Statutory Issue Paper No. 83

Accounting for Income Taxes

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Current Authoritative Guidance for Income Taxes: SSAP No. 101
This issue paper may not be directly related to the current authoritative statement.

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Type of Issue:
Common Area

b. Amounts incurred or received during the current year relating to prior periods, to the extent not previously provided, as such amounts are deemed to be changes in accounting estimates as defined in *Issue Paper No. 3—Accounting Changes* (Issue Paper No. 3).

6. Additionally, for purposes of statutory accounting, a reporting entity's Statement of Assets, Liabilities, Surplus and Other Funds, shall include deferred income tax assets (DTAs) and liabilities (DTLs). DTAs and DTLs are the expected future tax consequences of temporary differences generated by statutory accounting, as defined in paragraph 11 of FAS 109. FAS 109 is excerpted in paragraph 50 of this issue paper.

7. A reporting entity's deferred tax assets and liabilities are computed as follows:

a. Temporary differences are identified and measured using a "balance sheet" approach whereby statutory and tax basis balance sheets are compared,

b. Temporary differences include unrealized gains and losses and nonadmitted assets but do not include asset valuation reserve (AVR), interest maintenance reserve (IMR), Schedule F penalties and, in the case of a mortgage guaranty insurer, amounts attributable to its statutory contingency reserve to the extent that "tax and loss" bonds have been purchased,

c. Total DTAs and DTLs are computed using enacted tax rates and

d. Consistent with FAS 109, a DTL is not recognized for amounts described in paragraph 31 of FAS 109.

8. Changes in DTAs and DTLs, including changes attributable to changes in tax rates and changes

and the impact, if any, of the Alternative Minimum Tax shall be determined in accordance with the provisions of the Internal Revenue Code, and regulations thereunder;

c. The amount of carryback potential that may be considered in calculating the gross DTAs of a reporting entity in subparagraph 9.a. above, that files a consolidated income tax return with one or more affiliates, may not exceed the amount that the reporting entity could reasonably expect to have refunded by its parent; and

d. The phrases "reverse by the end of the subsequent calendar year" and "realized within one year of the balance sheet date" are intended to accommodate interim reporting dates and reporting entities that file on an other than calendar year basis for federal income tax purposes.

11. Current income tax recoverables are defined to include all current income taxes, including interest, reasonably expected to be recovered in a subsequent accounting period, whether or not a return or claim has been filed with the taxing authorities. Current income tax recoverables are assets, as defined in *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets* (Issue Paper No. 4), and are reasonably expected to be recovered if the refund is attributable to an overpayment of estimated tax payments, an error, a carryback, as defined in paragraph 289 of FAS 109, or an item for which the reporting entity has *substantial authority,* as defined in paragraph 52 of this issue paper.

be reported in the interim period in which the item is reported. APB 28 is excerpted in paragraph 51 of this issue paper.

15. Statutory financial statement disclosure shall be made in a manner consistent with the provisions

c. Statutory accounting principles with respect to the recognition of income tax transactions

licenses, and fees." State income taxes are excluded from the definition of income taxes to ensure comparability of financial statements, since such taxes are generally not significant to the surplus of a reporting entity and, since not all state taxes are based on income.

b. In order to ensure that a reporting entity's surplus is conservatively measured, the *more likely than not* criteria of paragraph 17.e. of FAS 109 is replaced by the realization criteria in paragraph 9 of this issue paper.

c. DTAs are not reduced by a valuation allowance. Instead, that portion of a reporting entity's DTAs that is not realizable pur

a. A DTA "embodies a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows" inasmuch as deductible temporary differences reduce taxable income and taxes payable in future years thereby contributing indirectly to future net cash inflows,

b. A reporting entity has exclusive rights to the future benefit associated with its DTA and

c. A DTA is the tax effect of the difference between the tax basis of an asset or liability and its reported amount in the financial statemen

b. *Accounting Principles Board Opinion No. 4 (Amending No. 2), Accounting for the "Investment Credit,"* is rejected in its entirety;

c. *Accounting Principles Board Opinion No. 10, Omnibus Opinion—1966,* paragraph 6 is adopted;

d. *Accounting Principles Board Opinion No. 23, Accounting for Income Taxes—Special Areas,* paragraphs 1-3, 5-9, 12-13, and 15-18 are adopted, and paragraphs 19-25, and 31-33 are rejected;

e. *Accounting Principles Board Opinion No. 28, Interim Financial Reporting,* paragraphs 19 and 20 are adopted and all other paragraphs rejected;

i. *FASB Emerging Issues Task Force No. 95-20, Measurement in the Consolidated Financial Statements of a Parent of the Tax Effects Related to the Operations of a Foreign Subsidiary That Receives Tax Credits Related to Dividend Payments*, is rejected in its entirety.

36. This statement rejects

Method of Accounting for Federal Income Taxes

As mentioned above, the statutory method of accounting as used in the annual statement plays the key role in determining the federal income tax liability of property/liability insurers. The insurance sections of the Internal Revenue Code in general provide that taxable income should be computed on the basis of the underwriting and investment exhibits of the annual statement except where such basis conflicts with other preemptive provisions of the Code. Such preemptive provisions have been dramatically increased as a result of the 1986 TRA.

Differences Between Annual Statement "Net Income" and "Taxable Income"

Due to specific Internal Revenue Code provisions which affect determination of taxable income, there have always been differences between annual statement "net income" and "taxable income," such as tax exempt interest income, depreciation expense, etc.

The TRA, however, introduced four major provisions at variance with annual statement accounting which increase the taxable income of property/liability insurers:

1. Discounting of loss reserves. Property/liability insurers are required to discount loss and loss adjustment expense reserves in the following manner:

   - The discount rate is a moving average of the mid-term applicable federal rate under Code Section 1274, which fluctuates from year to year;

   - The payout period is based on industry averages, but the company may elect to use its own experience;

   - The maximum payout period for former Schedule O lines is three years and ten years for all lines that were reported in Schedule P before the 1989 annual statement; and

   - There is an extension of the 10-year payout period for certain reserves remaining at the end of ten years.

     The impact of discounting is to spread the deduction for ultimate incurred losses and loss adjustment expenses over a number of years to reflect the assumed investment earnings on those reserves.

2. Revenue Offset. Property/liability insurers must include in taxable income annually 20% of the increase (decrease) in their unearned premium reserves.

   There is also a transition rule whereby 20% of a company's unearned premium reserve at the end of 1986 is includable in taxable income ratably over a six year period beginning in 1987.

3. Proration. Property/liability insurers are now required to reduce their deduction for losses incurred by 15% of the sum of the tax exempt interest and the deduction for dividends received. This proration rule does not apply to tax exempt interest and the deductible portion of dividends received or accrued on stock or obligations acquired by the insurer before August 8, 1986.

4. Alternative Minimum Tax. A new corporate tax concept was introduced wherein a tax is imposed on a company's "economic" income at a reduced rate of 20%. The corporation's tax liability will be the higher of the regular tax or this alternative minimum tax.

   Certain tax preference items are added to a company's (or a group's) consolidated taxable income resulting in alternative minimum taxable income. Tax preferences should include:

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- 50% of excess of book income over taxable income adjusted for other tax preferences.

- Interest on certain private activity municipal bonds issued after August 8, 1986.

- Accelerated depreciation on real and personal property, to the extent it is in excess of depreciation calculated under an alternative method.

Book income is annual statement net income for mutual insurance companies. For stock insurers that file GAAP financial statements, book income is GAAP net income. Beginning in 1990, this preference will be based on adjusted current earnings ("ACE"), similar to earnings and profits, rather than statutory income. Also in 1990, the preference will equal 75% of the excess of ACE over taxable income, plus other preferences.

(The Superfund Revenue Act of 1986 requires corporations to pay an "environmental" tax, set at an annual rate of $12 per $10,000 of alternative minimum taxable income, payable even if the corporation pays no alternative minimum tax. This tax of .12% is levied on a corporation's modified alternative minimum taxable income over $2,000,000.)

Other Additions To Annual Statement "Net Income"

Examples of additions are:

1. Provisions for federal income taxes deducted in the annual statement;

2. Excess of realized capital losses over realized capital gains in the annual statement;

3. Gain on sale of capital assets in excess of annual statement gain;

4. Excess of annual statement depreciation and amortization over tax depreciation and amortization;

5. Cost of assets, leasehold improvements, acquisition of leases, and special assessments on real estate owned, which have been included as expenses in the annual statement, but which are capital improvements for tax purposes;

6. Charitable donations exceeding deductible limits;

7. Premiums for officers' or employees' life insurance policies where the company is the beneficiary;

Deductions From Annual Statement "Net Income"

Examples of deductions are:

1. Tax-exempt interest as reduced by proration;

2. Dividends received deduction as reduced by proration;

3. Excess of tax depreciation and amortization over annual statement depreciation and amortization;

7. Items previously not deductible for tax purposes that were charged to annual statement in prior years;

8. Loss on sale of capital assets in excess of annual statement loss.

* See above for discounting, revenue offset, proration and anticipation of salvage and subrogation.

Reporting Federal Income Taxes

Federal income taxes can appear in the following places in the annual statement:

Recoverable federal income taxes are allowable as an admitted asset and appear as an asset on the balance sheet. Note, however, that the NAIC does not recognize as an admitted deferred asset "special estimated tax payments" authorized by Section 847 of the Internal Revenue Code.

Federal income taxes due or accrued are included as a liability on the "Liabilities, Surplus and Other Funds" page of the balance sheet.

Federal income taxes incurred during the year are reported as a deduction from income in the Underwriting and Investment Exhibit of the Statement of Income.

Federal income taxes incurred or refunded during the year relating to prior period adjustments are to be included with current year provisions for taxes, but in some instances, if material, they may be charged or credited directly to unassigned surplus in the capital and surplus account.

Also, a footnote to the Statement of Income discloses the amount of federal income taxes incurred and available for recoupment in the event of future net losses. Further, it discloses the amount of any net losses carried forward and available to offset future net income subject to federal income taxes.

Federal income taxes paid are included in the Statement of Changes in Financial Position.

General Interrogatories include a series of questions regarding federal income taxes. They disclose whether a consolidated return is filed and, if so, the methods used to allocate the taxes between the companies. (See Chapter 8-Other Admitted Assets.)

Federal Income Tax Recoverable - Consolidated Return

4. Any receivables arising out of such allocation meet the criteria for admitted assets as prescribed by the domiciliary state of the insurer, and

5. Liabilities which offset the related intercompany receivables are established by other companies participating in the consolidated tax return.

38. Chapter 23, Federal Income Taxes, of the Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies (Life/A&H Accounting Practices and Procedures Manual) provides the following guidance:

Introduction

With the passage of the Deficit Reduction Act of 1984, Congress substantially changed the taxation of life insurance companies under the U.S. Internal Revenue Code. From 1958 through 1983, life insurance companies were taxed under the provisions of the Life Insurance Company Income Tax Act of 1959 which prescribed a complex three phase taxing formula unique to such companies. The 1984 Act mandated a simpler single-phase basis of taxation which essentially parallels the taxation of the income of other corporations. Subsequent modifications have retained the basic single-phase system.

However, there are several aspects of determining life insurance company taxable income that are unique to the life insurance industry. The most notable of these are deductions for increases in life insurance company reserves, deductions for dividends to policyholders, the special treatment of the company's share of tax exempt interest and dividends received deduction, and the small life insurance company deduction.

Definition of a Life Insurance Company for Federal Income Tax Purposes

To obtain the special treatment afforded life insurance companies under the Internal Revenue Code, a business enterprise must meet the Internal Revenue Code's definition of a life insurance company. A life insurance company is defined as a company for which, during the taxable year, more than half of its business is the issuance of insurance and annuity contracts or the reinsuring of risks underwritten by insurance companies, provided that more than 50% of its total reserves consist of life insurance reserves and unearned premiums and unpaid losses on noncancellable life, accident, or health policies. As a result of this definition in the Internal Revenue Code, companies that are incorporated as life insurance companies under applicable state insurance laws may not qualify as life insurance companies for federal income tax purposes.

Deduction for Increase in Reserves

Life insurance companies are permitted deductions in each tax year for the net amount of the increase in:

- Life insurance reserves (as defined in the Internal Revenue Code).
- Unearned premiums and unpaid losses not included in life insurance reserves.
- Other items set forth in the Internal Revenue Code.

In general, a life insurance reserve is defined in the Internal Revenue Code as a liability amount which is required by state law and which:

- Is computed or estimated on the basis of recognized mortality or morbidity tables and assumed rates of interest, and
- Recognizes the company's future liability for unaccrued claims from life insurance, annuity, and noncancellable accident and health insurance contracts.

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Noncancellable accident and health insurance is defined to include guaranteed renewable accident and health insurance.

Calculation of Life Insurance Reserves for Deduction Purposes

Prior to the 1984 Act, a life insurance company's reserves for federal income tax purposes were generally based upon those held in its statutory annual statement. As a result of the 1984 Act, federal standards were established for the calculation of life insurance reserves for income tax purposes and may be summarized as follows:

- The reserve calculation method is specified—in general, a company is to use the Commissioners' Reserve Valuation Method (CRVM) for life insurance contracts, the Commissioners' Annuity Reserve Valuation Method (CARVM) for annuity contracts and a two-year full preliminary term for noncancellable accident and health insurance.

- The interest rate is specified—beginning in 1988 it has been the greater of:

  An interest rate determined by the Internal Revenue Service based on an average of monthly interest rates for certain Treasury obligations, referred to as the "applicable federal interest rate" (AFR), or

  The "prevailing state assumed interest rate", i.e., the highest interest rate which at least 26 states permit to be used for statutory annual statement reserves for such contracts.

- The mortality/morbidity basis is specified—the "prevailing commissioners' standard tables for mortality and morbidity", i.e., the most recent tables adopted by the NAIC which at least 26 states permit to be used for reserve determination for such contracts. In the event there are no "prevailing commissioners' standard tables", the Secretary of the Treasury is authorized to specify the mortality or morbidity tables to be used.

Life insurance companies are permitted to use the larger of the reserve amount calculated by the foregoing rules or the net surrender value of the contract to determine the reserve deduction for the tax year. In any event, the tax reserve cannot exceed the reserve amount shown on the company's annual statement.

As a result of legislation in 1986, certain other reserves which generally are not discounted for annual statement purposes, such as accident and health unpaid claims, now must be discounted for tax deduction purposes using a discounting method and rate specified by the Internal Revenue Code.

Deduction for Policyholder Dividends

As a result of the 1984 Act, the deduction by a stock life insurance company for policyholder dividends paid or accrued during a taxable year generally is not subject to limitation. However, a mutual life insurance company is required by the Internal Revenue Code to reduce its deduction for policyholder dividends (and, next, its deduction for increase in reserves) by an amount referred to as the "differential earnings amount." According to the 1984 Act Congressional Conference Report, "...This reduction reflects recognition that, to some extent, policyholder dividends paid by mutual companies are distributions of the companies' earnings to the policyholders as owners..."

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The Internal Revenue Code's definition of "policyholder dividends" includes the following items:

- Amounts returned to policyholders where the amounts so returned were not fixed in the policy but, instead, depended on the experience of the company or the discretion of management.

- Excess interest, defined as any amount in the nature of interest paid or credited to policyholders in excess of the prevailing state assumed interest rate (rather than in excess of the minimum rate guaranteed in the contract).

- Premium adjustments, defined as any reduction in the premiums which would have been required to be paid under the contracts.

- Experience-rated refunds, defined as including a refund based on the experience of the policyholder.

Under the Internal Revenue Code, the differential earnings amount for mutual companies is determined by multiplying an individual company's "average equity base" for the taxable year by the "differential earnings rate." The average equity base is an amount calculated by each mutual company. It is based on specific rules in the Internal Revenue Code and includes a company's capital and surplus. The differential earnings rate is computed by the Internal Revenue Service based on information reported by all mutual life insurance companies and the 50 largest stock life insurance companies. The rate for each year is announced by the Internal Revenue Service.

Company's Share of Tax-Exempt Interest and Dividends-Received Deduction

In determining taxable income for most corporations, tax exempt interest is excluded and a deduction is allowed for a percent of United States source dividend income received. However, special rules apply as to life insurance companies. Life insurance companies are allowed to reduce taxable income by only the "company's share" of the tax exempt interest and the dividends received deduction. The "company's share" is calculated using specific rules in the Internal Revenue Code.

Small Life Insurance Company Deduction

For life insurance companies with assets of less than $500 million, a special small company deduction from taxable income is allowed. The deduction is equal to 60% of tentative life insurance company taxable income up to $3 million. This deduction is reduced by 15% of tentative life insurance company taxable income between $3 million and $15 million (at $15 million, the deduction becomes zero). For purposes of the $500 million asset ceiling, all members of a controlled group, including nonlife insurance companies, are treated as one company.

Other Considerations

Alternative Minimum Tax

The Tax Reform Act of 1986 replaced the prior add-on minimum tax with a new alternative minimum tax (AMT) on corporations. The AMT is, in substance, an alternative tax calculation which applies if it exceeds the regular tax.

The AMT is applicable to all companies, including life insurance companies, and is intended to ensure that no taxpayer with substantial economic income can avoid income tax through the use of exclusions, deductions, and credits. The AMT is equal to 20% of the recomputed taxable income that recognizes certain adjustments and items of tax preference. The significant adjustment for life insurance companies for the tax years 1987, 1988, and 1989 was the book income adjustment. This adjustment increases (but does not decrease) the alternative minimum taxable income by 50% of the difference between pretax financial statement income and taxable

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income. Another adjustment, applicable only to mutual companies, limits the reduction in book income for policyholder dividends.

Starting with 1990, the calculation of alternative minimum taxable income has been based on an earnings and profits concept rather than a book income adjustment. Among the adjustments for tax years beginning after 1989 that are of importance to life insurance companies are a requirement to amortize acquisition costs, the addback of the company's share of tax exempt interest and the dividends received deduction, and the addback of the small company deduction.

Policyholders' Surplus Account

A stock life insurance company may be required to maintain a memorandum account for tax purposes called the "policyholders' surplus account." The policyholders' surplus account represents, in effect, income of a stock life insurance company for which tax was deferred under pre-1984 tax rules. Under the 1984 Act, there can be no additions to the policyholders' surplus account after 1983. However, reductions in the policyholders' surplus account are included in taxable income in the year in which such reductions occur (referred to as "Phase III income").

<u>Expense Group Classifications</u>

Expenses for fire and casualty insurance companies are allocated to expense groups as follows:

B. Other Underwriting Expenses

Other underwriting expenses are classified into three categories as follows:

3. Taxes, Licenses, and Fees

These are state and local insurance taxes, insurance department licenses and fees, allocable payroll taxes, and all other taxes excluding federal and foreign income and real estate taxes.

All other taxes might include: (1) qualifying bond premiums; (2) statement publication fees; (3) advertising required by law; (4) personal property taxes; (5) state income taxes; (6) capital stock taxes; (7) business or corporation licenses or fees; (8) marine profits taxes; (9) documentary stamps on reinsurance; (10) guaranty association assessments; and (11) any other taxes.

Real estate taxes on investment properties are generally included with investment expenses, and capital stock taxes and apportioned payroll taxes may be reported as investment expenses.

40. Appendix A, Mortgage Guaranty Insurance Accounting Principles Supplement of the P&C Accounting Practices and Procedures Manual provides the following guidance with respect to "tax and loss" bonds of U.S. mortgage guaranty insurance companies:

BONDS

<u>U.S. Mortgage Guaranty Tax and Loss Bonds</u>

To obtain a current federal income tax benefit derived from annual additions to the statutory contingency reserve (for tax purposes, the "mortgage guaranty account"), mortgage guaranty insurers must purchase "tax and loss" bonds to the extent of such benefits. These bonds are noninterest bearing obligations of the U.S. Treasury, and mature 10 years after issue. The usual purpose of "tax and loss" bonds is to satisfy taxes that will be due in 10 years when the tax benefit is reversed; however, the bonds may be redeemed earlier in the event of excess underwriting losses. (See chapter on Contingency Reserve.) These bonds are carried as an asset for statutory purposes allowing mortgage insurers to conserve capital.

FEDERAL INCOME TAXES

<u>Contingency Reserve (for Tax Purposes, the "Mortgage Guaranty Account")</u>

Under IRS Code Section 832(e), mortgage guaranty insurers are permitted to deduct from gross income the annual addition to the contingency reserve. The tax deduction is generally an amount equal to (a) 50% of earned premium or (b) taxable income as computed prior to this special deduction if less than 50% of earned premium. Annual deductions not utilized for tax purposes during the current period may be carried forward for eight years on a basis similar to net operating losses. The amount deducted must be restored to gross income after ten years; however, the amount may be restored to gross income at an earlier date in the event of a taxable net operating loss.

The tax deduction is permitted only if special "U.S. Mortgage Guaranty Tax and Loss Bonds" are purchased in an amount equal to the tax benefit derived from the deduction (see section on "Bonds"). Upon redemption the "tax and loss" bonds can be used to satisfy the additional tax liability that arises when the deduction is restored to income.

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The purchase of "tax and loss" bonds will often defer the entire tax expense that would otherwise be payable on the current year's taxable income.

41. Chapter 22, General Expenses and Taxes, Licenses and Fees of the Life/A&H Accounting Practices and Procedures Manual contains the following guidance with respect to state income taxes:

Classification of Expenses

The following points should be noted with respect to specific classifications of expenses:

12. Taxes, licenses and fees generally include all payments to federal, state, local, and foreign governments with the exception of federal income taxes.

Taxes, Licenses, and Fees Due or Accrued

Taxes, licenses, and fees which are unpaid but applicable to the accounting period should be accrued and reported as a liability in the balance sheet. With respect to premium taxes and state income taxes, the amount accrued should relate to the related premiums or taxable income recorded in the period, less, of course, prepayments of those taxes. Payroll taxes accrued should include all unpaid taxes applicable to salaries and wages which have been paid, plus taxes applicable to accrued payroll.

42. The NAIC Annual Statement Instructions for Property and Casualty Insurance Companies provides the following guidance with respect to federal income taxes:

UNDERWRITING AND INVESTMENT EXHIBIT

STATEMENT OF INCOME

Line 15 - Federal and Foreign Income Taxes Incurred

Include: Current year provisions for federal and foreign income taxes, and federal and foreign income taxes incurred or refunded during the year relating to prior period adjustments. In some instances such prior period adjustments, if material, may be charged or credited directly to Unassigned Surplus in the "Capital and Surplus Account."

The statutory method of accounting as used in the annual statement plays the key role in determining the federal income tax liability of property and casualty insurance companies. The insurance sections of the Internal Revenue Code, in general, provide that taxable income should be computed on the basis of the underwriting and investment exhibits of the annual statement except where such basis conflicts with other preemptive provisions of the Internal Revenue Code.

The amount of this item equals Line 14 of Exhibit 2, adjusted for reserves in Line 6 on page 3 of the current and prior years' statements, and recoverables in Line 14, Column 4 on Page 2 of current and prior years' statements.

The amount of this item equals Line 9, Page 5, adjusted for reserves in Line 6 on Page 3 of the current and prior years' statements, and recoverables in Line 14, Column 4 on Page 2 of current and prior years' statements.

CAPITAL AND SURPLUS ACCOUNT

Line 29 - Extraordinary Amounts of Taxes for Prior Years

Include: Interest and expenses related to prior year taxes on this line.

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Line 14 - Federal Income tax Recoverable

In the case on an insurer that is a party to a consolidated tax return with one or more affiliates, the caption for Federal Income Tax Recoverable should reflect the source of the recoverable; e.g., Federal Income Tax Recoverable - Parent.

Insurers may recognize intercompany transactions arising from income tax allocations among companies participating in a consolidated income tax return, provided the following conditions are met:

1. There is a written agreement describing the method of allocation and the manner in which intercompany balances will be settled, and

2. Such agreement requires that any intercompany balance will be settled within a reasonable time following the filing of the consolidated tax return, and

3. Such agreement complies with regulations promulgated by the Internal Revenue Service, and

4. Any receivables arising out of such allocation meet the criteria for admitted assets as prescribed by the domiciliary state of the insurer, and

5. Liabilities which offset the related intercompany receivables are established by other companies participating in the consolidated tax return.

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forward from the current year and each of the six years preceding the current year.

Illustration:

a. 1. The Company's federal income tax return is combined with the following entities:

The Affiliated Company

1. There is a written agreement describing the method of allocation and the manner in which intercompany balances will be settled, and

2. Such agreement requires that any intercompany balance will be settled within a reasonable time following the filing of the consolidated tax return, and

3. Such agreement complies with regulations promulgated by the Internal Revenue Service, and

4. Any receivables arising out of such allocation meet the criteria for admitted assets as prescribed by the domiciliary state of the insurer, and

5. Liabilities which offset the related intercompany receivables are established by other companies participating in the consolidated tax return.

NOTES TO FINANCIAL STATEMENTS

5. Federal Income Tax Allocation

Instruction:

If the company's federal income tax return is combined with those of any other entity or entities, provide the following:

a. A list of names of the entities with whom the company's federal income tax return is combined for the current year.

b. The substance of the written agreement, approved by the company's Board of Directors, which sets forth the manner in which the total combined federal income tax for all entities is allocated to each entity which is a party to the consolidation. (If no written agreement has been executed, give an explanation of why such an agreement has not been executed.) Describe the method of allocation, setting forth the manner in which the company has an enforceable right to recoup federal income taxes in the event of future net losses which it may incur or to recoup its net losses carried forward as an offset to future net income subject to federal income taxes.

Illustration:

a. The Company's federal income tax return is combined with the following entities:

The Affiliated Company

b. The method of allocation between the companies is subject to written agreement, approved by the Board of Directors. Allocation is based upon separate return calculations with current credit for net losses. Intercompany tax balances are settled annually in the first quarter.

44. Emerging Accounting Issues Working Group Position EI-86-1, *True-up of Federal Income Taxes*

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Accounting issues discussed were as follows:

1. What is the most appropriate option for mutual life insurers to adopt in accruing for 1984 and 1985 in the absence of an announced differential rate by the U.S. Treasury?

2. Should the adjustments to federal income taxes of prior years' tax liability relative to the true–up be reported through operations or as a direct charge to surplus?

The working group concluded the following:

1. "Best estimates" should be used in accruing for the 1984 and 1985 tax liabilities in the absence of an announced differential rate by the U.S. Treasury.

2. Adjustments of prior years' tax liability relative to the true–up should be reported through the operations statement.

45. Emerging Accounting Issues Working Group Position EI 87-6, *Accounting for the Impact of the Tax Reform Act of 1986*, provides the following guidance (However, note that reference to the FASB relates to consideration of deferred taxes pursuant to *FASB Statement of Financial Accounting Standards No. 96*, *Accounting for Income Taxes*, which was superseded by FAS 109):

<u>Accounting for Impact of the Tax Reform Act of 1986 (Loss Reserves Discounting)</u>

The question of accounting on a statutory basis for the implications of tax reform was initially raised by Mary Jan Robertson, Vice President–Controller of United Capital Insurance Company. Subsequent to, and, independent of her request, tax reform impact questions were also referred to the Emerging Issues Working Group by action of the Financial Condition (EX4) Subcommittee.

The Tax Reform Act of 1986 made significant changes in the taxation of property and casualty insurance companies. Among the changes are "fresh start" provisions, loss reserve discounting, limitation in the deduction of the unearned premium, taxation of a portion of previously tax–exempt income, imposition of an alternative minimum tax in some cases and lower rates. The act changes the timing of tax payments and taxable income may be considerably higher than before, particularly in the first few years:

The working group considered the following issues:

1. Should the loss reserve discounting required for federal tax purposes be reflected in the insurer's statutory statement?

   The working group concluded that loss reserve discounting required for federal tax purposes was not an acceptable statutory accounting treatment.

2. Should a deferred tax asset, i.e., prepaid income taxes, arising from current timing differences be permitted on a statutory basis?

   The consensus of the working group was that a deferred tax asset should not be permitted for statutory accounting purposes. The consensus was based, among other things, on the following:

   a. The asset is not convertible to cash; it generally only reflects timing differences.

   b. The asset is not recoverable within a definitive and short (1 to 2 years) time frame nor is the value readily determinable.

   c. Statutory accounting has not previously recognized prepaid or deferred liability items (e.g., prepaid rent and deferred acquisition expenses).

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> The working group voted to reject the recommendation to allow reciprocal insurers an admitted asset for Section 847 deposits. The working group also reiterated its position against deferred taxes for statutory purposes.

48. Emerging Accounting Issues Working Group Position EI 95-3, *Equity Tax*, provides the following guidance on statutory accounting for a mutual life insurer's equity tax:

> Norris Clark (Calif.) summarized an issue submitted by Martin Carus (N.Y.) (Attachment A) regarding a component of federal income taxes for mutual life insurance companies commonly referred to as the "equity tax." The question is whether it is more appropriate to charge that component of federal income taxes directly to surplus or through operations as income tax expense.
>
> Armand de Palo (The Guardian Life Insurance Company of America) was recognized to present some additional information in support for charging the "equity tax" directly to surplus (Attachment B). Mr. Clark distributed minutes from a 1986 meeting of the working group (Attachment C) that include a discussion of this topic, and a recent letter received from John J. Palmer (Life of Virginia) concerning the issue (Attachment D).
>
> After further discussion, the working group reached a tentative consensus that this component of federal income taxes should be recorded as tax expense in the summary of operations and should not be charged directly to surplus. The issue will be further discussed at the Winter National Meeting in San Antonio in anticipation of reaching a final consensus.

49. Emerging Accounting Issues Working Group Position EI 95-4, *Equity Tax*, provides the following guidance on statutory accounting for a mutual life insurer's equity tax:

> 1. Equity Tax

assets for the future tax consequences of events[3] that have been recognized in an enterprise's financial statements or tax returns.

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[3] Some events do not have tax consequences. Certain revenues are exempt for taxation and certain expenses are not deductible. In the United States, for example, interest earned on certain municipal obligations is not taxable and fines are not deductible.

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7. Ideally, the second objective might be stated more specifically to recognize the *expected* future tax consequences of events that have been recognized in the financial statements or tax returns. However, the objective is realistically constrained because (a) the tax payment or refund that results from a particular tax return is a joint result of all the items included in that return, (b) taxes that will be paid or refunded in future years are the joint result of events of the current or prior years and events of future years, and (c) information available about the future is limited. As a result, attribution of taxes to individual items and events is arbitrary and, except in the simplest situations, requires estimates and approximations.

8. To implement the objectives in light of these constraints, the following basic principles (the only exceptions are identified in paragraph 9) are applied in accounting for income taxes at the date of the financial statements:

a. A current tax liability or asset is recognized for the estimated taxes payable or refundable on tax returns for the current year.
b. A deferred tax liability or asset is recognized for the estimated future tax effects attributable to temporary differences and carryforwards.
c. The measurement of current and deferred tax liabilities and assets is based on provisions of the enacted law; the effects of future changes in tax laws or rates are not anticipated.
d. The measurement of deferred tax assets is reduced, if necessary, by the amount of any tax benefits that, based on available evidence, are not expected to be realized.

9. The only exceptions in applying those basic principles are that this Statement:

a. Continues certain exceptions to the requirements for recognition of deferred taxes for the areas addressed by APB Opinion No. 23*, Accounting for Income Taxes - Special Areas*, as amended by this Statement (paragraphs 31-34)
b. Provides special transitional procedures for temporary differences related to deposits in statutory reserve funds by U.S. steamship enterprises (paragraph 32)
c. Does not amend accounting for leveraged leases as required by FASB

Temporary Differences

g. An increase in the tax basis of assets because of indexing whenever the local currency is the functional currency. The tax law for a particular tax jurisdiction

of deferred tax assets. This Statement refers to those actions as tax-planning strategies. An enterprise shall consider tax-planning strategies in determining the amount of valuation allowance required. Significant expenses to implement a tax-planning strategy or any significant losses that would be recognized if that strategy were implemented (net of any recognizable tax benefits associated with those expenses or losses) shall be included in the valuation allowance. Refer to paragraphs 246-251 for additional guidance.

23. Forming a conclusion that a valuation allowance is not needed is difficult when there is negative evidence such as cumulative losses in recent years. Other examples of negative evidence include (but are not limited to) the following:

a. A history of operating loss or tax credit carryforwards expiring unused
b. Losses expected in early future years (by a presently profitable entity)
c. Unsettled circumstances that, if unfavorably resolved, would adversely affect future operations and profit levels on a continuing basis in future years
d. A carryback, carryforward period that is so brief that it would limit realization of tax benefits if (1) a significant deductible temporary difference is expected to reverse in a single year or (2) the enterprise operates in a traditionally cyclical business.

24. Examples (not prerequisites) of positive evidence that might support a conclusion that a valuation allowance is not needed when there is negative evidence include (but are not limited to) the following:

a. Existing contracts or firm sales backlog that will produce more than enough taxable income to realize the deferred tax asset based on existing sales prices and cost structures
b. An excess of appreciated asset value over the tax basis of the entity's net assets in an amount sufficient to realize the deferred tax asset
c. A strong earnings history exclusive of the loss that created the future deductible amount (tax loss carryforward or deductible temporary difference) coupled with evidence indicating that the loss (for example, an unusual, infrequent, or extraordinary item) is an aberration rather than a continuing condition.

25. An enterprise must use judgment in considering the relative impact of negative and positive evidence. The weight given to the potential effect of negative and positive evidence should be commensurate with the extent to which it can be objectively verified. The more negative evidence that exists (a) the more positive evidence is necessary and (b) the more difficult it is to support a conclusion that a valuation allowance is not need for some portion or all of the deferred tax asset.

An Enacted Change in Tax Laws or Rates

27. Deferred tax liabilities and assets shall be adjusted for the effect of a change in tax laws or rates. The effect shall be included in income from continuing operations for the period that includes the enactment date.

A Change in Tax Status of an Enterprise

28. An enterprise's tax status may change from nontaxable to taxable or from taxable to nontaxable. An example is a change from a partnership to a corporation and vice versa. A deferred tax liability or asset shall be recognized for temporary differences in accordance with the requirements of this Statement at the date that a nontaxable enterprise becomes a taxable enterprise. A deferred tax liability or asset shall be eliminated at the date an enterprise ceases to be a taxable enterprise. In either case, the effect of (a) an election for a voluntary change in tax status is recognized on the approval date or on the filing date if approval is not necessary and (b) a change in tax status that results from a change in tax law is recognized on the enactment date.

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The effect of recognizing or eliminating the deferred tax liability or asset shall be included in income from continuing operations.

Opinion 23 and U.S. Steamship Enterprise Temporary Differences

31. A deferred tax liability is not recognized for the following types of temporary differences unless it becomes apparent that those temporary differences will reverse in the foreseeable future:

a. An excess of the amount for financial reporting over the tax basis of an investment in a foreign subsidiary or a foreign corporate joint venture as defined in *APB Opinion No. 18, The Equity Method of Accounting for Investments in Common Stock,* that is essentially permanent in duration.
b. Undistributed earnings of a domestic subsidiary or a domestic corporate joint venture that is essentially permanent in duration that arose in fiscal years beginning on or before December 15, 1992[9]
c. “Bad Debt reserves” for tax purposes of U.S. savings and loan associations (and other “qualified thrift lenders) that arose in tax years beginning before December 31, 1987 (that is, the base year amount)
d. “Policyholders’ surplus” of stock life insurance companies that arose in fiscal years beginning on or before December 15, 1992.

The indefinite reversal criterion of Opinion 23 shall not be applied to analogous types of temporary differences.

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[9] A last-in, first-out (LIFO) pattern determines whether reversals pertain to differences that arose in fiscal years beginning on or before December 15, 1992.

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32. A deferred tax liability shall be recognized for the following types of taxable temporary differences:

a. An excess of the amount for financial reporting over the tax basis of an investment in a domestic subsidiary that arises in fiscal years beginning after December 15, 1992
b. An excess of the amount for financial reporting over the tax basis of an investment in a 50-percent-or-less-owned investee except as provided in paragraph 31.a. and 31.b. for a corporate joint venture that is essentially permanent in duration
c. “Bad debt reserves” for tax purposes of U.S. savings and loan associations (and other “qualified thrin 2I not be applied to a amoeJ0ct

a. An enterprise may elect to determine taxable gain or loss on the liquidation of an 80-percent-or-more-owned subsidiary by reference to the tax basis of the subsidiary's net assets rather than by reference to the parent company's tax basis for the stock of that subsidiary.

b. An enterprise may execute a statutory merger whereby a subsidiary is merged into the parent company, the minority shareholders receive stock of the parent, the subsidiary's stock is cancelled, and no taxable gain or loss results if the continuity of ownership, continuity of business enterprise, and certain other requirements of the tax law are met.

Some elections for tax purposes are available only if the parent company owns a specified percentage of the subsidiary's stock. The parent company sometimes may own less than that specified percentage, and the price per share to acquire a minority interest may significantly exceed the per share equivalent of the amount reported as minority interest in the consolidated financial statements. In those circumstances, the excess of the amount for financial reporting over the tax basis of the parent's investment in the subsidiary is not a taxable temporary difference if settlement of the minority interest is expected to occur at the point in time when settlement would not result in a significant cost. That could occur, for example, toward the end of the life of the subsidiary, after it has recovered and settled most of its assets and liabilities, respectively. The fair value of the minority interest ordinarily will approximately equal its percentage of the subsidiary's net assets if those net assets consist primarily of cash.

34. A deferred tax asset shall be recognized for an excess of the tax basis over the amount for financial reporting of an investment in a subsidiary or corporate joint venture that is essentially permanent in duration only if it is apparent that the temporary difference will reverse in the foreseeable future. The need for a valuation allowance for that deferred tax asset and other deferred tax assets related to Opinion 23 temporary differences (for example, a deferred tax asset for foreign tax credit carryforwards or for a savings and loan association's bad-debt reserve for financial reporting) shall be assessed. Paragraph 21 identifies four sources of taxable income to be considered in determining the need for and amount of a valuation allowance for those and other deferred tax assets. One source is future reversals of temporary differences. Future reversals of taxable differences for which a deferred tax liability has not been recognized based on the exceptions cited in paragraph 31, however, shall not be considered. Another source is future taxable income exclusive of reversing temporary differences and carryforwards. Future distributions of future earnings of a subsidiary or corporate joint venture, however, shall not be considered except to the extent that a deferred tax liability has been recognized for existing undistributed earnings or earnings have been remitted in the past.

Intraperiod Tax Allocation

35. Income tax expense or benefit for the year shall be allocated among continuing operations, discontinued operations, extraordinary items, and items charged or credited directly to shareholders' equity (paragraph 36). The amounts allocated to continuing operations is the tax effect of the pretax income or loss from continuing operations that occurred during the year, plus or minus income tax effects of (a) changes in circumstances that cause a change in judgment about the realization of deferred tax assets in future years (paragraph 26), (b) changes in tax laws or rates (paragraph 27), (c) changes in tax status (paragraph 28), and (d) tax-deductible dividends paid to shareholders (except as set forth in paragraph 36 for dividends paid on unallocated shares held by an employer stock ownership plan [ESOP] or any other stock compensation arrangement). The remainder is allocated to items other than continuing operations in accordance with the provisions of paragraph 38.

36. The tax effects of the following items occurring during the year are charged or credited directly to related components of shareholders' equity:

a. Adjustments of the opening balance of retained earnings for certain changes in accounting principles or a correction of an error

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b. Gains and losses included in comprehensive income but excluded from net income (for example, translation adjustments under Statement 52 and changes in the carrying amount of marketable securities under FASB Statement No. 12, Accounting for Certain Marketable Securities)

c. An increase or decrease in contributed capital (for example, deductible expenditures reported as a reduction of the proceeds from issuing capital stock)

d. An increase in the tax basis of assets acquired in a taxable business combination accounted for as a pooling of interests and for which a tax benefit is recognized at the date of the business combination

e. Expenses for employee stock options recognized differently for financial reporting and tax purposes (refer to paragraph 17 of APB Opinion No. 25, Accounting for Stock Issued to Employees)

f. Dividends that are paid on unallocated shares held by an ESOP and that are charged to retained earnings

g. Deductible temporary differences and carryforwards that existed at the date of a quasi reorganization (except as set forth in paragraph 39).

37. The tax benefit of an operating loss carryforward or carryback (other than those carryforwards referred to at the end of this paragraph) shall be reported in the same manner as the source of the income or loss in the current year and not in the same manner as (a) the source of the operating loss carryforward or taxes paid in a prior year or (b) the source of expected future income that will result in realization of a deferred tax asset for an operating loss carryforward from the current year. The only exceptions are as follows:

b. The total of all deferred tax assets measured in procedures (c) and (d) of paragraph 17
c. The total valuation allowance recognized for deferred tax assets determined in procedure (e) of paragraph 17.

The net change during the year in the total valuation allowance also shall be disclosed. A public enterprise shall disclose the approximate tax effect of each type of temporary difference and carryforward that gives rise to a significant portion of deferred tax liabilities and deferred tax assets (before allocation of valuation allowances). A nonpublic enterprise shall disclose the types of significant temporary differences and carryforwards but may omit disclosure of the tax effects of each type. A public enterprise that is not subject to income taxes because its income is taxed directly to its owners shall disclose that fact and the net difference between the tax bases and the reported amounts of the enterprise's assets and liabilities.

44. The following information shall be disclosed whenever a deferred tax liability is not recognized because of the exceptions to comprehensive recognition of deferred taxes for any of the areas addressed by Opinion 23 (as amended by this Statement) or for deposits in statutory reserve funds by U.S. steamship enterprises:

a. A description of the types of temporary differences for which a deferred tax liability has not been recognized and the types of events that would cause those temporary differences to become taxable
b. The cumulative amount of each type of temporary difference
c. The amount of the unrecognized deferred tax liability for temporary differences related to investments in foreign subsidiaries and foreign corporate joint ventures that are essentially permanent in duration if determination of that liability is practicable or a statement that determination is not practicable
d. The amount of the deferred tax liability for temporary differences other than those in (c) above (that is, undistributed domestic earnings, the bad-debt reserve for tax purposes of a U.S. savings and loan association or other qualified thrift lender, the policyholders' surplus of a life insurance enterprise, and the statutory reserve funds of a U.S. steamship enterprise) that is not recognized in accordance with the provisions of paragraphs 31 and 32.

45. The significant components of income tax expense attributable to continuing operations for each year presented shall be disclosed in the financial statements or notes thereto. Those components would include, for example:

a. Current tax expense or benefit
b. Deferred tax expense or benefit (exclusive of the effects of other components listed below)
c. Investment tax credits
d. Government grants (to the extent recognized as a reduction of income tax expense)
e. The benefits of operating loss carryforwards
f. Tax expense that results from allocating certain tax benefits either directly to contributed capital or to reduce goodwill or other noncurrent intangible assets of an acquired entity
g. Adjustments of a deferred tax liability or asset for enacted changes in tax laws or rates or a change in the tax status of the enterprise
h. Adjustments of the beginning-of-the-year balance of a valuation allowance because of a change in circumstances that causes a change in judgment about the realizability of the related deferred tax asset in future years.

46. The amount of income tax expense or benefit allocated to continuing operations and the amounts separately allocated to other items (in accordance with the provisions of paragraphs 35-39) shall be disclosed for each year for which those items are presented.

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47. A public enterprise shall disclose a reconciliation using percentages or dollar amounts of (a) the reported amount of income tax expense attributable to continuing operations for the year to (b) the amount of income tax expense that would result from applying domestic federal statutory tax rates to pretax income from continuing operations. The "statutory" tax rates shall be the regular tax rates if there are alternative tax systems. The estimated amount and the nature of each significant reconciling item shall be disclosed. A nonpublic enterprise shall disclose the nature of significant reconciling items but may omit a numerical reconciliation. If not otherwise evident from the disclosures required by this paragraph and paragraphs 43-46, all enterprises shall disclose the nature and effect of any other significant matters affecting comparability of information for all periods presented.

48. An enterprise shall disclose (a) the amounts and expiration dates of operating loss and tax credit carryforwards for tax purposes and (b) any portion of the valuation allowance for deferred tax assets for which subsequently recognized tax benefits will be allocated to reduce goodwill or other noncurrent intangible assets of an acquired entity or directly to contributed capital (paragraphs 30 and 36).

49. An entity that is a member of a group that files a consolidated tax return shall disclose in its separately issued financial statements:

a. The aggregate amount of current and deferred tax expense for each statement of earnings presented and the amount of any tax-related balances due to or from affiliates as of the date of each statement of financial position presented

a. The effect, if any, of adopting this Statement on pretax income from continuing operations (for example, the effect of adjustments for prior purchase business

- *FASB Emerging Issues Task Force No. 92-8, Accounting for the Income Tax Effects under FASB Statement No. 109 of a Change in Functional Currency When an Economy Ceases to Be Considered Highly Inflationary*
- *FASB Emerging Issues Task Force No. 93-13, Effect of a Retroactive Change in Enacted Tax Rates That Is Included in Income from Continuing Operations*
- *FASB Emerging Issues Task Force No. 93-16, Application of FASB Statement No. 109 to Basis*

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