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In the Beginning… A Column Devoted to Tax Basics
Tax DAC

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In many accounting frameworks, insurance companies are required to capitalize policy acquisition costs rather than expensing them in the year they were incurred. This article will discuss the complexities of such a simple statement as well as highlight certain differences between tax and book treatment of that capitalization. Due to the deferral of the expense, the capitalized policy acquisition costs are often referred to as "deferred acquisition costs" or "DAC" for federal income tax purposes.

TAX GENERAL RULE

Internal Revenue Code[1] (the Code) Section 848 requires insurance companies to capitalize specified policy acquisition expenses and deduct them ratably over a 120 month period beginning with the first month of the second half of the tax year. This one sentence is pregnant with defined terms and the need for significantly more information.

TO WHAT SHOULD THE COMPANY APPLY THE DAC RULES?

Specified Policy Acquisition Expenses

The DAC rules use specified policy acquisition expenses as a proxy for the actual costs incurred. Specified policy acquisition expenses are defined as the amount of general deductions (for any taxable year) that do not exceed a percentage of net premiums on specified insurance contracts.

Specified Insurance Contract

Section 848(e)(1) provides both a definition of and exceptions to the term "specified insurance contract." The basic definition "…is any life insurance, annuity, or non-cancellable accident and health insurance contract (or any combination thereof)." This is further refined through a series of exceptions and definitions. Guaranteed renewable life, accident, and health insurance contracts are treated in the same manner as non-cancellable life, accident, and health insurance. The following contracts are excluded from the term "specified insurance contract:" any pension plan contract, flight insurance contract, qualified foreign contract [this is a defined item not included in this discussion], Archer MSA, and health savings account.[2]

HOW MUCH DOES THE COMPANY TREAT AS DAC?

Proper computation of DAC requires further clarification of three key items: (1) the definition of "general deductions," (2) the percentages used to limit the capitalization amount, and (3) the definition of "net premiums." General deductions are the itemized deductions and qualified deferred compensation.[3] The percentage used in calculating specified policy acquisition expenses varies by specified insurance contract type and is shown in Table 1. Net premiums will be discussed later in this article.

Table 1
DAC Percentage by Contract Type

Annuity Contracts	1.75% of net premiums
Group Life Insurance Contracts	2.05% of net premiums
Other Contracts Not Described Above	7.70% of net premiums

Example 1 visualizes the above. In this example Sample Insurance Company (SIC) underwrites a variety of policies. Table 2 provides the contract type, net premium amount, and capitalization percentage and amount.

Example 1.

Table 2

Contract Type	Net Premiums	Capitalization %	Capitalized Amount
Annuities	100,000	1.75%	1,750
Individual Life	200,000	7.70%	15,400
Group Life	150,000	2.05%	3,075
Non-cancellable A&H	50,000	7.70%	3,850
Total	500,000		24,075

Several types of contracts receive special treatment for purposes of selecting the appropriate DAC percentage. Each is described below.

- Reinsurance: treated in the same manner as the contract it reinsures.
- Group life contracts: the Treasury Regulations[4] provide a significant set of requirements to qualify for this lower percentage. The scope of these requirements is beyond the purview of this article.
- Annuity combined with non-cancellable accident and health insurance: treated entirely as a non-cancellable accident and health contract, subject to the 7.7 percent rate.
- Annuity or life combined with a qualified long-term care insurance contract: treated entirely as the "other contracts" classification, subject to the 7.7 percent rate.
- Other combination contracts: If the company separately states the premium for each type of coverage on its annual statement, then the premium allocable to each type of coverage is as if that portion of the contract were issued separately. If the premium is not separately stated, the entire premium is subject to the highest capitalization percentage of the coverage provided. A de minimis rule does apply, providing that if the premium attributable to one type of coverage is equal to or less than 2 percent of the entire contract premium, that type of coverage does not determine the capitalization percentage applicable to the contract as a whole.[5]
- New categories: Congress has reserved the right for the Secretary of Treasury to specify a new, separate category if certain conditions are met, but no such regulations have been issued.

Example 2.

In this example, SIC underwrote a few combination contracts. Contract 1 combines an annuity and long term care product. As discussed above, this leads to a costly result. Contract 2 combines a group life policy with a non-cancellable disability coverage. Contract 3 combines an annuity product with a cancellable accident product. Cancellable accident is not subject to DAC. In each case, the premiums for the different types of coverage are stated separately on SIC's annual statement. Table 3 provides the illustration.

Table 3

Policy Type	Net Premiums	Capitalization %	Capitalized Amount
Contract 1			
Annuity	250,000	7.70%	19,250
LTC Rider	150,000	7.70%	11,550
Total Contract 1	400,000		30,800
Policy Type	**Net Premiums**	**Capitalization %**	**Capitalized Amount**
Contract 2			
Group Life	200,000	2.05%	4,100
Non-Cancellable Disability	200,000	7.70%	15,400
Total Contract 2	400,000		19,500
Policy Type	**Net Premiums**	**Capitalization %**	**Capitalized Amount**
Contract 3			
Annuity	200,000	1.75%	3,500
Cancellable Accident	200,000	0.00%	0
Total Contract 3	400,000		3,500

Net Premiums

As noted above, DAC is determined in reference to net premiums. Net premiums are defined as the gross amount of premiums and other consideration on insurance and annuity contracts minus return premiums and reinsurance costs incurred on such contracts.

Gross premiums include the following items applicable to insurance and annuity contracts: advance premiums, deposits, fees, assessments, consideration in respect of assuming liabilities under contracts not issued by the taxpayer and the amount

of policyholder dividends reimbursable to the taxpayer by a reinsurer in respect of reinsured policies.

Several items are excluded from the definition of gross premiums:

- Deferred and uncollected premiums.
- Amounts that are effectively paid to the policyholder and immediately returned to the insurance company as a premium on the same contract, including items such as dividends and partial surrenders.
- Premiums waived as a result of the disability of an insured or the disability or death of a premium payor.
- Amounts treated as premiums when a policyholder or beneficiary selects a settlement option for receiving death benefits.
- Amounts received or accrued from a guaranty association relating to an insurance company that is subject to insolvency or similar proceedings.

Return premiums do not include the following:

- Policyholder dividends.
- Claims or benefits payments.

Also, amounts relating to reinsurance agreements are not included in gross premiums or return premiums but are instead included as part of "net consideration" for a reinsurance agreement, discussed next.

Reinsurance

The most important thing to remember about DAC for reinsurance agreements is that "net consideration" is a very broad term. Net considerations include reinsurance premiums, ceding commissions, and expense allowances, as you might naturally expect, but they also include items such as claim payments, experience rating adjustments, modified coinsurance reserve adjustments, and even loan transactions relating to funds-withheld reinsurance.

The ceding and assuming companies must treat amounts arising from reinsurance consistently in determining net premiums. For example, if the ceding company reflects –100 of net reinsurance considerations, the assuming company must reflect +100. This can involve significant coordination between the parties and typically involves making an election to ignore the "general deductions" limitation—that is, agreeing in the reinsurance treaty that both parties will capitalize based on the specified percentages even if that results in more expenses being capitalized in a year than were actually incurred.

There is a current industry discussion surrounding the capitalization of reinsurance ceding commissions. This discussion is beyond the purview of this article.

Unless an election is made, an insurance company may not reduce its net premiums with respect to premiums paid to a party not subject to U.S. taxation. The Treasury Regulations[6] provide guidance on the relevant definitions and election guidance. The amount of detail exceeds the purpose of this article.

Negative Net Premiums (Negative Capitalization Amount)

A negative net premium amount for any category of specified insurance contracts is labeled a "negative capitalization amount" and is subject to specific application. The negative capitalization amount first reduces (not below zero) the capitalized amount for the same tax year for any of the other categories. Should a negative capitalization amount still remain, this amount will reduce (not below zero) the unamortized balance as of the beginning of the tax year, of amounts capitalized under the general rule, creating a deduction in the current year. If there is still negative capitalization amount that has not been applied after these two steps, the remainder may be carried forward to future years.

WHAT IS THE AMORTIZATION PERIOD?

As a general rule, capitalized acquisition costs are deducted ratably over 120 months. The amortization period begins with the first month of the second half of the taxable year. For calendar year taxpayers, this results in 50 percent of a whole year amount being amortized in years 1 and 11, rather than amortization and calendar years being congruent.

Table 4

Tax year	Specified policy acquisition expenses in the tax year	Portion subject to 5-year amortization period	Portion subject to 10-year amortization period
2012	7,000,000	5,000,000	2,000,000
2013	9,500,000	5,000,000	4,500,000
2014	14,000,000	1,000,000	13,000,000
2015	15,000,000	-	15,000,000

Insurance companies are entitled to a five year (60 month) amortization period with respect to the first 5 million dollars of specified policy acquisition expenses. However, this more favorable amortization is phased out to the extent that policy acquisition expenses exceed 10 million dollars. In addition, all members of a controlled group are treated as one company for purposes of the phase out, and the five year amortization period does not apply to amounts attributable to reinsurance contracts.

Table 4 illustrates the application of the amortization periods to hypothetical amounts of capitalized acquisition costs.

The paragraphs above have described the tax aspects of DAC. The remainder of this article highlights a certain item that often frustrates the practitioner: the differing treatment under statutory and GAAP reporting to create the need to understand three sets of rules for the same thing.

ECONOMIC EFFECT OF CAPITALIZATION AND AMORTIZATION

The impact of Tax DAC is to defer the deduction for the amount capitalized (net of initial year pro-rata amortization), and then to recognize the deductions in subsequent years as amortization occurs. Over the course of the period, the taxable income is unchanged, but the timing of taxable income has been accelerated.

COMPARISONS AND CONFUSION

Statutory

Statutory Accounting Treatment [Annual Statement Accounting] is provided for in the Statements of Statutory Accounting Principles (SAP). SAP 71 provides guidance on the statutory treatment of acquisition costs. As a general rule acquisition costs and commissions are expenses as incurred. This varies from the mandatory capitalization (deferral of deduction) for the same costs under the tax rules.

GAAP

Rules for Generally Accepted Accounting Principles (GAAP) are discussed in the Accounting Standards Codification (ASC). DAC is specifically discussed in ASC 944-30. Policy acquisition costs are required to be capitalized based upon a different classification system than used in tax. Capitalization rules vary upon whether a contract is a short-duration, long-duration or reinsurance contract. A detailed discussion of the GAAP rules is not within the scope of this article but a few pertinent items are presented.

- GAAP focuses on the actual upfront costs involved in acquiring new contracts whereas Tax DAC capitalizes a flat percentage of first-year and renewal premiums alike.
- GAAP does not capitalize several types of acquisition costs (for example recurring costs) whereas Tax DAC begins with the view to all costs.
- GAAP amortization periods vary with the type of contract whereas all Tax DAC uses the same period.
- GAAP amortization schedules are developed using actuarial models that are based on the characteristics of the underlying business whereas Tax DAC is amortized on a straight-line basis.
- GAAP requires subsequent measurement and possible adjustment compared to the Tax DAC concept that the amortization is measured and set when the premium is received. ■

This article represents the opinion of the author only and does not represent any opinion of his employer or affiliates.

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ENDNOTES

1 Unless otherwise noted, all references are to the Internal Revenue Code of 1986, as amended, and the Treasury Regulations promulgated thereunder.

2 IRC Section 848(e)(1)(B) and Treas. Reg. Section 1.848-1(b).

3 A detailed listing of these items is beyond the scope of this article. The general deductions are defined as those in Part VI of Subchapter B (Itemized Deductions) and Part IV of Subchapter D (Qualified Deferred Compensation) of the Code.

4 Treas. Reg. § 1.848-1(h).

5 Treas. Reg. § 1.848-1(g).

6 Treas. Reg. § 1.848-2(h).