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Tax Accounting and Deferred Taxes for Life Insurance Companies

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Most actuaries are familiar with the major book/tax differences that affect the taxation of a U.S. life insurance company: adjustments to insurance reserves, the "DAC tax," the dividends-received deduction and limitations on the utilization of losses, to name a few. But how do these adjustments affect a company's financial statements? What impact do taxes have on statutory surplus? And what are some key concepts every actuary should understand in order to properly model the tax-related financial impacts of decisions being analyzed? This edition of "In the Beginning … A Column Devoted to Tax Basics" will address these questions through an introductory discussion of tax accounting for insurance companies.

THE TAX PROVISION

Every quarter, most insurance company tax departments across the country prepare the provision for federal, state and foreign income taxes under U.S. Generally Accepted Accounting Principles (GAAP) defined by the Financial Accounting Standards Board (FASB) and under statutory accounting principles (SAP) defined by the National Association of Insurance Commissioners (NAIC).[1] This article will focus primarily on statutory income tax accounting.

The tax provision includes both *current tax expense/(benefit)*, which estimates the company's income taxes payable or refundable for the current period, and *deferred tax expense/(benefit)*, which reflects the future income tax consequences of events that have been recognized in the company's financial statements. Generally speaking, current taxes represent what will be on the company's tax return for the current year, while deferred taxes represent what will be on future tax returns with respect to events that have already occurred. One important distinction between GAAP tax accounting and SAP tax accounting is the geography of deferred taxes: for GAAP, both the current and deferred tax expense/(benefit) are reported as part of the total provision for income taxes in net income. For SAP, only the current tax expense/(benefit) is reported in net income; the change in deferred taxes is recorded directly to surplus.

A simple example will illustrate the basics of current and deferred taxes. Assume that an individual life insurance contract has an annual premium of 100 due on Dec. 15, 2019, but by year-end the premium has not yet been received. Under SAP, the insurance company's statutory annual statement for 2019 will reflect the 100 of premium income anyway because it has been "earned." Because the 100 of uncollected premium has been recognized in the financial statements, tax accounting principles require that we consider the current and deferred tax consequences of that premium.

Tables 1 and 2 illustrate these consequences, looking at the uncollected premium in isolation.[2] Because the individual policyholder has not paid the premium yet, it is not includible in taxable income, so the tax provision would subtract 100 from pre-tax book income in order to get to current taxable income, and there would be no current tax expense in 2019 (Table 1). However, in 2019 the company would recognize a deferred tax expense of 21 (100 of premium multiplied by the current enacted tax rate of 21 percent). This is because, in 2020, either the premium will actually be received and will become taxable income at that time (Table 2A), or the premium will not be received and will be reversed out of statutory earned premiums (Table 2B). Either way, the timing difference from the earlier recognition of the premium in statutory income will "reverse" in 2020 when the statutory uncollected premium asset is either settled or written off.

Notice that in all three tables, the line "Tax: Uncollected premium adjustment" involves 21 of tax expense on one side, and (21) of tax benefit on the other. In this case, the tax adjustment line reflects deferred tax expense and current tax benefit in 2019 when the earned premium is reported in statutory income, followed by current tax expense and deferred tax benefit in 2020. This is a typical pattern for timing or temporary differences, and it is commonly referred to as a *current/deferred flip*. Ultimately, the cumulative total tax expense is equal to 21 percent of whatever premium is actually received; the current/deferred flip is merely accounting that in many cases may have no material economic impact, although it can create significant differences in statutory surplus, as we will explore later.

Table 1
As of 12/31/2019: Premium is Due Dec. 15 but Uncollected

	Current		Deferred (in Surplus)	
	Gross	Tax (at 21%)	Gross	Tax (at 21%)
Statutory earned premium	100	21		
Tax: Uncollected premium adjustment	(100)	(21)	100	21
Tax expense/ (benefit) in 2019		**0**		**21**

Table 2A
As of 12/31/2020: If Premium Due is Collected in January

	Current		Deferred (in Surplus)	
	Gross	Tax (at 21%)	Gross	Tax (at 21%)
Statutory earned premium	0	0		
Tax: Uncollected premium adjustment	100	21	(100)	(21)
Tax expense/ (benefit) in 2020		**21**		**(21)**
Cumulative tax expense/(benefit)		**21**		**0**

Table 2B
As of 12/31/2020: If Premium Due is Never Received

	Current		Deferred (in Surplus)	
	Gross	Tax (at 21%)	Gross	Tax (at 21%)
Statutory earned premium	(100)	(21)		
Tax: Uncollected premium adjustment	100	21	(100)	(21)
Tax expense/ (benefit) in 2020		**0**		**(21)**
Cumulative tax expense/(benefit)		**0**		**0**

CURRENT TAXES AND PERMANENT AND TEMPORARY DIFFERENCES

Let's step back from the uncollected premium example for a more general view of the tax provision, beginning with the current side. The following series of formulas summarizes how a current tax provision operates.

Pre-tax book income

+/– Permanent differences

+/– Temporary differences

Taxable income before net operating loss (NOL) carryforward

– NOL carryforward

Taxable income

× Applicable tax rate

Current tax provision before credits and adjustments

– Applicable tax credits

+/– Other discrete adjustments

Provision for current tax expense/(benefit)

Permanent differences are items that are included in book income but never included in taxable income, or vice versa. For example, certain meals, entertainment expenses, fines and penalties that a company incurs are disallowed as a tax deduction; the company must "add back" those expenses to pre-tax book income in order to determine taxable income. Also, certain investment income items have favorable permanent differences: municipal bonds and corporate stocks produce interest income and dividend income, respectively, but these amounts can be partially excluded from taxable income through tax-exempt interest adjustments and the dividends-received deduction.

Temporary differences are items that may be included in book income in one year and taxable income in a later year, or vice versa. As we saw in the uncollected premium example, these differences are only timing and do not affect the ultimate amount of taxable income over the life of the item. However, particularly after the 2017 tax law commonly known as the Tax Cuts and Jobs Act (TCJA),[3] some of a life insurance company's timing differences can be very large and of long duration, creating significant costs due to the time value of money. Further, as we will see, the requirements of statutory deferred tax accounting mean that a company may have an immediate surplus hit due to a temporary difference. Despite the fact that a company expects to realize an offsetting tax benefit in the future when the

temporary difference reverses, it may have to reflect most of the tax expense in its surplus position today and only recognize the offsetting tax benefit gradually over time.

Some of the temporary differences that regularly affect life insurance companies include:

- adjustments to insurance reserves—*e.g.*, exclusion of deficiency reserves, application of the 92.81-percent factor under the TCJA;
- DAC tax—*i.e.*, capitalization and amortization of certain expenses, based on a proxy policy acquisition expense rate;
- deferred and uncollected premiums and premiums received in advance;
- investment timing differences—*e.g.*, accrual of market discount on bonds, credit-related impairment of a debt instrument, recognition of unrealized gains and losses on certain investments; and
- depreciation of fixed assets—*e.g.*, computers, software, office furniture.

As illustrated in the formulas, loss carryforwards also create book/tax differences. When an insurance company incurs a loss, it is not necessarily able to realize a tax benefit immediately. For a life insurance company after the TCJA, ordinary losses can no longer be carried back to recover taxes already paid; NOLs may be carried forward indefinitely to realize tax benefits in future years, but they can only offset up to 80 percent of pre-NOL taxable income in any year.[4] Capital losses may be carried back three years and forward five years but can only be used to offset capital gains, not ordinary income. Tax credits (*e.g.*, for investments in subsidized housing for low-income residents) also have limitations on utilization in a given year and on carryovers to other years. These are important rules to recognize in actuarial

modeling activities, especially stress testing, and to keep in mind when analyzing deferred tax assets, which we will discuss next.

DEFERRED TAX ASSETS AND LIABILITIES

Temporary differences and loss carryforwards create *deferred tax assets* (DTAs) or *deferred tax liabilities* (DTLs). A deductible temporary difference generates a DTA because it will result in tax deductions (or reductions of pre-tax book income in order to determine taxable income) and current tax benefits in the future—*e.g.*, the future amortization of DAC tax balances. A taxable temporary difference generates a DTL because it will result in taxable income (or reduction of a pre-tax book expense) and current tax expense in the future—*e.g.*, the future inclusion of uncollected premiums that have already been recognized in statutory income. The collection of all of a company's DTAs and DTLs is known as its *deferred tax inventory*.

While the current tax provision primarily addresses the current year's tax return, deferred tax consequences may persist for years or even decades.[5] As a result, the accounting authorities have established a range of evaluation criteria for determining whether deferred tax items can be fully reflected in the financial statements in a given reporting period. In particular, a DTA represents a future tax deduction (or reduction in future pre-tax book income), so accounting rules require consideration of whether the company will have sufficient taxable income of appropriate character in those future periods to be able to realize the tax benefit. Both U.S. GAAP and SAP require a company to post a *valuation allowance* against a DTA if the company is not sufficiently likely to be able to realize the tax benefit. Additionally, SAP establishes rules for determining the *admissibility* of a DTA; nonadmitted DTAs, like other nonadmitted statutory assets, may not be counted toward the statutory surplus of the company.

A valuation allowance is applied, if necessary, to reduce gross DTAs to the amount that the company is more likely than not to be able to realize.[6] For example, a valuation allowance may be applied if a company has historically experienced losses and does not have evidence that this will change in the future, or if a company has capital DTAs (representing capital losses) but no expectation of future capital gains against which to offset them. Valuation allowance analysis is similar under U.S. GAAP and SAP, although SAP requires each entity separately to consider the realizability of its own DTAs, while U.S. GAAP generally assesses realizability for the consolidated group in accordance with U.S. consolidated tax return rules.

Under SAP, once a company has determined its "adjusted gross DTAs" after application of a valuation allowance, if any, it must also consider admissibility of those adjusted gross DTAs. This is a statutory concept not present in U.S. GAAP, and it generally reflects the focus of SAP on regulating solvency for the protection of policyholders. In short, an insurance company is not allowed to take a surplus benefit for a net DTA that would only be realized many years in the future—if the company is still profitably in business—because such tax benefits cannot be used to satisfy policyholder obligations today. As a result, SAP imposes limitations on the period of time within which net DTAs must be realized, among other limits, in order to be admitted in surplus.

Specifically, admissibility of adjusted gross DTAs under SAP is based on a three-part calculation defined in paragraph 11 of Statement of Statutory Accounting Principles No. 101 (SSAP 101). The three parts generally involve carrybacks, three-year reversals (sometimes referred to as three-year turns) and a DTL offset:

- **Paragraph 11.a. Carryback**. An insurance company is permitted to recognize DTA reversals that could be carried back to recover federal income taxes paid in prior years. For this purpose, the carryback period is as defined under applicable tax law, not to exceed three years. As mentioned previously, ordinary losses can no longer be carried back by a life insurance company under TCJA; thus, application of paragraph 11.a. is now limited to capital DTAs for companies taxed as life insurance companies.

- **Paragraph 11.b. Three-year reversals.** An insurance company is also permitted to recognize DTA reversals that can reduce taxes payable in future years. The period for which such reversals may be reflected is limited to three years, with stricter limits applying to companies that do not meet certain solvency thresholds. Additionally, the DTA admitted under paragraph 11.b. cannot exceed 15 percent of adjusted capital and surplus, again with stricter limits applying to companies that do not meet certain thresholds. This is perhaps the most "actuarial" component of SSAP 101, because it requires the projection of future statutory income, taxable income and the timing of reversals of existing DTAs, including those relating to insurance reserves.

- **Paragraph 11.c. DTL offset.** In very general terms, a company may admit adjusted gross DTAs under paragraph 11.c. in an amount equal to the lesser of (1) its adjusted gross DTAs, after subtracting the amount admitted under paragraphs 11.a. and 11.b., or (2) its gross DTLs.

There are many other complications in practice, requiring careful attention to character (ordinary vs. capital), timing, grouping of items, adjustments to prevent double-counting, application of

Table 3
2019 Statutory Tax Provision

		Current		Deferred (in Surplus)	
		Gross	Tax (at 21%)	Gross	Tax (at 21%)
Statutory pre-tax income[7]		100	21		
Permanent differences					
Fines and penalties					
Add back non-deductible penalty		20	4		
Temporary differences					
Reserves		400	84	(400)	(84)
Add back change in statutory reserves	9,700				
Deduct change in tax reserves	(9,300)				
DAC tax		202	42	(202)	(42)
Add DAC capitalization	209				
Deduct DAC amortization	(7)				
Taxable income; Tax expense/(benefit)		**722**	**151**	**(602)**	**(126)**

the limitations on loss utilization, changes in enacted tax rates, consideration of tax-planning strategies and other nuances. For purposes of this article, the general concepts can be illustrated through a simple example involving an insurance company that issues a single annuity contract, producing two DTA components to be considered under SSAP 101 paragraph 11.

While the current tax provision primarily addresses the current year's tax return, deferred tax consequences may persist for years or even decades.

STATUTORY TAX PROVISION EXAMPLE

Let's assume a life insurance company sells one individual non-qualified fixed deferred annuity contract in 2019, for a single consideration of 10,000. Also:

- The DAC tax capitalization rate for individual non-qualified annuities is 2.09 percent of premium, and this is amortized over 15 years beginning in the middle of 2019. As a result, the company would capitalize 209, of which 7 would amortize in the first year and 14 each following year until the remaining balance is amortized in 2034.

- The statutory reserve at the end of 2019 is 9,700 and the net surrender value is 9,300. The tax reserve is 9,300, which is the greater of the 9,300 net surrender value, or 9,003 (92.81 percent of the 9,700 statutory reserve).

- The company has investment income of 400 and general expenses (including acquisition expenses) of 600, which includes a non-deductible penalty of 20. Aside from the DAC tax and the disallowance of the penalty, no other adjustments or limitations apply to these items.

- The company has a strong surplus position, permitting reflection of three years of DTA reversals and up to 15 percent of surplus in paragraph 11.b.

- The company has no other DTAs or DTLs.

Without regard to the limitations on admissibility of deferred tax assets, the company's tax provision for statutory reporting would be as shown in Table 3.

Note that the total tax expense in this view is 25, which is the current tax expense of 151 reflected in net income, partially offset by a deferred tax benefit of (126) recorded directly to surplus. As expected, the total tax expense is equal to statutory pre-tax income, plus permanent differences, multiplied by the 21-percent tax rate; the temporary differences are merely a current/deferred flip.

The (126) deferred tax benefit reflects that the company has established 126 of new DTAs. However, as required by SAP, the company must consider the realizability and admissibility of the DTAs. Assume the company has a strong earnings history and reasonable expectation of continued future income, so it concludes it is more likely than not to realize its DTAs and no valuation allowance is required. Then, we proceed through the three steps for determining the admitted DTA:

- **Paragraph 11.a. Carryback.** Because the reserves and DAC tax are ordinary income items, these are not eligible for carryback by a life insurance company under the TCJA, so no DTAs are admissible under paragraph 11.a.

- **Paragraph 11.b. Three-year reversals.** Assume the actuary projects that the reserve temporary difference for this contract will decrease by 80 each year for five years, until both the statutory and tax reserves are equal to the net surrender value. The DAC amortization is 14 per year (one-fifteenth of the original 209 capitalization). Thus, the total deductible temporary differences will be 94 per year during the three-year reversal period. Assume the company has a reasonable expectation of continued future earnings, with enough projected income to absorb the reversing temporary differences each year, and also that the surplus cap does not come into play. Then, the cumulative three-year reversal is 282 gross (94 per year for three years), which produces 59 of admitted DTA at 21 percent.

- **Paragraph 11.c. DTL offset.** In this example, we are assuming the company does not have any other DTAs or DTLs. Thus, there is no additional DTA to admit under paragraph 11.c.

As a result, the total admitted DTA is 59, which means the remaining 67 (that is, 126 gross DTA minus 59 admitted) is nonadmitted. The statutory Summary of Operations for 2019 would be as shown in Table 4.

Table 4
Tax Components in Summary of Operations

	Increase/(Decrease) in Surplus
Federal income taxes incurred *Current tax (expense), a component of net income*	(151)
Change in net deferred income tax *Total deferred tax benefit, recorded directly to surplus*	126
Change in nonadmitted assets *(Increase) in nonadmitted DTA, recorded directly to surplus*	(67)
Total (decrease) in surplus due to federal income tax	**(92)**

Thus, although the total tax expense in Table 3 was only 25, the reduction in surplus in 2019 due to federal income taxes is 92 after reflecting statutory limitations on DTA admissibility. As long as the company remains a going concern with sufficient income, eventually the remaining DTA will become admitted as it rolls into the three-year reversal period, and ultimately the total tax expense over time will be 25 if there are no future changes in enacted tax rates. However, there is additional surplus strain up front due to the SSAP 101 admissibility requirements. This effect has been made worse under the TCJA due to the increased DAC tax capitalization rates, generally steeper haircut on reserves and generally longer reversal patterns for both DAC tax and reserves,

although these adverse effects may be mitigated over time by the reduction in the corporate tax rate from 35 percent to 21 percent.

In light of the importance of statutory surplus to company management and other stakeholders and the sometimes unintuitive surplus results that may arise due to corporate income taxes, an actuary would be well served by investing time to develop a working knowledge of the key tax law and tax accounting concepts applicable to insurance companies. This article has provided only a starting point but has hopefully encouraged the reader to collaborate across actuarial and tax functions in order to properly model the tax and surplus impacts of products and transactions under consideration. ■

The views expressed are the author's and do not necessarily reflect those of Symetra Life Insurance Company.

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ENDNOTES

1 The U.S. GAAP requirements for accounting for income taxes are defined under Accounting Standards Codification Topic 740. The NAIC requirements for accounting for income taxes are defined under Statement of Statutory Accounting Principles No. 101. Some companies are also subject to other accounting regimes, such as International Financial Reporting Standards or Canadian GAAP.

2 Note that there would likely also be related adjustments involving reserves and loading.

3 Pub. L. No. 115-97, "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018," enacted Dec. 22, 2017.

4 Insurance companies that do not qualify as life insurance companies for federal income tax purposes continue to be subject to the two-year NOL carryback/20-year NOL carryforward periods that applied to such companies prior to the TCJA, with no 80-percent limitation. Life and non-life insurance companies have the same rules for utilization of capital losses.

5 Of course, examinations by the Internal Revenue Service and any resulting controversy may also take years to reach final resolution.

6 It can sometimes be confusing to discuss DTAs and DTLs because the term "gross" may be used to mean either (1) not tax-effected, *e.g.*, the amount of a temporary difference before multiplying by 21 percent, or (2) the DTAs or DTLs separately, *e.g.*, a gross DTA of 21 combined with a gross DTL of (14) produces a net DTA/(DTL) of 7. This ambiguity can usually be resolved through context.

7 Statutory pre-tax income is 10,000 premium plus 400 investment income, less 9,700 increase in reserves and 600 expenses.