

# Statutory Issue Paper No. 83

## Accounting for Income Taxes

### STATUS

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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

### SUMMARY OF ISSUE

1. Current statutory accounting principles, as applied to income taxes, generally only reflect a reporting entity's incurred current taxes and do not consider the tax effects of differences between statutory accounting income and taxable income. While there have always been differences between statutory accounting income and taxable income, tax law changes since 1984 have resulted in greater differences between the two accounting methods. As a result, statutory surplus does not clearly reflect a reporting entity's ultimate income tax obligation for transactions recorded in the financial statements.
2. GAAP guidance on accounting for income taxes is provided in *FASB Statement No. 109, Accounting for Income Taxes* (FAS 109).
3. Current statutory accounting guidance is not specific with respect to:
  - a. The definition of incurred taxes as it relates to accounting for tax contingencies and the "true-up" portion of the equity tax of mutual life insurance companies and
  - b. The criteria for admissibility of income tax recoverables from the Internal Revenue Service (IRS) and the definition of "settled within a reasonable time" as applied to recoverables from a reporting entity's parent pursuant to a written income tax allocation agreement.
4. The purpose of this paper is to establish statutory accounting principles for income taxes that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

### SUMMARY CONCLUSION

5. For purposes of statutory accounting, "income taxes incurred" includes current income taxes, the amount of federal and foreign income taxes paid (recovered) or payable (recoverable) for the current year. Current income taxes are defined as:
  - a. Current year estimates of federal and foreign income taxes (including the equity tax of a mutual life insurer and the "true-up" of such tax), based on tax returns for the current year, and tax contingencies for current and all prior years, to the extent not previously provided, computed in accordance with *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets* (Issue Paper No. 5) and

- 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 in tax status, if any, shall be recognized as a separate component of gains and losses in unassigned funds (surplus).
9. Gross DTAs shall be admitted in an amount equal to the sum of:
  - a. Federal income taxes paid in prior years that can be recovered through loss carrybacks for existing temporary differences that reverse by the end of the subsequent calendar year,
  - b. The lesser of:
    - i. The amount of gross DTAs, after the application of paragraph 9.a., expected to be realized within one year of the balance sheet date, or
    - ii. Ten percent of statutory capital and surplus as required to be shown on the statutory balance sheet of the reporting entity for its most recently filed statement with the domiciliary state commissioner adjusted to exclude any net DTAs, EDP equipment and operating system software and any net positive goodwill; and
  - c. The amount of gross DTAs, after the application of paragraphs 9.a. and 9.b., that can be offset against existing DTLs.
10. In computing a reporting entity’s gross DTA pursuant to paragraph 9;
  - a. Existing temporary differences that reverse by the end of the subsequent calendar year shall be determined in accordance with paragraphs 228 and 229 of FAS 109;
  - b. In determining the amount of federal income taxes that can be recovered through loss carrybacks, the amount and character (i.e., ordinary versus capital) of the loss carrybacks

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.

12. In the case of a reporting entity that files a consolidated income tax return with one or more affiliates, income tax transactions (including payment of tax contingencies to its parent) between the affiliated parties shall be recognized if:

- a. Such transactions are *economic transactions* as defined in *Issue Paper No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties* (Issue Paper No. 25),
- b. Are pursuant to a written income tax allocation agreement and
- c. Income taxes incurred are accounted for in a manner consistent with the principles of FAS 109, as modified by this issue paper.

Amounts owed to a reporting entity pursuant to a recognized transaction shall be treated as a loan or advance, and nonadmitted, pursuant to Issue Paper No. 25, to the extent that the recoverable is not settled within 90 days of the filing of a consolidated income tax return, or where a refund is due the reporting entity’s parent, within 90 days of the receipt of such refund.

13. Income taxes incurred shall be allocated to net income and realized capital gains or losses in a manner consistent with paragraph 38 of FAS 109. Furthermore, income taxes incurred or received during the current year attributable to prior years shall be allocated, to the extent not previously provided, to net income in accordance with Issue Paper No. 3 unless attributable, in whole or in part, to realized capital gains or losses, in which case, such amounts shall be apportioned between net income and realized capital gains and losses, as appropriate.

14. Income taxes incurred in interim periods shall be computed using an estimated annual effective current tax rate for the annual period in accordance with the methodology described in paragraphs 19 and 20 of *Accounting Principles Board Opinion No. 28, Interim Financial Reporting* (APB 28). Estimates of the annual effective tax rate at the end of interim periods are, of necessity, based on estimates and are subject to subsequent refinement or revision. If a reliable estimate cannot be made, the actual effective tax rate for the year-to-date may be the best estimate of the annual effective tax rate. If a reporting entity is unable to estimate a part of its “ordinary” income (or loss) or the related tax (or benefit) but is otherwise able to make a reliable estimate, the tax (or benefit) applicable to the item that cannot be estimated shall

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 of paragraphs 43-45 and 48 of FAS 109. However, required disclosures with regard to a reporting entity's valuation allowance shall be replaced with disclosures relating to the nonadmittance of some portion or all of a reporting entity's DTAs. Additionally, to the extent that the sum of a reporting entity's "income taxes incurred" (i.e., current income taxes) and the change in its DTAs and DTLs is different from the result obtained by applying the federal statutory rate to its pretax net income, a reporting entity shall disclose the nature of the significant reconciling items. Current statutory financial statement disclosure, as it relates to intercompany tax allocation agreements, is retained. Current statutory financial statement disclosure is excerpted in paragraphs 42 and 43 of this issue paper. Paragraphs 16-21 describe the disclosure requirements as modified for the difference between the requirements of FAS 109 and those prescribed by this issue paper.

16. The components of the net DTA or DTL recognized in a reporting entity's balance sheet shall be disclosed as follows:

- a. The total of all DTAs (admitted and nonadmitted);
- b. The total of all DTLs;
- c. The total DTAs nonadmitted as the result of the application of paragraph 9; and
- d. The net change during the year in the total DTAs nonadmitted.

17. To the extent that DTLs are not recognized for amounts described in paragraph 31 of FAS 109, the following shall be disclosed:

- a. A description of the types of temporary differences for which a DTL 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 DTL 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; and
- d. The amount of the DTL for temporary differences other than those in item c. above that is not recognized in accordance with the provisions of paragraphs 31 of FAS 109.

18. The significant components of income taxes incurred (i.e., current income tax expense) and the changes in DTAs and DTLs shall be disclosed. Those components would include, for example:

- a. Current tax expense or benefit;
- b. The change in DTAs and DTLs (exclusive of the effects of other components listed below);
- c. Investment tax credits;
- d. The benefits of operating loss carryforwards; and

- e. Adjustments of a DTA or DTL for enacted changes in tax laws or rates or a change in the tax status of the reporting entity.
19. Additionally, to the extent that the sum of a reporting entity's income taxes incurred and the change in its DTAs and DTLs is different from the result obtained by applying the federal statutory rate to its pretax net income, a reporting entity shall disclose the nature of the significant reconciling items.
20. A reporting entity shall also disclose the following:
- a. The amounts, origination dates and expiration dates of operating loss and tax credit carryforwards available for tax purposes; and
  - b. The amount of federal income taxes incurred in the current year and each preceding year, which are available for recoupment in the event of future net losses.
21. If a reporting entity's federal income tax return is consolidated with those of any other entity or entities, the following shall be disclosed:
- a. A list of names of the entities with whom the reporting entity's federal income tax return is consolidated for the current year; and
  - b. The substance of the written agreement, approved by the reporting entity'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.) Additionally, the disclosure shall include the manner in which the entity 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.

## DISCUSSION

22. Statutory accounting principles with respect to income taxes incurred (i.e., current income taxes), as set forth in this issue paper, differ from current statutory guidance as follows:
- a. The definition of current income taxes is clarified by defining such taxes to include current year estimates of federal and foreign income taxes, based on tax returns for the current year, tax contingencies computed in accordance with Issue Paper No. 5, and all 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. In the case of a mutual life insurance company, current income tax includes the reporting entity's best estimate of its equity tax for the current year, after recomputation (i.e., including the "true-up") in accordance with the guidance contained in Emerging Accounting Issues Working Group Positions 86-1, True-up of Federal Income Taxes for Mutual Life Insurance Companies, and 95-3 & 4, Equity Tax.
  - b. The definition of current income tax recoverables is modified by defining such amounts as including all current income taxes reasonably expected to be received in a subsequent period, whether or not a return or claim has been filed with the taxing authorities. The criteria for admissibility of current income tax recoverables is also modified by admitting them if they are reasonably expected to be recovered pursuant to Issue Paper No. 4.

- c. Statutory accounting principles with respect to the recognition of income tax transactions between affiliated parties that file a consolidated income tax return are modified to ensure that such transactions are recognized consistently among all reporting entities.
- d. Statutory accounting principles with respect to the computation of income taxes incurred in interim periods is modified by requiring the use of the estimated annual effective tax rate for purposes of computed income taxes incurred in interim periods as such a method allows for the comparison of income tax rates among reporting entities, recognizes that an interim period is an integral part of the annual accounting period, and adopts paragraphs 19 and 20 of APB 28.
- e. Financial statement disclosure is expanded to include disclosure of the components of current income tax expense, DTAs and DTLs, information as to the portion of a reporting entity's DTAs that are nonadmitted and, items for which DTLs have not been established in order to provide meaningful information to the users of a reporting entity's financial statements.
- f. Current statutory accounting practice of recording extraordinary amounts of taxes relating to prior years as a component of gains and losses in surplus has been changed to provide that all changes in estimates of income taxes incurred will be recorded in statutory income consistent with Issue Paper No. 3.

23. The definition of current income taxes is clarified to ensure that current income taxes incurred are computed in accordance with the Statement of Concepts, to enhance the comparability of financial statements, and, with respect to the inclusion of tax contingencies, to ensure consistency with the recognition principle of the Statement of Concepts which requires the recognition of liabilities as they are incurred.

24. The definition of current income tax recoverables, and their admissibility, is modified by defining such amounts as including all current income taxes reasonably expected to be received in a subsequent period, whether or not a return or claim has been filed with the taxing authorities, so that such amounts are recorded and admitted based on reasonably objective criteria (i.e., expectation of recovery) and not predicated on subjective criteria (e.g., receipt within a specific timeframe). Current statutory accounting principles' use of subjective criteria precludes reporting entities that are continually under Internal Revenue Service (IRS) audit pursuant to the Coordinated Examination Program from admitting valid income tax recoverables since the IRS will not refund such amounts until an audit is completed. As a result, many of these taxpayers do not file amended income tax returns but rather present these valid claims to the IRS during the audit as "affirmative adjustments".

25. The principles of FAS 109, including the recognition of DTAs and DTLs, are adopted with the following modifications:

- a. For purposes of this issue paper, income taxes do not include state income taxes. State income taxes (including franchise taxes) shall be computed in accordance with Issue Paper No. 5 and shall be limited to (a) taxes due as a result of the current year's taxable income calculated in accordance with state laws and regulations and (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. Property and casualty insurance companies shall report state income taxes as other underwriting expenses under the caption "Taxes, licenses, and fees." Life and accident and health insurance companies shall report such amounts as general expense under the "Insurance taxes, licenses, and fees, excluding federal income taxes." Other health entities shall report such amounts as general administration expenses under the caption "Taxes,

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 pursuant to this issue paper is nonadmitted.
  - d. Temporary differences do not include AVR, 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. Current statutory guidance on the accounting for “tax and loss” bonds is excerpted in paragraph 40 of this issue paper.
  - e. Changes in DTAs and DTLs, including amounts attributable to changes in tax rates and changes in tax status are not included in net income in accordance with paragraphs 27 and 28 of FAS 109, but rather are allocated to gains and losses in surplus pursuant to this issue paper.
  - f. Paragraphs 29-30, 36-37, 39, 41-42, 46 and 49-59 of FAS 109 are not adopted, inasmuch as they are not applicable to insurance companies or are inconsistent with other statutory accounting principles. Paragraph 47 of FAS 109 is adopted with modification to provide for the disclosures required for non-public reporting entities.
26. The recognition of DTAs and DTLs is consistent with the Statement of Concepts and Issue Paper Nos. 4 and 5, respectively. While Emerging Accounting Issues Working Group Position EI 89-2, Establishing a Liability for Deferred Federal Income Taxes for Statutory Accounting Purposes allows the recording of DTLs, this issue paper requires the recording of DTAs. In defining the objectives of statutory financial reporting the Statement of Concepts states:

The primary responsibility of each state insurance department is to regulate insurance companies in accordance with state laws with an emphasis on solvency for the protection of policyholders. The ultimate objective of solvency regulation is to ensure that policyholder, contractholder and other legal obligations are met when they come due and that companies maintain capital and surplus at all times and in such forms as required by statute to provide an adequate margin of safety. The cornerstone of solvency measurement is financial reporting. Therefore, the regulator’s ability to effectively determine relative financial condition using financial statements is of paramount importance to the protection of policyholders. An accounting model based on the concepts of conservatism, consistency, and recognition is essential to useful statutory financial reporting.

27. Recognition of DTAs and DTLs and the requisite determination that the temporary differences underlying DTAs and DTLs will result in taxable or deductible amounts ensures that statutory surplus reflects the tax consequences of recorded events and is consistent with the assumptions inherent in the financial statements that the reported assets and liabilities will be recovered and settled, respectively. The conclusion reached with respect to the nonadmissibility of Section 847 deposits in Emerging Accounting Issues Working Group Position EI-93-4, Section 847 Deposits, need not be revisited as the tax effect of loss reserve discounting (i.e., a DTA) will be recognized, subject to a nonadmissibility test.

28. DTAs embody the three characteristics of assets, as described in Issue Paper No. 4, for the following reasons:

- 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 statements, and is therefore attributable to a “transaction or other event giving rise to the entity’s right to or control of the benefit [that] has already occurred.”

29. DTLs embody the three characteristics of liabilities, as described in Issue Paper No. 5, for the following reasons:

- a. Inasmuch as a DTL stems from a legal obligation imposed by a taxing authority, it “embodies a present duty or responsibility to one or more other entities that entails settlement by probable future transfer or use of assets at a specified or determinable date, on occurrence of a specified event, or on demand,”
- b. While a reporting entity may be able to delay the future reversal of the temporary differences, a DTL embodies a reporting entity’s duty or responsibility to pay a tax “leaving it little or no discretion to avoid the future sacrifice,” and
- c. A DTL is the tax effect of the difference between the tax basis of an asset or liability and its reported amount in the financial statements, and is therefore attributable to a “transaction or other event obligating the entity [that] has already happened.”

30. Temporary differences do not include differences, such as AVR, IMR, Schedule F penalties, or tax-exempt interest, inasmuch as these differences do not result in taxable or deductible amounts in future years when the related asset or liability for statutory reporting purposes is recovered or settled. Additionally, IMR is excluded from the definition of temporary differences since it is already net of current taxes paid (i.e., in essence a deferred tax has already been recorded). To the extent that a U.S. mortgage guaranty insurer has purchased “tax and loss” bonds, corresponding amounts of its statutory contingency reserve are excluded from the definition of temporary differences in order to preserve the statutory admissibility of “tax and loss” bonds and to ensure that the tax effect of the reserve is not double counted in a mortgage guaranty insurer’s surplus.

31. By adoption of the principles of FAS 109, as modified in this issue paper, temporary differences include unrealized gains and losses. As a result, unrealized gains and losses of reporting entities shall be recorded, net of any allocated DTA or DTL, in gains and losses in surplus. The amount allocated shall be computed in a manner consistent with paragraph 38 of FAS 109.

32. This statement rejects *FASB Interpretation No. 18, Accounting for Income Taxes in Interim Periods...an interpretation of APB Opinion No. 28*.

33. The following lists Accounting Principles Board Opinions that are adopted or rejected by this statement:

- a. *Accounting Principles Board Opinion No. 2, Accounting for the “Investment Credit,”* paragraphs 9-15 are adopted with modification to utilize the cost reduction method only and rejects all other paragraphs;



- 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;
34. The following lists FASB Technical Bulletins that are adopted or rejected by this statement:
- a. *FASB Technical Bulletin No. 79-9, Accounting in Interim Periods for Changes in Income Tax Rates* is rejected in its entirety;
  - b. *FASB Technical Bulletin No. 82-1, Disclosure of the Sale or Purchase of Tax Benefits through Tax Leases* is adopted in its entirety.
35. The following lists FASB Emerging Issues Task Force Issues that are adopted or rejected by this statement:
- a. *FASB Emerging Issues Task Force No. 91-8, Application of FASB Statement No. 96 to a State Tax Based on the Greater of a Franchise Tax or an Income Tax,* is rejected in its entirety;
  - b. *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,* is adopted in its entirety;
  - c. *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,* is rejected in its entirety;
  - d. *FASB Emerging Issues Task Force No. 93-16, Application of FASB Statement No. 109 to Basis Differences within Foreign Subsidiaries That Meet the Indefinite Reversal Criterion of APB Opinion No. 23,* is rejected in its entirety;
  - e. *FASB Emerging Issues Task Force No. 93-17, Recognition of Deferred Tax Assets for a Parent Company's Excess Tax Basis in the Stock of a Subsidiary That Is Accounted for as a Discontinued Operation,* is adopted in its entirety;
  - f. *FASB Emerging Issues Task Force No. 94-10, Accounting by a Company for the Income Tax Effects of Transactions among or with Its Shareholders under FASB Statement No. 109,* is rejected in its entirety;
  - g. *FASB Emerging Issues Task Force No. 95-9, Accounting for Tax Effects of Dividends in France in Accordance with FASB Statement No. 109,* is rejected in its entirety;
  - h. *FASB Emerging Issues Task Force No. 95-10, Accounting for Tax Credits Related to Dividend Payments in Accordance with FASB Statement No. 109,* is rejected in its entirety;

- 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 *AICPA Accounting Interpretations, Accounting for the Investment Credit: Accounting Interpretations of APB Opinion No. 4* in its entirety.

#### **Drafting Notes/Comments**

None

### **RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE**

#### **Statutory Accounting**

37. Chapter 20, Federal Income Taxes, of the Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies (P&C Accounting Practices and Procedures Manual) provides the following guidance:

Beginning with the Revenue Act of 1921, the Internal Revenue Code incorporates certain sections which govern the federal income taxation of property/liability insurance companies. The 1986 Tax Reform Act ("TRA") dramatically changed the manner in which such insurers are taxed, repealing Sections 821 through 826 of the Code and eliminating the differences that previously existed in the taxation of mutual and stock property/liability companies. The taxation of property/liability insurers is governed by Section 831 and 832 of the Internal Revenue Code of 1986.

With the enactment of the TRA, not only were the differences in tax treatment between mutual and stock companies eliminated, but, for the first time, a single property/liability tax return was developed — Form 1120-PC. Gone are the Protection Against Loss ("PAL") account and Form 1120M for mutual property/liability insurers, although provisions concerning the runoff of existing PAL accounts still exist.

Section 832 of the Code continues to define "gross income" as:

"A combined gross amount earned during the taxable year, from investment income and from underwriting income as provided in this subsection, computed on the basis of the underwriting and investment exhibit of the annual statement approved by the National Association of Insurance Commissioners. . ."

Small insurers continue to be eligible for different tax treatment, although they were also affected by the TRA. Any property/liability company with less than \$350,000 per year in (the greater of) net written or direct written premiums is exempt from federal income taxation under Code Section 501(c)(15). Property/liability insurers with net written premiums or direct written premiums (whichever is greater) in excess of \$350,000, but less than \$1,200,000, may make an election to be taxed only on taxable investment income. In the case of a member of a controlled group of corporations, the direct or net written premiums of the controlled group are aggregated in order to determine if the company may make the election. The ownership test for a control group is 50%, rather than 80%, for purposes of determining eligibility for the small company provision.

Each company must establish an appropriate liability for federal income taxes payable in its annual statement. This liability must be sufficient to cover computed taxes for current and prior years that are currently payable (total income tax less estimated tax payments), and any additional taxes the company expects to pay.

This chapter considers the method of accounting for federal income tax, and the differences between annual statement "net income" and "taxable income."

### 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:

- 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;
4. Carry-forward of any allowable deductions, such as excess charitable contributions;
5. Operating or capital loss carry-forwards allowable to the company;
6. Federal income tax refunds included in "net income";

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

In the case of 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 such as “Federal Income Tax Recoverable - Parent.”

Insurers may recognize intercompany transactions arising from income tax allocations among companies participating on a consolidated 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.

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.

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...”

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



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").

Phase III income can occur as a result of any of the following circumstances:

- The company makes certain distributions to shareholders, either as dividends or redemptions of stock, which are in excess of the shareholders' surplus account and are considered as reductions of the policyholders' surplus account.
- The policyholders' surplus account exceeds certain maximums based on net premiums and life insurance reserves.
- The company ceases to qualify as a life insurance company for tax purposes.

#### Statutory Treatment of Federal Income Taxes

In addition to United States income taxes, federal income taxes in the annual statement include income taxes levied by foreign countries and United States possessions. The handling of federal income taxes can appear in different places in the annual statement. These places are:

- Federal income tax recoverable is reported as an asset subject to asset admissibility criteria.
- Federal income taxes due or accrued are reported as a liability.
- Federal income taxes incurred during the year (excluding tax on capital gains) are deducted in the Summary of Operations.
- Federal income taxes incurred during the year relating to prior-period adjustments generally are included with current year taxes. However, in extraordinary instances it may be appropriate to charge such adjustments directly to the surplus account.
- Federal income taxes incurred during the year on capital gains are shown as a reduction of Gross Capital Gains and Losses on Investments.

Insurers may recognize transactions arising from income tax allocations among companies participating in a consolidated return, provided certain conditions are met.

39. Chapter 19, Expenses, of the P&C Accounting Practices and Procedures Manual provides the following guidance with respect to state income taxes:

Expense Group Classifications

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.S. Mortgage Guaranty Tax and Loss Bonds

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**

Contingency Reserve (for Tax Purposes, the “Mortgage Guaranty Account”)

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.

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.

ASSETS, PAGE 2

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.

NOTES TO FINANCIAL STATEMENTS

4. Federal Income Tax Allocation

Instruction:

- a. If the company's federal income tax return is combined with those of any other entity or entities, provide the following:
  1. A list of names of the entities with whom the company's federal income tax return is combined for the current year.
  2. 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.
- b. If the company incurred federal income taxes which are available for recoupment in the event of future net losses, indicate the amount available for recoupment from the current year, the first preceding year, and the second preceding year.
- c. If the company incurred net losses which are carried forward and are available to offset future net income subject to income taxes, indicate the amounts carried

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

2. 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.

- b. The amount of federal income taxes incurred and available for recoupment in the event of future net losses is:  
current year \$ \_\_\_\_\_; first preceding year \$ \_\_\_\_\_;  
second preceding year \$ \_\_\_\_\_

- c. The amount of net losses carried forward and available to offset future net income subject to federal income taxes is:  
current year \$ \_\_\_\_\_; first preceding year \$ \_\_\_\_\_;  
second preceding year \$ \_\_\_\_\_; third preceding year \$ \_\_\_\_\_;  
fourth preceding year \$ \_\_\_\_\_; fifth preceding year \$ \_\_\_\_\_;  
sixth preceding year \$ \_\_\_\_\_

43. The NAIC Annual Statement Instructions for Life and Accident and Health Insurance Companies provides the following guidance with respect to federal income taxes:

SUMMARY OF OPERATIONS (EXCLUDING UNREALIZED CAPITAL GAINS & LOSSES)

Line 30 - Federal Income Taxes Incurred

Include: Income and excess profits taxes, of any foreign country or of any possession of the U.S., incurred on operations.

Exclude: Taxes on capital gains and Extraordinary amounts of taxes relating to prior years.

The total of the amount in Line 30 minus extraordinary amounts of taxes reported in the "Details of Write-ins Aggregated at Line 46 for Gains and Losses in Surplus" on Line 46 plus Exhibit 3, Footnote (a), Line 1, Column B should be equal to Exhibit 12, Line 23.2 plus Page 3, Line 14A, current year, plus Page 2, Line 14, prior year, minus Page 3, Line 14A, prior year, minus Page 2, Line 14, Column 4, current year.

ASSETS, PAGE 2

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.

#### 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 for Mutual Life Insurance Companies*, provides the following guidance:

###### True-Up of Federal Income Taxes for Mutual Life Insurance Companies

The second issue discussed was adjustment of the ownership differential earnings amount provided under the Deficit Reduction Act of 1984. Attached to these minutes is a memorandum prepared by Ernst & Whinney which provided the background material for the discussion.

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):

Accounting for Impact of the Tax Reform Act of 1986 (Loss Reserves Discounting)

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).

- d. In the majority of companies, i.e., those with growing premium volume and increasing loss reserve levels, the deferred tax asset would continually grow, probably to a very significant size.

The Financial Accounting Standard Board (FASB) has also reviewed this issue. FASB may allow some balance sheet recognition of a deferred tax asset, but it will be limited to a 3-year carryback amount if the amount and calculation thereof is clearly demonstrable. The working group believes in most cases, this will provide insignificant relief to property/casualty insurers.

The working group recommends to all insurance departments and to the NAIC Examiner Team that their financial analysis process take into consideration the impact on surplus caused by the new tax law. In some cases, effective tax rates will be very high, in excess of 100%, and that obviously will impact surplus. As a result, IRIS tests and other financial ratios which are surplus dependent may be distorted. Examiners and analysts should be cognizant of tax impact when evaluating companies. In certain situations, analytical recognition of additional equity resulting from deferred or prepaid taxes should be considered when determining financial stability and writing capacity. The working group believes this will be very pertinent with respect to new, growing companies writing long tail lines and to small, monoline, professional malpractice companies.

46. Emerging Accounting Issues Working Group Position EI 89-2, *Establishing a Liability for Deferred Federal Income Taxes for Statutory Accounting Purposes*, provides the following guidance on deferred taxes:

Establishing a Liability for Deferred Federal Income Taxes for Statutory Accounting Purposes

The issue summary for this topic was also prepared by Mr. Schaefer of the Michigan Insurance Bureau. A Michigan property and casualty insurer had established a liability for deferred federal income taxes consisting of a protection against loss account, unrealized gains from securities purchased at a discount and unrealized gains or losses from the write-up or write-down of the market value on stocks. While statutory accounting allows the deferral of taxes through the establishment of a P.A.L. account, the 1986 Tax Reform Act repealed the deduction for such an account.

The issue identified was:

Should the reporting of a liability for deferred federal income taxes be allowed under statutory accounting principles?

The working group concluded that while the existing accounting does not prohibit the establishment of a deferred tax liability, such a liability is not required. If an insurer does establish such a liability, it should be done on a consistent basis from year to year. In accordance with present annual statement instructions, it should not be included in the federal income tax liability.

47. Emerging Accounting Issues Working Group Position EI 93-4, *Section 847 Deposits*, provides the following guidance on the asset admissibility of these deposits:

2. Section 847 Deposits (Prepaid Federal Income Taxes)

This issue submitted by Dakota Truck Underwriters (Attachment B) was first considered by the working group in September 1993 (EI 93-3). The discussion at that meeting revealed that additional research was needed to provide information to the working group. John Baily (Coopers & Lybrand) summarized the result of such research (Attachment C). He indicated that this issue was not unlike the general issue of deferred tax assets considered and rejected by the working group previously.



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

Norris Clark (Calif.) summarized the issue and reviewed the preliminary consensus from the Fall National Meeting that the component of federal income taxes known as the "equity tax" should be recorded as tax expense in the summary of operations and should not be charged directly to surplus.

After further discussion the working group affirmed the preliminary conclusion.

**Generally Accepted Accounting Principles**

50. FAS 109 provides the following relevant guidance:

**STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING**

**SCOPE**

3. This Statement establishes the standards of financial accounting and reporting for income taxes that are currently payable and for the tax consequences of:

- a. Revenues, expenses, gains, or losses that are included in taxable income of an earlier or later year than the year in which they are recognized in financial income
- b. Other events that create differences between the tax bases of assets and liabilities and their amounts for financial reporting
- c. Operating loss or tax credit carrybacks for refunds of taxes paid in prior years and carryforwards to reduce taxes payable in future years.

**Objectives and Basic Principles**

6. One objective of accounting for income taxes is to recognize the amount of taxes payable or refundable for the current year. A second objective is to recognize deferred tax liabilities and

assets for the future tax consequences of events<sup>3</sup> that have been recognized in an enterprise's financial statements or tax returns.

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<sup>3</sup> 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 Statement No. 13, *Accounting for Leases*, and FASB Interpretation No. 21, *Accounting for Leases in a Business Combination* (paragraphs 256-258)
- d. Prohibits recognition of a deferred tax liability or asset related to goodwill (or the portion thereof) for which amortization is not deductible for tax purposes (paragraph 30)
- e. Does not amend Accounting Research Bulletin No. 51, *Consolidated Financial Statements*, for income taxes paid on intercompany profits on assets remaining within the group, and prohibits recognition of a deferred tax asset for the difference between the tax basis of the assets in the buyer's tax jurisdiction and their cost as reported in the consolidated financial statements
- f. Prohibits recognition of a deferred tax liability or asset for differences related to assets and liabilities that, under FASB Statement No. 52, *Foreign Currency Translation*, are remeasured from the local currency into the functional currency using historical exchange rates that result from (1) changes in exchange rates or (2) indexing for tax purposes.

## Temporary Differences

10. Income taxes currently payable<sup>4</sup> for a particular year usually include the tax consequences of most events that are recognized in the financial statements for that year. However, because tax laws and financial accounting standards differ in their recognition and measurement of assets, liabilities, equity, revenues, expenses, gains, and losses, differences arise between:

- a. The amount of taxable income and pretax financial income for a year
- b. The tax bases of assets or liabilities and their reported amounts in financial statements.

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<sup>4</sup> References in this Statement to income taxes currently payable and (total) income tax expense are intended to include also income taxes currently refundable and (total) income tax benefit, respectively.

11. An assumption inherent in an enterprise's statement of financial position prepared in accordance with generally accepted accounting principles is that the reported amounts of assets and liabilities will be recovered and settled, respectively. Based on that assumption, a difference between the tax basis of an asset or a liability and its reported amount in the statement of financial position will result in taxable or deductible amounts in some future year(s) when the reported amounts of assets are recovered and the reported amounts of liabilities are settled. Examples follow:

- a. Revenues or gains that are taxable after they are recognized in financial income. An asset (for example, a receivable from an installment sale) may be recognized for revenues or gains that will result in future taxable amounts when the asset is recovered.
- b. Expenses or losses that are deductible after they are recognized in financial income. A liability (for example, a product warranty liability) may be recognized for expenses or losses that will result in future tax deductible amounts when the liability is settled.
- c. Revenues or gains that are taxable before they are recognized in financial income. A liability (for example, subscriptions received in advance) may be recognized for an advance payment for goods or services to be provided in future years. For tax purposes, the advance payment is included in taxable income upon the receipt of cash. Future sacrifices to provide goods or services (or future refunds to those who cancel their orders) will result in future tax deductible amounts when the liability is settled.
- d. Expenses or losses that are deductible before they are recognized in financial income. The cost of an asset (for example, depreciable personal property) may have been deducted for tax purposes faster than it was depreciated for financial reporting. Amounts received upon future recovery of the amount of the asset for financial reporting will exceed the remaining tax basis of the asset, and the excess will be taxable when the asset is recovered.
- e. A reduction in the tax basis of depreciable assets because of tax credits.<sup>5</sup> Amounts received upon future recovery of the amount of the asset for financial reporting will exceed the remaining tax basis of the asset, and the excess will be taxable when the asset is recovered.
- f. ITC accounted for by the deferral method. Under Opinion 2, ITC is viewed and accounted for as a reduction of the cost of the related asset (even though, for financial statement presentation, deferred ITC may be reported as deferred income). Amounts received upon future recovery of the reduced cost of the asset for financial reporting will be less than the tax basis of the asset, and the difference will be tax deductible when the asset is recovered.

- 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 might require adjustment of the tax basis of a depreciable (or other) asset for the effects of inflation. The inflation-adjusted tax basis of the asset would be used to compute future tax deductions for depreciation or to compute gain or loss on sale of the asset. Amounts received upon future recovery of the local currency historical cost of the asset will be less than the remaining tax basis of the asset, and the difference will be tax deductible when the asset is recovered.
- h. Business combinations accounted for by the purchase method. There may be differences between the assigned values and the tax bases of the assets and liabilities recognized in a business combination accounted for as a purchase under APB Opinion No. 16, Business Combinations. Those differences will result in taxable or deductible amounts when the reported amounts of the assets and liabilities are recovered and settled, respectively.

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<sup>5</sup> The Tax Equity and Fiscal Responsibility Act of 1982 provided taxpayers with the choice of either (a) taking the full amount of Accelerated Cost Recovery System (ACRS) deductions and a reduced tax credit (that is, investment tax credit and certain other tax credits) or (b) taking the full tax credit and a reduced amount of ACRS deductions.

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### Recognition and Measurement

16. An enterprise shall recognize a deferred tax liability or asset for all temporary differences<sup>6</sup> and operating loss and tax credit carryforwards in accordance with the provisions of paragraph 17. Deferred tax expense or benefit is the change during the year in an enterprise's deferred tax liabilities and assets.<sup>7</sup> For deferred tax liabilities and assets acquired in a purchase business combination during the year, it is the change since the combination date. Total income tax expense or benefit for the year is the sum of deferred tax expense or benefit and income taxes currently payable or refundable.

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<sup>6</sup> Refer to paragraph 9. A deferred tax liability shall be recognized for the temporary differences addressed by Opinion 23 in accordance with the requirements of this Statement (paragraphs 31-34) and that Opinion, as amended.

<sup>7</sup> Paragraph 230 addresses the manner of reporting the transaction gain or loss that is included in the net change in a deferred tax liability or asset when the reporting currency is the functional currency.

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17. Deferred taxes shall be determined separately for each tax-paying component (an individual entity or group of entities that is consolidated for tax purposes) in each tax jurisdiction. That determination includes the following procedures:

- a. Identify (1) the types and amounts of existing temporary differences and (2) the nature and amount of each type of operating loss and tax credit carryforward and the remaining length of the carryforward period
- b. Measure the total deferred tax liability for taxable temporary differences using the applicable tax rate (paragraph 18)
- c. Measure the total deferred tax asset for deductible temporary differences and operating loss carryforwards using the applicable tax rate
- d. Measure deferred tax assets for each type of tax credit carryforward
- e. Reduce deferred tax assets by a valuation allowance if, based on the weight of available evidence, it is *more likely than not* (a likelihood of more than 50 percent) that some portion or all of the deferred tax assets will not be realized. The valuation allowance should be sufficient to reduce the deferred tax asset to the amount that is more likely than not to be realized.

18. The objective is to measure a deferred tax liability or asset using the enacted tax rate(s) expected to apply to taxable income in the periods in which the deferred tax liability or asset is expected to be settled or realized. Under current U.S. federal tax law, if taxable income exceeds a specified amount, all taxable income is taxed, in substance, at a single flat rate. That rate shall be used for measurement of a deferred tax liability or asset by enterprises for which graduated tax rates are not a significant factor. Enterprises for which graduated tax rates are a significant factor shall measure a deferred tax liability or asset using the average graduated tax rate applicable to the amount of estimated annual taxable income in the periods in which the deferred tax liability or asset is estimated to be settled or realized (paragraph 236). Other provisions of enacted tax laws should be considered when determining the tax rate to apply to certain types of temporary differences and carryforwards (for example, the tax law may provide for different tax rates on ordinary income and capital gains). If there is a phased-in change in tax rates, determination of the applicable tax rate requires knowledge about when deferred tax liabilities and assets will be settled and realized.

19. In the U.S. federal tax jurisdiction, the applicable tax rate is the regular tax rate, and a deferred tax asset is recognized for alternative minimum tax credit carryforwards in accordance with the provisions of paragraph 17.d. and 17.e. of this Statement. If alternative tax systems exist in jurisdictions other than the U.S. federal jurisdiction, the applicable tax rate is determined in a manner consistent with the tax law after giving consideration to any interaction (that is, a mechanism similar to the U.S. alternative minimum tax credit) between the two systems.

20. All available evidence, both positive and negative, should be considered to determine whether, based on the weight of that evidence, a valuation allowance is needed. Information about an enterprise's current financial position and its results of operations for the current and preceding years ordinarily is readily available. That historical information is supplemented by all currently available information about future years. Sometimes, however, historical information may not be available (for example, start-up operations) or it may not be as relevant (for example, if there has been a significant, recent change in circumstances) and special attention is required.

21. Future realization of the tax benefit of an existing deductible temporary difference or carryforward ultimately depends on the existence of sufficient taxable income of the appropriate character (for example, ordinary income or capital gain) within the carryback, carryforward period available under the tax law. The following four possible sources of taxable income may be available under the tax law to realize a tax benefit for deductible temporary differences and carryforwards:

- a. Future reversals of existing taxable temporary differences
- b. Future taxable income exclusive of reversing temporary differences and carryforwards
- c. Taxable income in prior carryback year(s) if carryback is permitted under the tax law
- d. Tax-planning strategies (paragraph 22) that would, if necessary, be implemented to, for example:
  - (1) Accelerate taxable amounts to utilize expiring carryforwards
  - (2) Change the character of taxable or deductible amounts from ordinary income or loss to capital gain or loss
  - (3) Switch from tax-exempt to taxable investments.

Evidence available about each of those possible sources of taxable income will vary for different tax jurisdictions and, possibly, from year to year. To the extent evidence about one or more sources of taxable income is sufficient to support a conclusion that a valuation is not necessary, other sources need not be considered. Consideration of each source is required, however, to determine the amount of the valuation allowance that is recognized for deferred tax assets.

22. In some circumstances, there are actions (including elections for tax purposes) that (a) are prudent and feasible, (b) an enterprise ordinarily might not take, but would take to prevent an operating loss or tax credit carryforward from expiring unused, and (c) would result in realization

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.

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<sup>9</sup>
- 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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<sup>9</sup> 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" thrift lenders) that arise in tax years beginning after December 31, 1987 (that is, amounts in excess of the base-year amount).

The tax effects of temporary differences related to deposits in statutory reserve funds by U.S. steamship enterprises that arose in fiscal years beginning on or before December 15, 1992 and that were not previously recognized shall be recognized when those temporary differences reverse or in their entirety at the beginning of the fiscal year for which this Statement is first applied.

33. Whether an excess of the amount for financial reporting over the tax basis of an investment in a more-than-50-percent-owned domestic subsidiary is a taxable temporary difference must be assessed. It is not a taxable temporary difference if the tax law provides a means by which the reported amount of that investment can be recovered tax-free and the enterprise expects that it will ultimately use that means. For example, under current U.S. federal tax law:

- 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



- 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:

- a. Tax effects of deductible temporary differences and carryforwards that existed at the date of a purchase business combination and for which a tax benefit is initially recognized in subsequent years in accordance with the provisions of paragraph 30
- b. Tax effects of deductible temporary differences and carryforwards that are allocated to shareholders' equity in accordance with the provisions of paragraph 36 (items c. and e.-g.).

38. If there is only one item other than continuing operations, the portion of income tax expense or benefit for the year that remains after the allocation to continuing operations is allocated to that item. If there are two or more items other than continuing operations, the amount shall be allocated among those other items in proportion to their individual effects on income tax expense or benefit for the year. When there are two or more items other than continuing operations, the sum of the separately calculated, individual effects of each item sometimes may not equal the amount of income tax expense or benefit for the year that remains after the allocation to continuing operations. In those circumstances, the procedures to allocate the remaining amount to items other than continuing operations are as follows:

- a. Determine the effect on income tax expense or benefit for the year of the total net loss for all net loss items
- b. Apportion the tax benefit determined in (a) ratably to each net loss item
- c. Determine the amount that remains, that is, the difference between (1) the amount to be allocated to all items other than continuing operations and (2) the amount allocated to all net loss items
- d. Apportion the tax expense determined in (c) ratably to each net gain item.

39. The tax benefits of deductible temporary differences and carryforwards as of the date of a quasi reorganization as defined and contemplated in ARB No. 43, Chapter 7, "Capital Accounts," ordinarily are reported as a direct addition to contributed capital if the tax benefits are recognized in subsequent years. The only exception is for enterprises that have previously both adopted Statement 96 and effected a quasi reorganization that involves only the elimination of a deficit in retained earnings by a concurrent reduction in contributed capital prior to adopting this Statement. For those enterprises, subsequent recognition of the tax benefit of prior deductible temporary differences and carryforwards is included in income and reported as required by

paragraph 37 (without regard to the referenced exceptions) and then reclassified from retained earnings to contributed capital. Those enterprises should disclose (a) the date of the quasi reorganization, (b) the manner of reporting the tax benefits and that it differs from present accounting requirements for other enterprises and (c) the effect of those tax benefits on income from continuing operations, income before extraordinary items, and on net income (and on related per share amounts).

### Separate Financial Statements of a Subsidiary

40. The consolidated amount of current and deferred tax expense for a group that files a consolidated tax return shall be allocated among the members of the group when those members issue separate financial statements. This Statement does not require a single allocation method. The method adopted, however, shall be systematic, rational, and consistent with the broad principles established by this Statement. A method that allocates current and deferred taxes to members of the group by applying this Statement to each member as if it were a separate taxpayer<sup>10</sup> meets those criteria. Examples of methods that are not consistent with the broad principles established by this Statement include:

- a. A method that allocates only current taxes payable to a member of the group that has taxable temporary differences
- b. A method that allocates deferred taxes to a member of the group using a method fundamentally different from the asset and liability method described in this Statement (for example, the Opinion 11 deferred method)
- c. A method that allocates no current or deferred tax expense to a member of the group that has taxable income because the consolidated group has no current or deferred tax expense.

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<sup>10</sup> In that situation, the sum of the amounts allocated to individual members of the group may not equal the consolidated amounts. That may also be the result when there are intercompany transactions between members of the consolidated group. The criteria are satisfied, nevertheless, after giving effect to the type of adjustments (including eliminations) normally present in preparing consolidated financial statements.

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41. In a classified statement of financial position, an enterprise shall separate deferred tax liabilities and assets into a current amount and a noncurrent amount. Deferred tax liabilities and assets shall be classified as current or noncurrent based on the classification of the related asset or liability for financial reporting. A deferred tax liability or asset that is not related to an asset or liability for financial reporting (paragraph 15), including deferred tax assets related to carryforwards, shall be classified according to the expected reversal date of the temporary difference pursuant to *FASB Statement No. 37, Balance Sheet Classification of Deferred Income Taxes*. The valuation allowance for a particular tax jurisdiction shall be allocated between current and noncurrent deferred tax assets for that tax jurisdiction on a pro rata basis.

42. For a particular tax-paying component of an enterprise and within a particular tax jurisdiction, (a) all current deferred tax liabilities and assets shall be offset and presented as a single amount and (b) all noncurrent deferred tax liabilities and assets shall be offset and presented as a single amount. However, an enterprise shall not offset deferred tax liabilities and assets attributable to different tax-paying components of the enterprise or to different tax jurisdictions.

### Financial Statement Disclosure

43. The components of the net deferred tax liability or asset recognized in an enterprise's statement of financial position shall be disclosed as follows:

- a. The total of all deferred tax liabilities measured in procedure (b) of paragraph 17

- 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.

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
- b. The principal provisions of the method by which the consolidated amount of current and deferred tax expense is allocated to members of the group and the nature and effect of any changes in that method (and in determining related balances to or from affiliates) during the years for which the disclosures in (a) above are presented.

### **Effective Date and Transition**

50. This Statement shall be effective for fiscal years beginning after December 15, 1992. Earlier application is encouraged. Financial statements for any number of consecutive fiscal years before the effective date may be restated to conform to the provisions of this Statement. Initial application of this Statement shall be as of the beginning of an enterprise's fiscal year (that is, if the Statement is adopted prior to the effective date and during an interim period other than the first interim period, all prior interim periods of that fiscal year shall be restated). Application of the requirements for recognition of a deferred tax liability or asset for a restated interim or annual period shall be based on the facts and circumstances as they existed at that prior date and without the benefit of hindsight.

51. The effect of initially applying this Statement shall be reported as the effect of a change in accounting principle in a manner similar to the cumulative effect of a change in accounting principle (APB Opinion No. 20, Accounting Changes, paragraph 20) except for initially recognized tax benefits of the type required by this Statement to be excluded from comprehensive income. If the earliest year restated is not presented in the financial statements, the beginning balance of retained earnings and, if necessary, any other components of shareholders' equity for the earliest year presented shall be adjusted for the effect of the restatement as of that date. Paragraph 30 addresses the manner of reporting acquired tax benefits initially recognized subsequent to a business combination and paragraph 36 identifies five items ((c)-(g)) for which tax benefits are excluded from comprehensive income and allocated directly to contributed capital or retained earnings. Pro forma effects of retroactive application (Opinion 20, paragraph 21) are not required if statements of earnings presented for prior years are not restated.

52. When initially presented, the financial statements for the year this Statement is first adopted shall disclose:

- 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 combinations and for regulated enterprises) for the year of adoption if restated financial statements for the prior year are not presented
- b. The effect of any restatement on income from continuing operations, income before extraordinary items, and net income (and on related per share amounts) for each year for which restated financial statements are presented.

### **Prior Business Combinations**

53. If financial statements for prior years are restated, all purchase business combinations that were consummated in those prior years shall be remeasured in accordance with the requirements of this Statement.

54. For a purchase business combination consummated prior to the beginning of the year for which this Statement is first applied, any balance remaining as of that date for goodwill or negative goodwill shall not be adjusted to equal the amount it would be if financial statements for the year of the combination and subsequent years were restated. However, except for leveraged leases and except as provided in paragraph 55, (a) remaining balances as of the date of initially applying this Statement for assets and liabilities acquired in that combination shall be adjusted from their net-of-tax amounts to their pretax amounts and (b) any differences between those adjusted remaining balances and their tax bases are temporary differences. A deferred tax liability or asset shall be recognized for those temporary differences pursuant to the requirements of this Statement as of the beginning of the year for which this Statement is first applied.

55. If, for a particular business combination, determination of the adjustment for any or all of the assets and liabilities referred to in paragraph 54 is impracticable, either because the necessary information is no longer available or because the cost to develop that information is excessive, none of the remaining balances of any assets and liabilities acquired in that combination shall be adjusted to pretax amounts, that is, all remaining amounts that were originally assigned on a net-of-tax basis pursuant to paragraph 89 of Opinion 16 shall not be adjusted. Any differences between those unadjusted remaining balances and their tax bases are temporary differences, and a deferred tax liability or asset shall be recognized for those temporary differences pursuant to the requirements of this Statement as of the beginning of the year for which this Statement is first applied.

56. The net effect of the adjustments required by paragraphs 54 and 55 shall be included in the effect of initially applying this Statement and reported in accordance with the provisions of paragraph 51.

### **Assets of Regulated Enterprises Reported on a Net-of-Tax or After-Tax Basis**

57. Some regulated enterprises that apply Statement 71 have accounted for certain components of construction in progress on either a net-of-tax or after-tax basis, or both. Upon initial application of this Statement, those enterprises shall make appropriate adjustments required by this Statement to account for the net-of-tax and after-tax components of construction in progress as if the requirements of this Statement were applied to that construction in progress in all prior years. Except as provided in paragraph 58, the reported amount of plant in service at the beginning of the year for which this Statement is first applied shall be similarly adjusted.

58. If determination of the adjustment to plant in service referred to in paragraph 57 is impracticable, either because the necessary information is no longer available or because the cost to develop that information is excessive, any difference between the reported amount and the tax basis of that plant in service is a temporary difference, and a deferred tax liability shall be recognized for that temporary difference. If, as a result of an action by a regulator, it is probable that amounts required for settlement of that deferred tax liability will be recovered from customers through future rates, an asset and the related deferred tax liability for that additional temporary difference shall be recognized for that probable future revenue.

59. The net effect of the adjustments required by paragraphs 57 and 58 shall be included in the effect of initially applying this Statement and reported in accordance with the provisions of paragraph 51.

## 289. GLOSSARY

### Carrybacks

Deductions or credits that cannot be utilized on the tax return during a year that may be carried back to reduce taxable income or taxes payable in a prior year. An operating loss carryback is an excess of tax deductions over gross income in a year; a tax credit carryback is the amount by which tax credits available for utilization exceed statutory limitations. Different tax jurisdictions have different rules about whether excess deductions or credits may be carried back and the length of the carryback period.

### Carryforwards

Deductions or credits that cannot be utilized on the tax return during a year that may be carried forward to reduce taxable income or taxes payable in a future year. An operating loss carryforward is an excess of tax deductions over gross income in a year; a tax credit carryforward is the amount by which tax credits available for utilization exceed statutory limitations. Different tax jurisdictions have different rules about whether excess deductions or credits may be carried forward and the length of the carryforward period. The terms carryforward, operating loss carryforward, and tax credit carryforward refer to the amounts of those items, if any, reported in the tax return for the current year.

51. APB 28 provides the following guidance (However, note that FAS 109 supersedes APB Opinion Nos. 11 and 24 and amends APB Opinion No. 23);

19. In reporting interim financial information, income tax provisions should be determined under the procedures set forth in APB Opinion Nos. 11, 23, and 24. At the end of each interim period the company should make its best estimate of the effective tax rate expected to be applicable for the full fiscal year. The rate so determined should be used in providing for income taxes on a current year-to-date basis. The effective tax rate should reflect anticipated investment tax credits, foreign tax rates, percentage depletion, capital gains rates, and other available tax planning alternatives. However, in arriving at this effective tax rate no effect should be included for the tax related to significant unusual or extraordinary items that will be separately reported or reported net of their related tax effect in reports for the interim period or for the fiscal year.<sup>2</sup>

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<sup>2</sup> Disclosure should be made of the reasons for significant variations in the customary relationship between income tax expense and pretax accounting income, if they are not otherwise apparent from the financial statements or from the nature of the entity's business (refer to FASB Statement No. 109, *Accounting for Income Taxes*, paragraph 47).

20. The tax effects of losses that arise in the early portion of a fiscal year should be recognized only when the tax benefits are expected to be (a) realized during the year or (b) recognizable as a deferred tax asset at the end of the year in accordance with the provisions of Statement 109. An established seasonal pattern of loss in early interim periods offset by income in later interim periods should constitute evidence that realization is more likely than not, unless other evidence indicates the established seasonal pattern will not prevail. The tax effects of losses incurred in early interim periods may be recognized in a later interim period of a fiscal year if their realization, although initially uncertain, later becomes more likely than not. When the tax effects of losses that arise in the early portions of a fiscal year are not recognized in that interim period, no tax provision should be made for income that arises in later interim periods until the tax effects of the previous interim losses are utilized.<sup>3</sup> The tax effect of a valuation allowance expected to be necessary for a deferred tax asset at the end of the year for originating deductible temporary differences and carryforwards during the year should be included in the effective tax

rate. The effect of a change in the beginning-of-the-year balance of a valuation allowance as a result of a change in judgment about the realizability of the related deferred tax asset in future years shall not be apportioned among interim periods through an adjustment of the effective tax rate but shall be recognized in the interim period in which the change occurs. The effects of new tax legislation shall not be recognized prior to enactment. The tax effect of a change in tax laws or rates on taxes currently payable or refundable for the current year shall be reflected after the effective dates prescribed in the statutes in the computation of the annual effective tax rate beginning no earlier than the first interim period that includes the enactment date of the new legislation. The effect of a change in tax laws or rates on a deferred tax liability or asset shall not be apportioned among interim periods through an adjustment of the annual effective tax rate. The tax effect of a change in tax laws or rates on taxes payable or refundable for a prior year shall be recognized as of the enactment date of the change as tax expense (benefit) for the current year.

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<sup>3</sup> The tax benefits of interim losses accounted for in this manner would not be reported as extraordinary items in the results of operations of the interim period.

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## OTHER SOURCES OF INFORMATION

52. Federal Income Tax Regulation Section 1.6662-4(d) provides the following guidance:

**(d) Substantial authority** (1) *Effect of having substantial authority.* If there is substantial authority for the tax treatment of an item, the item is treated as if it were shown properly on the return for the taxable year in computing the amount of the tax shown on the return. Thus, for purposes of section 6662(d), the tax attributable to the item is not included in the understatement for that year. (For special rules relating to tax shelter items see section 1.6662-4(g).)

(2) *Substantial authority standard.* The substantial authority standard is an objective standard involving an analysis of the law and application of the law to relevant facts. The substantial authority standard is less stringent than the “more likely than not” standard (the standard that is met when there is a greater than 50-percent likelihood of the position being upheld), but more stringent than the reasonable basis standard (the standard which, if satisfied, generally will prevent imposition of the penalty under section 6662(b)(1) for negligence). The possibility that a return will not be audited or, if audited, that an item will not be raised on audit, is not relevant in determining whether the substantial authority standard (or the reasonable basis standard) is satisfied.

(3) *Determination of whether substantial authority is present.* (i) *Evaluation of authorities.* There is substantial authority for the tax treatment of an item only if the weight of the authorities supporting the treatment is substantial in relation to the weight of authorities supporting contrary treatment. All authorities relevant to the tax treatment of an item, including the authorities contrary to the treatment, are taken into account in determining whether substantial authority exists. The weight of authorities is determined in light of the pertinent facts and circumstances in the manner prescribed by paragraph (d)(3)(ii) of this section. There may be substantial authority for more than one position with respect to the same item. Because the substantial authority standard is an objective standard, the taxpayer's belief that there is substantial authority for the tax treatment of an item is not relevant in determining whether there is substantial authority for that treatment.

(ii) *Nature of analysis.* The weight accorded an authority depends on its relevance and persuasiveness, and the type of document providing the authority. For example, a case or revenue ruling having some facts in common with the tax treatment at issue is not particularly relevant if the authority is materially distinguishable on its facts, or is otherwise inapplicable to the tax treatment at issue. An authority that merely states a conclusion ordinarily is less persuasive than one that reaches its conclusion by cogently relating the applicable law to pertinent facts. The weight of an authority from which information has been deleted, such as a private letter ruling, is diminished to the extent that the deleted information may have affected the authority's conclusions. The type of document also must be considered. For example, a revenue ruling is

accorded greater weight than a private letter ruling addressing the same issue. An older private letter ruling, technical advice memorandum, general counsel memorandum or action on decision generally must be accorded less weight than a more recent one. Any document described in the preceding sentence that is more than 10 years old generally is accorded very little weight. However, the persuasiveness and relevance of a document, viewed in light of subsequent developments, should be taken into account along with the age of the document. There may be substantial authority for the tax treatment of an item despite the absence of certain types of authority. Thus, a taxpayer may have substantial authority for a position that is supported only by a well-reasoned construction of the applicable statutory provision.

## RELEVANT LITERATURE

### Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 22, General Expenses and Taxes, Licenses and Fees, and Chapter 23, Federal Income Taxes
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapter 19, Expenses, Chapter 20, Federal Income Taxes, and Appendix A, Mortgage Guaranty Insurance Accounting Principles Supplement
- NAIC Annual Statement Instructions for Property and Casualty Insurance Companies
- NAIC Annual Statement Instructions for Life and Accident and Health Insurance Companies
- *Issue Paper No. 3—Accounting Changes*
- *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets*
- *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*
- *Issue Paper No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties*
- Emerging Accounting Issues Working Group Position EI 86-1, True-up of Federal Income Taxes for Mutual Life Insurance Companies
- Emerging Accounting Issues Working Group Position EI 87-6, Accounting for the Impact of the Tax Reform Act of 1986
- Emerging Accounting Issues Working Group Position EI 89-2, Establishing a Liability for Deferred Federal Income Taxes for Statutory Accounting Purposes
- Emerging Accounting Issues Working Group Position EI 93-4, Section 847 Deposits
- Emerging Accounting Issues Working Group Position EI 95-3, Equity Tax
- Emerging Accounting Issues Working Group Position EI 95-4, Equity Tax

### Generally Accepted Accounting Principles

- *FASB Statement No. 109, Accounting for Income Taxes*
- *FASB Interpretation No. 18, Accounting for Income Taxes in Interim Periods...an interpretation of APB Opinion No. 28*
- *Accounting Principles Board Opinion No. 2, Accounting for the “Investment Credit”*
- *Accounting Principles Board Opinion No. 4 (Amending No. 2), Accounting for the “Investment Credit”*
- *Accounting Principles Board Opinion No. 10, Omnibus Opinion—1966*
- *Accounting Principles Board Opinion No. 23, Accounting for Income Taxes—Special Areas—*
- *Accounting Principles Board Opinion No. 28, Interim Financial Reporting*
- *FASB Technical Bulletin No. 79-9, Accounting for Interim Periods for Changes in Income Tax Rates*
- *FASB Technical Bulletin No. 82-1, Disclosure of the Sale or Purchase of Tax Benefits through Tax Leases*
- *FASB Emerging Issues Task Force No. 91-8, Application of FASB Statement No. 96 to a State Tax Based on the Greater of a Franchise Tax or an Income Tax*



- *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 Differences within Foreign Subsidiaries That Meet the Indefinite Reversal Criterion of APB Opinion No. 23*
- *FASB Emerging Issues Task Force No. 93-17, Recognition of Deferred Tax Assets for a Parent Company's Excess Tax Basis in the Stock of a Subsidiary That Is Accounted for as a Discontinued Operation*
- *FASB Emerging Issues Task Force No. 94-10, Accounting by a Company for the Income Tax Effects of Transactions among or with Its Shareholders under FASB Statement No. 109*
- *FASB Emerging Issues Task Force No. 95-9, Accounting for Tax Effects of Dividends in France in Accordance with FASB Statement No. 109*
- *FASB Emerging Issues Task Force No. 95-10, Accounting for Tax Credits Related to Dividend Payments in Accordance with FASB Statement No. 109*
- *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*
- *AICPA Accounting Interpretation, Accounting for the Investment Credit: Accounting Interpretations of APB Opinion No. 4*

**Other Sources of Information**

- Federal Income Tax Regulation Section 1.6662-4(d)

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