Statement of Statutory Accounting Principles No. 10

Income Taxes

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Income Taxes

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for current and deferred federal and foreign income taxes and current state income taxes.

SUMMARY CONCLUSION

2. For purposes of accounting for federal and foreign income taxes, reporting entities shall adopt *FASB Statement No. 109, Accounting for Income Taxes* (FAS 109) with modifications for state income taxes, the realization criteria for deferred tax assets, and the recording of the impact of changes in its deferred tax balances. As a result, financial statements will recognize current and deferred income tax assets and liabilities in accordance with the provisions of this statement.

Current Income Taxes

3. "Income taxes incurred" shall include current income taxes, the amount of federal and foreign income taxes paid (recovered) or payable (recoverable) for the current year. Current income taxes are defined as:

   a. Current year estimates of federal and foreign income taxes (including the equity tax of a mutual life insurer and the "true-up" of such tax), based on tax returns for the current year, and tax contingencies for current and all prior years, to the extent not previously provided, computed in accordance with *SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets* (SSAP No. 5R);

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

4. State taxes (including premium, income and franchise taxes) shall be computed in accordance with SSAP No. 5R and shall be limited to (a) taxes due as a result of the current year's taxable basis calculated in accordance with state laws and regulations and (b) amounts incurred or received during the current year relating to prior periods, to the extent not previously provided as such amounts are deemed to be changes in accounting estimates. Property and casualty insurance companies shall report state taxes as other underwriting expenses under the caption "Taxes, licenses, and fees." Life and accident and health insurance companies shall report such amounts as general expenses under the caption "Insurance taxes, licenses, and fees, excluding federal income taxes." Other health entities shall report such amounts as general administration expenses under the caption "Taxes, licenses, and fees." State tax recoverables that are reasonably expected to be recovered in a subsequent accounting period are admitted assets. State taxes are reasonably expected to be recovered if the refund is attributable to overpayment of estimated tax payments, errors, carrybacks, or items for which the reporting entity has authority to recover under a state regulation or statute.

Deferred Income Taxes

5. A reporting entity's balance sheet shall include deferred income tax assets (DTAs) and liabilities (DTLs), the expected future tax consequences of temporary differences generated by statutory accounting, as defined in paragraph 11 of FAS 109.

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

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

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

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

   d. A DTL is not recognized for amounts described in paragraph 31 of FAS 109.

7. Changes in DTAs and DTLs, including changes attributable to changes in tax rates and changes in tax status, if any, shall be recognized as a separate component of gains and losses in unassigned funds (surplus). DTAs and DTLs shall be offset and presented as a single amount on the statement of financial position.

Admissibility of Income Tax Assets

8. Current income tax recoverables shall include all current income taxes, including interest, reasonably expected to be recovered in a subsequent accounting period, whether or not a return or claim has been filed with the taxing authorities. Current income tax recoverables are reasonably expected to be recovered if the refund is attributable to overpayment of estimated tax payments, errors, carrybacks, as defined in paragraph 289 of FAS 109, or items for which the reporting entity has substantial authority, as that term is defined in Federal Income Tax Regulations.

9. Current income tax recoverables meet the definition of assets as specified in *SSAP No. 4—Assets and Nonadmitted Assets* and are admitted assets to the extent they conform to the requirements of this statement.

10. Gross DTAs shall be admitted in an amount equal to the sum of:

   a. Federal income taxes paid in prior years that can be recovered through loss carrybacks for existing temporary differences that reverse by the end of the subsequent calendar year;

   b. The lesser of:

      i. The amount of gross DTAs, after the application of paragraph 10.a., expected to be realized within one year of the balance sheet date; or

      ii. Ten percent of statutory capital and surplus as required to be shown on the statutory balance sheet of the reporting entity for its most recently filed statement with the domiciliary state commissioner adjusted to exclude any net DTAs, EDP equipment and operating system software and any net positive goodwill; and

   c. The amount of gross DTAs, after application of paragraphs 10.a. and 10.b. that can be offset against existing gross DTLs.

11. In computing a reporting entity's gross DTA pursuant to paragraph 10;

   a. Existing temporary differences that reverse by the end of the subsequent calendar year shall be determined in accordance with paragraphs 228 and 229 of FAS 109;

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b. In determining the amount of federal income taxes that can be recovered through loss carrybacks, the amount and character (i.e., ordinary versus capital) of the loss carrybacks and the impact, if any, of the Alternative Minimum Tax shall be determined in accordance with the provisions of the Internal Revenue Code, and regulations thereunder;

c. The amount of carryback potential that may be considered in calculating the gross DTAs of a reporting entity in subparagraph 10.a. above, that files a consolidated income tax return with one or more affiliates, may not exceed the amount that the reporting entity could reasonably expect to have refunded by its parent; and

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

Intercompany Income Tax Transactions

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

a. Such transactions are economic transactions as defined in *SSAP No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties (SSAP No. 25)*;

b. Are pursuant to a written income tax allocation agreement; and

c. Income taxes incurred are accounted for in a manner consistent with the principles of FAS 109, as modified by this statement.

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

Intraperiod Tax Allocation

14. In accordance with paragraph 35 of FAS 109, a reporting entity's unrealized gains and losses shall be recorded net of any allocated DTA or DTL. The amount allocated shall be computed in a manner consistent with paragraph 38 of FAS 109.

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

Interim Periods

16. Income taxes incurred in interim periods shall be computed using an estimated annual effective current tax rate for the annual period in accordance with the methodology described in paragraphs 19 and 20 of *Accounting Principles Board Opinion No. 28, Interim Financial Reporting*. Estimates of the annual effective tax rate at the end of interim periods are, of necessity, based on estimates and are subject to subsequent refinement or revision. If a reliable estimate cannot be made, the actual effective tax rate

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for the year-to-date may be the best estimate of the annual effective tax rate. If a reporting entity is unable to estimate a part of its "ordinary" income (or loss) or the related tax (or benefit) but is otherwise able to make a reliable estimate, the tax (or benefit) applicable to the item that cannot be estimated shall be reported in the interim period in which the item is reported.

Disclosures

17. Statutory financial statement disclosure shall be made in a manner consistent with the provisions of paragraphs 43-45 and 48 of FAS 109. However, required disclosures with regard to a reporting entity's valuation allowance shall be replaced with disclosures relating to the nonadmittance of some portion or all of a reporting entity's DTAs. The financial statements shall include the disclosures required by paragraph 47 of FAS 109 for non-public companies. Paragraphs 18-23 describe the disclosure requirements as modified for the difference between the requirements of FAS 109 and those prescribed by this statement.

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

a. The total of all DTAs (admitted and nonadmitted);

b. The total of all DTLs;

c. The total DTAs nonadmitted as the result of the application of paragraph 10; and

d. The net change during the year in the total DTAs nonadmitted.

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

a. A description of the types of temporary differences for which a DTL has not been recognized and the types of events that would cause those temporary differences to become taxable;

b. The cumulative amount of each type of temporary difference;

c. The amount of the unrecognized DTL for temporary differences related to investments in foreign subsidiaries and foreign corporate joint ventures that are essentially permanent in duration if determination of that liability is practicable or a statement that determination is not practicable; and

d. The amount of the DTL for temporary differences other than those in item c. above that is not recognized in accordance with the provisions of paragraph 31 of FAS 109.

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

a. Current tax expense or benefit;

b. The change in DTAs and DTLs (exclusive of the effects of other components listed below);

c. Investment tax credits;

d. The benefits of operating loss carryforwards; and

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e. Adjustments of a DTA or DTL for enacted changes in tax laws or rates or a change in the tax status of the reporting entity.

21. Additionally, to the extent that the sum of a reporting entity's income taxes incurred and the change in its DTAs and DTLs is different from the result obtained by applying the federal statutory rate to its pretax net income, a reporting entity shall disclose the nature of the significant reconciling items.

22. A reporting entity shall also disclose the following:

a. The amounts, origination dates and expiration dates of operating loss and tax credit carryforwards available for tax purposes; and

b. The amount of federal income taxes incurred in the current year and each preceding year, which are available for recoupment in the event of future net losses.

c. The aggregate amount of deposits admitted under Section 6603 of the Internal Revenue Service Code.

23. If a reporting entity's federal income tax return is consolidated with those of any other entity or entities, the following shall be disclosed:

a. A list of names of the entities with whom the reporting entity's federal income tax return is consolidated for the current year; and

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

24. Refer to the preamble for further discussion regarding disclosure requirements.

Relevant Literature

25. This statement adopts the provisions of FAS 109 except as modified in paragraph 2 of this statement which results in paragraphs 29-30, 36-37, 39, 41-42, 46, and 49-59 of FAS 109 being rejected, inasmuch as they are not applicable to reporting entities subject to this statement or are inconsistent with other statutory accounting principles. Paragraph 47 of FAS 109 is adopted with modification to provide for the disclosures required for non public reporting entities.

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

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

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

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

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

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

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

28. The following lists FASB Technical Bulletins that are adopted or rejected by this statement:

a. *FASB Technical Bulletin No. 79-9, Accounting in Interim Periods for Changes in Income Tax Rates* is rejected in its entirety;

b. *FASB Technical Bulletin No. 82-1, Disclosure of the Sale or Purchase of Tax Benefits through Tax Leases* is adopted in its entirety.

29. The following lists FASB Emerging Issues Task Force Issues that are adopted or rejected by this statement:

a. *FASB Emerging Issues Task Force No. 91-8, Application of FASB Statement No. 96 to a State Tax Based on the Greater of a Franchise Tax or an Income Tax,* is rejected in its entirety;

b. *FASB Emerging Issues Task Force No. 92-8, Accounting for the Income Tax Effects under FASB Statement No. 109 of a Change in Functional Currency When an Economy Ceases to Be Considered Highly Inflationary*, is adopted in its entirety;

c. *FASB Emerging Issues Task Force No. 93-13, Effect of a Retroactive Change in Enacted Tax Rates That Is Included in Income from Continuing Operations*, is rejected in its entirety;

d. *FASB Emerging Issues Task Force No. 93-16, Application of FASB Statement No. 109 to Basis Differences within Foreign Subsidiaries That Meet the Indefinite Reversal Criterion of APB Opinion No. 23*, is rejected in its entirety;

e. *FASB Emerging Issues Task Force No. 93-17, Recognition of Deferred Tax Assets for a Parent Company's Excess Tax Basis in the Stock of a Subsidiary That Is Accounted for as a Discontinued Operation*, is adopted in its entirety;

f. *FASB Emerging Issues Task Force No. 94-10, Accounting by a Company for the Income Tax Effects of Transactions among or with Its Shareholders under FASB Statement No. 109*, is rejected in its entirety;

g. *FASB Emerging Issues Task Force No. 95-9, Accounting for Tax Effects of Dividends in France in Accordance with FASB Statement No. 109*, is rejected in its entirety;

h. *FASB Emerging Issues Task Force No. 95-10, Accounting for Tax Credits Related to Dividend Payments in Accordance with FASB Statement No. 109*, is rejected in its entirety;

i. *FASB Emerging Issues Task Force No. 95-20, Measurement in the Consolidated Financial Statements of a Parent of the Tax Effects Related to the Operations of a*

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Foreign Subsidiary That Receives Tax Credits Related to Dividend Payments, is rejected in its entirety.

30. This statement rejects *AICPA Accounting Interpretations, Accounting for the Investment Credit: Accounting Interpretations of APB Opinion No. 4* in its entirety.

Effective Date and Transition

31. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with SSAP No. 3.

AUTHORITATIVE LITERATURE

Generally Accepted Accounting Principles

- FASB Statement No. 109, Accounting for Income Taxes
- Accounting Principles Board Opinion No. 2, Accounting for the "Investment Credit"
- Accounting Principles Board Opinion No. 10, Omnibus Opinion—1966, paragraph 6
- Accounting Principles Board Opinion No. 23, Accounting for Income Taxes—Special Areas, paragraphs 1-3, 5-9, 12-13, and 15-18
- Accounting Principles Board Opinion No. 28, Interim Financial Reporting, paragraphs 19 and 20
- FASB Technical Bulletin No. 82-1, Disclosure of the Sale or Purchase of Tax Benefits through Tax Leases
- FASB Emerging Issues Task Force No. 92-8, Accounting for the Income Tax Effects under FASB Statement No. 109 of a Change in Functional Currency When an Economy Ceases to Be Considered Highly Inflationary
- FASB Emerging Issues Task Force No. 93-17, Recognition of Deferred Tax Assets for a Parent Company's Excess Tax Basis in the Stock of a Subsidiary That Is Accounted for as a Discontinued Operation

RELEVANT ISSUE PAPERS

- Issue Paper No. 83—Accounting for Income Taxes

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SSAP NO. 10 – EXHIBIT A

Implementation Questions and Answers

The National Association of Insurance Commissioners issued Statement of Statutory Accounting Principle No. 10 – *Income Taxes* (SSAP No. 10) with an effective date of January 1, 2001. This statement represents a significant change in statutory accounting for income taxes in that it adopts Financial Accounting Standards Board Statement No. 109, *Accounting for Income Taxes* (FAS 109) with modifications.

Questions regarding implementation of this new standard were raised with the NAIC staff by reporting entities, regulators and auditors. The staff determined that this Question & Answer report should be issued as an aid in understanding and implementing SSAP No. 10 because of the relatively high number of inquiries received on that SSAP.

This Q&A is effective for reporting periods ending on or after December 31, 2001, with the exception of Question 8, which is effective for reporting periods beginning on or after January 1, 2002. In accordance with paragraph 12 of *SSAP No. 1— Disclosure of Accounting Policies, Risks & Uncertainties, and Other Disclosures* it is expected that the audit report would include a disclosure of the effect on the financial statements if:

a. It is at least reasonably possible that the estimate used to determine the admission of deferred tax assets at December 31, 2001 will change on January 1, 2002 due to the implementation of Question 8; and

b. The effect of the change would be material to the financial statements.

This Q&A nullifies the following Interpretations of the Emerging Accounting Issues Working Group:

INT 00-21: *Disclose Requirement of SSAP No. 10 paragraphs 17 and 18*
INT 00-22: *Application of SSAP No. 10 to Admissibility of DTA*
INT 01-19: *Measurement of DTA Associated with Nonadmitted Assets*

NOTE: SSAP No. 10, Exhibit A, Implementation Questons and Answers (Q&A), has not been included in *SSAP No. 10R—Income Taxes—A Temporary Replacement of SSAP No. 10* (SSAP No. 10R). This Q&A continues to provide assistance in understanding and applying guidance for income taxes but does not reflect the substantive revisions incorporated in SSAP No. 10R.

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1. Q – What are the primary differences between the accounting for income taxes pursuant to FAS 109 and SSAP No. 10? [No specific paragraph reference]

1.1 A – SSAP No. 10 establishes statutory accounting principles for current and deferred federal and foreign income taxes and current state income taxes. In general, SSAP No. 10 adopts the concepts of FAS 109, with modifications. The primary differences and modifications are summarized below:

1.2 <u>State Income Tax</u>

- FAS 109 – State income taxes should be included as "income taxes incurred." Deferred state income taxes are provided.
- SSAP No. 10 – State income taxes should be included as "Taxes, Licenses, and Fees" by property and casualty insurers and as "Insurance taxes, licenses, and fees, excluding federal income taxes" by life and accident and health insurers. No deferred state income taxes are provided.

1.3 <u>Valuation Allowance</u>

- FAS 109 – Gross deferred tax assets (DTAs) are reduced by a valuation allowance if it is more likely than not that some portion or all of the DTAs will not be realized. The valuation allowance should be sufficient to reduce the DTA to the amount that is more likely than not to be realized.
- SSAP No. 10 –DTAs are not reduced by a valuation allowance. Instead, that portion of a reporting entity's DTAs not meeting the criteria of paragraph 10 of SSAP No. 10 is nonadmitted. SSAP No. 10 paragraph 2 states that FAS 109 is adopted with modifications for "the realization criteria for deferred tax assets." Therefore, the admission standards outlined in paragraphs 8-11 is a replacement of the valuation allowance criteria of FAS 109. See Question 4 for a further discussion of the admissibility test.

1.4 <u>Unique Statutory Accounting Items</u>

- FAS 109 – In general, the effects of all temporary differences must be reflected with limited exceptions provided in FAS 109 paragraphs 31-34 (relating to items specified in Accounting Principles Board Opinion No. 23) and for temporary differences related to goodwill for which amortization is not deductible for tax purposes.
- SSAP No. 10 – In addition to the exceptions provided in FAS 109, temporary differences do not include asset valuation reserve (AVR), interest maintenance reserve (IMR), Schedule F penalties and, in the case of a mortgage guaranty insurer, amounts attributable to its statutory contingency reserve to the extent that "tax and loss" bonds have been purchased.

1.5 <u>Changes in Deferred Tax Assets and Liabilities</u>

- FAS 109 – Changes in DTAs and deferred tax liabilities (DTLs) are included in income tax expense or benefit and are allocated to continuing operations, discontinued operations, extraordinary items and items charged directly to shareholders' equity.
- SSAP No. 10 – Changes in DTAs and DTLs are recognized as a separate component of gains and losses in surplus, except to the extent allocated to changes in unrealized gains and losses.

1.6 <u>Regulated Enterprises</u>

- FAS 109 – Regulated enterprises that meet the criteria for application of FAS 71, *Accounting for the Effects of Certain Types of Regulation*, are not exempt from the requirements of FAS 109. However, assets are reported on a net-of-tax basis (see paragraphs 29, 57, 58 and 59 of FAS 109).
- SSAP No. 10 – These special paragraphs do not apply pursuant to paragraph 25 of SSAP No. 10.

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1.7 Business Combinations

- FAS 109 – Paragraphs 30 and 53-56 of FAS 109 provide certain guidance regarding the treatment of business combinations. In general, a deferred tax asset or liability is recognized for the differences between the assigned values and the tax bases of the assets and liabilities recognized in a purchased business combination. If financial statements for prior years are restated, all purchase business combinations that were consummated in those prior years shall be remeasured in accordance with FAS 109.
- SSAP No. 10 – These special paragraphs do not apply pursuant to paragraph 25 of SSAP No. 10.

1.8 Intraperiod Tax Allocation

- FAS 109 – Income tax expense or benefit is allocated among continuing operations, discontinued operations, extraordinary items, and items charged or credited directly to shareholders' equity pursuant to paragraphs 36 and 37 of FAS 109.
- SSAP No. 10 – These paragraphs of SFAS 109 do not apply pursuant to paragraph 25 of SSAP No. 10. Instead, paragraphs 14 and 15 of SSAP No. 10 provide special rules for statutory accounting. See Question 10 for a further discussion of these rules.

1.9 Certain Quasi Reorganizations

- FAS 109 –Paragraph 39 provides special rules relating to the treatment of deductible temporary differences and carryforwards as of the date of a quasi reorganization.
- SSAP No. 10 – Paragraph 39 of FAS 109 does not apply pursuant to paragraph 25 of SSAP No. 10.

1.10 Financial Statement Classification of DTAs and DTLs

- FAS 109 – Pursuant to paragraphs 41 and 42 of FAS 109, DTAs and DTLs are to be classified separately as either current or noncurrent, depending on the classification of the related asset or liability. Furthermore, current DTAs and DTLs and noncurrent DTAs and DTLs are netted within the classification and with the net amount reported.
- SSAP No. 10 – These paragraphs do not apply to statutory accounting pursuant to paragraph 25 of SSAP No. 10. The net admitted DTA, or the net DTL, should be reported in the statutory financial statements.

1.11 Financial Statement Disclosures

- FAS 109 – Paragraphs 43-45, 47 and 48 of FAS 109 provide various requirements for providing information in the financial statements regarding the income taxes of the reporting entity. In general, the reporting entity is to provide certain information regarding the components of its DTAs and DTLs, the amount of and changes in its valuation allowance, significant components of income tax expense, differences between the expected amount of income tax expense using current tax rates and the amount of reported income tax expense, and tax attributes being carried over.
- SSAP No. 10 – In general, paragraphs 17-23 of SSAP No. 10 follow the disclosure requirements provided by FAS 109, but with various modifications. The disclosures regarding valuation allowance are replaced with disclosures relating to the nonadmitted portion of the DTA, if any. Also, the disclosures relating to deferred income tax expense or benefit are replaced with certain disclosures relating to the reporting entity's "change in DTAs and DTLs." Furthermore, only the nature of significant reconciling items between the reported amount and "expected" amount of income tax expense and change in DTAs and DTLs are to be disclosed. This generally follows the disclosure requirements of FAS 109 for nonpublic entities. See Question 12 for a more detailed discussion of the disclosure requirements of SSAP No. 10.

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2. Q – How should an entity measure its gross deferred tax assets and liabilities? [Paragraph 6]

2.1 A – An enterprise shall record a gross deferred tax liability or asset for all temporary differences and operating loss, capital loss and tax credit carryforwards. Temporary differences include unrealized gains and losses and nonadmitted assets but do not include AVR, IMR, Schedule F penalties and, in the case of a mortgage guaranty insurer, amounts attributable to its statutory contingency reserve to the extent that "tax and loss" bonds have been purchased. In general, temporary differences produce taxable income or result in tax deductions when the related asset is recovered or the related liability is settled. A deferred tax asset or liability represents the increase or decrease in taxes payable or refundable in future years as a result of temporary differences and carryforwards at the end of the current year. This answer only addresses the recognition of gross DTAs and DTLs and does not address the admissibility of such amounts. See Question 4 for a discussion of the admissibility criteria of SSAP No. 10.

2.2 Paragraph 6 of SSAP No. 10 states that temporary differences are identified and measured using a "balance sheet" approach whereby the statutory balance sheet and the tax basis balance sheet are compared. Operating loss, capital loss and tax credit carryforwards are computed in accordance with the applicable Internal Revenue Code.

2.3 The following illustrates the recognition and measurement of a typical book to tax difference for an insurance company:

Illustration
Assumptions:

1/1/01 Purchase 100 shares of Darby/Allyn Corp. stock for $25 a share
3/31/01 Fair Value of Darby/Allyn Corp. stock has increased to $35 a share
3/31/01 Tax basis reserves are computed and determined to be 80% of the statutory basis reserves

Balance Sheet at 3/31/01:

	Statutory Basis	**Tax Basis**	**Basis Difference**	**Tax Effect DTA (DTL) (35%)[1]**
Common Stock	$3,500	$2,500	($1,000) [2]	($350)
Reserves	$100,000	$80,000	$20,000 [3]	$7,000

[1] See question 3 for a discussion of "enacted rates."

[2] The carrying value of the stock on the statutory balance sheet reflects the fair value of the common stock per SSAP 30—*Investments in Common Stock (excluding investments in common stock of subsidiary, controlled, or affiliated entities)* whereas the carrying value of the stock for tax purposes is its original cost. This difference is defined as temporary in that the $1,000 appreciation in value will be recognized in the tax return when the stock is disposed of. The difference is a deferred tax liability in that the reversal of this temporary difference will increase future taxable income.

[3] The reserve difference is due to the fact that statutory reserves are computed on a more conservative set of assumptions than for tax (life and health entities) or the tax reserves are discounted (property and casualty and other health entities). This amount is a temporary difference in that the entity will recognize the difference between statutory and tax carrying values over the life of the reserve or upon settlement of the claim or payment of the reserve. The difference is a deferred tax asset in that the reversal of this temporary difference will decrease future taxable income

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Journal Entries:

1/1/01	DR	Common stock	$2,500
	CR	Cash	($2,500)
		Acquisition of common stock at $25 per share	

3/31/01	DR	Common stock	$1,000
	CR	Change in unrealized capital gains and losses	($1,000)
		Adjust carrying value to FV of $35 per share at end of quarter	

3/31/01	DR	Change in reserves or unpaid losses	$100,000
	CR	Reserves or Unpaid losses	($100,000)
		Recognition of reserves computed on a statutory basis	
3/31/01	DR	Deferred tax asset	$7,000
	CR	Change in deferred income taxes	($6,650)
	CR	Deferred tax liability	($350)
		Recognition of deferred taxes	

NOTE: Presentation of deferred tax amounts and unrealized gain or losses net of tax is addressed in Question 12.

2.4 As depicted in the Illustration, the deferred tax assets and liabilities are tracked gross in the entity's ledger and not netted until after consideration of the admissibility of deferred tax assets.

Grouping of assets and liabilities for measurement

2.5 The manner in which an entity groups its assets and liabilities for measurement shall be conducted in a reasonable and consistent manner. For instance, an entity may group its invested assets into Annual Statement classifications (stocks, bonds, preferred stocks, etc.) or other reasonable groupings (lines of business for grouping its reserves). Entities have the option of recognizing the DTA and DTL within each grouping on a net or gross basis. For instance, a portfolio of common stocks will have both unrealized gain and unrealized losses associated with them. The reporting entity may elect to combine the unrealized gains and losses and compute a single DTA or DTL or it may elect to segregate the unrealized gains from the unrealized losses and compute separate DTAs and DTLs. This option might also arise with respect to depreciable assets. Regardless of which method an entity elects, it is crucial that consistency is maintained to and within each grouping from period to period. An entity shall retain internal documentation to support its grouping in addition to the methodologies employed to arrive at such. An entity is permitted to modify its groupings should events or circumstances change from a previous period. Examples include a change in materiality of underlying assets and liabilities, administrative costs associated with detailing groupings increases or changes in the computer systems that allow more specificity. Entities that modify their groupings should be prepared to rationalize these changes. These entities should also disclose that a modification was made and general reason for such in the notes to the financial statements.

Measurement of Nonadmitted Assets

2.6 As noted in paragraph 6.b. of SSAP No. 10, temporary differences include nonadmitted assets. The measurement of these types of assets is not addressed in FAS 109 in that the concept of nonadmission is unique to statutory accounting. For assets that are nonadmitted for statutory accounting purposes, DTAs and DTLs should be measured after nonadmission.

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Illustration:

	Statutory Before Nonadmit (Info Purpose)	Statutory After Nonadmit	Tax	Basis Difference[4]	Tax Effect DTA (DTL) (35%)
Furniture Fixtures and Equipment	$1,000	0	$1,000		
Accumulated Depreciation	200	0	400		
Basis	$800	0	$600	$600	$210

2.7 The effect of this illustration is a reduction of surplus by $590 ($800 decrease for nonadmitted asset and $210 increase for DTA), provided the resulting DTA meets the admissibility test in paragraph 10 of SSAP No. 10.

3. Q – A reporting entity's deferred tax assets and liabilities are computed using "enacted tax rates." What is the meaning of the term "enacted tax rates"? [Paragraph 6.c.]

3.1 A – SSAP No. 10 provides the following:

> 6. A reporting entity's deferred tax assets and liabilities are computed as follows:
>
> a. Temporary differences are identified and measured using a "balance sheet" approach whereby statutory and tax basis balance sheets are compared;
>
> b. Temporary differences include unrealized gains and losses and nonadmitted assets but do not include asset valuation reserve (AVR), interest maintenance reserve (IMR), Schedule F penalties and, in the case of a mortgage guaranty insurer, amounts attributable to its statutory contingency reserve to the extent that "tax and loss" bonds have been purchased;
>
> c. Total DTAs and DTLs are computed using enacted tax rates; and
>
> d. A DTL is not recognized for amounts described in paragraph 31 of FAS 109.

3.2 SSAP No. 10 further requires that deferred tax assets and liabilities be measured using the enacted tax rate that is expected to apply to taxable income in the periods in which the deferred tax asset or liability is expected to be settled or realized. The effects of future changes in tax rates are not anticipated in the measurement of deferred tax assets and liabilities. Deferred tax assets and liabilities are adjusted for changes in tax rates and other changes in the tax law, and the effects of those changes are recognized at the time the change is enacted.

3.3 Tax laws may apply different tax rates to ordinary income and capital gains. In instances where the enacted tax law provides for different rates on income of different character, deferred tax assets and liabilities should be measured by applying the appropriate enacted tax rate based on the type of taxable or deductible amounts expected to be realized from the reversal of existing temporary differences.

3.4 Currently, under U.S. federal tax law, if taxable income (both ordinary and capital gain) exceeds a specified amount, all taxable income is taxed at a single flat tax rate, 35%. Unless graduated tax rates are a significant factor, (i.e., unless the company's taxable income frequently falls below the specified amount), the enacted tax rate is 35% for both ordinary income and capital gain. Alternative minimum tax

[4] Difference is computed from the "Statutory After Nonadmit" balance.

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and the effect of special deductions, such as the small life deduction, are ignored, except to the extent necessary to estimate future taxable income and therefore the enacted rate applicable to that level of taxable income is used.

3.5 If graduated tax rates are expected to be a significant factor in the determination of taxes payable or refundable in future years, deferred tax assets and liabilities should be measured using the average tax rate (based on currently enacted graduated rates) that is expected to apply to estimated average annual taxable income in the period in which the deferred tax asset or liability is expected to be settled or realized. For example, assume a property and casualty insurance company consistently has taxable income less than $10 million, but in excess of $1 million. The enacted graduated rate applicable to that level of taxable income is 34%. Therefore, the reporting entity should use 34% for the determination of its taxes payable or refundable.

3.6 As a reference, FAS 109 paragraphs 18 and 236 provide the following:

> 18. The objective is to measure a deferred tax liability or asset using the enacted tax rate(s) expected to apply to taxable income in the periods in which the deferred tax liability or asset is expected to be settled or realized. Under current U.S. federal tax law, if taxable income exceeds a specified amount, all taxable income is taxed, in substance, at a single flat tax rate. That tax rate shall be used for measurement of a deferred tax liability or asset by enterprises for which graduated tax rates are not a significant factor. Enterprises for which graduated tax rates are a significant factor shall measure a deferred tax liability or asset using the average graduated tax rate applicable to the amount of estimated annual taxable income in the periods in which the deferred tax liability or asset is estimated to be settled or realized (paragraph 236). Other provisions of enacted tax laws should be considered when determining the tax rate to apply to certain types of temporary differences and carryforwards (for example, the tax law may provide for different tax rates on ordinary income and capital gains). If there is a phased-in change in tax rates, determination of the applicable tax rate requires knowledge about when deferred tax liabilities and assets will be settled and realized.
>
> 236. The following example illustrates determination of the average graduated tax rate for measurement of deferred tax liabilities and assets by an enterprise for which graduated tax rates ordinarily are a significant factor. At the end of year 3 (the current year), an enterprise has $1,500 of taxable temporary differences and $900 of deductible temporary differences, which are expected to result in net taxable amounts of approximately $200 on the future tax returns for each of years 4-6. Enacted tax rates are 15 percent for the first $500 of taxable income, 25 percent for the next $500, and 40 percent for taxable income over $1,000. This example assumes that there is no income (for example, capital gains) subject to special tax rates.
> The deferred tax liability and asset for those reversing taxable and deductible temporary differences in years 4-6 are measured using the average graduated tax rate for the estimated amount of annual taxable income in future years. Thus, the average graduated tax rate will differ depending on the expected level of annual taxable income (including reversing temporary differences) in years 4-6. The average tax rate will be:
>
> a. 15 percent if the estimated annual level of taxable income in years 4-6 is $500 or less
>
> b. 20 percent if the estimated annual level of taxable income in years 4-6 is $1,000
>
> c. 30 percent if the estimated annual level of taxable income in years 4-6 is $2,000.
>
> Temporary differences usually do not reverse in equal annual amounts as in the example above, and a different average graduated tax rate might apply to reversals in different future years. However, a detailed analysis to determine the net reversals of temporary differences in each future year usually is not warranted. It is not warranted because the other variable (that is, taxable income or losses exclusive of reversing temporary differences in each of those future years) for determination of the average graduated tax rate in each future year is no more than an estimate.

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For that reason, an aggregate calculation using a single estimated average graduated tax rate based on estimated average annual taxable income in future years is sufficient. Judgment is permitted, however, to deal with unusual situations, for example, an abnormally large temporary difference that will reverse in a single future year, or an abnormal level of taxable income that is expected for a single future year. The lowest graduated tax rate should be used whenever the estimated average graduated tax rate otherwise would be zero.

4. Q – How should a reporting entity calculate the amount of its admitted gross DTAs? [Paragraph 10]

4.1 A – SSAP No. 10 paragraph 10 states that:

10. Gross DTAs shall be admitted in an amount equal to the sum of:

a. Federal income taxes paid in prior years that can be recovered through loss carrybacks for existing temporary differences that reverse by the end of the subsequent calendar year;

b. The lesser of:

i. The amount of gross DTAs, after the application of paragraph 10.a., expected to be realized within one year of the balance sheet date; or

ii. Ten percent of statutory capital and surplus as required to be shown on the statutory balance sheet of the reporting entity for its most recently filed statement with the domiciliary state commissioner adjusted to exclude any net DTAs, EDP equipment and operating system software and any net positive goodwill; and

c. The amount of gross DTAs, after application of paragraphs 10.a. and 10.b. that can be offset against existing gross DTLs.

4.2 After a reporting entity has calculated the amount of its gross DTAs and DTLs pursuant to paragraph 6, it must determine the amount of its gross DTAs that can be admitted under paragraph 10. The amount of gross DTAs is not recalculated under paragraph 10; rather, some or all of the gross DTA may not be currently admitted.

4.3 Paragraphs 10.a., 10.b. and 10.c. require three interdependent calculations that when added together equals the amount of the reporting entity's admitted gross DTAs. Each of the calculations starts with the total of the reporting entity's gross DTAs, and determines the amount of such gross DTAs that can be admitted under that part. For example, the consideration of existing temporary differences in the calculation of admitted gross DTAs under paragraph 10.a. does not prevent the reconsideration of the same temporary differences in the paragraph 10.b.i. calculation. However, to avoid duplication of admitted gross DTAs when adding the three parts together, the amount of admitted gross DTAs under paragraph 10.a. must be subtracted from the amount of gross DTAs in the paragraph 10.b.i. calculation. Similarly, the amount of admitted gross DTAs under paragraphs 10.a. and 10.b. must be subtracted from the total gross DTAs in the paragraph 10.c. calculation.

4.4 Under paragraphs 10.a. and 11.b. a reporting entity can admit gross DTAs to the extent that it would be able to recover federal income taxes paid in the carryback period, by treating existing temporary differences that reverse by the end of the subsequent calendar year as ordinary or capital losses that originated in such subsequent calendar year. Reversing temporary differences for unrealized losses and nonadmitted assets are treated as capital or ordinary losses depending on their character for tax purposes. The entity is not required to project an actual net operating loss in future periods.

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4.5 Paragraph 11.b. limits the amount of federal income taxes recoverable under paragraph 10.a. to the amount that would be refunded to the reporting entity if a carryback claim was filed with the IRS. If some amount of taxes paid in the carryback period is not recovered because of limitations imposed by the Alternative Minimum Tax system, the resulting AMT credit is not treated as a newly created DTA. Paragraph 11.c. further limits the amount of federal income taxes recoverable under paragraph 10.a. for a reporting entity that files a consolidated income tax return with one or more affiliates, to the amount that the reporting entity could reasonably expect to have refunded by its parent. See Question 8 for a further discussion of the impact of filing a consolidated federal income tax return.

4.6 The amount of admitted gross DTAs under paragraph 10.b.i. is limited to the amount that the reporting entity expects to realize within one year of the balance sheet date. See Question 6 for a further discussion of the meaning of “expected to be realized.” The amount of admitted gross DTAs under the paragraph 10.a. calculation is subtracted from the amount of gross DTAs under paragraph 10.b.i. to prevent the counting of the same gross DTAs more than once. If the reporting entity expects to realize an amount of gross DTAs under paragraph 10.b.i. that is equal to or less than the admitted gross DTAs calculated under paragraph 10.a. then the resulting admitted gross DTAs under paragraph 10.b.i. will be zero. The amount of admitted gross DTAs under paragraph 10.b. i. may also be limited by the ten percent of statutory capital and surplus test under paragraph 10.b.ii.

4.7 Under paragraph 10.c. a reporting entity can admit gross DTAs in an amount equal to the lesser of: (1) its gross DTAs, after subtracting the amount of admitted gross DTAs under paragraphs 10.a. and 10 b., or (2) its gross DTLs, regardless of the expected time of reversal. In determining the amount of gross DTAs that can be offset against existing gross DTLs in the paragraph 10.c. calculation, the character (i.e., ordinary versus capital) of the DTAs and DTLs must be taken into consideration such that offsetting would be permitted in the tax return under existing enacted federal income tax laws and regulations. For example, a gross DTA related to unrealized capital losses could not be offset against an ordinary income DTL. This analysis becomes more critical in situations where a reporting entity does not have sufficient ordinary deduction DTAs to offset existing DTLs.

4.8 In certain situations, a reporting entity’s expected federal income tax rate on its reversing temporary differences will be less than the enacted tax rate used in the determination of its gross DTAs and DTLs. Examples of such entities include: property/casualty insurance companies with large municipal bond portfolios that are AMT taxpayers, Blue Cross-Blue Shield Organizations with section 833(b) deductions, small life insurance companies, reporting entities projecting a tax loss for the year, and entities that file in a consolidated federal income tax return that cannot realize the full amount of their gross DTAs under the existing intercompany tax sharing or tax allocation agreement. Pursuant to paragraphs 231, 232 and 238 of FAS 109, such entities are required to report their gross DTLs at the enacted tax rate, and cannot take into consideration the impact of the AMT, section 833(b) deduction, or the small life insurance company deduction to reduce their gross DTLs.

4.9 For those entities, the amount of admitted gross DTAs calculated under paragraphs 10.a. and 10.b. will reflect the actual tax rate in the carryback period under paragraph 10.a. and the expected tax rate in the subsequent year under paragraph 10.b., which takes into consideration the impact of the AMT, special deductions, and the provisions of the intercompany tax sharing or allocation agreement See Question 6 for further discussion of this issue. As such, the entity’s admitted gross DTAs under paragraphs 10.a. and 10.b. may be less than its gross DTAs on temporary differences at the enacted rate. Any unused amount of DTAs resulting from a rate differential under paragraphs 10.a. and 10.b. can be used under paragraph 10.c. to offset existing DTLs.

4.10 As a reporting entity performs its paragraph 10.a., 10.b. and 10.c. calculations it must evaluate whether a particular gross DTA has the potential to generate an actual income tax benefit equal to its gross DTA value. For example, a gross DTA related to an NOL or tax credit that is expiring would not generate an income tax benefit in the paragraph 10.c. calculation that could be offset against existing

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gross DTLs. Similarly, a gross DTA related to an AMT credit carryover would not generate a tax benefit if the reporting entity always expected to be an AMT taxpayer. Another example might include, gross DTAs related to temporary differences for tax basis intangible assets may not generate an income tax benefit based on the assets' full appraised value. In such cases, the gross DTAs related to these temporary differences may have to be reduced if management concludes that based on the weight of available evidence, it is more likely than not that the full income tax benefit will not be realized. However, if a prudent and feasible tax planning strategy were available so that the reporting entity was able to realize the full amount of its gross DTA, then such strategy would be taken into consideration.

4.11 The above principles can be illustrated by the following example:

4.12 Facts:

1. Insurance Company ABC has $10,000,000 of deductible temporary differences at 12-31-01 that generate $3,500,000 of gross DTAs, at the enacted federal income tax rate of 35%. Management has concluded that it has the potential to realize gross DTAs of $3,500,000 related to its $10 million of deductible temporary differences. ABC also has $4,000,000 of taxable temporary differences resulting in $1,400,000 of gross DTLs.

2. ABC has determined that $5,000,000 of its existing deductible temporary differences will reverse by 12-31-02.

3. ABC reported $1,000,000 of taxable income and $350,000 of tax expense on its 2000 federal income tax return. It has also projected taxable income of $1,200,000, and $420,000 of federal income taxes for 2001 that have been reflected in its current statutory income tax provision calculation. There are no differences between its regular and alternative minimum taxable income in 2000 or 2001.

4. ABC is projecting an effective income tax rate of 20% in 2002 based on its estimated taxable income and federal income tax liability. As such, ABC expects to realize a federal income tax benefit of 20% in 2002 related to reversing temporary differences.

5. Ten percent of statutory capital and surplus under paragraph 10.b.ii. is $6,000,000. The surplus limitation at 12/31 was computed by subtracting the admitted balances of net DTA's, goodwill and EDP from statutory surplus (as reported in the 9/30 quarterly statement filed with the domiciliary state commissioner). Statutory surplus is defined in paragraph 2 of SSAP No. 72.

4.13 Calculation of ABC's Admitted Gross DTAs:

1. ABC can admit $726,000 of gross DTAs under paragraph 10.a. The difference between the total taxes paid in the 2000 and 2001 carryback period of $770,000 ($350,000 + $420,000), and the amount recoverable ($726,000) through carryback of the $2,200,000 net operating loss, represents a $44,000 AMT credit generated as a result of the 90% AMT NOL limitation. This AMT credit is not treated as a new DTA at 12-31-01. Also, the fact that the full $5,000,000 of reversing deductible temporary differences available for carryback were not used in the paragraph 10.a. calculation, does not prevent their inclusion in the paragraph 10.b. and 10.c. calculations.

2. ABC can admit $274,000 of gross DTAs under paragraph 10.b. The company expects to realize a federal income tax benefit of $1,000,000 ($5,000,000 X 20%) in 2002 related to its reversing deductible temporary differences. The $1,000,000 amount must be reduced by the $726,000 of admitted gross DTAs under paragraph 10.a. to prevent double counting of the same income tax benefit. Ten percent of capital and surplus is not a limiting factor in this example.

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3. ABC can admit $1,400,000 of gross DTAs under paragraph 10.c. This amount is equal to its gross DTLs at 12-31-01. If ABC's gross DTAs, after reduction for the amount of gross DTAs admitted under paragraphs 10.a. and 10.b. were less than $1,400,000 in this example, ABC would be limited to the balance of its gross DTAs in the paragraph 10.c. calculation.

4.14 Summary of ABC's Admitted Gross DTA Calculation:

Gross DTAs at Enacted Tax Rate		$3,500,000
Admitted Gross DTAs (paragraph 10.a.)	$ 726,000	
Admitted Gross DTAs (paragraph 10.b.)	274,000	
Admitted Gross DTAs (paragraph 10.c.)	1,400,000	
Total Admitted Gross DTAs	2,400,000	(2,400,000)
Nonadmitted Gross DTAs		1,100,000
Admitted DTA		2,400,000
Gross DTL		(1,400,000)
Net Admitted DTA/DTL		$1,000,000

5a. Q – How is the timing of reversals of temporary differences and carryforwards determined for SSAP No. 10 purposes? [Paragraphs 10.a., 10.b.i. and 11.a.]

5.1 A – The timing of temporary difference reversals is critical in determining the amount of gross admitted DTAs. Determining the one-year reversal of temporary differences impacts the DTA admitted pursuant to paragraphs 10.a. and 10.b i. of SSAP No. 10.

5.2 Paragraph 11.a. of SSAP No. 10 states that "[e]xisting temporary differences that reverse by the end of the subsequent calendar year shall be determined in accordance with paragraphs 228 and 229 of FAS 109."

5.3 Paragraph 228 of FAS 109 states, in pertinent part, that "[t]he particular years in which temporary differences result in taxable or deductible amounts generally are determined by the timing of the recovery of the related asset or settlement of the related liability." Question 1 of the FASB's Special Report on Statement 109 provides additional guidance on scheduling. It defines "scheduling" as the analysis performed to determine the pattern and timing of the reversal of temporary differences. It also provides certain guidelines to be followed, including the need for the method employed to be systematic and logical, that a consistent method be used for each category of temporary differences, and that a change in the method used be considered a change in accounting principle.

5.4 Assume Company A purchases its only asset for $1,000, an asset that is admissible for statutory accounting purposes and depreciated over five years on a straight-line basis. Assume also that the asset is depreciated over seven years for tax purposes using the Modified Accelerated Cost Recovery System (MACRS). The following table summarizes the statutory and tax basis of the asset at the end of each year.

Year	Cost	Statutory Depreciation	Statutory Basis	Tax Depreciation	Tax Basis	Deductible/ (Taxable) Temporary Difference
1	$1,000	$200	$800	$143	$857	$57
2	-	200	600	245	612	12
3	-	200	400	175	437	37
4	-	200	200	125	312	112
5	-	200	-	89	223	223

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Year	Cost	Statutory Depreciation	Statutory Basis	Tax Depreciation	Tax Basis	Deductible/ (Taxable) Temporary Difference
6	-	-	-	89	134	134
7	-	-	-	89	45	45
8	-	-	-	45[5]	-	-

5.5 At the end of year one, the Company would examine reversals by the end of year two and conclude that $45 of the $57 outstanding deductible temporary difference would reverse within one year, leaving a temporary difference of $12 at the end of year two. However, at the end of year two, the Company would not project a reversal of the temporary difference by the end of year three as the deductible temporary difference is scheduled to increase (from $12 to $37). If the Company had decided (at the end of year two) to sell the asset in year three, it may be appropriate to conclude that the outstanding deductible temporary difference of $12 would reverse within one year.

5.6 A similar rationale would apply in the instance of a nonadmitted asset. Assume the same facts as aforementioned, except that the asset is nonadmitted for statutory accounting purposes. The results are summarized in tabular form below.

Year	Cost	Statutory Charge to Surplus	Statutory Basis	Tax Depreciation	Tax Basis	Deductible/ (Taxable) Temporary Difference
1	$1,000	$1,000	-	$143	$857	$857
2	-	-	-	245	612	612
3	-	-	-	175	437	437
4	-	-	-	125	312	312
5	-	-	-	89	223	223
6	-	-	-	89	134	134
7	-	-	-	89	45	45
8	-	-	-	45	-	-

5.7 In this example, the Company has a steady decline in the deductible temporary difference that is not complicated by competing depreciation regimes. This is due to the fact that the Company took the large surplus charge when the asset was nonadmitted, thereby created a significant deductible temporary difference. At the end of year one, the Company would project a $245 temporary difference reversal by the end of year two. Although the Company will take income statement charges for depreciation on the nonadmitted asset, the statutory basis is nonetheless zero from the moment the asset was nonadmitted. Future statutory depreciation deductions will not impact the statutory basis and have no impact on the analysis.

5.8 The above examples assume a single asset. However, the analysis becomes more complicated when the Company has hundreds or thousands of assets within its fixed asset pool. In this instance, it is expected that management will make its best estimate of the expected reversal pattern determined in a manner consistent with the grouping for measurement (see question 2.5 for more discussion about grouping).

5.9 As indicated above, the timing of the reversal of a particular balance sheet item will depend on the expected recovery of the related asset and liability. For example, the temporary difference associated

[5] Due to the mid-year convention applicable to most asset acquisitions for tax purposes, the asset is treated as acquired in mid-year, meaning that a seven (7) year asset is depreciated over eight (8) tax years.

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with property & casualty loss reserves would be expected to reverse in a manner consistent with the payout pattern ("development") of the underlying loss reserves. Historical loss development triangles may be useful in substantiating a reversal pattern. For instance, assume Company A writes two types of property and casualty policies: auto liability and workers' compensation. The following table details the components of the statutory and tax reserves for Company A as of December 31, 2001.

Private Passenger Auto Liability	Statutory Reserves	Tax Reserves	Temporary Difference
AY + 0	$1,000	$900	$100
AY + 1	850	690	160
AY + 2	700	580	120
AY + 3	550	490	60
AY + 4	400	385	15
AY + 5	300	275	25
AY + 6	200	175	25
AY + 7	100	90	10
AY + 8	80	75	5
AY + 9	70	65	5
Prior	50	45	5
Total	$4,300	$3,770	$530

Workers' Compensation	Statutory Reserves	Tax Reserves	Temporary Difference
AY + 0	$1,000	$825	$175
AY + 1	900	800	100
AY + 2	850	770	80
AY + 3	790	695	95
AY + 4	725	610	115
AY + 5	695	600	95
AY + 6	655	575	80
AY + 7	605	545	60
AY + 8	575	505	70
AY + 9	550	495	55
Prior	505	450	55
Total	$7,850	$6,870	$980

5.10 One option in analyzing the reversal of the temporary difference would be to calculate the historical one-year loss development patterns for the two lines of business by accident year. By applying these development patterns to the individual temporary differences, the Company could estimate the expected one-year reversal of the temporary difference as a whole.

5.11 Another option would be to apply the average one-year development factor by line of business to each reserve. If the average one-year development factor for all accident years for auto liability and workers' compensation were 70% and 35%, respectively, the one-year temporary difference reversal would be $371 ($530 x 70%) for auto liability and $343 ($980 x 35%) for workers' compensation.

5.12 The temporary difference related to property and casualty unearned premiums is typically twenty percent (20%) of the outstanding statutory unearned premium reserve. If a company issues only one-year policies, it is reasonable to assume that the entire temporary difference will reverse in one year. If a company writes multi-year contracts, management will be required to estimate the percentage of the unearned premium that will be earned within one year and apply this percentage to the outstanding temporary difference.

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5.13 The reversal of the temporary difference related to life insurance reserves may require actuarial assistance, normally involving anticipated development of the statutory and tax reserves for policies issued prior to the end of the current reporting year. In computing the anticipated development, it would be expected that reasonable assumptions be used, which may include cash-flow modeling of the entity's reserves. Deferred acquisition costs on life insurance policies are amortized over prescribed periods pursuant to federal tax law. The amortization schedules should provide management with the ability to estimate the one-year reversal with reasonable accuracy.

5.14 For those temporary differences that do not have a defined reversal period, such as unrealized losses on common stock or deferred compensation liabilities, management will need to determine when the temporary difference is "expected" to reverse. For instance, assume a company has an unrealized loss of $200 in its equity portfolio and that, on average, the portfolio turns over twenty-percent (20%) per year. It would be appropriate for the company to conclude that $40 of the temporary difference will reverse in one year. When determining when the temporary difference would be "expected" to reverse, management should normally take into account events that are likely to occur using information, facts and circumstances in existence as of the reporting date. The estimates used in this circumstance should not be extended to other tests of impairment. For instance, when the entity assumed a 20% turnover in its equity portfolio, it is not involuntarily required to record an impairment in accordance with paragraph 9 of *SSAP No. 30 - Investments in Common Stock (excluding investments in common stock of subsidiary, controlled, or affiliated entities)*.

5.15 In summary, the methodology used to develop the reversal pattern should be consistent, systematic, and rational. Although consistency is encouraged, business conditions may dictate that certain factors be given more or less weight than in previous periods. Factors to be considered include historical patterns, recent trends, and the likely impact of future initiatives (without regard to future originating temporary differences). For instance, if a company has migrated to a more efficient claims management system, outstanding reserves may be settled more quickly than historical payment patterns may indicate. A company that expects to enter into a loss portfolio transfer reinsurance transaction should consider the implications of that treaty in determining the reversal of the loss reserve temporary difference.

5b. Q – How should future originating differences impact the one-year scheduling of temporary difference reversals? [Paragraphs 10.a., 10.b.i. and 11.a.]

5.16 A – Future originating differences, and their subsequent reversals, are considered in assessing the existence of future taxable income. However, they should not impact the one-year scheduling of existing temporary difference reversals. Paragraph 229 of FAS 109 provides the following:

> 229. For some assets or liabilities, temporary differences may accumulate over several years and then reverse over several years. That pattern is common for depreciable assets. Future originating differences for existing depreciable assets and their subsequent reversals are a factor to be considered when assessing the likelihood of future taxable income (paragraph 21.b.) for realization of a tax benefit for existing deductible temporary differences and carryforwards.

6. Q – What is meant by the phrase "expected to be realized"? [Paragraph 10.b.i.]

6.1 A – Paragraph 10 states that:

> 10. Gross DTAs shall be admitted in an amount equal to the sum of:
>
> a. Federal income taxes paid in prior years that can be recovered through loss carrybacks for existing temporary differences that reverse by the end of the subsequent calendar year;
>
> b. The lesser of:

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i. The amount of gross DTAs, after application of paragraph 10.a., expected to be realized within one year of the balance sheet date; or

ii. Ten percent of statutory capital and surplus as required to be shown on the statutory balance sheet of the reporting entity for its most recently filed statement with the domiciliary state commissioner adjusted to exclude any net DTAs, EDP equipment and operating system software and any net positive goodwill; and

c. The amount of gross DTAs, after application of paragraphs 10.a. and 10.b. that can be offset against existing gross DTLs.

6.2 A reporting entity calculates the amount of its gross DTAs and DTLs under paragraph 6 using the enacted tax rate. The amount of gross DTAs and DTLs is not recalculated under paragraph 10. The purpose of paragraph 10 is to determine the amount of gross DTAs that can be admitted in the reporting period.

6.3 An excerpt of *SSAP No. 4 – Assets and Nonadmitted Assets* indicates:

2. For purposes of statutory accounting, an asset shall be defined as: probable[6] future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.

6.4 The phrase "expected to be realized" encompasses a reasonable expectation as to the value of the DTA consistent with SSAP 4. This means that if a reporting entity's management expects that deductible temporary differences that reverse in the subsequent year will produce a federal income tax benefit at a rate that is lower than the enacted rate, the expected rate should be taken into consideration in the determination of the amount of admitted gross DTAs under paragraph 10.b.i. In other words, available evidence causes the reporting entity to expect the asset to be realized at less than the enacted rate. In such cases, it would not be appropriate to calculate the amount of admitted gross DTAs under paragraph 10.b.i. on the basis of reversing deductible temporary differences at the enacted tax rate.

6.5 The following examples illustrate situations where the amount of admitted gross DTAs under paragraph 10.b.i. would be less than the gross DTAs calculated using deductible temporary differences reversing in the subsequent year at the enacted income tax rate. The approach in these examples is to determine the tax savings that the company would expect to realize from its reversing deductible temporary differences. This is accomplished through a calculation of the company's income tax liability "with and without" these temporary differences. It is assumed that in these examples there are no prudent and feasible tax-planning strategies that would cause the entity to expect the asset to be realized at a rate different than that presented in the examples.

Example 1:

6.6 P&C has a significant portion of its investment portfolio in municipal bonds. It is estimating regular taxable income for 2002 to be $6,000,000. Included in this amount is $10,000,000 of excluded tax-exempt interest and $2,000,000 of reversing deductible temporary differences that were included in P&C's deferred inventory at 12/31/01.

[6] *FASB Statement of Financial Accounting Concepts No. 6, Elements of Financial Statements* (CON 6), states:
Probable is used with its usual general meaning, rather than in a specific accounting or technical sense (such as that in FASB Statement No. 5, Accounting for Contingencies, par. 3), and refers to that which can reasonably be expected or believed on the basis of available evidence or logic but is neither certain nor proved.

	Without Reversing Temporary Differences		With Reversing Temporary Differences	
	Regular Tax	AMT	Regular Tax	AMT
Regular Taxable Income	$8,000,000	$8,000,000	$8,000,000	$8,000,000
AMT/ACE Adjustment		6,375,000[7]		6,375,000
Reversing Temporary Differences			(2,000,000)	(2,000,000)
Taxable Income	8,000,000	14,375,000	6,000,000	12,375,000
Tax (35% regular/20% AMT)	2,800,000	2,875,000	2,100,000	2,475,000
Tax Liability	$2,800,000	75,000	$2,100,000	375,000
Total Tax		$2,875,000		$2,475,000

6.7 In 2002, the reversing deductible temporary differences of $2,000,000 are expected to save P&C income taxes at a rate of 20% or $400,000 ($2,875,000 – $2,475,000). The remaining 15% tax benefit represents an additional AMT credit carryover of $300,000 ($375,000 – $75,000). Therefore, P&C's admitted gross DTAs under paragraph 10.b.i. before reduction for any admitted gross DTAs under paragraph 10.a. would be 400,000, which is less than the amount of its gross DTAs of $700,000 ($2,000,000 x 35%) on reversing deductible temporary differences at the enacted rate. However, the $300,000 difference generated by the 15% (35% - 20%) rate differential under paragraph 10.b.i. would be taken into account in the paragraph 10.c. calculation to offset existing gross DTLs.

Example 2:

6.8 SL is a small life insurance company with projected assets of less than $500 million at the end of 2002. SL also estimates that its taxable income before the small life insurance company deduction (SLICD) will be $1,300,000. Included in this amount is $400,000 of reversing deductible temporary items that were part of SL's deferred inventory at 12/31/01.

	Without Reversing Temporary Differences		With Reversing Temporary Differences	
	Regular Tax	AMT	Regular Tax	AMT
Regular Taxable Income before SLICD	$1,700,000	$1,700,000	$1,700,000	$1,700,000
Reversing Temporary Differences			(400,000)	(400,000)
Net	1,700,000	1,700,000	1,300,000	1,300,000
Small Life Insurance Company Deduction (60%)	(1,020,000)	(1,020,000)	(780,000)	(780,000)
AMT/ACE Adjustment (75% of SLICD)		765,000		585,000
Taxable Income	680,000	1,445,000	520,000	1,105,000
Tax (35% regular/20% AMT)	238,000	289,000	182,000	221,000
Tax Liability	$238,000	51,000	$182,000	39,000
Total Tax		$289,000		$221,000

6.9 Since SL is a small life insurance company with less than $3 million of taxable income before the small life insurance company deduction, it is taxed at an effective federal income tax rate of 17%. The $400,000 of reversing deductible temporary differences in 2002 is expected to save SL $68,000 ($289,000 - $221,000) in federal income taxes at the 17% rate. The tax savings represents a reduction in regular taxes of $56,000 and AMT taxes of $12,000. Under paragraph 10.b.i., SL would admit gross DTAs of $68,000, before reduction for any gross DTAs admitted under paragraph 10.a. Any unused

[7] $10,000,000 x 85% x 75%

amount of gross DTAs related to the 18% (35% - 17%) rate differential under paragraph 10.b.i. would be taken into account under paragraph 10.c. to offset existing gross DTLs.

Example 3:

6.10 BCBS is a Blue Cross/Blue Shield Organization that expects to fully offset its regular taxable income with available section 833 (b) deductions in 2002. Prior to considering the section 833 (b) deduction, BCBS projects $8,000,000 of taxable income in 2002 which includes $3,000,000 of reversing deductible temporary differences that were part of its deferred inventory at 12/31/01.

	Without Reversing Temporary Differences		**With Reversing Temporary Differences**	
	Regular Tax	AMT	Regular Tax	AMT
Regular Taxable Income Before 833(b)	$11,000,000	$11,000,000	$11,000,000	$11,000,000
Reversing Temporary Differences			(3,000,000)	(3,000,000)
Net	11,000,000	11,000,000	8,000,000	8,000,000
Section 833 (b) Deduction	(11,000,000)		(8,000,000)	
Taxable Income	0	11,000,000	0	8,000,000
Tax (35% regular/20% AMT)	0	2,200,000	0	1,600,000
Tax Liability	$0	2,200,000	$0	1,600,000
		$2,200,000		$1,600,000

6.11 BCBS has a 0% effective tax rate on regular taxable income and is taxed at 20% for AMT. Its regular taxable income is $0, both "with and without" the $3,000,000 reversing deductible temporary differences since the section 833 (b) deduction changes by an equal amount. The $600,000 reduction in AMT tax liability related to the $3,000,000 reversing deduction temporary differences is expected to generate a 20% tax savings in 2002. Therefore, BCBS would admit $600,000 of gross DTAs under paragraph 10.b.i. before reduction for any gross DTAs admitted under paragraph 10.a. Any unused amount of gross DTAs related to the 15% (35% - 20%) rate differential under paragraph 10.b.i. would be taken into account under paragraph 10.c. to offset existing gross DTLs.

Example 4:

6.12 ABC insurance company is projecting an income tax loss in 2002 of $20,000,000, which includes $5,000,000 of reversing deductible temporary differences that were part of its deferred inventory at 12/31/01. ABC expects to pay $0 federal income taxes in 2002 for both regular and AMT tax purposes as a result of its tax loss.

	Without Reversing Temporary Differences		**With Reversing Temporary Differences**	
	Regular Tax	AMT	Regular Tax	AMT
Regular Taxable Income (Loss)	($15,000,000)	($15,000,000)	($15,000,000)	($15,000,000)
Reversing Temporary Differences			(5,000,000)	(5,000,000)
Taxable Income (Loss)	(15,000,000)	(15,000,000)	(20,000,000)	(20,000,000)
Tax (35% regular/20% AMT)	$0	$0	$0	$0

6.13 In 2002, ABC expects to realize no tax benefit related to the $5,000,000 of reversing deductible temporary differences since they simply increase the amount of an NOL. Its expected income tax rate for 2002 would be 0% and ABC would have $0 admitted gross DTAs under paragraph 10.b.i. However, if some or all of the reversing temporary differences could be absorbed in the carryback period, ABC would have an admitted gross DTA under paragraph 10.a. The gross DTAs of $1,750,000 ($5,000,000 x 35%),

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related to ABC's reversing temporary differences, would also be available as part of its total gross DTAs, to offset gross DTLs in the paragraph 10.c. calculation.

7. Q – SSAP No. 10 provides that a reporting entity may admit deferred tax assets in an amount equal to federal income taxes paid in prior years that can be recovered through loss carrybacks for existing temporary differences that reverse by the end of the subsequent calendar year. What is the meaning of the term "taxes paid"? [Paragraph 10.a.]

7.1 A – SSAP No. 10 Paragraph 10 states that:

> 10. Gross DTAs shall be admitted in an amount equal to the sum of:
>
> a. Federal income taxes paid in prior years that can be recovered through loss carrybacks for existing temporary differences that reverse by the end of the subsequent calendar year;

7.2 The term "taxes paid" means the total tax (both regular and AMT), that was or will be reported on the reporting entity's federal income tax returns for the periods included in the carryback period including any amounts established in accordance with the provision of SSAP 5 as described in paragraph 3.a. of SSAP No. 10 related to those periods. If a federal income tax return in the carryback period has been amended, or adjusted by the IRS, "taxes paid" would reflect the impact of the amended tax return, or settlement with the IRS.

7.3 In applying the term "taxes paid" to a reporting entity that is party to a consolidated federal income tax return, the term "taxes paid" means the total federal income tax (both regular and AMT) that was paid, or is expected to be paid to the common parent of the reporting entity's affiliated group, in accordance with the intercompany tax sharing agreement, with respect to the income tax years included in the carryback period. "Taxes paid" includes amounts established in accordance with the provision of SSAP 5 as described in paragraph 3.a. of SSAP No. 10 related to those periods, including current federal income taxes payable (i.e., accrued in the entity's financial statements) related to the carryback period. The ability of the reporting entity to recover (through loss carrybacks) taxes that were paid to its common parent is generally governed by the terms and provisions of the affiliated group's intercompany tax sharing or tax allocation agreement.

8. Q – How is a company's computation of gross and admitted deferred taxes impacted if it joins in the filing of a consolidated federal income tax return? [paragraphs 6, 10, and 11.c.]

8.1 A – For purposes of determining the amount of DTAs and the amount admitted under paragraph 10, the calculation should be made on a separate company, reporting entity basis. Under paragraph 6, a reporting entity's gross deferred tax assets and liabilities are determined by identifying its temporary differences. These temporary differences are measured using a "balance sheet" approach by comparing statutory and tax basis balance sheets for that entity. Once a reporting entity determines its gross DTAs, the amount that is admitted is determined in accordance with paragraph 10.

8.2 Under paragraph 10.a. an entity shall determine the amount of "federal income taxes paid in prior years that can be recovered through loss carrybacks for existing temporary differences that reverse by the end of the subsequent calendar year." Consistent with guidance promulgated in other EAIWG interpretations, a reporting entity that files a consolidated federal income tax return with its parent should look to the amount of taxes it paid (or were allocable to it) as a separate legal entity in determining the admitted DTA under paragraph 10.a. Furthermore, the DTA under paragraph 10.a. may not exceed the amount that the entity could reasonably expect to have refunded by its parent (paragraph 11.c.). The taxes paid by the reporting entity represent the maximum DTA that may be admitted under paragraph 10.a., although the amount could be reduced pursuant to the group's tax allocation agreement.

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8.3 The amount of admitted gross DTAs under paragraph 10.b.i. is limited to the amount that the reporting entity expects to realize within one year of the balance sheet date on a separate company basis. The entity must estimate its separate company taxable income and the tax benefit that it expects to receive from reversing deductible temporary differences in the form of lower tax payments to its parent. A reporting entity that projects a tax loss in the following year cannot admit a DTA related to the loss under paragraph 10.b. even if the loss could offset taxable income of other members in the consolidated group and the reporting entity could expect to be paid for the tax benefit pursuant to its tax allocation agreement.

8.4 The following examples reflect this analysis and assume that the surplus limitation of paragraph 10.b.ii. is not applicable:

Example 1:

8.5 Assume Company A joins in the filing of a consolidated federal income tax return. Consolidated taxes paid in prior carryback years total $150, of which Company A paid $100. Company A has existing temporary differences that reverse by the end of the subsequent calendar year on a separate company, reporting entity basis that, at 35%, would give rise to a tax benefit of $125.

8.6 Under paragraph 10.a. Company A could record an admitted DTA under 10 a. of $100, equal to the taxes it paid. Additionally, under paragraph 10.b.i. Company A could admit an additional $25, assuming it expects to realize such tax benefit based on its separate company analysis. Due to the consolidated return filing, the $100 admitted under paragraph. 10.a. could only be admitted provided this amount could reasonably be expected to be refunded by the parent [paragraph 11.c.] and would be available pursuant to a written income tax allocation agreement [paragraph 12.b.].

Example 2:

8.7 Assume the same facts as in Example 1, except consolidated taxes paid in prior carryback years that could be recovered are $70 and, pursuant to a written income tax allocation agreement, taxes recoverable through loss carrybacks may not exceed consolidated taxes paid in prior carryback years.

8.8 In this situation, Company A would admit a DTA of $70 under paragraph 10.a. (recoverable taxes limited to consolidated taxes paid which could be refunded by the parent). In addition, $55 ($125-$70) of DTA may be admitted under paragraph 10.b.i. if Company A expected to realize this tax benefit on the basis of its separate company estimated taxable income and temporary differences that are expected to be realized within one year of the balance sheet date.

Example 3:

8.9 Parent Company P files a consolidated federal income tax return with its insurance subsidiaries, R, S and T. Assume consolidated taxes that could be recovered through loss carryback total $450. However, in the prior carryback years $200 was paid by each of the subsidiaries, R, S and T. The difference between the amount paid by the subsidiaries ($600) and the amount available through loss carryback ($150) is attributable to interest expense incurred by Company P. Pursuant to the group's written income tax allocation agreement, in the case of loss carrybacks, taxes recoverable are limited to the consolidated taxes paid in the carryback years.

8.10 Because the DTA admitted under paragraph 10.a. for each reporting entity cannot exceed what each entity paid and could reasonably be expected to be refunded by P, no more than $450 in total may be admitted by the subsidiaries (under paragraph 10.a.). If the DTA associated with the subsidiaries' temporary differences that reverse in the 10 a. period exceed the $450 of taxes recoverable through loss carryback on a consolidated basis the DTA admitted by the insurance subsidiaries under paragraph 10.a. should be allocated among the subsidiaries, consistent with the principles of its written income tax

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allocation agreement. This allocation would, in most instances, be based on each subsidiary's share of reversing temporary differences.

8.11 Under paragraph 10.c. an entity may admit its gross DTAs, after application of paragraphs 10.a. and 10.b., based upon offset against its own existing gross DTLs and not against DTLs of other members of the affiliated or consolidated group.

9. Q – Current income taxes are defined by paragraph 3.a. to include estimates of tax contingencies for the current and all prior years, to the extent not previously provided, computed in accordance with SSAP 5R. What impact, if any, does the inclusion of tax contingencies as a component of current income taxes have on the determination of deferred income taxes? [Paragraph 3.a.]

9.1 A – It is not the intention of this interpretation to modify existing FAS 109 guidance with respect to the general reporting of tax contingencies and/or the net interest on such contingencies. The purpose of this interpretation is to address when such contingencies should be "grossed-up" and reflected in the calculation of both statutory current and deferred federal income taxes.

9.2 Gross deferred tax assets and liabilities are determined in accordance with paragraph 6 of SSAP No. 10, and reflect the changes in temporary differences taken into account in estimating taxes currently payable and are manifested in the enterprise's tax basis balance sheet. If gross tax contingencies associated with temporary differences have been included in taxes currently payable, a corresponding adjustment must be made to the tax basis balance sheet used in the determination of gross deferred tax assets and liabilities. Deferred tax assets and liabilities are not adjusted for tax contingencies not associated with temporary differences (i.e. permanent differences).

9.3 For example, assume that a company determines, in accordance with SSAP 5, a tax contingency is required to be established for a $100 deduction claimed in a prior year federal income tax return. Assuming a 35% tax rate, the company would establish a current tax liability in the amount of $35, increasing its current income tax expense by $35.

DR	Current income tax expense	$35
CR	Liability for current income tax	$35

9.4 If the $100 deduction was associated with a temporary difference such as reserves, the company would make a corresponding adjustment to deferred taxes. The company would increase its gross deferred tax asset for reserves by $35 to reflect the future tax benefit associated with that reserve deduction.

DR	Gross deferred tax asset	$35
CR	Change in net deferred tax (surplus)	$35

9.5 If the $100 deduction was associated with a permanent item such as meals and entertainment expenses, the company would make no corresponding adjustment to the deferred tax assets.

9.6 In determining when tax contingencies associated with temporary differences should be included in current income taxes under Paragraph 3.a., and, thus, deferred taxes, a reporting entity is not required to "gross-up" its current and deferred taxes until such time as an event has occurred that would cause a re-evaluation of the contingency and its probability of assessment, e.g., the IRS has identified the item as one which may be adjusted upon audit. Such an event could be the company's receipt of a Form 5701, Proposed Audit Adjustment, or could occur earlier upon receipt of an Information Document Request. At such time, the company must reassess the probability of an adjustment, reasonably re-estimate the amount of loss (see SSAP 5R), make any necessary adjustment to deferred taxes, and redetermine the admissibility of any gross deferred tax asset as provided in Paragraph 10 in SSAP No. 10.

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10a. Q – If the reporting entity adjusts the amount of regular taxable income and capital gains reported on a prior year income tax return from the amount originally determined for financial reporting purposes, how is the effect of the change reported in the current year? [Paragraph 15]

10.1 A – Paragraph 15 of SSAP No. 10 indicates that "income taxes incurred or received during the current year attributable to prior years shall be allocated, to the extent not previously provided, to net income in accordance with SSAP No. 3 unless attributable, in whole or in part, to realized capital gains or losses, in which case, such amounts shall be apportioned between net income and realized capital gains and losses, as appropriate". Paragraph 15 also indicates that income taxes incurred are to be allocated to ordinary income and realized capital gains consistent with paragraph 38 of FAS 109. Paragraph 38 of FAS 109 provides, in general, that the portion of the total income tax expense remaining after allocation to ordinary income would be allocated to realized capital gains or losses.

10.2 In accordance with paragraph 15, the amount of additional federal income taxes incurred in the current year with respect to the prior year would be allocated between ordinary income and realized capital gain items. The amount of additional federal income tax expense allocated to ordinary income should be determined by comparing the amount of additional tax expense actually incurred to the amount of tax expense that would have been incurred had the adjustment to ordinary income been zero (a "with and without" computation). The remaining amount of additional federal income tax expense would then be allocated to realized capital gains. The amounts of additional federal income tax expense allocated to ordinary income and realized capital gains would be included in the current period's federal income tax expense and not as a direct adjustment to surplus.

10.3 As an example, assume Company X files its 2000 Federal income tax return and reports $1,000,000 of taxable income comprised of $800,000 of ordinary income and $200,000 of capital gain income. Since the company is subject to taxation at a 34 percent tax rate on all its income, it incurred federal income tax expense of $340,000. In preparing its 2000 statutory income tax provision, the company estimated that its liability for 2000 federal income tax would be $238,000 based on $600,000 of ordinary income and $100,000 realized capital gains.

10.4 In determining the amount of "income taxes incurred" for its 2001 financial statement, Company X must include the additional $102,000 of income tax expense incurred on its 2000 federal income tax return ($340,000 actual tax incurred less $238,000 originally reported) in net income for 2001 pursuant to paragraph 15 of SSAP No. 10 and not as a surplus adjustment. The $102,000 additional expense would be allocated to federal income taxes on net income and realized capital gains and losses as follows:

Total additional income tax expense	$102,000
Tax expense allocated to operations ($200,000 additional income x 34%)	68,000
Tax expense allocated to realized gains	$ 34,000

The tax expense allocated to operations was determined as follows:

Total recomputed tax expense	$340,000
Tax expense with only capital gain changes	272,000 [8]
Tax expense allocated to operations	$ 68,000

10.5 For all purposes of computing and allocating federal income taxes between operations and capital gains and losses, the character of the income or loss item as determined for statutory accounting purposes should be followed. Thus, if an income item is treated as a capital gain for statutory accounting purposes

[8] This is a company with less than $10 million of taxable income therefore $600,000 of original ordinary income plus $200,000 recomputed capital gains equals $800,000 taxable income times 34 percent applicable tax rate equals $272,000.

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but as ordinary income for tax purposes, the federal income tax allocable to such income would be considered tax expense attributable to capital gains.

10b. Q – What is meant by the phrase in paragraph 14 "a reporting entity's unrealized gains and losses shall be recorded net of any allocated DTA or DTL"? [Paragraph 14]

10.6 A – Pursuant to Paragraph 14 of SSAP No. 10, a reporting entity's unrealized gains and losses shall be recorded net of any allocated DTA or DTL in accordance with paragraph 35 of FAS 109. Paragraph 35 of FAS 109 indicates that income taxes incurred are to be allocated between various items, including gains from operations and items charged or credited directly to shareholders' equity, such as the change in unrealized gains and losses.

10.7 To the extent a reporting entity's admitted DTA or its DTL changes during the year, the portion of such change allocable to changes in unrealized gains and losses during the year should be determined. The portion so allocable would be reported with, and netted against, the related change in unrealized gains and losses reported as a component of changes in surplus. The remaining portion of the change in DTA or DTL allocable to other temporary differences should be reported as a separate component of changes in surplus and/or change in nonadmitted assets.

10.8 For example, assume the reporting entity has DTAs of $1,000 relating to temporary differences other than unrealized losses, and a $100 DTL relating to unrealized gains as of the beginning of the year. Since the entity is subject to tax at 35 percent and all of its DTAs are expected to reverse within one year, the entity recorded a $900 net admitted DTA as of the beginning of the year.

10.9 During the current year, the DTAs relating to temporary differences other than unrealized losses did not change, but the DTL relating to the entity's unrealized gains increased by $100 (unrealized gains increased by $285 during the year). As a result, the amount of the entity's net admitted DTAs decreased by $100.

10.10 Pursuant to paragraph 14 of SSAP No. 10, the $100 decrease in the DTA during the year is to be allocated between changes attributable to temporary differences other than unrealized gains and losses and those attributable to unrealized gains and losses. Since the DTA relating to temporary differences other than unrealized gains and losses did not change during the year, the entire decrease is allocable to the change in unrealized gains. Therefore, the $100 decrease is to be allocated and netted against the $285 change in unrealized gains reported in change in surplus, resulting in a $185 net increase in surplus relating to its unrealized gains. If a portion of the unrealized loss DTA is determined to be nonadmitted, that amount is not recorded separately from the operating differences DTA. The change in the total nonadmitted DTA from period to period is recorded in surplus as a Change in Nonadmitted Assets.

11. Q – How are current and deferred income taxes to be accounted for in interim periods? [Paragraphs 11.d. and 16]

11.1 A – In setting forth the methodology for the computation of current income taxes (income taxes incurred) in interim periods, paragraph 16 states:

> 16. Income taxes incurred in interim periods shall be computed using an estimated annual effective current tax rate for the annual period in accordance with the methodology described in paragraphs 19 and 20 of *Accounting Principles Board Opinion No. 28, Interim Financial Reporting*. Estimates of the annual effective tax rate at the end of interim periods are, of necessity, based on estimates and are subject to subsequent refinement or revision. If a reliable estimate cannot be made, the actual effective tax rate for the year-to-date may be the best estimate of the annual effective tax rate. If an insurer is unable to estimate a part of its "ordinary" income (or loss) or the related tax (or benefit) but is otherwise able to make a reliable estimate,

the tax (or benefit) applicable to the item that cannot be estimated shall be reported in the interim period in which the item is reported.

11.2 As a result, to the extent a reliable estimate can be made of an expected annual effective tax rate, reporting entities should apply this rate to net income before federal and foreign income taxes, in the case of property and casualty insurers and health insurers, and net income and realized capital gains before federal and foreign income taxes in the case of life insurers. If a reliable estimate of the expected annual effective tax rate cannot be made, reporting entities should compute current and deferred taxes at interim reporting dates using the most reliable information that is available.

11.3 The following examples illustrate the estimation process for income taxes incurred using the estimated annual effective rate:

Projected statutory net income for current year			$10,000,000
Estimated annual permanent differences:			
	Tax exempt income	$(2,000,000)	
	Officers' life insurance premiums	(50,000)	
			(2,050,000)
Estimated annual temporary differences:			
	Loss reserve discounting	1,000,000	
	Unearned premium reserve offset	250,000	
			1,250,000
Projected taxable income for current year			$9,200,000
Projected federal tax for current year (at 35%)			$3,220,000
Estimated annual effective tax rate			32.2%

11.4 As a result, assuming that during the calendar year the insurer's expectations as to its statutory and taxable income do not change, income tax incurred will be recorded on a quarterly basis as follows:

Quarter	Statutory Income (Loss)	Income Taxes Incurred
1	$(2,000,000)	$(644,000)
2	4,000,000	1,288,000
3	6,000,000	1,932,000
4	2,000,000	644,000
Total	$10,000,000	$3,220,000

11.5 If the insurer's expectations as to its statutory and taxable income change in the second quarter so that it expects that its annual effective rate will increase from 32.2% to 34%, it will record income taxes incurred in the second quarter of $1,324,000 (cumulative statutory income at end of the second quarter of $2,000,000 at 34% or $680,000 less $644,000 tax benefit recorded in first quarter).

11.6 As noted above, life insurers must estimate their annual effective tax rate and record income taxes incurred based on net income and realized capital gains before federal and foreign income taxes. With regard to intraperiod tax allocation, paragraph 15 states in relevant part:

15. Income taxes incurred shall be allocated to net income and realized capital gains or losses in a manner consistent with paragraph 38 of FAS 109.

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11.7 As a result of the above and where the insurer expects realized capital gains or losses for the annual period, income taxes incurred must be allocated using a “with and without” methodology to net income before taxes and realized capital gains (see paragraph 10.4 for further discussion).

11.8 An example of this “with and without” methodology is as follows:

Projected statutory net income for current year			$10,000,000
Realized gains included above			(1,000,000)
			9,000,000
Estimated annual permanent differences:			
	Tax exempt income	$(2,000,000)	
	Officers’ life insurance premiums	(50,000)	
			(2,050,000)
Estimated annual temporary differences:			
	Loss reserve discounting	1,000,000	
	Unearned premium reserve offset	250,000	
			1,250,000
Projected ordinary taxable income for current year			$8,200,000
Projected ordinary federal tax for current year (at 35%)			$2,870,000
Projected capital gain federal tax for current year (at 35%)			350,000
Projected total federal tax for current year			$3,220,000
Estimated ordinary annual effective tax rate			31.9%
Estimated capital gain annual effective tax rate			35.0%
Estimated total annual effective tax rate			32.2%

11.9 As a result, assuming that during the calendar year the insurer’s expectations as to its statutory and taxable income (including the amounts of ordinary and capital income) do not change, income tax incurred will be recorded on a quarterly basis as follows:

Quarter	Ordinary Income (Loss)	Capital Income (Loss)	Ordinary Taxes Incurred	Capital Taxes Incurred
1	$(1,000,000)	$(1,000,000)	$(319,000)	$(350,000)
2	3,000,000	1,000,000	956,000	350,000
3	5,000,000	1,000,000	1,595,000	350,000
4	2,000,000	0	638,000	0
Total	$9,000,000	$1,000,000	$2,870,000	$350,000

11.10 With respect to the recording of deferred taxes on an interim basis paragraph 11.d. states:

> 11(d) The phrases “reverse by the end of the subsequent calendar year” and “realized within one year of the balance sheet date” are intended to accommodate interim reporting dates and insurers that file on an other than a calendar year basis for federal income tax purposes.

11.11 When considered in the context of paragraph 16, this paragraph requires the use of the annual effective rate when determining deferred taxes at an interim reporting date. As such, an insurer’s admissible deferred tax assets are determined in accordance with paragraph 10 by reference to the deferred tax assets that will reverse in the subsequent calendar year (tax year when the insurer’s tax year is not the calendar year). Note however, that due to the inherent unpredictability, and general inability to project changes in capital gains and losses on a quarter by quarter basis, the deferred tax implications of the changes in unrealized gains and losses should be recorded on a discrete period basis (i.e., based on the change in the amounts on a quarter by quarter basis). For example in determining its admissible deferred

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tax assets at March 31, 2002, the reversal period referred to above is calendar year 2003 (i.e., expected deferred tax assets at December 31, 2002 that are expected to reverse in 2003).

11.12 This methodology is illustrated by the following example:

Projected statutory net income for 2002			$10,000,000
Estimated annual permanent differences:			
	Tax exempt income	$(2,000,000)	
	Officers' life insurance premiums	(50,000)	
			(2,050,000)
Estimated annual temporary differences:			
	Loss reserve discounting	1,000,000	
	Unearned premium reserve offset	250,000	
			1,250,000
Projected ordinary taxable income for current year			$9,200,000
Temporary differences at December 31, 2001:			
	Loss reserve discounting		5,000,000
	Unearned premium reserve offset		750,000
Estimated temporary differences at December 31, 2002:			
	Loss reserve discounting		6,000,000
	Unearned premium reserve offset		1,000,000
Taxable income in carryback period (taxes paid at 35%):			
	Year ended December 31, 2000	$1,000,000	($350,000)
	Year ended December 31, 2001	2,000,000	(700,000)
	Year ended December 31, 2002	9,200,000	(3,220,000)

Note: Year ended December 31, 2002 taxable income and taxes paid considered in the calculation of its interim tax accruals are based on the insurer's estimate of its annual taxable income and taxes to be paid. This amount may differ from the quarterly federal income tax estimates it expects to make during the year.

Temporary differences anticipated to reverse in 2002:			
	Loss reserve discounting		$1,250,000
	Unearned premium reserve		750,000
Temporary differences anticipated to reverse in 2003:			
	Loss reserve discounting		$3,000,000
	Unearned premium reserve		1,000,000
Estimated surplus, as adjusted at September 30, 2002			$10,000,000

Admitted deferred tax assets at December 31, 2001:				
	Paragraph 10.a.			
		2000	$1,000,000	
		2001	1,000,000	
			2,000,000	
		Taxes paid at 35%		$700,000
	Paragraph 10.b.			0
	Paragraph 10.c.			0
	Total admitted			$700,000

Admitted deferred tax assets at December 31, 2002:				
	Paragraph 10.a.			
		2001	$1,000,000	
		2002	3,000,000	
			4,000,000	
		Taxes paid at 35%		$1,400,000
	Paragraph 10.b.			0
	Paragraph 10.c.			0
	Total admitted			$1,400,000
Total estimated federal taxes for 2002:				
	Income taxes incurred (current tax)			$3,220,000
	Change in deferred tax			(700,000)
				$2,520,000

11.13 As a result of the above, the annual effective tax rate for current and deferred income taxes is as follows:

Current ($3,220,000/$10,000,000)	32.2%
Deferred (($700,000)/$10,000,000)	(7.0)%
Total annual effective rate	25.2%

Quarter	Statutory Income (Loss)	Income Taxes Incurred	Deferred Taxes
1	$(2,000,000)	$(644,000)	$140,000
2	4,000,000	1,288,000	(280,000)
3	6,000,000	1,932,000	(420,000)
4	2,000,000	644,000	(140,000)
Total	$10,000,000	$3,220,000	$(700,000)

11.14 To the extent that an insurer's estimated December 31, 2002, admitted deferred tax assets are limited by its surplus pursuant to paragraph 10.b.ii., the annual effective deferred tax rate must be adjusted to consider the impact of this limitation on a quarterly basis.

12. Q – How do you present deferred taxes in the Annual Statement? [Paragraphs 7, 14 and 17-23]

12.1 A – This answer is divided into four different parts.

Change in Accounting Principle

12.2 The initial recognition of balances computed under SSAP No. 10 on January 1, 2001 shall be presented in the Annual Statement as a Cumulative Effect of Changes in Accounting Principles. SSAP 3 provides the following:

> 3. A change in accounting principle results from the adoption of an accepted accounting principle, or method of applying the principle, which differs from the principles or methods previously used for reporting purposes. A change in the method of applying an accounting principle shall be considered a change in accounting principle.
>
> 4. A characteristic of a change in accounting principle is that it concerns a choice from among two or more statutory accounting principles. However, a change in accounting principle is neither (a) the initial adoption of an accounting principle in recognition of events or transactions

occurring for the first time or previously immaterial in their effect, nor (b) the adoption or modification of an accounting principle necessitated by transactions or events that are clearly different in substance from those previously occurring.

5. The cumulative effect of changes in accounting principles shall be reported as adjustments to unassigned funds (surplus) in the period of the change in accounting principle. The cumulative effect is the difference between the amount of capital and surplus at the beginning of the year and the amount of capital and surplus that would have been reported at that date if the new accounting principle had been applied retroactively for all prior periods.

12.3 In accordance with an interpretation from the Emerging Accounting Issues Working Group, *INT 01-27: Accounting Change versus Correction of Error*, adjustments to amounts recorded as of January 1, 2001 would be recorded as a modification to the changes in accounting principle account rather than corrections of an error through the period of 2001.

Illustration A Assumptions:

12.4 On January 1, 2001 the AlphaBeta P/C Company computed the following balances related to deferred taxes:

	1/1/01
Gross DTA	$200,000
Gross DTL	100,000
Net DTA	100,000
Nonadmitted DTA	25,000
Net Admitted DTA	$75,000

12.5 The Cumulative Effect of Changes in Accounting Principles line shown in the surplus section of the Annual Statement would show an increase of $75,000 ($200,000 DTA – $100,000 DTL – $25,000 Nonadmitted DTA) on 1/1/01. During the second quarter of 2001, the Company modified its opening balance as follows (note that modifications were not a result of changes in circumstances or events which occurred during 2001):

	Revised 1/1/01
Gross DTA	$220,000
Gross DTL	100,000
Net DTA	120,000
Nonadmitted DTA	55,000
Net Admitted DTA	$65,000

12.6 The Company would record the following balances in its 3/31/01 financial statements:

	1/1/01	**Revised 1/1/01**	**Increase (Decrease)**
Gross DTA	$200,000	$220,000	$20,000
Gross DTL	100,000	100,000	0
Net DTA	100,000	120,000	20,000
Nonadmitted DTA	25,000	55,000	30,000
Net Admitted DTA	$75,000	$65,000	($10,000)

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12.7 The $10,000 decrease in net admitted DTA would be recorded through the Cumulative Effect of Changes in Accounting Principles line shown in the surplus section of the Annual Statement.

Unrealized Capital Gains and Losses

12.8 SSAP No. 10 paragraph 14 states:

> 14. In accordance with paragraph 35 of FAS 109, a reporting entity's unrealized gains and losses shall be recorded net of any allocated DTA or DTL. The amount allocated shall be computed in a manner consistent with paragraph 38 of FAS 109.

12.9 The following illustrates the presentation of such requirement in the Annual Statement:

Illustration B Assumptions:

12.10 Entity grouped its investments in a reasonable and consistent manner and calculated the following gross amounts attributable to appreciation and depreciation in the fair value of its common stocks during 2001 (see question 2 regarding grouping of assets and liabilities for measurement):

	Gross	Carrying Value	Rate	Tax effected DTA (DTL)
Common stock carrying value 1/1/01		$800,000		
Unrealized (loss)	($428,571)		35%	$150,000
Unrealized gain	342,857		35%	(120,000)
Net (loss) gain		(85,714)		$30,000
Common stock carrying value 12/31/01		$714,286		

12.11 The journal entries need to present unrealized losses and gains net of tax are:

12/31/01	DR	Change in unrealized capital gains and losses	$85,714
	CR	Common stock	($85,714)
	Recognition of net depreciation in FV of common stock		

12/31/01	DR	Deferred tax asset	$150,000
	CR	Deferred tax liability	($120,000)
	CR	Change in deferred income taxes	($30,000)
	Recognition of gross deferred tax amounts		

12/31/01	DR	Change in deferred income taxes	$30,000
	CR	Change in unrealized capital gains and losses	($30,000)
	Reclass tax effect of net unrealized loss per paragraph 14 of SSAP No. 10		

12.12 Condensed 12/31/01 Balance Sheet:

ASSETS	2001	2000	LIABILITIES & SURPLUS	2001	2000
Common Stock	$714,286	$800,000	Surplus:		
Net deferred tax asset	30,000		Beginning of year	$800,000	
			Change in UNL	(55,714)[9]	
Total Assets	$744,286	$800,000	**Liabilities & Surplus**	$744,286	$800,000

[9] Computed at $85,714 (total change in UNG/UNL) - $30,000 tax effect

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Annual Statement Presentation

12.13 In accordance with SSAP No. 10, DTAs and DTLs shall be offset and presented as a single amount on the statement of financial position. The following illustrates this requirement:

Illustration C Assumptions:

12.14 The entity had the following balances (1/1/01 balances carried forward from Illustration A):

	1/1/01	**12/31/01**	**Change**
Gross DTA	$200,000	$500,000	$300,000
Gross DTL	100,000	200,000	100,000
Net DTA	100,000	300,000	200,000[10]
Nonadmitted DTA	25,000	150,000	125,000
Net Admitted DTA	$75,000	$150,000	$75,000
Current FIT Recoverable	**$18,000**	**$20,000**	**$2,000**

12.15 Illustrative 12/31/01 Balance Sheet for Illustration C:

ASSETS	Current Year			Prior Year
	1 Assets	2 Nonadmitted Assets	3 Net Admitted Assets (Cols. 1 - 2)	4 Net Admitted Assets
Federal and foreign income tax recoverable and interest thereon (including $150,000[11] net admitted deferred tax asset)	$320,000	$150,000	$170,000	$18,000

12.16 Illustrative 12/31/01 Income Statement for Illustration C:

STATEMENT OF INCOME (P/C) SUMMARY OF OPERATIONS (Life & Health) STATEMENT OF REVENUES AND EXPENSES (Health)	1 Current Year	2 Prior Year
GAINS AND (LOSSES) IN SURPLUS		
Net unrealized capital gains (losses)	($55,714)	0
Change in net deferred income tax	$170,000	0
Change in nonadmitted assets (Exhibit 1, Line 6, Col. 3)	($125,000)	0

12.17 Illustrative 12/31/01 Analysis of Nonadmitted Assets and Related Items for Illustration C:

	1 End of Current Year	2 End of Prior Year	3 Changes for Year (Increase) Decrease
Aggregate write-ins for other-than-invested assets	$150,000	$25,000[12]	($125,000)
Total	$150,000	$25,000	($125,000)

[10] Includes $30,000 resulting from net unrealized losses as shown in Illustration B. As such the change in net deferred income taxes at 12/31/01 is $170,000 ($200,000 (gross change in DTA) - $30,000 reclass to net unrealized capital gains (losses)).

[11] The parenthetical disclosure of net DTA should be after application of admission test. The RBC formula will utilize the net admitted DTA in 2002 and as such the amount should be shown on the face of the balance sheet for ease of data capture.

[12] Prior year balance adjusted to include 1/1/01 Change in Accounting Principle

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Illustration D Assumptions:

12.18 The entity had the following balances (1/1/01 balances carried forward from Illustration A):

	1/1/01	12/31/01	Change
Gross DTA	$200,000	$500,000	$300,000
Gross DTL	100,000	200,000	100,000
Net DTA	100,000	300,000	200,000[13]
Nonadmitted DTA	25,000	150,000	125,000
Net Admitted DTA	$75,000	$150,000	$75,000
Current FIT Liability	**$7,000**	**$12,000**	**$5,000**

12.19 Illustrative 12/31/01 Balance Sheet for Illustration D:

ASSETS	Current Year			Prior Year
	1 Assets	2 Nonadmitted Assets	3 Net Admitted Assets (Cols. 1 - 2)	4 Net Admitted Assets
Federal and foreign income tax recoverable and interest thereon (including $150,000[14] net admitted deferred tax asset)	$300,000	$150,000	$150,000	0

LIABILITIES, SURPLUS AND OTHER FUNDS	1 Current Year	2 Prior Year
Federal and foreign income taxes (including $0 net deferred tax liability)	$12,000	$7,000

12.20 Illustrative 12/31/01 Income Statement for Illustration D:

STATEMENT OF INCOME (P/C) SUMMARY OF OPERATIONS (Life & Health) STATEMENT OF REVENUES AND EXPENSES (Health)	1 Current Year	2 Prior Year
GAINS AND (LOSSES) IN SURPLUS		
Net unrealized capital gains (losses)	($55,714)	0
Change in net deferred income tax	$170,000	0
Change in nonadmitted assets (Exhibit 1, Line 6, Col. 3)	($125,000)	0

12.21 Illustrative 12/31/01 Analysis of Nonadmitted Assets and Related Items for Illustration D:

	1 End of Current Year	2 End of Prior Year	3 Changes for Year (Increase) Decrease
Aggregate write-ins for other-than-invested assets	$150,000	$25,000[15]	($125,000)
Total	$150,000	$25,000	($125,000)

Notes to the Financial Statements Disclosures:

12.22 SSAP No. 10 paragraphs 17-23 include extensive disclosure requirements. Although some of these amounts are presented on the face of the financial statements or in schedules or exhibits to the

[13] Includes $30,000 resulting from net unrealized losses as shown in Illustration B. As such the change in net deferred income taxes at 12/31/01 is $170,000 ($200,000 (gross change in DTA) - $30,000 reclass to net unrealized capital gains (losses)).

[14] The parenthetical disclosure of net DTA should be after application of admission test. The RBC formula will utilize the net admitted DTA in 2002 and as such the amount should be shown on the face of the balance sheet for ease of data capture

[15] Prior year balance adjusted to include 1/1/01 Change in Accounting Principle

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Annual Statement, they will be included in the Notes to the Financial Statements both in the Annual Statement and in the Annual Audited Financial Statements.

12.23 This section provides specific examples that illustrate the disclosures required in SSAP No. 10. The formats in the illustrations are not requirements. Some of the disclosure paragraphs of SSAP No. 10 are not specific as to whether the entity should disclose the nature of certain items or whether the entity should disclose specific amounts. The illustrations included herein use a combination of each method. The NAIC encourages a format that provides the information in the most understandable manner in the specific circumstances. The following illustrations are for a single hypothetical insurance enterprise, referred to as AlphaBeta Property & Casualty Insurance Company. Note that in certain disclosures, the prior year balances are as of January 1, 2001 (date of cumulative change in accounting principle).

12.24 All of the disclosures would be completed in the year-end Annual Statement and audited statutory financial statements. The disclosures of paragraphs 18, 20.b., 21 (on a prospective basis) and 23 should be presented in accordance with paragraph 61 of the Preamble, therefore these notes would only be presented in the first, second and third Quarterly Statements if the underlying data changed significantly.

12.25 Selected AlphaBeta P/C Company Financial Data at December 31, 2001 (Balance Sheet information carried forward from Illustration C):

ASSETS	Current Year			Prior Year
	1 Assets	2 Nonadmitted Assets	3 Net Admitted Assets (Cols. 1 - 2)	4 Net Admitted Assets
Federal and foreign income tax recoverable and interest thereon (including $150,000 net deferred tax asset)	$320,000	$150,000	$170,000	$18,000

GAINS AND (LOSSES) IN SURPLUS	1 Current Year	2 Prior Year
Net unrealized capital gains (losses)	($55,714)	0
Change in net deferred income tax	$170,000	0
Change in nonadmitted assets	($125,000)	0

ANALYSIS OF NONADMITTED ASSETS AND RELATED ITEMS	1 End of Current Year	2 End of Prior Year	3 Changes for Year (Increase) Decrease
Aggregate write-ins for other-than-invested assets	$150,000	$25,000[16]	($125,000)

STATEMENT OF INCOME	**2001**
Premiums earned	$5,250,000
Losses incurred	3,550,000
Loss expenses incurred	1,750,000
Other underwriting expenses incurred	525,000
Net underwriting gain (loss)	(575,000)
Net investment gain (loss)	1,350,000
Total other income	125,000
Net income before dividends to policyholders and before federal and foreign income taxes	900,000
Dividends to policyholders	200,000
Net income, after dividends to policyholders but before federal and foreign income taxes	700,000
Federal and foreign income taxes incurred	210,000
Net income	$490,000

[16] Prior year balance adjusted to include 1/1/01 Change in Accounting Principle

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Paragraph 18 Illustration:

12.26 The components of the net DTA recognized in the Company's Assets, Liabilities, Surplus and Other Funds are as follows:

	Dec. 31, 2001	**Jan. 1, 2001**
Total of gross deferred tax assets	$500,000	$200,000
Total of deferred tax liabilities	(200,000)	(100,000)
Net deferred tax asset	300,000	100,000
Deferred tax asset nonadmitted	(150,000)	(25,000)
Net admitted deferred tax asset	$150,000	$75,000
(Increase) decrease in nonadmitted asset	($125,000)	-

Paragraph 19 Illustration:

12.27 The Company has not recognized a deferred tax liability of approximately $30,000 for the undistributed earnings of its 100 percent owned foreign subsidiaries that arose in 2001 and prior years because the Company does not expect those unremitted earnings to reverse and become taxable to the Company in the foreseeable future. A deferred tax liability will be recognized when the Company expects that it will recover those undistributed earnings in a taxable manner, such as through receipt of dividends or sale of the investments. As of December 31, 2001, the undistributed earnings of these subsidiaries were approximately $88,000.
Paragraph 20 Illustration:

12.28 The provisions for incurred taxes on earnings for the years ended December 31 are:

	2001	**2000**
Federal	$170,000	$135,000
Foreign	40,000	15,000
	210,000	150,000
Federal income tax on net capital gains	52,000	36,000
Utilization of capital loss carry-forwards	(52,000)	(36,000)
Federal and foreign income taxes incurred	$210,000	$150,000

12.29 The tax effects of temporary differences that give rise to significant[17] portions of the deferred tax assets and deferred tax liabilities are as follows:

	Dec. 31, 2001	**Jan. 1, 2001**
Deferred tax assets:		
Discounting of unpaid losses	$30,000	$10,000
Change in unearned premium reserve	235,000	50,000
Deferred compensation	55,000	15,000
Unrealized capital losses	150,000	60,000
Net capital loss carryforward	10,000	62,000
Other	20,000	3,000
Total deferred tax assets	500,000	200,000
Nonadmitted deferred tax assets	(150,000)	(25,000)
Admitted deferred tax assets	350,000	175,000

[17] Significant defined as any amount in excess of 5% of the total applicable DTA or DTL

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	Dec. 31, 2001	Jan. 1, 2001
Deferred tax liabilities:		
Depreciation	70,000	30,000
Unrealized capital gains	120,000	60,000
Other	10,000	10,000
Total deferred tax liabilities	200,000	100,000
Net admitted deferred tax asset	$150,000	$75,000

12.30 The change in net deferred income taxes is comprised of the following (this analysis is exclusive of nonadmitted assets as the Change in Nonadmitted Assets is reported separately from the Change in Net Deferred Income Taxes in the surplus section of the Annual Statement):

	Dec. 31, 2001	Jan. 1, 2001	Change
Total deferred tax assets	$500,000	$200,000	$300,000
Total deferred tax liabilities	200,000	100,000	100,000
Net deferred tax asset (liability)	$300,000	$100,000	200,000
Tax effect of unrealized gains (losses)			(30,000)
Change in net deferred income tax			$170,000

Paragraph 21 Illustration[18]:

12.31 The provision for federal and foreign income taxes incurred is different from that which would be obtained by applying the statutory Federal income tax rate to income before income taxes. The significant items causing this difference are as follows:

	Dec. 31, 2001	Effective Tax Rate
Provision computed at statutory rate	$245,000	35.0%
Tax exempt income deduction	(102,000)	(14.6)
Dividends received deduction	(84,000)	(12.0)
Tax differentials on foreign earnings	(34,000)	(4.8)
Nondeductible goodwill	8,000	1.1
Other	7,000	1.0
Total	$40,000	5.7%
Federal and foreign income taxes incurred	$210,000	30.0%
Change in net deferred income taxes[19]	(170,000)	(24.3)
Total statutory income taxes	$40,000	5.7%

[18] This illustration includes both the rate reconciliation and the tax effected amounts although only one of these is required to be disclosed under SSAP No. 10.

[19] As reported in the surplus section of the Annual Statement. The change in net deferred income taxes is before nonadmission of any DTA. The change in nondamitted DTA is reported as together with the total change in nonadmits and presented as a separate component of surplus.

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Paragraph 22 Illustration:

12.32 The Company has net capital loss carryforwards which expire as follows: 2001 through 2005, $9,000; 2005 through 2010; $1,000.

Paragraph 23 Illustration:

12.33 The Company is included in a consolidated federal income tax return with its parent company, Alpha Corporation. The Company has a written agreement, approved by the Company's Board of Directors, which sets forth the manner in which the total combined federal income tax is allocated to each entity which is a party to the consolidation. Pursuant to this agreement, the Company has the enforceable right to recoup federal income taxes paid in prior years in the event of future net losses, which it may incur, or to recoup its net losses carried forward as an offset to future net income subject to federal income taxes.

13. Q – Are tax-planning strategies to be considered in determining admitted DTAs? [Paragraphs 10.a. and 10.b.i.]

13.1 A – An entity needs to demonstrate that it has a prudent and feasible tax-planning strategy available that, if implemented, would result in realization of DTAs within one year of the balance sheet date. While the entity is not required to implement the strategy within the 12 month period, it must have the ability to implement such strategy within such time period. Additionally, the entity must demonstrate that while it ordinarily might not take such actions, elections, etc., it would do so to prevent an operating loss, tax credit carryforward or other similar item from expiring unused. In such circumstances an entity may recognize, as admitted assets, the related DTAs that are realizable as a result of the available tax-planning strategy in accordance with paragraphs 10.a. and 10.b.i. of SSAP No. 10. Using tax-planning strategies in determining the admissible DTA is analogous to the use of tax-planning strategies in determining the amount of valuation allowance required under FAS 109, as outlined in Paragraph 22 of FAS 109, which states:

> 22. In some circumstances, there are actions (including elections for tax purposes) that (a) are prudent and feasible, (b) an enterprise ordinarily might not take, but would take to prevent an operating loss or tax credit carryforward from expiring unused, and (c) would result in realization of deferred tax assets. This Statement refers to those actions as tax-planning strategies. An enterprise shall consider tax-planning strategies in determining the amount of valuation allowance required. Significant expenses to implement a tax-planning strategy or any significant losses that would be recognized if that strategy were implemented (net of any recognizable tax benefits associated with those expenses or losses) shall be included in the valuation allowance.

13.2 Paragraph 248 of FAS 109 additionally states that:

> 248. Tax-planning strategies also may shift the estimated pattern and timing of future reversals of temporary differences…. A tax-planning strategy to accelerate the reversal of deductible temporary differences in time to offset taxable income that is expected in an early future year might be the only means to realize a tax benefit for those deductible temporary differences if they otherwise would reverse and provide no tax benefit in some later future year(s).

13.3 The requirement in Paragraph 10.a. and 10.b.i. of SSAP No. 10 to consider only those DTAs that reverse or are realized within one year of the balance sheet date causes those DTAs which would otherwise reverse beyond one year of the balance sheet date to potentially provide no tax benefit (unless admitted under Paragraph 10.c.). The potential reversal beyond one year of the balance sheet date is comparable to an expiring net operating loss, in that the deduction would not provide a tax benefit under SSAP No. 10. Thus, to the extent prudent and feasible tax-planning strategies exist to accelerate the

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reversal or realization of these DTAs, these strategies are comparable to those contemplated in Paragraph 248 of FAS 109 above.

13.4 It should be noted that if a tax planning strategy is used to accelerate the reversal or realization of an item, any potential costs associated with the implementation of the strategy should reduce the admitted DTA.

13.5 An example of a prudent and feasible tax-planning strategy is as follows:

13.6 Company A, a property/casualty insurance company for federal income tax purposes, has paid federal income taxes of $500,000 in each of calendar years 2000 and 2001. It has capital and surplus for purposes of Paragraph 10.b.ii. of SSAP No. 10 of $20,000,000. Company A has an obligation to provide post-retirement health benefits to its employees. At December 31, 2001, Company A has included a liability for $1,000,000 on its statutory-basis financial statements for post-retirement health benefits. This liability is not deductible for federal income tax purposes, and only $50,000 reverses within the next calendar year. This is Company A's only DTA under SSAP No. 10, and there are no DTLs. Company A, absent any tax-planning strategies, would compute a DTA of $350,000 ($1,000,000 times 35%), and would admit $17,500 ($50,000 times 35%) under Paragraph 10.a., and has no additional admitted DTA under Paragraph 10.b.

13.7 Company A could implement a welfare benefit fund for tax purposes, and contribute assets to the fund to cover qualifying welfare benefits. The contribution, subject to limitations, would be deductible for federal income tax purposes, and would have the effect of accelerating the deduction for Company A's post-retirement health benefits. Company A has computed that $300,000 could be contributed to the welfare benefit fund, and to implement this strategy, it would cost $15,000 on an after-tax basis. Company A management believe that this strategy is prudent and feasible, and the Company would be able to implement this strategy if necessary. Company A would be able to admit an additional $90,000 of DTAs ($300,000 times 35%, or $105,000, less $15,000 in costs) under Paragraph 10.a. with no additional admitted DTA under Paragraph 10.b.

13.8 A tax-planning strategy would not be considered prudent or feasible if use of the strategy would be inconsistent with assumptions inherent in statutory or other accounting basis financial statements. For instance, a tax-planning strategy to sell securities identified as "held to maturity" for GAAP-basis financial statements at a loss would not be prudent or feasible. Additionally, if a potential tax planning strategy were to involve selling debt securities at a loss, it would not be prudent or feasible if the securities had not been identified as impaired and the loss recognized for statutory-basis financial statements. Additionally, a tax-planning strategy that could not be implemented within twelve months of the balance sheet date or is inconsistent with management's business plan objectives, would not be prudent and/or feasible.

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