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ISSUES PAPER

Accounting for Income Taxes of Stock Life Insurance Companies

Prepared by
Insurance Companies Committee
Auditing Standards Division
American Institute of Certified Public Accountants

830427

ISSUES PAPER

Accounting for Income Taxes of Stock Life Insurance Companies

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Prepared By The
Insurance Companies Committee
of the
American Institute of Certified Public Accountants

FOREWORD

This issues paper, "Accounting for Income Taxes of Stock Life Insurance Companies," was prepared by the AICPA Insurance Companies Committee for consideration by the Accounting Standards Executive Committee ("AcSEC"). The paper discusses five proposed methods of accounting for changes in the federal income tax law for life insurance companies as a result of the Life Insurance Company Tax Act of 1984 ("LITA-84"), which law is retroactive to January 1, 1984. The five proposed methods of accounting for the transition from the pre-1984 tax law to LITA-84 are described in paragraph 18 of the paper. The paper also includes advisory conclusions on the application of the deferred method of accounting for income taxes under APB No. 11 for stock life insurance companies.

AcSEC's Views on the Proposed Methods

The Insurance Companies Committee presented the issues paper for discussion at AcSEC's meetings on May 3 and June 13, 1984, and AcSEC voted on its preferences from among the five proposed methods at the June 13 meeting.

To better arrive at a consensus on a preferable method, AcSEC took a preliminary vote to determine whether any of the five proposed methods were viewed as unacceptable to a majority of the AcSEC members. As

a result of that preliminary vote, Methods C and D were eliminated from further consideration. Members who voted against those methods expressed the view that Methods C and D are unacceptable accounting practices because they would recognize the tax effects of the fresh start adjustment, as referred to in connection with LITA-84, as a reduction in income tax expense in post-1983 periods.

The thirteen AcSEC members present then voted on the method they viewed as preferable from among the three remaining proposed methods. The results of that vote were as follows:

Method A - 5
B - 1
E - 7

Method A would require stock life insurance companies to establish a deferred tax balance as of January 1, 1984 for timing differences that exist at that date and that will reverse in the future under LITA-84. That recalculated January 1, 1984 deferred tax balance would be based on tax rates under LITA-84, applied to the cumulative timing differences after giving effect to the LITA-84 fresh start adjustment. Some view Method A as, in effect, a one-time use of a liability method of accounting for income taxes. Therefore, some believe that Method A would require a significant amendment by the FASB of current accounting standards.

In AcSEC's view, Methods B and E could be more easily implemented within the framework of existing accounting standards. Thus, Methods B and E would be less likely to establish a precedent for accounting for future changes in tax laws that presently cannot be foreseen. AcSEC therefore took the following vote on their preference between Methods B and E:

Method B - 5
E - 8

Other Recommendations of AcSEC

Both Methods A and B would require an adjustment, as of January 1, 1984, of the deferred tax balance existing at December 31, 1983. Method B would result in a credit to income tax expense in 1984. Method A generally would result in a charge to income tax expense in 1984. AcSEC voted (12 yes, 0 no, 1 abstain) that, if the FASB adopts Method A or B, the charge or credit should be reported as an extraordinary item in the 1984 income statement. Some believe that extraordinary-item treatment is justified because of the unique and nonrecurring nature of the charge or credit which is due to the change from the pre-1984 three-phase tax structure that was unique to stock life insurance companies to the single-phase tax structure under LITA-84.

Insurance Companies Committee's Views on the Proposed Methods

At its May 9, 1984 meeting, the Insurance Companies Committee voted on their preference from among the five proposed methods. The results of that vote are as follows:

Method A - 1
B - 4
C - 2
D - 2
E - 5

Paragraphs 54-58 provide additional recommendations of the Insurance Companies Committee regarding certain other issues in accounting for income taxes of stock life insurance companies under LITA-84.

Issues Paper

ACCOUNTING FOR INCOME TAXES OF STOCK LIFE INSURANCE COMPANIES

Applicability

1. This issues paper discusses theoretical concepts and provides advisory conclusions on accounting for income taxes by stock life insurance companies in post-1983 financial statements that purport to be presented in accordance with generally accepted accounting principles ("GAAP"). The accounting issues addressed in this paper arise from a change in the federal income tax law for life insurance companies enacted in 1984 and made retroactive to January 1, 1984; that legislation, the Life Insurance Company Tax Act of 1984, is referred to herein as "LITA-84". This paper does not address accounting issues related to net operating loss carrybacks/carryforwards, purchase accounting, and consolidated tax return matters for life-life and/or life-nonlife returns.

Background

2. Before 1982, life insurance companies were taxed under provisions of the Life Insurance Company Income Tax Act of 1959 (the "1959 Act"). The method for taxing life insurance companies under the 1959 Act was considerably different from that for other business entities. For a description of the method of taxation, and the accounting therefore, under the 1959 Act, see Appendix B.

3. As part of the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), Congress made certain permanent amendments to the 1959 Act and provided certain "stop-gap" provisions for 1982 and 1983 until Congress could consider the entire issue of taxation of life insurance companies. TEFRA provided that, with the expiration of the stop-gap provisions on December 31, 1983, the tax law applicable to life insurance companies would revert to the 1959 Act as amended unless a new tax bill were enacted.

Significant Provisions of LITA-84

4. LITA-84 replaces the three-phase tax structure under the 1959 Act and TEFRA with a one-phase structure that results in life insurance company taxes being computed on a basis not too dissimilar to all other corporations. While LITA-84's effect on individual companies will vary, a common view, but not necessarily a majority view, in the life insurance industry is that LITA-84 will generally increase the amount of taxes to be paid by the industry when compared to amounts paid in recent years.

5. Other significant provisions of LITA-84 that may affect stock life insurance company GAAP-basis income tax provisions are as follows:

a. A significant factor in determining taxable income of a life insurance company is the calculation of benefit reserves (called "liabilities for future

policy benefits" in GAAP terminology). The increase in these benefit reserves each period is a deductible expense (i.e., a "reserve deduction"). Over the life of a life insurance policy, these deductions ordinarily would total the amount of policy benefits provided by the policy. Under the pre-1984 laws, various optional methods were specified for calculating these tax-basis reserves, as well as certain related additional tax-basis deductions. The use of certain of these optional methods may have had the effect of accelerating the available tax-basis reserve deductions and increasing the tax-basis reserves in the earlier years of a policy when compared to the GAAP-basis reserves and reserve increases. One such additional available tax-basis reserve deduction was attributable to the Section 818c election* ("818c"); this election was eliminated by LITA-84.

LITA-84 provides that those additional tax-basis reserve deductions, taken before 1984, will not

*The total amount of these 818c differences as of December 31, 1983 has been estimated to aggregate $8 billion for the life insurance industry. The amounts are expected to be material to many publicly reporting stock life insurance companies.

have to be added back to taxable income in post-1983 years, i.e., they will not be recaptured. Further, tax-basis reserves for future policy benefits will be recomputed as of January 1, 1984, based on the new computational rules of LITA-84.* For many companies, the recomputed tax-basis reserves as of January 1, 1984 (i.e., the "new tax-basis reserves") will be less than the tax-basis reserves at December 31, 1983 (i.e., the "old tax-basis reserves"). The difference between the old tax-basis reserves (including the amount, if any, attributable to the 818c election) and new tax-basis reserves will not have to be added back to post-1983 taxable income. Thus, the difference between the old and new tax-basis reserves (hereinafter referred to as the "fresh start adjustment") will, when considered in relation to pre-1984 deductions, become an additional tax-basis reserve deduction** to be reflected in post-1983 tax returns during the periods in which the pre-1984 in-force policies become fully paid up or are removed from the in-force records through death, surrender, or other means.

*Certain small companies, as defined in LITA-84, can elect to use statutory reserves for tax purposes and need not recompute their reserves at January 1, 1984; thus, these companies would not be affected by the fresh start adjustment, unless they had previously made a Section 818c election.

**The references in this paper to reserve increases (and the corresponding tax deductions) refer to net changes in reserves, that is, increases in reserves less releases of reserves in the period.

b. Under LITA-84, life insurance companies will not be permitted to deduct year-end amounts accrued as a "reserve for policyholder dividends". This reserve represents the amount of policyholder dividends as of the balance sheet date to be paid or credited to policyholders in the following year. Although such accruals were generally deductible under pre-1984 tax laws, this type of reserve does not satisfy the "all events" test under LITA-84 since one or more future events must occur (typically, the receipt of the next year's annual premium from the policyholder). Thus, a company's December 31, 1983 reserve for policyholder dividends will be accorded tax return treatment similar to amounts involved in the "fresh start adjustment". Any such reserve at December 31, 1983 will be revalued to zero as of January 1, 1984. The company will be permitted tax deductions in 1984 for dividends paid or credited to policyholders in 1984 even though all or a portion of such amounts were accrued and deducted in the 1983 tax return.

Under pre-1984 tax laws, the amount of policyholder dividends (including the amounts accrued at year end) deductible for tax purposes was subject to

certain limitations; LITA-84 eliminates these limitations for stock life insurance companies.

c. Under LITA-84, life insurance companies will no longer recognize due and deferred premiums, or the policy reserve amounts related to such premiums, for tax return purposes; such items do not meet the "all events" criteria of LITA-84 since the receipt of such premium amounts are not assured. Deferred and uncollected premiums represent actuarially established assets which are not legally enforceable receivables from the policyholders.

d. LITA-84 eliminates the "special deductions" that existed under the pre-1984 tax laws for accident and health and group life insurance and certain nonparticipating contracts. These special deductions, along with 50% of the pre-1984 amounts by which the Gain from Operations exceeded Taxable Investment Income ("50% provision"), were added to the "policyholders surplus account" under the pre-1984 laws (as such terms are defined under pre-1984 tax laws). LITA-84 also provides that the "policyholders surplus account" will be frozen at its December 31, 1983 balance; as such, there will be no future

additions to this account since these special deduction provisions and the three-phase tax structure have been eliminated under LITA-84. However, although LITA-84 freezes the policyholders surplus account, the account is not eliminated; thus, taxable income can arise in post-1983 periods if the account balance is reduced below its December 31, 1983 balance.

e. LITA-84 provides for a new special taxable income adjustment whereby life insurance companies will be allowed to reduce taxable income by 20% before computing the amount of taxable income actually subject to taxes. Income taxes will be computed at the statutory corporate rates on taxable income after this "taxable income adjustment" ("TIA").

f. LITA-84 eliminates the present small business deduction and provides a new small life insurance company deduction, available only to life insurance companies that qualify as "small" on the basis of their assets. The deduction is equal to 60% of the first $3,000,000 of tentative "life insurance company taxable income" ("LICTI") and decreases

to zero when the tentative LICTI equals or exceeds $15,000,000.

Key Accounting Theoretical Considerations Under LITA-84

6. The change effected by LITA-84 can be viewed for accounting purposes as a change in circumstances (see FASB No. 60, paragraph 58) for the taxation of stock life insurance companies, as a change in the overall tax rate applicable to those companies, or some combination thereof. These different views have implications for the selection of an appropriate accounting method.

7. Although LITA-84 does not change the statutory tax rate, its overall effect will be to change the tax burden of individual life insurance companies. Therefore, the substance of the tax law change under LITA-84 could be accounted for as a change in the overall effective tax rate of stock life insurance companies, rather than attempting to account for each change under LITA-84 without considering the effect of other changes. APB Opinion No. 11 and related pronouncements prescribe the accounting treatment for a change in tax rates. An interpretation of Opinion No. 11 states that "the deferred method neither requires assumptions as to future tax rates or the imposition of new taxes, nor does it require adjustments of balance sheet deferred tax accounts when tax rates change or new taxes are imposed."

8. The effect of changes that would result from LITA-84 can be addressed in relation to each change contained therein. Under such a piecemeal approach, the "fresh start adjustment" could be viewed as a timing difference that became a permanent difference as of January 1, 1984 or it could be viewed as a series of permanent differences that will arise after January 1, 1984 when previously deducted tax reserves are deducted again in post-1983 tax returns. Other unreversed timing differences existing at December 31 1983 could be viewed as timing differences for which the effective deferred income tax rate ranged from zero to the maximum statutory rate, depending on the circumstances of the company when the timing differences originated. Similarly, the elimination of "special deductions" and the 50% provision under LITA-84 could be viewed as an adjustment of the effective income tax rate for post-1983 years or it could be viewed as the elimination of post-1983 "special deductions" that were anticipated in the computation of deferred income taxes in pre-1984 years. If this piecemeal approach were adopted, some would suggest that the requirements of FASB No. 60, paragraph 58, regarding accounting for a change in circumstances would be applicable.

Applicable Accounting Pronouncements

9. APB Opinion No. 11 is the basic authority on accounting for income taxes. Various subsequent pronouncements and interpretations provide additional guidance. Opinion No. 11 states that comprehensive interperiod tax allocation is an integral part of the determination

of income tax expense. It requires that the deferred method of tax allocation be followed, using either the net change or the gross change method; most, if not all, stock life insurance companies use the net change method to account for the tax effects of timing differences.

10. The 1972 AICPA audit guide, "Audits of Stock Life Insurance Companies", provided guidance on applying GAAP in accounting for income taxes of stock life insurance companies under the 1959 Act. In 1982, FASB Statement No. 60, "Accounting and Reporting by Insurance Enterprises", among other things, extracted the principles from the audit guide. Pertinent excerpts of FASB No. 60 and the audit guide are presented in Appendices A and B of this paper.

11. APB Opinion No. 23 includes special provisions for accounting for deferred taxes related to the policyholders surplus account of stock life insurance companies. Paragraph 28 of that Opinion states that a company should not accrue income taxes on the difference between taxable income and pretax accounting income attributable to amounts designated as policyholders surplus because the reversal of such a difference is indefinite and under the control of the company. It further states that "If circumstances indicate that the insurance company is likely to pay income taxes, either currently or in later years, because of known or expected reductions in policyholders' surplus, income taxes attributable to that reduction should be accrued as a tax expense of the current period."

12. None of the various pronouncements on accounting for income taxes directly addresses the situation currently faced by stock life insurance companies as a result of the passage of LITA-84. The appropriate method of accounting under LITA-84 is not clear because the application of the various accounting pronouncements to this situation can be interpreted differently. Appendix C provides additional excerpts from the relevant pronouncements, other than those contained in FASB No. 60 and the audit guide (see Appendices A and B).

Deferred Taxes Before LITA-84

13. Stock life insurance companies, in their GAAP-basis financial statements, perform a "with-and-without" calculation to determine the deferred tax expense for the period. However, because of the unique three-phase tax structure for life insurance companies that existed prior to 1984, they were allowed to look forward and determine whether the originating timing differences would actually enter into the determination of future taxable income when the timing differences reverse. Specifically, FASB No. 60, paragraph 55, states, in part:

> Amounts deferred in the with-and-without calculation (paragraph 36 of Opinion 11) need to be considered further to determine whether the difference will reverse in the future. Deferred taxes need not be provided for the current tax effect of timing differences if circumstances indicate that the current tax will not reverse in the future. Similarly, a change in category of taxation (the basis on which the enterprise determines its income tax liability) resulting from the with-and-without calculation need not be recognized unless circumstances indicate that a change in category will result when the timing difference reverses.

If the reversal of tax effects cannot be reasonably determined, deferred income taxes shall be provided based on the differential determined using the with-and-without calculation as if the enterprise's tax return was filed on the basis on which financial statements are prepared, including any resulting change in category of taxation.

14. The effect on deferred tax provisions of special deductions and policyholder dividend deductions likewise required consideration of future circumstances. In this connection, FASB No. 60, paragraph 56, states:

> Although (a) special deductions (allowable only for income tax purposes) never enter into the determination of pretax accounting income in any period and (b) the amount of policyholder dividend deductions and special deductions may be limited on the tax return (the unused deductions cannot be carried forward to subsequent periods), the amount of policyholder dividend deductions and special deductions may be used to offset timing differences that affect taxable income to the extent that the limitations on those deductions change when based on pretax accounting income, unless known or anticipated circumstances indicate that future taxable income resulting from the reversal of timing differences will not be offset by like deductions. In the case of provisions for policyholder dividends (including policyholder dividends deducted as part of the change in the liability for future policy benefits), which may be timing differences themselves, statutory limitations shall not be applied to eliminate their current tax effect unless circumstances indicate that the dividends will be limited when the timing differences reverse. Special deductions that are directly affected by timing differences need to be redetermined in the with-and-without calculation unless circumstances indicate that future special deductions will not be directly affected by the timing differences when the timing differences reverse. If the reversal of tax effects cannot be reasonably determined, special deductions that are not affected by timing differences and, therefore, do not reverse shall be limited to amounts available in the tax return.

15. Finally, FASB No. 60, paragraph 58, provides guidance on the deferred tax accounting to be followed when circumstances change from those assumed when deferred taxes were initially determined. It states:

> If deferred income taxes have not been provided on timing differences on the presumption that the timing differences will not have tax effects when they reverse and circumstances change so that it becomes apparent that tax effects will result, deferred income taxes attributable to those timing differences shall be accrued and reported as income tax expense in that period; those income taxes shall not be reported as an extraordinary item. If deferred income taxes have been provided on timing differences and circumstances change so that it becomes apparent that the tax effects will differ from those originally expected, income taxes previously deferred shall be included in income only as the related timing differences reverse, regardless of whether the life insurance enterprise uses the gross change or net change method (paragraph 37 of Opinion 11).

16. Under the pre-1984 three-phase tax structure, some companies were taxed on their net investment income. Companies that expected to continue to be taxed on that basis did not have to provide deferred taxes attributed to timing differences in the determination of Gain from Operations since the timing differences affecting only Gain from Operations would have no tax effect when they reverse. Those timing differences were, however, included in the with-and-without calculation.

17. Because of the three-phase tax structure, special deductions, policyholder dividends, and the unique requirements of FASB No. 60, the amount of deferred taxes provided on pre-1984 timing differences could range, depending on the circumstances of the individual company,

from zero to the amount based on the statutory tax rate in effect when the timing differences originated.

Possible Methods of Accounting Under LITA-84

18. Five basic approaches have been suggested for accounting for deferred taxes of stock life insurance companies under LITA-84. Because these five approaches do not readily lend themselves to classification and definition within standard accounting terminology, they have been assigned an alphabetical reference (i.e., Method A, B, C, D, and E) for purposes of this paper. A summary of each of these methods is as follows (views on these methods are contained in the following section of this paper):

Method A

Under Method A, a deferred tax balance will be calculated and established as of January 1, 1984. This January 1, 1984 balance will represent the tax effect of the inventory of timing differences that exist as of January 1, 1984 under LITA-84 and that will reverse under the provisions of LITA-84. This deferred tax balance would be based on tax rates under LITA-84. The difference between the recalculated January 1, 1984 deferred tax balance and the existing December 31, 1983 deferred tax balance would be recognized by a charge or credit to income taxes in 1984.

Deferred taxes provided for post-1983 periods would be calculated by the with-and-without method based on the law then in effect, and, with respect to 1984, the GAAP tax provision would be increased or decreased by the charge or credit referred to in the preceding paragraph.

<u>Method B</u>*

Under Method B, the deferred tax balance as of December 31, 1983 would be adjusted by a one-time credit to income taxes in 1984 by reversing an allocated portion of the December 31, 1983 deferred tax balance which would no longer be required as a result of the fresh start adjustment.

Deferred taxes provided for post-1983 periods would be calculated by the with-and-without method based on the law then in effect, and, with respect to 1984, the GAAP tax provision would be reduced by the calculated credit referred to in the preceding paragraph.

*Under Methods B, C, and D, the deferred tax balance as of December 31, 1983 would be associated with the timing differences existing at that date. For this purpose, special deductions and the 50% provision would not be considered timing differences but rather as adjustments to the rate that was used to provide for the other timing differences. The portion (not to exceed 100%) of the December 31, 1983 deferred tax credit balance related to the pre-1984 reserve timing differences would be eliminated by a credit to income tax expense; under Method B, this credit would occur in 1984; under Method C, this credit would occur over a number of post-1983 periods; and, under Method D, this credit would only occur if post-1983 deferred tax calculations resulted in net reversing timing differences or if a company were using the gross change method.

Method C*

Method C is similar to Method B in that it would identify the portion of the deferred tax balance as of December 31, 1983 which would no longer be required as a result of the fresh start adjustment. However, under Method C, that portion of the December 31, 1983 deferred tax balance that is no longer required would be recognized in income taxes in post-1983 periods in amounts (calculated using pre-1984 effective tax rates) that would correspond with the reversal of timing differences had the pre-1984 tax laws remained in effect.

Deferred taxes provided for post-1983 periods would be calculated by the with-and-without method based on the law then in effect, and, with respect to the post-1983 periods during which the pre-1984 timing differences would have reversed, the GAAP tax provisions would be reduced by an allocated portion of the calculated credit referred to in the preceding paragraph.

Method D*

Under Method D, no adjustment would be made to the December 31, 1983 deferred tax balance. The deferred method would be used to compute the tax expense for post-1983

*See asterisk explanation on page 15.

periods, but the portions of post-1983 tax deductions for reserve increases that represent amounts previously deducted would be treated as permanent differences. In post-1983 GAAP-basis tax provisions, this approach would recognize the benefit of additional tax-basis reserve deductions in the periods in which they are realized for tax purposes; however, the effects of the permanent differences could be offset in future years if post-1983 tax computations indicate a net reversal of reserve timing differences and the December 31, 1983 deferred tax balance related to such timing differences is exhausted prior to the time that such timing differences reverse. Such an occurrence is likely under the net change method if a company's effective deferred tax rate on such timing differences at December 31, 1983 is lower than the effective tax rate applied to the net reversing timing differences in post-1983 GAAP-basis tax calculations and post-1983 originating timing differences are less than reversing timing differences.

Deferred taxes provided for post-1983 periods would be calculated by the with-and-without method based on the law then in effect; however, because a portion of the post-1983 tax-basis reserve deductions represent amounts which have been deducted in pre-1984 tax returns, those amounts should be identified and recognized as permanent differences in

the with-and-without tax calculations so that only newly originating or reversing (to the extent permitted) net tax timing differences are appropriately tax effected.

Method E

Under Method E, no adjustment would be made to the December 31, 1983 deferred tax balance. Also, under Method E, no recognition would be given to the additional tax-basis reserve deductions or other changes resulting from the fresh start adjustment or the elimination of special deductions and the 50% provision. Under Method E, differences between post-1983 tax-basis and GAAP-basis reserve increases would be treated as timing differences in the deferred tax calculations.

Deferred taxes provided for post-1983 periods would be calculated by the with-and-without method based on the law then in effect, and there would be no special considerations or calculations as a result of LITA-84, i.e., the amount of the fresh start adjustment would be ignored and the January 1, 1984 LITA-84 revalued balances should be used as the opening tax-basis reserves in the 1984 deferred tax calculation. In other words, a company's December 31, 1983 deferred tax credit balance would not be reduced in post-1983 periods unless the company has net reversing timing differences.

Views on Method A

19. Method A results in a one-time establishment of a deferred tax liability as of January 1, 1984. Method A proponents believe that, because of the special circumstances arising from the change in the tax law in 1984, this one-time adjustment of the deferred tax balance to establish a liability is justified to put all stock life insurance companies into a more comparable position for accounting for income taxes in future years. They believe that stock life insurance companies have historically used a version of the liability method when they made deferred tax calculations in that the audit guide and FASB No. 60 required companies to look into the future to determine if originating timing differences would have a tax effect when such timing differences reversed. The proponents of Method A believe that the elimination of the three-phase tax structure (which made this alleged quasi-liability method necessary), the fresh start adjustment, and the other changes of LITA-84 cause the amounts recorded as deferred taxes as of December 31, 1983 to be substantially irrelevant for purposes of accounting for income taxes in post-1983 years under LITA-84. In effect, the adoption of Method A would produce results similar to those achieved in purchase accounting when there is no step up in basis.

20. Those who favor Method A believe that this method results in stock life insurance companies having deferred taxes on a more consistent basis with companies in other industries. They further

suggest that the adoption of Method A will result in life insurance companies having more comparable tax expense relationships in post-1983 periods. In addition to providing more meaningful information about income tax expense in post-1983 periods under LITA-84, they believe that Method A will provide users of 1984 financial statements with information as to whether, and to what extent, a company benefited from, or was adversely affected by, LITA-84 as a result of pre-1984 deferred tax accounting decisions. Method A proponents believe that the other methods do not provide all this information. Method B may provide information regarding benefits from the fresh start adjustment, but it does not reflect, with respect to cumulative timing differences remaining after the fresh start adjustment, any "deficiency" of deferred taxes previously provided when compared to the LITA-84 tax rate. Methods C and D would indirectly provide information as to companies that benefited from the fresh start adjustment in that they would report a lower effective tax rate, but the extent of that benefit would not be fully reported to users for a number of years. Method E would provide no information to determine whether a company benefited or was adversely affected.

21. For many companies, the adjustment of the deferred tax balance required by Method A would result in a charge to income tax expense in 1984. This adjustment would result because many life insurance companies had, in prior years, provided deferred taxes at rates less than the effective tax rate under LITA-84. However, for some companies,

the adjustment of the deferred tax balance under Method A might result in a credit to income tax expense in 1984. Some believe that the charge or credit resulting from the adjustment of the deferred tax balance should be reported as an extraordinary item in 1984. APB Opinion No. 30, paragraph 20, defines extraordinary items as "events or transactions that are distinguished by their unusual nature <u>and</u> their infrequency of occurrence." Those who favor reporting the charge or credit as an extraordinary item believe that the charge or credit results from the one-time change from the pre-1984 three-phase tax structure that was unique to stock life insurance companies to a single-phase structure under LITA-84 that is not too dissimilar to that applicable to all other corporations. Thus, they believe that the charge or credit meets both of the criteria of being unusual in nature and infrequent in occurrence.

22. Opponents of Method A believe that Method A is, in essence, the liability method and, therefore, is proscribed by Opinion No. 11; as such, they claim that there is no justification for its use under current accounting standards. These same opponents to Method A point out that APB Opinion No. 11 does not require or permit adjustments to existing deferred tax balances as a result of changes in tax rates or tax laws.

23. Of the five proposed methods, only Method A would require companies to provide deferred taxes for pre-1984 timing differences that will

reverse under LITA-84 if they had not done so in the past. Method A proponents believe that Methods B, C, and D are one sided in that they only recognize the effects of the tax change that provide a benefit. Under Methods B, C, D, and E, no company would be directly penalized for not having provided sufficient deferred taxes in pre-1984 periods for timing differences that will reverse in post-1983 periods under LITA-84. Methods B, C, and D would cause companies to recognize a benefit in post-1983 after-tax income if they had provided deferred taxes in pre-1984 periods related to the fresh start adjustment. Some believe that companies should not be required to provide for pre-1984 timing differences if they had not previously done so because those companies had appropriately accounted for deferred taxes in pre-1984 periods under the circumstances and laws then in effect. Some believe that Method A may result in companies providing too much deferred taxes at January 1, 1984 because it does not take into account possible future tax planning actions by the companies that will reduce their post-1983 effective tax rates.

Views on Method B

24. Some proponents of Method B suggest that the forgiveness of any repayment of the tax effect of the excess of the December 31, 1983 tax-basis reserves over the revalued January 1, 1984 tax-basis reserves (i.e., the tax effect of the fresh start adjustment) is a significant concession of Congress in exchange for an increased tax burden in the future. Thus, the "gift" should be accounted for in the year

received. Certain opponents of Method B agree that the non-repayment of the tax effect of the fresh start adjustment is a significant concession, but that the benefits of this concession will be received over the remaining in-force period of policies in force at December 31, 1983, not just in 1984, and, therefore, the benefit should be recognized for GAAP purposes in the same periods in which it is realized for tax purposes.

25. Some proponents of Method B support the adjustment of the December 31, 1983 deferred tax balances by a one-time credit to income taxes under the theory that such treatment would be similar to that accorded to a change in an accounting estimate, i.e., changes in estimates are reflected in operations in the period that they occur. These proponents argue that a change in estimate concept is appropriate because, due to the fresh start adjustment, certain pre-1984 timing differences that had been expected to reverse in post-1983 periods will not now reverse. Others would contend that the change in the tax law has nothing to do with accounting estimates.

26. Some proponents of Method B contend that the effect of the fresh start adjustment represents a complete reversal of a like grouping of timing differences (i.e., the reserve differences) and that Opinion No. 11 requires any deferred taxes relating to the reversal of like timing differences to be credited to income taxes regardless of the results of the with-and-without calculation. Opponents of Method B

contend that the fresh start adjustment does not represent a reversal of reserve timing differences; rather, it represents a change in tax-basis reserves at January 1, 1984 that will result in additional deductions for life insurance companies in post-1983 years since LITA-84 does not require the recapture of these pre-1984 reserve deductions.

27. Some proponents of Method B believe that the deferred taxes at December 31, 1983 that relate to existing December 31, 1983 reserve timing differences that will be decreased or eliminated as a result of the January 1, 1984 revaluation should be reversed in 1984. If such a reversal does not occur, these proponents of Method B contend that a deferred tax amount will remain on the balance sheet forever. Some opponents of Method B argue that to recognize this credit in 1984 violates Opinion No. 11.

28. Some proponents of Method B believe that the elimination of the allocated portion of the December 31, 1983 deferred tax balance which is applicable to the fresh start adjustment is similar to the treatment under FASB No. 31 for accounting for tax benefits related to U. K. stock relief legislation. Under FASB No. 31, if a tax benefit related to stock relief had been deferred and circumstances subsequently changed so that the tax benefit would not be recaptured, the tax benefit previously deferred would be recognized by a credit to income tax expense in the period in which the circumstances changed. Opponents of Method B believe that the treatment under FASB No. 31 should not

be used as a guide to accounting by life insurance companies, and they cite paragraph 2 of that Statement which says that "The Board believes that the change in the U. K. tax law with regard to 'stock relief' creates a unique situation in accounting for income taxes and that the accounting specified by this Statement should not extend to other situations."

29. The opponents to Method B also argue that Opinion No. 11 is concerned primarily with matching revenues and expenses, and that the balance sheet is just a repository for the contra-entries to each year's deferred tax debit or credit to the income statement; thus, an entry that can only be justified on the basis that it corrects the balance sheet is unnecessary and incorrect. Opponents of Method B also argue that one commonly perceived effect of LITA-84 is to increase the tax burden of the life insurance industry, and the recognition of a current credit to income taxes in 1984 would not appropriately reflect the economic substance of the event. Some opponents of Method B (and also Methods C and D) believe that it recognizes only the changes in the tax law that are beneficial to stock life insurance companies. Some opponents contend that Methods B and C do not give accounting recognition to the fact that LITA-84 may also have certain adverse effects on some companies' tax provisions because of the higher effective tax rate that may result in post-1983 periods if and when there is a net reversal of timing differences.

30. The requirements under Methods B, C, and D for companies to inventory their timing differences as of December 31, 1983 to permit an allocation of the deferred tax balance at that date to the fresh start adjustment may present significant practical difficulties. Some opponents to these Methods contend that some companies may not have the information (e.g., timing differences and related tax effects by year of origination) necessary to make such an allocation. There also is no prior practice or available guidance on how the calculation should be made. The proponents of Methods B, C, and D point out that the resulting computational methods selected by companies may be, to some extent, arbitrary, but that the selected methodology may be similar to other accounting allocations required by GAAP.

31. Some believe that, if Method B is followed, the credit resulting from the recognition of the fresh start adjustment should be reported in the 1984 income statement as an extraordinary item. They believe that the credit results from the change from the pre-1984 three-phase tax structure that was unique to stock life insurance companies to a single-phase tax structure that is not too dissimilar to the method of taxation for all other corporations. Thus, they believe that the credit meets both of the criteria for extraordinary items of being unusual in nature and infrequent of occurrence.

Views on Method C

32. Proponents of Method C believe that the major changes (see paragraphs 4 and 5) brought about by LITA-84 constitute a change in

tax rates and also create a permanent difference. Accordingly, because the enactment of LITA-84 is of considerable dollar magnitude and because it affects an entire industry, deferred tax balances existing at December 31, 1983 should be analyzed, and these balances should be allocated both to continuing timing differences and the fresh start adjustment. The pre-1984 special deductions and the consequences of the 50% provision that have been eliminated or significantly altered as a result of LITA-84 (which items were, in essence, rate adjustments when deferred taxes were provided in pre-1984 periods) should be considered when determining the portions of the December 31, 1983 deferred tax balances which are attributable to the components comprising or giving rise to the December 31, 1983 deferred tax balance. This allocation is predicated principally on the assumption that the companies provided deferred taxes in pre-1984 years because their tax position warranted such provisions when considered in connection with the unique tax formulas affecting them; however, many of these considerations have been completely superseded by LITA-84. Accordingly, any such deferred tax balances remaining at December 31, 1983 should be reversed over the period of time when such reversals would have occurred had the pre-1984 tax laws remained in effect. Others would argue that, because the policyholders surplus account has not been eliminated by LITA-84, any pre-1984 deferred tax effects existing at December 31, 1983 as a result of special deductions and the 50% provision should remain unaffected in post-1983 with-and-without tax calculations unless or until a Phase III tax is incurred.

33. Proponents of Method C argue that, under deferred tax accounting principles for stock life insurance companies, deferred taxes in pre-1984 periods were provided on the assumption that subsequent period tax returns would be affected by the items giving rise to the provision of such taxes. Since certain of these items will not be so affected in post-1983 tax returns (as a result of LITA-84), they believe that any December 31, 1983 deferred tax balance attributable to such items should be reversed over a number of years in a systematic and rational manner (e.g., over the period of years when these items would have reversed and when the excess deductions are realized).

34. Proponents of Method C contend that Method C is similar to the transitional rules provided in APB Opinion No. 11. Also FASB No. 60, paragraph 58, provided that excess deferred income taxes should be included in income only when the related timing differences reverse. These proponents believe that, since the change to be accounted for results from changes in the tax law rather than from a change in the operations of the company, any excessive or deficient deferred income tax balances should be accounted for when the timing differences reverse.

35. Opponents of Method C contend that this approach is a violation of the deferred tax method as espoused in Opinion No. 11. This opposition contends that the adoption and implementation of this concept would be a partial use of the liability method (i.e., the concept

is balance sheet oriented and does not focus on the matching of income and expense).

36. Similar to an argument against Method B, opponents of Methods C and D believe that those methods recognize only the changes in the tax law that are beneficial to stock life insurance companies. These opponents contend that Methods B, C, and D do not give accounting recognition to the fact that LITA-84 may also have certain adverse effects on some companies' tax provisions because of the higher effective tax rate that may result in post-1983 periods if and when there is a net reversal of timing differences. Also, Methods B, C, and D do not reflect, with respect to cumulative timing differences remaining after the fresh start adjustment, any "deficiency" of deferred taxes previously provided when compared to the LITA-84 tax rate. These opponents also contend that Methods C and D require a difficult, if not impossible, calculation and a somewhat arbitrary allocation of the December 31, 1983 deferred tax balance among the items causing such a balance to exist at that date; then, Methods C and D require a somewhat similar allocation, or series of allocations, to apportion that identified portion of the December 31, 1983 deferred tax balance over several post-1983 periods as the related timing differences would have reversed. However, proponents of Method C believe that the period of these reversals can be actuarially calculated based on assumptions used in providing reserves applicable to the in force business. A similar technique could be used to identify the permanent differences proposed in Method D.

37. The opponents to Method C also argue that the identification of the excess tax deductions requires special reserve calculations which violate the with-and-without method of Opinion No. 11. As such, these opponents of Method C assert that the applicable deferred tax amounts and the periods subject to such reversals are not objectively determinable, which, in turn, can result in incomparability between insurance company financial statements, difficulty in financial statement comprehension by the general public, and possible misuse of the general methodology inherent in the Method C concept.

38. Some believe that the fresh start adjustment provides a future benefit to companies. They believe that the fresh start benefit was provided to reduce the taxes that would otherwise have become payable on pre-1984 business under LITA-84. Thus, they believe that Methods C and D, which produce lower reported effective tax rates in post-1983 years (compared to the other methods) as the pre-1984 business matures or runs off, appropriately reflect the future benefit. They believe that Methods A, B, and E do not appropriately recognize the effects of the fresh start adjustment, in that Method A would often report a charge in 1984, Method B would report a benefit in 1984, and Method E would report no benefit or charge in any post-1983 period. Some believe that readers of financial statements would disregard the large tax effects that might be separately reported in 1984 under Methods A or B; they believe it is more meaningful to recognize those effects in income tax expense in post-1983 years.

39. Others believe that the benefit of the fresh start adjustment relates to events and transactions of pre-1984 years, not post-1983 years. For example, companies that took the 818c deduction in pre-1984 years will benefit since those deductions will not be recaptured. However, in post-1983 years, these companies will be permitted the same deductions and will pay the same tax regardless of whether they elected to take or not take the 818c deduction in pre-1984 years. Opponents of Methods C and D therefore favor Methods A or B (which recognize the fresh start benefit immediately in 1984) or Method E (which does not directly recognize the fresh start benefit) since they believe that those methods will more meaningfully report after-tax income in post-1983 periods.

Views on Method D

40. Proponents of Method D believe that Congress did not require the fresh start adjustment to be spread (i.e., reported as taxable income) in a number of post-1983 tax returns so that the effects of the commonly perceived increased tax burden caused by LITA-84 on the life insurance industry could be phased in over future years. Thus, accounting for the additional deductions arising from the fresh start adjustment as permanent differences when they are deducted for tax purposes results in the proper matching of revenue and expense for GAAP purposes and appropriately reflects the phasing in of the increased tax burden resulting from LITA-84. Opponents of Method D argue that the method arbitrarily masks the effects of any such increased tax

burden and may result in noncomparable year-to-year GAAP net income amounts over many post-1983 periods. Others would argue that the deferred tax benefit of LITA-84 relates to pre-1984 transactions and does not relate to the remaining lives of in-force policies at December 31, 1983. Some opponents also argue that, like Methods B and C, Method D recognizes only the effects of the change in the tax law that are beneficial and ignores any adverse implications of the tax law change. Proponents of Method D would counter this argument by pointing out that Method D can produce a limitation on the post-1983 beneficial aspects of the GAAP tax provision attributable to the fresh start adjustment when deferred taxes relating to the pre-1984 reserve timing differences are exhausted.

41. Proponents of Method D contend that, if companies do not recognize the benefits of the excess deductions in post-1983 periods, they would ignore, in GAAP-basis tax provisions, the actual tax savings that accrue to the companies. Put another way, failure to recognize the benefits of these permanent differences, as they arise, will result in aggregate tax-basis reserve deductions for pre-1984 policy issues being greater than the aggregate reserve deductions for such issues taken in computing GAAP-basis taxable income. Thus, it is likely that many companies would never recognize the benefit of these additional deductions. Some opponents of Method D would suggest that these additional deductions, if any, should be recognized at the end of the policy in-force period rather than systematically over the remaining in-force period.

42. Proponents of Method D contend that Method D is the only alternative that properly recognizes the deferred tax effects of the accounting considerations of LITA-84 under the guidance of Opinion No. 11. Since LITA-84 represents a comprehensive tax law change, no adjustment of the beginning deferred tax balances is required nor is such an adjustment even permitted. These proponents claim that Method D is also the only method that properly segregates post-1983 timing and permanent differences that occur as a result of LITA-84. Opinion No. 11 provides the following definitions of timing and permanent differences:

> Timing differences. Differences between the periods in which transactions affect taxable income and the periods in which they enter into the determination of pretax accounting income. Timing differences originate in one period and reverse or "turn around" in one or more subsequent periods. Some timing differences reduce income taxes that would otherwise be payable currently; others increase income taxes that would otherwise be payable currently.
>
> Permanent differences. Differences between taxable income and pretax accounting income arising from transactions that, under applicable tax laws and regulations, will not be offset by corresponding differences or "turn around" in other periods.

43. The proponents of Method D contend that the non-recognition of the portion of post-1983 tax-basis reserve increases that represents previously taken tax-basis reserve deductions in pre-1984 periods as permanent differences in computing post-1983 GAAP-basis taxable income could result in inappropriately tax-effecting a book-tax

difference as a timing difference. The result then would be the establishment of deferred taxes on book/tax differences that will never "turn around" in subsequent periods, an obvious violation of Opinion No. 11. Opponents of Method D would present the counter argument that the identification of the permanent differences requires special reserve calculations that are not inherently evident in the with-and-without calculation method required by Opinion No. 11. However, proponents point out that Opinion No. 11 requires the grouping of like timing differences in the with-and-without calculation and, further, that the identification of the permanent portion of the book-tax difference is not unlike the calculations properly required in tax accounting for excess statutory depletion in the oil and gas industry or for revalued depreciable assets resulting from an acquisition accounted for as a purchase.

44. Under Methods C and D, the post-1983 deferred income tax consequences may be somewhat similar; however, the underlying concepts are quite different and Method D generally would result in a more appropriate recognition of the fresh start adjustment benefit than would Method C for those companies whose December 31, 1983 deferred tax balance was provided at an effective tax rate less than the rate under LITA-84.

Views on Method E

45. Proponents of Method E believe that LITA-84 represents essentially a change in the tax rate for life insurance companies. Although LITA-84 includes many specific changes, two of its objectives are to simplify the tax laws for all life insurance companies and to eliminate the extraordinarily complex three-phase tax structure; as a consequence, the taxation of life insurance companies in post-1983 periods will be generally similar to that for other corporations. Thus, they believe that special tax provisions of FASB No. 60 are no longer necessary.

46. The proper matching of income and expenses is the prominent objective under the deferred tax method of accounting, and, as such, the deferred tax balance on the balance sheet is not adjusted when tax rates change or new taxes are imposed. Proponents of Method E believe that life insurance companies' deferred tax balances as of December 31, 1983 should not be adjusted because of the enactment of LITA-84. They acknowledge that the December 31, 1983 deferred tax balance will continue in post-1983 years to include amounts related to differences that will, for all practical purposes, never reverse in a going-concern situation. They note, however, that, in other industries, companies that use the net change method may also have comparable amounts in their deferred tax balances as a result of past changes in tax rates.

47. Prior to LITA-84, stock life insurance companies appropriately provided deferred taxes based on the tax laws then in effect and the specific circumstances of the respective companies. Under LITA-84, certain unreversed timing differences at December 31, 1983, for which deferred taxes may have been provided in pre-1984 periods, will not reverse, and taxes that had been expected to become payable will not be paid. Proponents of Method E believe that this nonreversal of pre-1984 timing differences will, in itself, have no cash effect in future periods. They believe that income tax expense, and after-tax income, to be reported in post-1983 years should not be affected solely by pre-1984 accounting decisions in determining deferred taxes, i.e., the passage of a 1984 tax bill should not be permitted to serve as a reason or excuse to revisit and revise the effects of pre-1984 accounting decisions. As a consequence, companies should not necessarily be permitted to report lower income taxes in post-1983 years simply because they had recorded higher income tax expense in pre-1984 years than, in retrospect, was necessary.

48. Method E proponents believe that the adoption of any method other than Method E will inappropriately report income effects that are related to provisions of tax laws that, with the enactment of LITA-84, have been repealed and that have no relation to post-1983 events or transactions. Proponents of Method E believe that future income tax provisions should be determined based only on the actual origination and reversal of timing differences under the law then in effect. After

1984, Methods A and E would produce similar tax expense in future periods provided that originating timing differences exceeded reversing timing differences. For companies with net reversing timing differences and a December 31, 1983 deferred tax balance established at a rate less than the post-1983 effective tax rate, Method E would result in the recognition of portions of the December 31, 1983 deferred tax balance related to the fresh start adjustment in post-1983 income tax expense.

49. Since most, if not all, life insurance companies follow the net change method*, only companies meeting the conditions described in the preceding paragraph would be permitted to reduce their December 31, 1983 deferred tax credit balance in post-1983 periods. Some opponents of Method E believe that such a limitation on the results of a GAAP tax provision, computed under the deferred method, is arbitrary and a departure from APB Opinion No. 11. Proponents of Method E believe that, without such a limitation, companies in the same circumstances could report different results while ostensibly following Method E. In applying the net change method, many stock life insurance companies historically have not attempted to identify timing differences by particular groups except, possibly, to distinguish them between insurance and investment activities. However, those companies probably

*Interpretation No. 9 of APB Opinion No. 11 describes the net change method as "a single computation...made at the current tax rates for the net cumulative effect of both originating and reversing differences occurring during a period relating to a particular group of similar timing differences."

would be able to retroactively identify and group their timing differences at either December 31, 1983 or January 1, 1984 and may allocate their deferred tax balance at those dates to the identified groups of timing differences; but, irrespective of whether any such allocation or reallocation of the deferred tax balance is made, no post-1983 income tax expense should be credited for any amount relating to the fresh start adjustment. In the absence of such a limitation, some believe that, in applying Method E, companies might credit income tax expense in 1984 for the deferred tax amounts related to the fresh start adjustment because they view the related timing differences as reversing when LITA-84 became effective; thus, they would apply Method E in a way to produce the same result as Method B. They cite Interpretation No. 10 of APB Opinion No. 11, which contains the following guidance regarding the amortization of deferred taxes:

> In a period when reversal of all timing differences of a particular type occurs, the entire related deferred tax account should be amortized regardless of the amount determined under the differential computation. For example, a company that has been using the installment method of accounting for gross margin on installment sales for tax purposes may decide to abandon the method by selling all installment receivables. The entire amount of deferred tax credits relative to installment sales which was carried over the preceding period should then be amortized.

Others have argued that, in applying Method E under the net change method, companies might allocate the December 31, 1983 deferred tax balance to the timing differences remaining at January 1, 1984 and credit income tax expense in post-1983 periods for amounts related to the fresh start adjustment as those timing differences reverse; thus, they would apply Method E in a way to produce a result similar

to Method C. Others might argue that, in applying Method E under the net change method, companies might allocate post-1983 tax-basis reserve increases as partially a timing difference and partially a permanent difference; thus, they would apply Method E in a way to produce the same result as Method D. Some might also argue that the deferred tax amounts allocated to the fresh start adjustment might be credited to income tax expense when the related life insurance policies expire or are otherwise eliminated from the financial statements, e.g., through reinsurance. In summary, proponents of Method E believe that Method E should not be interpreted or applied in such a manner as to effectively produce the results of any of the other methods in this paper. Proponents of Method E believe that the objective of Method E is to recognize periodic income tax expense determined solely by the tax effects of transactions entering into the determination of results of operations for the period and based on the law then in effect. They believe that recognition of the fresh start adjustment by credits to income tax expense would not, except when there are net reversing timing differences, appropriately reflect the periodic income tax expense.

50. Some opponents of Method E argue that Method E does not represent an appropriate application of the deferred method in post-1983 years in that it ignores the fact that a portion of the post-1983 tax-basis reserve deductions represents an additional reserve deduction for tax purposes that will never be reflected in GAAP pre-tax income. Thus,

by not identifying this extra tax-basis reserve deduction and accounting for it as a permanent difference for GAAP-basis tax calculations, companies' aggregate reserve deductions on pre-1984 policy issues taken in tax returns will be greater than the related aggregate reserve deductions taken in determining GAAP-basis taxable income with the result being an overstatement of GAAP-basis tax expense. A further overstatement in GAAP-basis tax expense could result under Method E in that the with-and-without calculations could lead to an inappropriate conclusion that net originating timing differences are arising in post-1983 years when, in fact, a net reversal of timing differences is occurring.

51. Opponents of Method E also believe that it is inappropriate in that it does not recognize the benefit of the fresh start adjustment provided by LITA-84 that will accrue to certain life insurance companies as a result of not having to recapture pre-1984 tax-basis reserve deductions. Thus, Method E would not provide information to users of financial statements to permit them to determine whether a company did or did not benefit from the fresh start adjustment.

52. Some opponents of Method E agree that there should be no adjustment to opening deferred tax balances because of LITA-84, but disagree with the Method E conclusion in that it does not allow for the recognition of tax benefits in post-1983 years that were appropriately deferred in pre-1984 years under the tax laws then in effect.

53. Opponents of Method E believe that it is inappropriate to consider the changes resulting from LITA-84 simply as a rate change; rather, they contend that LITA-84 qualifies as a change in circumstances as contemplated in FASB No. 60, paragraph 58, and that the applicable provisions of that paragraph should be implemented, as required, in life insurance companies' post-1983 GAAP-basis tax provisions. Some opponents of Method E further believe that its proponents have misunderstood the objective of LITA-84. These opponents contend that the objective of LITA-84 is not to raise the tax burden of the industry, rather, it is to simplify the life insurance tax formula and more equitably distribute the tax burden among life insurance companies. These opponents believe that Method E's proponents have based their conclusion on the mistaken presumption that any method that produces a lower effective GAAP tax rate than that proposed in LITA-84 would not be credible to users of the financial statements.

Advisory Conclusions

The views of AcSEC and the Insurance Companies Committee on the five proposed accounting methods are described in the Foreword to this paper. The following advisory conclusions provide recommendations of the Insurance Companies Committee on other aspects of income tax accounting by stock life insurance companies.

54. Under LITA-84, stock life insurance companies should provide deferred taxes in accordance with APB Opinion No. 11. The circumstances that gave rise to the special computational techniques discussed in FASB No. 60, paragraphs 55 through 58, have been eliminated by LITA-84. Accordingly, those paragraphs should no longer apply.

55. Under LITA-84, the provisions of APB Opinion No. 23, paragraph 28, regarding income taxes related to the policyholders surplus account continue to apply.

56. Companies using the net change method should continue to tax effect timing differences using the with-and-without calculation and the applicable statutory rates in effect. Any company using the gross change method should tax effect reversing timing differences at the effective rates at which the deferred taxes were established, and originating timing differences should be tax effected using the current effective statutory tax rates in the with-and-without calculation.

57. For post-1983 GAAP-basis tax provision calculations, the "taxable income adjustment" and, if applicable, the "small life insurance company deduction", should be accounted for in the deferred tax calculation in a manner similar to that accorded permanent differences (i.e., the equivalent of a modification of the statutory tax rate) even though the amounts of these deductions may have to be revalued when timing differences are considered. If a company meets the LITA-84 criteria for "small company" status (i.e., a company with total tax-basis assets of less than $500,000,000), its GAAP-basis balance sheet does not affect this status.

58. The accounting principles for deferred taxes relating to net operating loss carryovers/carrybacks and to unrealized gains on marketable equity securities are unaffected by LITA-84.

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APPENDIX A

EXCERPTS FROM FASB STATEMENT NO. 60 ACCOUNTING AND REPORTING BY INSURANCE ENTERPRISES

Income Taxes of Life Insurance Enterprises

Deferred Income Taxes

55. Because of the provisions of the Life Insurance Company Income Tax Act of 1959 (Act),[8] timing differences (paragraph 13(e) of APB Opinion No. 11, *Accounting for Income Taxes*) of life insurance enterprises arising in the current period may not affect the determination of income taxes in future periods when those timing differences reverse. Amounts determined in the with-and-without calculation (paragraph 36 of Opinion 11) need to be considered further to determine whether the difference will reverse in the future. Deferred taxes need not be provided for the current tax effect of timing differences if circumstances indicate that the current tax effect will not reverse in the future. Similarly, a change in category of taxation (the basis on which the enterprise determines its income tax liability) resulting from the with-and-without calculation need not be recognized unless circumstances indicate that a change in category will result when the timing difference reverses. If the reversal of tax effects cannot be reasonably determined, deferred income taxes shall be provided based on the differential determined using the with-and-without calculation as if the enterprise's tax return was filed on the basis on which financial statements are prepared, including any resulting change in category of taxation.

56. Although (a) special deductions (allowable only for income tax purposes) never enter into the determination of pretax accounting income in any period and (b) the amount of policyholder dividend deductions and special deductions may

[8]The Act contemplated taxation of total income of life insurance enterprises, but the determination of tax is complex because of the manner in which total taxable income is classified as investment income, gain from operations (including investment income and less special deductions for certain accident and health, group life, and nonparticipating insurance contracts), policyholders' surplus (gain from operations previously excluded from tax and the special deductions), and the interrelationship of those elements. Taxable income consists of (a) taxable investment income, (b) 50 percent of the amount by which gain from operations exceeds taxable investment income, and (c) any reductions in policyholders' surplus. If gain from operations is less than taxable investment income, the lesser amount, plus any reductions in policyholders' surplus, is taxable income. If a loss from operations occurs, there is no taxable income except to the extent that there are reductions in policyholders' surplus. Deductions from gain from operations for policyholder dividends and the special deductions are limited and unused deductions cannot be carried forward to subsequent periods.

be limited on the tax return (the unused deductions cannot be carried forward to subsequent periods), the amount of policyholder dividend deductions and available special deductions and limitations on those deductions may properly be determined based on pretax accounting income. For example, unused policyholder dividend deductions and special deductions may be used to offset timing differences that affect taxable income to the extent that the limitations on those deductions change when based on pretax accounting income, unless known or anticipated circumstances indicate that future taxable income resulting from the reversal of timing differences will not be offset by like deductions. In the case of provisions for policyholder dividends (including policyholder dividends deducted as part of the change in the liability for future policy benefits), which may be timing differences themselves, statutory limitations shall not be applied to eliminate their current tax effect unless circumstances indicate that the dividends will be limited when the timing differences reverse. Special deductions that are directly affected by timing differences need to be redetermined in the with-and-without calculation unless circumstances indicate that future special deductions will not be directly affected by the timing differences when the timing differences reverse. If the reversal of tax effects cannot be reasonably determined, special deductions that are not affected by timing differences and, therefore, do not reverse shall be limited to amounts available in the tax return.

57. A life insurance enterprise's liability for future policy benefits and capitalization and amortization of acquisition costs indirectly affect the amount of taxable investment income used in determining the income tax provision for financial reporting purposes. Differences in taxable investment income caused by differences between the liability for future policy benefits and capitalization and amortization of acquisition costs for income tax and financial reporting purposes shall be considered permanent differences (paragraph 13(f) of Opinion 11).

58. If deferred income taxes have not been provided on timing differences on the presumption that the timing differences will not have tax effects when they reverse and circumstances

change so that it becomes apparent that tax effects will result, deferred income taxes attributable to those timing differences shall be accrued and reported as income tax expense in that period; those income taxes shall not be reported as an extraordinary item. If deferred income taxes have been provided on timing differences and circumstances change so that it becomes apparent that the tax effects will differ from those originally expected, income taxes previously deferred shall be included in income only as the related timing differences reverse, regardless of whether the life insurance enterprise uses the gross change or net change method (paragraph 37 of Opinion 11).

Disclosures

60. Insurance enterprises shall disclose the following in their financial statements:

i. For life insurance enterprises or a parent of a life insurance enterprise that is either consolidated or accounted for by the equity method:
   (1) The treatment of policyholders' surplus under the U.S. Internal Revenue Code and that income taxes may be payable if the enterprise takes certain specified actions, which shall be appropriately described
   (2) The accumulated amount of policyholders' surplus for which income taxes have not been accrued
j. For life insurance enterprises, any retained earnings in excess of policyholders' surplus on which no current or deferred federal income tax provisions have been made and the reasons for not providing the deferred taxes

Appendix C

Deferred Income Taxes

Life Insurance Taxation

Life insurance companies are taxed under provisions of the Life Insurance Company Income Tax Act of 1959. The Act contemplated taxation of total income, but the computation of tax is complex because of the manner in which total taxable income is segmented between investment income, gain from operations and policyholders' surplus (gain from operations previously excluded from tax) and the interrelationship of these elements. Total taxable income composed of those three elements, referred to as Phase I, Phase II, and Phase III income, is subject to tax in the same manner as other corporations, including alternative tax computation for capital gains, foreign tax credit, and investment credit. However, an operations loss deduction (the equivalent of a net operating loss carryover) is treated as a deduction from gain from operations in arriving at taxable income. The terms Phase I, Phase II, Phase III, and combinations thereof are frequently used to describe the specific situations in which companies are taxed. There is a lack of uniformity in the use of these terms; therefore, their use has been avoided in describing various taxable situations in this appendix.

Taxable investment income consists of that portion of invest-

ment yield (gross investment income less investment expenses) deemed not required to maintain reserves ("company's share") reduced by a proportionate share of tax exempt interest and dividends-received deduction. The portion of investment yield which is considered to be required to maintain reserves ("policyholders' share") is the sum of (1) the lower of the average or current earnings rate ("adjusted reserves rate") applied to mean life insurance reserves adjusted to reflect the effect of the difference between the adjusted reserves rate and the assumed rate actually used to calculate reserves, (2) the current earnings rate applied to mean pension plan reserves, and (3) interest paid during the year.

Gain or loss from operations consists of all income and cost, including investment income, with limitation on deductibility of dividends to policyholders and certain other special deductions described later herein. Investment income for this purpose is net of the policyholders' share computed using rates of interest assumed in calculating reserves as opposed to adjusted rates used in determining taxable investment income. However, this is offset in the reserve increase with no effect on income. Taxable income consists of taxable investment income and 50% of the amount by which gain from operations exceeds taxable investment income. If gain from operations is less than taxable investment income, the lesser amount is taxable income. If there is a loss from operations, there is no taxable income except to the extent of any reductions from policyholders' surplus.

The 50% portion of gain from operations which is excluded from taxable income, together with the amount of special deductions for certain accident and health, and group life insurance and nonparticipating contracts is added to the policyholders' surplus account until the total policyholders' surplus account equals a specified maximum. Reductions in this account are included in taxable income in the year when such reduction occurs. Reductions in this account arise when the company (a) makes distributions, in excess of shareholders' surplus, to stockholders as dividends or in redemption of stock in partial or complete liquidation, (b) accumulates policyholders' surplus in excess of the specified maximum, (c) elects to transfer amounts to shareholders' surplus, or (d) ceases to qualify as a life insurance company for tax purposes.

Dividends to Policyholders and Special Deductions

The Life Insurance Company Income Tax Act of 1959 provides deductions for dividends to policyholders and special deductions for certain accident and health and group life contracts, and nonparticipating contracts.

Deductions for dividends to policyholders generally enter into the determination of taxable income and pretax accounting income. Such deductions may represent timing differences when the amounts deducted in the financial statements differ from the amounts deducted in the tax return.

The special deductions for nonparticipating contracts and accident and health and group life contracts do not enter into the determination of pretax accounting income in any period. Deductions for nonparticipating contracts are based on a percentage of increase in reserves or a percentage of total premiums, whichever produces the larger deduction. When based on a percentage of increase in reserves, the deduction may be directly affected by other timing differences related to the calculation of reserves. However, when based on a percentage of total premiums, the deductions may be unaffected by other timing differences related to the calculation of reserves. Deductions for accident and health contracts are based on a percentage of annual premiums subject to a cumulative limitation. Such deductions are not directly affected by other timing differences.

Limitations have been placed on the aggregate of all the foregoing deductions which prevent the reduction of gain from operations to an amount which is less than taxable investment income minus $250,000. When gain from operations, computed without regard to such deductions, is less than taxable investment income, the aggregate of these deductions is limited to $250,000. When such deductions are limited, the unused deductions are not available in subsequent periods.

Categories of Taxation

If gain from operations, after deducting all dividends to policyholders and special deductions described above, is less than taxable investment income by more than $250,000, these dividends to policyholders and special deductions are limited to an amount which will not decrease gain from operations below this

level. As long as taxable income is $250,000 less than taxable investment income and all of the dividends or special deductions have not been used in arriving at taxable income, the tax base is taxable investment income less $250,000, not gain from operations. For a company which remains in this category, any timing difference affecting only gain from operations as a result of applying generally accepted accounting principles will have no tax effect when it reverses. This situation is described as category 1 on page 151.

If gain from operations, without regard to dividends to policyholders and special deductions, is less than taxable investment income, the aggregate of these special deductions is limited to $250,000. For a company which remains in this category, the tax base is gain from operations, and timing differences will produce tax effects which reverse. However, the unused special deductions may, in some cases, be used in calculating the tax effects of timing differences as described under "computational techniques." This situation is described as category 2 on page 151.

Gain from operations, without regard to dividends to policyholders and special deductions, may be less than taxable investment income, and the aggregate of these special deductions may be less than $250,000 so as not to be limited. For a company which remains in this category, the tax base is gain from operations, and timing differences will produce tax effects which reverse. This situation is described as category 3 on page 151.

Gain from operations, without regard to dividends to policyholders and special deductions, may be greater than taxable investment income and, if the aggregate of these special deductions does not reduce gain from operations to an amount which is less than taxable investment income or which is not $250,000 less than taxable investment income, these special deductions are not limited. For companies which remain in these categories, the tax base is gain from operations, and timing differences will produce tax effects which reverse. These situations are described as categories 4 and 5 on page 151.

Significant timing differences and their effects on special deductions in a "with-and-without" calculation could result in a current change in category. Methods for dealing with such a situation and for determining or dealing with the tax effects of timing differences in general are discussed under "Computational Techniques."

	Taxable investment income	Gain from operations before special deductions	Special deductions			Taxable income
			Total	Allowable	Unused	
Category 1	$1,000,000	$1,500,000	$1,200,000	$ 750,000	$ 450,000	$ 750,000
Category 2	1,000,000	900,000	1,200,000	250,000	950,000	650,000
Category 3	1,000,000	900,000	200,000	200,000	—	700,000
Category 4	1,000,000	3,000,000	1,200,000	1,200,000	—	1,400,000*
Category 5	1,000,000	2,100,000	1,200,000	1,200,000	—	900,000

* Taxable investment income		$1,000,000
Gain from operations after special deductions	$1,800,000	
Less taxable investment income	1,000,000	
Excess	$ 800,000	
50% of excess included in taxable income		400,000
Taxable income		$1,400,000

Nature of Timing Differences

While the usual timing differences, such as those resulting from depreciation methods, amortization of bond discount, and accrual of dividends and interest may exist for life insurance companies, the most significant timing differences result from the adoption of generally accepted accounting principles—principally from differences between adjusted life insurance reserves and those used for tax purposes and deferral and amortization of acquisition costs. Such timing differences affect only gain from operations.

The only transactions that give rise to timing differences with respect to taxable investment income would be those related to the timing of the inclusion of items of investment income or investment expense, such as cash vs. accrual basis of accounting for dividends and interest or accelerated vs. straight-line depreciation methods on real estate. While the inclusion of adjustments to life insurance reserves and deferral and amortization of acquisition costs resulting from the adoption of generally accepted accounting principles in a hypothetical tax return would indirectly affect taxable investment income, such effect is a permanent difference. These items affect only total assets or aggregate reserves, which amounts will, for income tax purposes, always be greater or less than comparable amounts for accounting purposes. Accordingly, amounts of such differences do not reverse in subsequent periods.

Computational Techniques

As stated in APB Opinion No. 11, "The tax effect of a timing difference should be measured by the differential between income taxes computed with and without inclusion of the transaction creating the difference between taxable income and pretax accounting income. The resulting income tax expense for the period includes the tax effects of transactions entering into the determination of results of operations for the period. The resulting deferred tax amounts reflect the tax effects which will reverse in future period." "With-and-without" computations for life insurance companies are more complicated than is the case in the normal tax return because of the complexities of the Life Insurance Company Income Tax Act of 1959. Accordingly, no

short-cut method of computing deferred income taxes is possible.

The differential tax effect tentatively determined in the with-and-without calculation must be further examined to determine whether such tax effect will reverse in the future. For example, as discussed previously, timing differences affecting only gain from operations may result in a current tax effect in such a with-and-without calculation which may not reverse in the future for companies who continue to be taxed on taxable investment income. Deferred taxes are not required to be provided for the current tax effect of timing differences if circumstances indicate that there will not be a reversal of such current tax effect in the future.

Although (1) certain special deductions never enter into the determination of pretax accounting income in any period and/or (2) the amount of dividends to policyholders and certain special deductions may be subject to limitation on the tax return so that unused deductions will not be available in subsequent periods, such deductions may be properly recomputed in the with-and-without calculation. For example, unused dividends to policyholders and special deductions may be used to offset timing differences which affect taxable income tc the extent that the limitations on these deductions change when based on pretax accounting income, unless known or anticipated circumstances indicate that future taxable income resulting from such timing differences will not be offset by like deductions when they reverse. Similarly, in the case of provisions for dividends to policyholders, which are timing differences themselves, statutory limitations should not be applied so as to eliminate their current tax effect unless circumstances indicate that such dividends will be limited when they reverse.[1] Special deductions that are directly affected by timing differences should be recomputed in the with-and-without calculation unless circumstances indicate that future special deductions will not be directly affected by the timing differences when such timing differences reverse.

Companies adopting generally accepted accounting principles for the first time will be required to reflect such change retro-

[1] For purposes of computing deferred taxes, it will be necessary to identify the amount of dividends to policyholders deducted in the financial statements even when they are considered as benefits in the reserving method.

actively in the year of change. This retroactive change will apply to all of the adjustments necessary to present financial statements in conformity with generally accepted accounting principles, including the application of deferred income tax accounting. Since the adjustment will be applied retroactively, the restriction on the use of the "net change method" described in APB Opinion No. 11 will not be applicable. The intent of the restriction was to preclude a company that was not applying interperiod tax allocation prior to the Opinion from using the tax effect of the reversal of a difference to offset deferred taxes required to be recognized for current originating timing differences. Accordingly, a life insurance company adjusting retroactively will be able to use the individual transaction, gross change, or net change methods.

From a practical standpoint, the gross change method may be very difficult to apply to timing differences related to reserves. Companies that elect this method must maintain detailed records of originating and reversing differences or must be prepared to demonstrate, by use of modelling or other techniques, that reasonable approximations of originating and reversing timing differences have been made.

Because of the complexity of life insurance income tax computations, the net change and gross change methods can produce substantially different results. For the purpose of using the gross change or net change methods, adjustments to reserves and the deferral and amortization of acquisition costs constitute similar timing differences which could be grouped. While reserves and deferred acquisition costs will be segregated in the balance sheet, their grouping for the purpose of determining pretax accounting income is justified because of their interrelationship and similar reversing characteristics. In addition, grouping of other timing differences may be most appropriate because separate treatment of individual timing differences can produce results which vary significantly from those that would result from the grouping of all timing differences. These different results are produced when the with-and-without calculation causes a change in category of taxation.

When results are produced which vary significantly from the company's current tax status because of the method used or the grouping or separate treatment of timing differences, consideration must be given to the reversal of the tax effects calculated. In determining whether there will be any future tax

effect, the reversing characteristics of the timing differences must also be considered. Deferred taxes need not be provided unless such taxes will reverse in the future, and a change in category of taxation resulting from the with-and-without calculation should not be recognized unless circumstances indicate that such change in category will result when the timing difference reverses.

When the reversal of tax effects cannot be reasonably determined, deferred income taxes should be provided based on the differential computed using a with-and-without calculation as if the company's tax return was filed on the basis on which financial statements were prepared, including any resulting change in phase of taxation. In such cases, special deductions which are not timing differences or which are not affected by other timing differences and, therefore, do not reverse, should be limited to amounts calculated in the tax return.

Changes in Circumstances

If deferred income taxes have not been provided on timing differences on the presumption that such timing differences will have no tax effects when they reverse, and circumstances change so that it becomes apparent that tax effects will result, a company should accrue as an expense of the current period income taxes attributable to those timing differences; income tax expenses for such timing differences should not be accounted for as an extraordinary item.

If deferred income taxes have been provided on timing differences, and circumstances change so that it becomes apparent that the tax effects will differ from those originally expected, deferred income taxes previously accrued should be included in income only as the related timing differences reverse.[1]

The facts and circumstances known about the company's income tax position in prior years and the current year must be considered, together with any changes which have affected or are expected to affect income taxes. Long range forecasts may also be useful. Examples of changes in circumstances which

[1] Amortization procedures described in paragraph 10 of *Accounting for Income Taxes—An Interpretation of APB Opinion No. 11*, Donald J. Bevis and Raymond E. Perry, AICPA, 1969, should be followed.

might indicate the need for adjusting tax accounts would include the following:

1. Change in volume and/or profitability of business.
2. Change in mix of health insurance and life insurance.
3. Change in mix of participating and nonparticipating business.
4. Change in dividends to policyholders.
5. Acquisition or disposition of subsidiaries.
6. Change from rental to ownership of home office building.
7. Adopting of tax planning techniques such as the Section 818 (c) reserve strengthening election.

Policyholders' Surplus

APB Opinion No. 23 states that deferred taxes should not be provided on amounts designated as policyholders' surplus on the tax return of a stock life insurance company unless circumstances indicate that the insurance company is likely to pay income taxes, either currently or in subsequent years, because of known or expected reductions in policyholders' surplus.

Pre-1958 Timing Differences

Prior to the enactment of the Life Insurance Company Income Tax Act of 1959, which was effective for 1958, life insurance companies were taxed on investment income. Accordingly, most of the retroactive adjustments to conform to generally accepted accounting principles will create timing differences that would have had no tax effect prior to 1958 and, therefore, no deferred income taxes should be provided for cumulative timing differences at January 1, 1958.

Discounting

Representatives of industry have proposed that discounting should be applied to unamortized deferred income tax balances. It has been stated that such discounting is consistent with the discounting of other liabilities in a life insurance company. However, the application of discounting would be applicable only under the liability method of accounting for deferred income taxes, which method was rejected by the Accounting Principles Board in Opinion No. 11.

Summary

As stated in APB Opinion No. 11, "the principal problems in accounting for income taxes arise from the fact that some transactions affect the determination of net income for financial accounting purposes in one reporting period and the computation of taxable income and income taxes payable in a different reporting period. . . . A major problem is . . . the measurement of the tax effects of such transactions and the extent to which the tax effects should be included in income tax expense in the same periods in which the transactions affect pretax accounting income." Tax effects are defined principally as "differentials in income taxes of a period attributable to . . . revenue or expense transactions which enter into the determination of pretax accounting income in one period and into the determination of taxable income of another period. . . ." The opinion further states that, "interperiod tax allocation procedures have been developed to account for the tax effects of transactions which involve timing differences," and that, "deferred tax amounts reflect the tax effects which will reverse in the future."

The foregoing language has been interpreted in this appendix to mean that interperiod tax allocation procedures should account for reversal of timing difference *and the reversal of their tax effects*. Accordingly, the calculation in the current period of the tax effect of a timing difference measured by the differential between income taxes computed with and without inclusion of the transaction creating the difference between taxable income and pretax accounting income must be reviewed to determine whether circumstances indicate that the tax effect so measured will reverse in the future when the timing difference reverses. This appendix describes some of the more obvious situations where there may be no reversal of effects measured by means of a with-and-without calculation and suggests that deferred taxes are not required to be provided if circumstances indicate that the tax effects so measured will not reverse in the future.

Because of the complexity of life insurance company taxation, it was not practical to discuss all the situations that might occur. Further experience will develop new situations and solutions thereto.

APPENDIX C

EXCERPTS FROM ACCOUNTING PRONOUNCEMENTS ON DEFERRED TAXES

This appendix provides selected excerpts from various pronouncements on accounting standards that discuss accounting for deferred taxes. It is not intended to be all-inclusive.

1. APB Opinion No. 11, "Accounting for Income Taxes" (December 1967)

   A. Paragraph 19

      The deferred taxes are determined on the basis of the tax rates in effect at the time the timing differences originate and are not adjusted for subsequent changes in tax rates or to reflect the imposition of new taxes.

   B. Paragraph 34

      The tax effects of those transactions which enter into the determination of pretax accounting income either earlier or later than they become determinants of taxable income should be recognized in the periods in which the differences between pretax accounting income and taxable income arise and in the periods in which the differences reverse. Since permanent differences do not affect other periods, interperiod tax allocation is not appropriate to account for such differences.

   C. Paragraph 36

      The tax effect of a timing difference should be measured by the differential between income taxes computed with and without inclusion of the transaction creating the difference between taxable income and pretax accounting income. The resulting income tax expense for the period includes the tax effects of transactions entering into the determination of results of operations for the period. The resulting deferred tax amounts reflect the tax effects which will reverse in future periods. The measurement of income tax expense becomes thereby a consistent and integral part of the process of matching revenues and expenses in the determination of results of operations.

D. Paragraph 57

Deferred charges and deferred credits relating to timing differences represent the cumulative recognition given to their tax effects and as such do not represent receivables or payables in the usual sense.

E. Paragraph 63

Certain other disclosures should be made in addition to those set forth in paragraphs 56-62.

* * *

c. Reasons for significant variations in the customary relationships 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.

The Board recommends that the nature of significant differences between pretax accounting income and taxable income be disclosed.

2. APB Opinion No. 16, "Business Combinations" (August 1970), paragraph 89

The market or appraisal values of specific assets and liabilities determined in paragraph .88 may differ from the income tax bases of those items.

* * *

Since differences between amounts assigned and tax bases are not timing differences (APB Opinion No. 11, paragraph 13 [section 4091.12], *Accounting for Income Taxes*), the acquiring corporation should not record deferred tax accounts at the date of acquisition.

3. Accounting Interpretation of APB Opinion No. 11, No. 23, "Transitional Problems" (1969)

There are cases in which a company, prior to the effective date of (APB 11), did not apply interperiod tax allocation procedures for significant timing differences in accordance with (APB 11) but was required to do so subsequent to the effective date. It should be noted that under such circumstances if the provisions of (APB 11) were not applied retroactively, there may be a significant lack of comparability among income statements for a number of years. This will occur because it will be necessary to recognize deferred taxes for timing differences that originate subsequent to the effective date of (APB 11) whereas it will not be permissible to reflect in the provision for deferred taxes the tax effects of similar timing differences that reverse during the same period. The effect of this procedure will be to place the accounts of the company on a full allocation basis gradually over a period of time. The period of time required for full allocation to be achieved and the significance of the lack of comparability will depend on the "rollover period" of the timing differences involved, and their materiality.

* * *

If a company decides to give retroactive effect to (APB 11), the computations of deferred taxes relating to timing differences for prior periods should be based on the provisions of (APB 11) and should be applied to all material items of those prior periods. It is unacceptable to compute such deferred taxes under the "liability" approach, which has been rejected in (APB 11), even though the liability approach would have been acceptable if it had been followed in prior years.

4. FASB Statement No. 19, "Financial Accounting and Reporting by Oil and Gas Producing Companies" (December 1977), paragraphs 61-62

Comprehensive interperiod income tax allocation by the deferred method, as described in *APB Opinion No. 11* [section 4091], "Accounting for Income Taxes," shall be followed by oil and gas producing companies for intangible drilling and development costs and other costs incurred that enter into the determination of taxable income and pretax accounting income in different periods.

In applying the comprehensive interperiod income tax allocation provision of the preceding paragraph, the possibility that statutory depletion in future periods will reduce or eliminate the amount of income taxes otherwise payable shall not be taken into account. That is, the so-called *interaction* of book/tax timing differences with any anticipated future excess of statutory depletion allowed as a tax deduction over the amount of cost depletion otherwise allowable as a tax deduction shall not be recognized in determining the appropriate periodic provision for income taxes. Accordingly, the excess of statutory depletion over cost depletion for tax purposes shall be accounted for as a permanent difference in the period in which the excess is deducted for income tax purposes; it shall not be anticipated by recognizing interaction.

5. FASB Statement No. 31, "Accounting for Tax Benefits Related to U.K. Tax Legislation Concerning Stock Relief" (September 1982)

A. Paragraph 2

The Board believes that the change in the U.K. tax law with regard to "stock relief" creates a unique situation in accounting for income taxes and that the accounting specified by this Statement should not extend to other situations.

B. Paragraph 5

.05 Because of the potential recapture of "stock relief," the tax benefit related thereto shall be deferred unless it is probable that the tax benefit will not be recaptured prior to the end of the relevant six-year recapture period. If the tax benefit related to "stock relief" has been deferred and circumstances subsequently change indicating that it is probable that the tax benefit will not be recaptured prior to the end of the relevant six-year recapture period, the tax benefit previously deferred shall be recognized by a reduction of income tax expense in the period in which circumstances change. If the tax benefit related to "stock relief" has not been deferred and circumstances subsequently change, the tax benefit attributable to that "stock relief" shall be deferred to the extent appropriate by a charge to income tax expense of the period in which circumstances change.

C. Paragraph 10

APB Opinion No. 11 [section 4091], *Accounting for Income Taxes,* defines differences as either timing differences or permanent differences and does not contemplate a timing difference that later changes into a permanent difference. The Board has therefore concluded that accounting for "stock relief" as a timing difference that becomes a permanent difference is inappropriate under the existing principles of income tax allocation.

FASB Interpretation #18, "Accounting for Income Taxes in Interim Periods"

Paragraph 23

Effect of New Tax Legislation

.114 Paragraph .122 states that changes resulting from new tax legislation shall be "reflected after the effective dates prescribed in the statutes." If new tax legislation prescribes changes that become effective during an enterprise's fiscal year, the tax effect of those changes shall be reflected in the computation of the estimated annual effective tax rate beginning with the first interim period that ends after the new legislation becomes effective. Paragraph .115 describes the determination of when new legislation becomes effective. [FIN18, ¶23]

Paragraph 24

Effective Date

.115 Legislation generally becomes effective on the date prescribed in the statutes. However, tax legislation may prescribe changes that become effective during an enterprise's fiscal year that are administratively implemented by applying a portion of the change to the full fiscal year. For example, if the statutory tax rate applicable to calendar-year corporations were increased from 48 percent to 52 percent, effective January 1, the increased statutory rate might be administratively applied to a corporation with a fiscal year ending at June 30 in the year of the change by applying a 50 percent rate to its taxable income for the fiscal year, rather than 48 percent for the first 6 months and 52 percent for the last 6 months. In that case the legislation becomes effective for that enterprise at the beginning of the enterprise's fiscal year. [FIN18, ¶24] (Refer to paragraphs .501 through .503 for supplemental guidance.)

7. APB Opinion No. 23, "Accounting for Income Taxes--Special Areas," paragraphs 26-30.

"POLICYHOLDERS' SURPLUS" OF STOCK LIFE INSURANCE COMPANIES

Discussion

26. The provisions of the United States Internal Revenue Code provide for the exclusion from taxable income of a stock life insurance company of amounts determined under a formula and the allocation of those amounts to policyholders' surplus until the total policyholders' surplus equals a specified maximum. The amounts excluded from taxable income and designated as policyholders' surplus are includable in taxable income of later years if the company elects to (a) distribute policyholders' surplus to stockholders as dividends, (b) transfer amounts from policyholders' surplus to shareholders' surplus designated for tax purposes as available for any business purpose, or (c) take, or if it fails to take, certain other specified actions (none of which usually occur).

27. Some believe that a difference between taxable income and pretax accounting income attributable to amounts designated as policyholders' surplus of a stock life insurance company has attributes of a permanent or indefinite deferral of tax payments. In their view, a stock life insurance company should not accrue income taxes on the difference between taxable income and pretax accounting income related to amounts designated as policyholders' surplus unless circumstances indicate that the insurance company is likely to pay income taxes, either currently or in future years, because of known or expected reductions in policyholders' surplus. Others believe that the difference has the principal attributes of a timing difference as described in paragraphs 36 and 37 of APB Opinion No. 11. In effect, they believe that the difference is a Government-sponsored deferral of tax, that the Government has an equity in the stock life insurance company to the extent of the deferred tax, and that it is inappropriate to include earnings in stockholders' equity without accruing income taxes which would be incurred by the stock life insurance company if those earnings were distributed to stockholders or otherwise became subject to tax. In their view the stock life insurance company should accrue deferred taxes on the difference.

Opinion

28. The Board concludes that a difference between taxable income and pretax accounting income attributable to amounts designated as policyholders' surplus of a stock life insurance company may not reverse until indefinite future periods or may never reverse. The insurance company controls the events that create the tax consequences and the company is generally required to take specific action before the initial difference reverses. Therefore, a stock life insurance company should not accrue income taxes on the difference between taxable income and pretax accounting income attributable to amounts designated as policyholders' surplus. However, if circumstances indicate that the insurance company is likely to pay income taxes, either currently or in later years, because of known or expected reductions in policyholders' surplus, income taxes attributable to that reduction should be accrued as a tax expense of the current period; the accrual of those income taxes should not be accounted for as an extraordinary item.

29. *Disclosure.* Information concerning amounts designated as policyholders' surplus of a stock life insurance company that should be disclosed in notes to financial statements includes:

a. The treatment of policyholders' surplus under the United States Internal Revenue Code and the fact that income taxes may be payable if the company takes certain specified actions, which should be appropriately described, and
b. The accumulated amount of the policyholders' surplus for which income taxes have not been accrued.[11]

30. The disclosure requirements set forth in paragraph 29 also apply to a parent company of a stock life insurance company accounting for that investment either through consolidation or by the equity method.

[11] Other disclosure requirements in paragraphs 55-64 of APB Opinion No. 11 may also apply.