

Insurance Spotlight

NAIC Approves SSAP No. 101, *Income Taxes*

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The Bottom Line

- The NAIC¹ has adopted SSAP No. 101² with minimal changes from the revised July exposure draft. The effective date is January 1, 2012, which aligns with the sunset provision in SSAP No. 10R³ that would have reverted statutory accounting for income taxes back to the original provisions of SSAP No. 10.⁴
- SSAP No. 101 retains some of the changes made to SSAP No. 10R, including (1) the possibility of a three-year reversal period and (2) a 15 percent surplus limit. Significant new changes to SSAP No. 101 include the deletion of the SSAP No. 10R optionality paragraphs. As a result of that deletion, companies that did not previously elect to record their admitted deferred tax assets (DTAs) under the three-year reversal period or 15 percent of surplus will now need to modify their processes to adopt the required provisions of SSAP No. 101.
- SSAP No. 101 changes the recognition and measurement guidance on uncertain tax positions by reducing the recognition threshold from probable to more likely than not. The contingency reserve is measured at management's best estimate, and if the estimated tax loss contingency is greater than the 50 percent threshold, then a contingency reserve must be recorded in an amount equal to the *full* benefit recorded by the entity.
- Regulators are focused, more than ever, on how management uses tax-planning strategies to admit DTAs. Companies need to prepare for the possibility of increased scrutiny during examinations, particularly as regulators look to ensure that tax-planning strategies are not inconsistent with other financial statement assertions (e.g., intent to sell securities). They should also examine why tax-planning strategies considered for admitting assets have not been implemented (e.g., elimination of discretionary costs such as employee benefits).

NAIC adopts SSAP No. 101 to align to the sunset provisions in SSAP No. 10R.

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¹ National Association of Insurance Commissioners.

² Statement of Statutory Accounting Principles No. 101, *Income Taxes, A Replacement of SSAP No. 10R and SSAP No. 10*.

³ Statement of Statutory Accounting Principles No. 10R, *Income Taxes, A Temporary Replacement of SSAP No. 10*.

⁴ Statement of Statutory Accounting Principles No. 10, *Income Taxes*.

Beyond the Bottom Line

This *Insurance Spotlight* summarizes the significant changes that result from the NAIC's approval of SSAP No. 101. This newly adopted guidance is effective January 1, 2012, and could significantly affect statutory accounting and the related disclosures for certain insurance companies.

Changes in Statutory Income Tax Accounting

Statutory accounting related to income taxes has been an area of considerable debate since the financial crisis began several years ago. Before the financial crisis, SSAP No. 10 remained relatively unchanged from its original form as adopted in 2001. However, beginning in 2008, insurance companies began requesting and using permitted practices to determine the amount of DTAs that could be admitted. These practices generally allowed for a greater admitted DTA to be recorded in the financial statements than under SSAP No. 10.

Diversity in the application of SSAP No. 10 led regulators to propose a temporary adoption of accounting for income taxes under SSAP No. 10R. The accounting standard under SSAP No. 10R offered companies the ability to make an accounting election to lengthen the realization period of DTAs to three years with a 15 percent capital surplus limit as opposed to the original SSAP No. 10 requirement for a one-year realization period of DTAs with a 10 percent capital surplus limit.

The NAIC exposed and reexposed SSAP No. 101 this year and proposed an effective date of January 1, 2012, to align with the sunset provisions created under SSAP No. 10R. On the basis of the feedback received, the NAIC addressed concerns initially raised by companies and in the fall of 2011 approved SSAP No. 101 with the significant changes from SSAP No. 10R outlined below.

Tax Contingency Reserves

SSAP No. 101 replaces the SSAP No. 5⁵ *probable* and *reasonably estimated* criterion for recording tax contingencies with a *more-likely-than-not* and *reasonably estimated* criterion consistent with the proposed criteria under SSAP No. 5R.⁶

The contingency reserve is measured at management's best estimate. If the estimated tax loss contingency is greater than 50 percent of the original benefit recorded, then a contingency reserve must be recorded equal to the full benefit recorded by the entity (i.e., 100 percent of the original benefit). Further, management must presume that the tax position will be examined by a taxing authority and that the taxing authority has full knowledge of the relevant facts.

Tax contingency reserves related to timing items are not required to be "grossed up" unless an event has occurred that has given rise to a potential adjustment being issued by the taxing authority.

Although SSAP No. 101 did not adopt the requirements of Interpretation 48,⁷ as codified in ASC 740,⁸ certain themes, such as the more-likely-than-not criterion, remain in SSAP No. 101. Unlike Interpretation 48, however, gross-up of the current and deferred taxes is not required under SSAP No. 101 unless certain triggering events have occurred, and SSAP No. 101 further helps to avoid penalizing companies that would otherwise be required to set up a liability without the benefit of the offsetting DTA.

The NAIC has responded to challenges faced by insurance companies not only initially, when the provisions were put in place, but also when revisions were made under the initial exposure requirements of SSAP No. 101.

⁵ Statement of Statutory Accounting Principles No. 5, *Liabilities, Contingencies and Impairments of Assets*.

⁶ Statement of Statutory Accounting Principles No. 5R, *Liabilities, Contingencies and Impairments of Assets*.

⁷ FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* — An Interpretation of FASB Statement No. 109.

⁸ FASB Accounting Standards Codification Topic 740, *Income Taxes*.

Deferred Taxes

The net admitted DTA under the new guidance in SSAP No. 101 is calculated as the sum of the following:

1. Federal income taxes paid in prior years that can be recovered through loss carrybacks for existing temporary difference that reverse in the timeframe consistent with the IRS loss carryback provisions, not to exceed three years. (For property and casualty companies, ordinary items are limited to two years while capital items are three years as mandated by the Internal Revenue Code.)
2. The remaining amount of adjusted gross DTA (as reduced by the statutory valuation allowance (SVA)) expected to be realized during the “applicable time period” (ranging from zero to three years) not to exceed the “applicable percentage” (ranging from zero to 15 percent) of the *current period* adjusted statutory surplus as determined by the type of risk-based capital (RBC) requirement that exists for the company.
3. The remaining amount of adjusted gross DTA that can be offset by deferred tax liabilities (DTLs). When applying the offsetting criteria, companies must consider the reversal patterns of temporary differences.

The loss carryback provisions as well as the offsetting provision of this calculation require companies to consider the tax character (i.e., whether the item is capital or ordinary in nature) when applying SSAP No. 101.

Asset Admissibility

SSAP No. 101 removes several items from SSAP No. 10R, including:

- The election related to a three-year reversal pattern of DTAs.
- A 15 percent surplus limitation if certain RBC criteria were met.
- The limitation related to the additional DTA benefits derived from the three-year DTA reversal (if such an election was made) as a surplus write-in.

The new guidance also requires the recording of an SVA to be a reduction of gross assets as recorded in the company’s annual statement balance sheet.

The manner of calculating an SVA is the same under SSAP No. 101 as it was under its predecessors. SSAP No. 101 merely clarified that the SVA is a *reduction of the gross DTA*. Therefore, the nonadmitted DTA does not include or serve as a substitute for the valuation allowance.

SSAP No. 101 also formally adopts the use of tax-planning strategies in the determination of the SVA and admissibility of DTAs consistent with ASC 740. The following three-step consideration process is used in the revised admissibility calculation under SSAP No. 101:

- *Step 1* — Requires consideration of a three-year reversal (scheduling) pattern of DTAs, without any consideration of a RBC limitation. Taxes paid under part one of the admissibility test should include tax contingency accruals along with income taxes paid in prior year determinations.
- *Step 2* — Requires a computation of the company’s authorized control level (ACL) RBC level excluding the DTA (ExDTA ACL RBC). Using the applicable industry tables, admissibility limits are either zero years and zero percent of adjusted surplus, one year and 10 percent of adjusted surplus, or three years and 15 percent of adjusted surplus.
- *Step 3* — Requires consideration of the character of the DTAs and DTLs, in addition to providing guidance on the level of detail required for scheduling of the DTAs and DTLs. It should be noted that the scheduling exercise should be consistent with the determination of an SVA before the admissibility test.

SSAP No. 101
removes the election
option previously
allowed under SSAP
No. 10R.

The scheduling of timing items often does not need to be a spreadsheet exercise. However, companies might consider including a memorandum in their accounting files discussing the nature of the timing differences and the reversal patterns.

Disclosures

SSAP No. 101 requires new disclosure of tax-planning strategies that takes into account reinsurance transactions. It also requires disclosure of tax contingency reserves for which it is *reasonably possible* that the total liability will significantly increase *within 12 months* of the reporting period. Further, it requires the reporting entity to disclose an estimate of the range or a statement that such an estimate cannot be made.

The NAIC has indicated that a revised questions and answers document will be drafted for the new SSAP No. 101 guidance. It is also anticipated that the NAIC will draft an issue paper discussing the rationale and basis for its conclusions under SSAP No. 101. The timeline for issuance of these documents is not yet known.

Challenges for Insurance Companies

SSAP No. 101 now requires companies to consider their current reporting period data as opposed to looking at prior reporting periods. Therefore, companies will be required to compute the ExDTA ACL RBC to calculate the admitted DTA.

Although companies may already have a process in place for calculating RBC, the permanence of SSAP No. 101 may warrant a fresh look at processes and controls over this important calculation. Further, coordination with multiple departments will be necessary as companies work to obtain and develop the necessary reversal schedules. Management, regulators, and auditors are likely to focus more on the process, controls, and results especially when a company's ExDTA ACL RBC is nearing a threshold for the number years and percentage of surplus to be considered in the admittance test. Controls may include those related to automated information technology as well as to user input and review.

Thinking Ahead

Although SSAP No. 101 is effective January 1, 2012, disclosure of the impact of the adoption of SSAP No. 101 may be required in the audited 2011 statutory basis financial statements given the timing for issuing these audited statements and the preparation of the first quarter 2012 statements. Therefore, companies should consider addressing any process modifications before January 1, 2012, to avoid last minute issues.

The adoption of SSAP No. 101 did not come without opposition; therefore, it is possible that some states will prescribe practices that modify SSAP No. 101 criteria.

Management, regulators, and auditors are likely to apply more scrutiny to the processes, controls, and results.

Other Deloitte Resources

- November 2011, Insurance Spotlight, "October Roundtable and Joint Meeting Highlights."
- September 2011, Insurance Spotlight, "Insurance Contracts — A Look at the Current State of the Convergence Project."

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