20 more DTLs (*i.e.*, [(a) – (b)–(c)]), and consequently \$20 less current tax expense, without any effect on its net admitted deferred taxes, resulting in \$20 additional surplus.

All such strategies would, of course, have to be evaluated in the context of the provisions of SSAP 101 addressing recognition of tax benefits.

Company B:

(a)	Adjusted Gross DTAs	50
(b)	DTAs Admitted through SSAP 101 parags. 11(a) and (b)	30
(c)	DTLs	(100)
(d)	Net Admitted DTA/(DTL), as reported	(50)
(e)	Nonadmitted DTAs	0

Note that the gross DTL overwhelms the 50 of DTA in line (a). Simply put, gross DTLs (100) minus gross DTAs (50) result in a 50 DTL as reported.

Company B is in the unusual position of having a net deferred tax liability, which might appear to be unfortunate. Remember, however, that DTLs are generally caused by reductions in current tax expense caused by the deferral of taxable income relative to statutory income. The DTL is simply providing for the reversal of the differences in the future on an undiscounted basis. In this case, increasing the amount of DTAs that reverse within three years and are admitted under paragraphs 11(a) and (b) simply reduces the amount offset against DTLs in paragraph 11(c) by a corresponding amount, with no net effect on surplus. For Company B, unlike Company A, transactions that would further increase DTLs

have no net effect on surplus because the decrease in current tax expense is offset by a reduction in surplus associated with the increase in the DTL. On the other hand, transactions that further increase DTAs reduce the net DTL and are offset by a current tax expense with no net effect on surplus up to, in this example, \$130 of Adjusted Gross DTA (*i.e.*, [(b) – (c)]) or \$80 of incremental DTA. Therefore, increases in DTAs by more than \$80 will have a detrimental effect on surplus unless they reverse within three years and are admitted under paragraphs 11(a) or (b).

This is illustrated by the following example:

Adjusted Gross DTAs	130
DTAs Admitted through SSAP 101 parags. 11(a) and (b)	30
DTLs	(100)
Net Admitted DTA/(DTL)	30
Nonadmitted DTAs	0

Note that surplus was increased by a deferred tax benefit of \$80 which is exactly offset by a current tax detriment of \$80. However, the \$80 constitutes a “limit” in this example. If Company B adds \$1 to that \$80 of incremental Adjusted Gross DTAs, and that \$1 does not add to the DTAs admitted through SSAP 101 parags. 11(a) and (b), then Company B would have \$131 Adjusted Gross DTA, the same \$30 of DTAs Admitted through SSAP 101 parags. 11(a) and (b), and a \$1 detriment to surplus considering the current tax expense and no offset in the deferred tax balance. Thus the neutrality “corridor” in this example extends only through the \$80 incremental DTA.

CONCLUSION

Actuaries involved in surplus management, modeling and projections, and pricing should understand the marginal effects on surplus of changes in current and deferred tax in order to properly measure and assess the surplus consequences of current management strategies and decisions and assess the potential impact of proposed changes of these strategies. ◀

END NOTES

- 1 American Academy of Actuaries, Deferred Tax Asset Bridge Group Report (Revised as of Dec. 13, 2010), p. 32.
- 2 Note that separate tables are provided for financial guarantee and mortgage insurers.
- 3 Authorized Control Level Risk Based Capital. The ratio equals “Total Adjusted Capital” divided by ACLRBC. Total Adjusted Capital excludes DTAs.
- 4 “Ordinary” versus “Capital.”