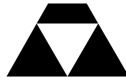

AMERICAN ACADEMY *of* ACTUARIES

Report on Federal Income Taxes by the American Academy of Actuaries' Life-Risk Based Capital's Codification Subgroup

Presented to the National Association of Insurance Commissioners' Life Risk-Based Capital Working Group
September 2000 – Dallas, Texas

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Preamble

Recognition of deferred taxes is probably the biggest single change in codification that affects risk-based capital and (possibly) total adjusted capital. Taxes have also been the most significant issue in reviewing how RBC should change as a result of codification. Other changes may also be recommended as a result of this tax review. The Academy's Life Risk-Based Capital Task Force and, primarily, the Codification Subgroup spent considerable time discussing the impact that this change may have and the best way to reflect it in regards to taxes. These recommendations (summarized in Attachment 1) are limited to the RBC tax structure. The tax rate(s) recommendation will be part of the factor recommendations in December (or, at the latest, in March).

Codification did not change the current recognition of the company's current tax liabilities. It did, as previously noted, make a significant change in recognizing deferred taxes for the first time. All deferred tax liabilities are fully recognized. Recognition of deferred tax assets is potentially limited by nonadmitting any excess over proscribed amounts as established by various criteria. See Attachment 2 (SSAP # 10) and Attachment 3 for a more complete description.

These discussions began with an attempt to develop a common understanding of the codification treatment of deferred taxes among the regulators and the Task Force. We reviewed the tax recognition in the current factors (see Attachment 3) and found that the treatment varied but tended to be full recognition of taxes for income items such as mortality claims and partial recognition (50%) on fixed income investments (such as bond defaults) and no recognition for capital losses on some equities such as common stock. For others, where the factors were based on judgment the tax basis is unknown. In some cases, the documentation was unclear.

Discussions with Academy Task Forces working on Property/Casualty and Health RBC formulas suggested that their factors also had varying degrees of tax recognition. These results led to our first two recommendations, that (1) there should be consistency within our formula and (2) where possible, there should be consistency among the RBC formulas.

To improve consistency and to reflect all potential relevant tax rates, we also recommend direct reflection of capital gain/loss risk items separately from other income type risk items. This recommendation is generally consistent with what is done for each factor currently, where taxes are reflected. All this change would do is to maintain separate recognition of these items.

We are recommending pretax factors with a tax adjustment to total income risk items and total capital risk items before covariance. This change in structure will permit simple and fewer changes in the future if either the corporate income or capital gain/loss tax rate were to change. The calculation must be done before covariance if these two tax rates were to differ. Currently they are the same. The ultimate RBC results should be the same as those using after tax results for each RBC risk factor.

Recognition of deferred tax assets (DTAs) and liabilities (DTL) is recommended. No risk-based capital charge factor applied to DTA or DTL is recommended. We do not feel that any RBC charge is needed for the risk that DTAs are overstated in part because there are already rules for nonadmitting portions of the DTAs. As to DTLS there is no need for a factor since there is little risk these will be understated. Obviously at this time even if one were to conclude a factor may be desirable, there is no experience with actual versus expected values to determine a possible RBC factor to reflect any such possible variations.

As to total adjusted capital recognition, we do not believe there is any reason to treat these new items any differently than any other total adjusted capital changes that result from codification.

Although there was some interest in reflecting individual company tax situations, after discussion our recommendation is to not do so. This recommendation is consistent with most of the RBC factor development, although there are exceptions such as the mortgage experience adjustment factor or the new C-3 requirements. The task force prefers and recommends using industry wide factors.

Individual company circumstances can, and should be, recognized by regulators if the sensitivity test we are recommending identifies the company as potentially weakly capitalized. The sensitivity test we are recommending in effect assumes no taxes and no DTAs or DTLs. As part of any review of these potentially weakly capitalized companies (or others separately identified), the regulator or the company can reflect the tax impact of consolidation, individual tax sharing agreements, tax carrybacks and forwards, holding company structures and many other important tax considerations that by their very nature would complicate the general RBC formula.

This recommended test will provide the regulator a quick idea of the maximum effect of taxes on potentially weakly capitalized companies or those that could become so if the tax effect were to be inappropriate in their situation.

Attachment 4 summarizes the historical taxes paid by companies just before haven been taken over. Attachment 5 summarizes the tax payments of companies for selected RBC levels. The complete listing is available electronically as it runs over 40 pages. We assumed that companies with negative taxes were either taxpayers in recent years or had other affiliated companies with a consolidated return that used the losses.

NOTE: Throughout this tax analysis, our emphasis has been that the RBC structure is designed to be indicative of potentially weakly capitalized companies. If the formal works well, corrective actions will be taken and the company will not be taken over.

Additional work to support these recommendations will be presented at the meeting.

ATTACHMENTS

1. Summary of Codification Recommendations Life/Health RBC Federal Income Tax Structure.

2. SSAP #10 Recommendations made on March 14, 2000.

3. Summary of Current RBC Tax Treatment of Various Components.

   The tax treatment for the RBC factors varies as shown on the chart. For some factors the documentation of tax recognition-is spelled out. For others, especially where judgment is involved, it isn't as clear or unknown.

4. Summary of Tax Status of Selected Companies That Were Taken Over in Last 10 Years Due to Insolvency.

5. Tax Status Summary of Low RBC Life Insurance Companies.

Attachment 1

SUMMARY OF CODIFICATION RECOMMENDATIONS
LIFE/HEALTH RBC FEDERAL INCOME TAX STRUCTURE

ISSUES	RECOMMENDATIONS
1. Consistency of treatment within Life/Health formula.	1. Recommend all factors are developed on a consistent basis.
2. Consistency of treatment with P/C and HORBC formulas	2. Recommend consistency.
3. Separate the RBC ordinary income and capital gain/loss events.	3. Recommend a structure that permits the potential for using different tax rates for ordinary income and capital gain/loss items.
4. Calculate factors, pre or post-tax.	4. Recommend calculating all RBC factors on a pre tax basis and then adjust the total RBC before covariance for taxes. *NOTES: A) The final RBC for the company is identical whether calculated with after tax factors or if the aggregate RBC (total RBC before covariance) is tax adjusted. B) It must be done before covariance if the aggregate RBC consists of a total of taxable income items and a total of taxable capital gains items. C) The pre tax recommendation makes it easier to make future adjustments if the tax rates are changed.*
5. Recognize Deferred Tax Assets (DTA) and Deferred Tax Liabilities (DTL) as part of Total Adjusted Capital.	5. Recommend to recognize both DTAs and DTLs in determining Total Adjusted Capital. Same approach for all other changes resulting from codification.
6. Tax Rate.	6. No recommendation at this time. Alternatives: _ Use full corporate tax rate. _ Use full corporate rate for taxable ordinary income items and some lessor rate (between 17-_% and 35%) for taxable capital gain/loss items. _ Use a rate less than full corporate rate for both taxable income and taxable capital items. *NOTES: Option 1 is usually used for tax analysis. For Option 2, C-2 items will be taxed as income items; C-1 items taxed as capital gain/loss and the tax rate used would be less than the full corporate rate (portion is tax deferred events that are not immediately recognized in the tax return). For Option 3, see discussion in appendices of slow bleed (Attachment 5) vs. sudden death companies (Attachment 4). The sensitivity test (recommendation #8) must also be considered.*

7. Adjust factor for individual company tax circumstances?	7. Not recommended. This recommendation to use industry wide tax rates is consistent with the development of most of the rest of the RBC factors – that is, most of the factors generally are based on broad industry or investment averages – not company specific experience.
8. Add Tax Sensitivity Test?	8. Recommend. Taxes on individual company basis involve many other considerations, that only need to be dealt with if the company is (or becomes) weakly capitalized. This sensitivity test will show the results for pre- tax RBC and pre-tax Total Adjusted Capital. It will assume the company is not a taxpayer, that its losses are of no value to another taxpayer, and that its DTAs and DTLs are zero. This test will alert regulators to companies that may require further review.

ATTACHMENT 2

INCOME TAXES

SSAP #	Accounting Change Change RBC	Recommendation e.g., change structure, change factor	Possible Impact (cannot do at this time)
10	<u>Current</u> income tax expense is generally consistent with precodification. <u>Deferred</u> tax expense or credit is recognized as a component of surplus. Deferred taxes are computed on temporary differences including unrealized gains or losses and non-admitted assets (exclude AVR, IMR or Schedule F penalties). Gross deferred tax liabilities (DTL) are recognized. Gross deferred tax assets (DTA) are admitted equal to the sum of: (1) FIT paid in prior years that can be recovered through loss carry backs for temporary differences that reverse by end of subsequent calendar year. (2) Lessor of: a) amount of gross DTAs after application of above, expected to be realized within one year of balance sheet date; or b) 10% of statutory capital and surplus for prior year excluding net DTAs, EDP equipment/software and positive good will. (3) Amount of gross DTAs after application of (1) and (2) above that can be offset against existing gross DTLs.	No change to current tax expense. Change all RBC factors to appropriately reflect deferred taxes. Note the current factors reflect no tax for common stock gains (losses) and partially recognize taxes for assumed realized losses on other investments. Recognize other statutory and tax differences (such as deferred acquisition expenses or reserves) in DTA and total adjusted capital.	None for current tax expenses. Deferred tax recognition could have significant impact on changes in value of common stock - less affect on losses on bonds, mortgages, real estate, and other assets.

<u>Basis for Recommendation</u>

Recognition of deferred taxes will (1) affect total adjusted capital by the difference, if any, of DTAs and DTLs (which recognize differences in statutory and tax accounting), and will (2) affect risk based capital - either directly in each factor or indirectly as an aggregate adjustment to pre-tax RBC. In either case, the affect will be quite significant especially for common stock. All future losses, whether realized or not, will, if admitted, (see DTA rules) reduce taxes - currently only projected realized losses have been tax adjusted.

Note: This SSAP introduces other changes that may affect surplus. For example, if there is an unfavorable audit adjustment for a temporary item, such as for a reserve, the adjustment will increase the current <u>operating</u> statement tax expense. The offsetting effect or deferred tax expense will be made directly to surplus. A favorable adjustment has the opposite effect.

<u>Questions</u>
None.

American Academy of Actuaries, February 28, 2000

Attachment 3

Current RBC Factor Tax Assumptions - August 31, 2000

Factor	Tax Assumption	Comments
C-0:		
Affiliated Domestic Life Insurers	Various	The RBC of the affiliated insurer is used. The tax assumptions in the RBC formula vary, as can be seen in the rest of this document.
Affiliated Domestic P&C and MCO Insurers	Various	The RBC of the affiliated insurer is used. (This hasn't been true for MCOs in the past, but will be true in the Life RBC formula in the near future.) The tax assumptions for the various factors in the P&C and MCO formulas vary.
Affiliated Canadian Insurers	???	Attempting to determine.
Affiliated Alien (not Canada) Insurers	???	The factor (100%) was based on judgment, so it is unclear what tax assumption was made.
C-1:		
Bonds	17%	Except that Risk Premium had a 0% tax assumption.
In Good Standing Mortgages	17%	Except that Risk Premium had a 0% tax assumption.
Impaired Mortgages	17%	Includes 90 Days Overdue & In Process of Foreclosure
Unaffiliated Preferred Stock	17%	Except that Risk Premium had a 0% tax assumption.
Unaffiliated Common Stock	0%	30% factor was based on pre-tax losses.
Affiliated Preferred and Common Stock	0%	Same analysis as unaffiliated common stock.
Affiliated Investment Subsidiaries	Various	Same analysis as Affiliated Domestic Life Insurers (above in C-0).
Non-Indexed MV Separate Accounts and Synthetic GICs	Various	Reserve Margins are pre-tax (0%), other factors are C-1 and C-3 documented elsewhere in this document.
Real Estate	34%	This includes home office, investment, foreclosed, and BA
Reinsurance	17%	The 0.5% factor was set assuming the risk was between that of a class 1 or 2 bond.
C-2:		
Health other than below	35%	The process provided for tax recoveries to offset current losses, plus tax carryforward calculations all based on the single type of health coverage.
DI & Other Health	???	This includes Stop Loss, Minimum Premium, and LTC. The factors were set based on judgment, so it is unclear what tax assumption was made.
Claim Reserves	???	Taxes were not considered in setting the 5% RBC factor.
Life (Mortality)	34%	
C-3:		
New Cash Flow Based Process	35%	Applies to companies who fail exemption tests.
Low Risk	0%	The factor is .5% which was derived as a 4% change in interest rates and a .125 year mismatch.
Medium and High Risk	17%	The factors were derived as the low risk .5% plus an increment. The increments were tax adjusted using the same assumption as bonds.
C-4:	???	Taxes were considered. However, the imprecision of this factor

		determination overwhelms any tax adjustments that vary by C-4 event.

This list was compiled based on input from: Bob Brown, Dennis Lauzon, Mark Rowley, Jim Reiskytl, Jim Tolliver, Bill Weller, and Mike Zurcher.

Attachment 4

Attachment 5

Tax Status Summary of Low RBC Life Insurance Companies

Comment

The 1999 tax statuses for all life insurance companies were compiled and reviewed after ranking the companies by their RBC ratio. This study is available electronically but isn't reproduced here because of its length. After reviewing it while recognizing this is only one year of data, two noteworthy observations were made:

First, "slow bleed" companies -- those defined to be companies that have low RBC to Total Adjusted Capital yet continue to be active -- appear to be primarily health companies that may have many other problems other than taxes.

Second, based on 1999 data, nearly 50% of those companies under 125%, paid zero taxes. About 20% of the companies with RBC ratios between 125% and 200%, paid zero taxes, while 13% of companies with RBC ration in excess of 200%, paid no taxes. This pattern is one that might be anticipated and suggests that as companies move from higher RBC ratios to lower RBC ratios, they are less likely to be in a tax paying status.

The following table shows the number of companies paying zero taxes, those with negative taxes and those with positive paid taxes. Those with negative taxes presumably have either been taxpayers in past years (the company is carrying the tax back to offset prior year gains) or can offset current losses in a consolidated return with other taxpayers in the family.

1999 Annual Statement Cash Taxes Paid

Number of Companies

RBC Ratio	No Taxes	Neg. Taxes	Pos. Taxes	Total	Percent Paying No Taxes
<125	13	6	8	27	48%
125-150	2	13	10	25	8%
150-175	9	10	11	30	30%
175-200	6	14	16	36	17%
200+	112	135	617	865	13%

Summary of Tax Status of Selected Companies That Were Taken Over in the Last 10 Years Due to Insolvency

Comment

The following study of selected failed companies suggests that they were "normal" tax payers prior to the adverse event. These are not "slow bleed" but "catastrophe" situations. As such it would seem to be inappropriate to use a lower tax adjustment in RBC because of this type of failure.

Company	Change	Year of Change	Year	FIT, incurred (excluding Cap Gains Tax)	Capital Gains Tax	FIT, paid
Conn. Mutual	Merge w/ Mass Mutual	1996	1995	48,059,000	2,394,032	(7,323,700)
			1994	242,010,265	(9,503,774)	(6,539,493)
			1993	47,402,000	12,684,117	71,774,203
New England	Merged w/ Metropolitan	1996	1995	12,872,838	13,044,170	50,411,443
			1994	15,724,866	20,314,753	(4,086,760)
			1993	33,562,120	5,271,424	0
General American	Converted to stock	1999	1999	21,151,872	(11,985,385)	50,147,396
			1998	7,047,628	9,839,076	22,797,902
			1997	21,952,416	13,241,019	50,112,165
			1996	14,026,809	7,444,925	7,547,889
			1995	8,576,542	94,118,073	96,814,050
Confederation Life & Ann		1994	1993	(529,037)	6,352	1,460,208
			1992	1,262,236	0	681,882
			1991	1,196,626	0	(679,261)
			1990	224,225	0	48,199
First Capital		1991	1992	1,092,478	0	(2,000,000)
			1991	(17,726,419)	0	(1,319,937)
			1990	8,206,000	133,000	16,367,000
			1989	10,870,000	6,175,974	6,521,442
			1988	13,890,369	12,251,641	7,380,843
National Heritage		1995	1993	(1,110,398)	506,407	0
			1992	595,742	27,966	1,702,332
			1991	863,506	0	10,771
			1990	(7,138)	0	(7,138)
			1989	7,138	0	7,138
Summit National		1994	1993	0	0	0
			1992	(2,377)	0	(2,377)
			1991	0	0	0
			1990	0	0	0
			1989	0	0	0

Attachment 4

Company	Change	Year of Change		FIT, incurred (excluding Cap Gains Tax)	Capital Gains Tax	FIT, paid
Executive Life			1990	74,065,000	(74,576,000)	122,094,594
			1989	4,219,969	19,956,000	(68,584,132)
			1988	6,076,000	0	4,800,000
				FIT, incurred (excluding Cap Gains Tax)	Capital Gains Tax	FIT, paid
Mutual Benefit		1991	1990	29,932,082	9,386,064	(7,581,878)
			1989	1,408,294	6,681,938	5,922,580
			1988	3,635,684	7,710,255	8,491,594