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Michael L. Balint



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# ACCOUNTING, FINANCIAL REPORTING, AND TAX CONSIDERATIONS FOR A CAPTIVE LIFE INSURER

*by Michael L. Balint*
*Partner, Los Angeles Office*

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During recent years, some interesting trends have developed in regard to the operation of insurance companies in the general economic environment. Foremost, at least from the standpoint of the volume of publicity, is the formation of holding company complexes by insurance interests to diversify their permitted scope of activities through noninsurance affiliates. Another trend is the acquisition or formation of insurers by noninsurance corporations. An example is the ownership of life and disability insurers by companies engaged in the sale of equity funding programs or in the consumer finance business.

Still another trend, if it may be considered one at this time, relates to the organizing of "so-called" captive insurance companies, particularly in the property and casualty field. The "so-called" is used advisedly since definitions of a captive range from any controlled insurance subsidiary to a controlled insurer that handles only the risks of a noninsurance parent and its affiliates. There are, of course, a variety of situations, including one in which a prominent company commenced operations by insuring the group benefit program for its own employees as a base for expansion into the insuring of outside risks.

## BASIC ASSUMPTIONS

In order to develop a framework for discussion, it will be necessary to agree on the following basic assumptions:

(1) The motivation for insuring through a captive has been explored, and it has been decided that a controlled operating subsidiary rather than a passive reinsuring entity will be the insuring vehicle; (2) captive will commence operations by insuring the life and accident and health benefit program of employees of the noninsurance parent and its other affiliates (possibly this source and the nature and characteristics of parent's business operations will be used to develop leads for insurance offerings to the general

public); (3) captive has complied with the capital and other legal requirements of its domiciliary state incident to obtaining a certificate of authority to transact insurance business.

Attention can now be focused on the specialized financial areas of the insurance industry pertaining to the captive life and accident and health insurer and, in some degree, to the parent company. Specifically, statutory accounting and reporting practices, other financial reporting considerations, and tax matters will be covered. In order to present important highlights of each of these areas, undue technicalities will be avoided.

## STATUTORY REPORTING AND ACCOUNTING PRACTICES

The insurance industry is regulated by the various states through a large body of laws administered by insurance departments. Insurance authorities are primarily concerned with the protection of policyholders and, consequently, the ability of insurers to meet obligations under contracts issued by them. In view of that responsibility and as a part of the regulatory environment, insurance companies must file in prescribed form an Annual Statement (referred to as the convention blank) with state insurance departments. The Annual Statement is filed on a calendar-year basis, but in some cases interim reporting is required. Although variations exist among states in regard to minimum capital and surplus requirements, investment restrictions and limitations, and other insurance practices, there is a generally uniform Annual Statement format. This condition results from the activities of the National Association of Insurance Commissioners, which organization comprises the Insurance Commissioners of the various states. The Annual Statement includes accrual-basis financial statements together with numerous schedules and exhibits displaying financial position, operating results, and other financial data in considerable detail.

The financial statements and related financial data contained in the Annual Statement are prepared in conformity with accounting practices prescribed or permitted by insurance regulatory authorities. These practices embody accounting and reporting characteristics unique to the insurance industry and varying in some respects from generally accepted accounting principles. The implications of these differences relative to the financial reporting of the noninsurance parent will be commented on later. Also, the mechanics of recording accounting transactions that have evolved within the industry differ significantly from the accounting process found in other commercial enterprises. This aspect, which will be described first, transcends such matters as the establishment of premium billing procedures, claims registers, and reserve valuation records, inherent features of the data processing system of an insurer.

It is customary for insurers to maintain their general ledger on essentially a cash basis of accounting. The reasons usually stated for this practice are that the daily business of insurance is carried out on a cash basis and, further, certain details in the Annual Statement exhibits and schedules are presented on a cash basis. Under this method of accounting, cash balances and other assets, such as securities, mortgage loans, and policy loans acquired through the disbursement of cash, are recorded in the general ledger together with generally minor liabilities, such as payroll deductions and unallocated collections arising directly from cash transactions. These items are referred to as ledger assets and liabilities. With few exceptions, the general ledger revenue and expense accounts will reflect the direct results of cash collections and disbursements.

In the insurance business, as in other commercial enterprises, cash transactions disclose only a part of the total financial picture. There will be many outstanding transactions that have not triggered a cash entry and, therefore, are not recorded in the general ledger, but have an important effect on an insurer's statutory financial position and operating results. Examples of these transactions are receivables related to premium billings, accrued interest on investments, payables related to claims and vendors' invoices that have not been processed through the payment cycle, and accrued policy reserves, which are usually the most significant liability of an insurer. Also, for statutory reporting purposes, unrealized appreciation applicable to certain investments is recognized by increasing carrying values from cost to market. The foregoing and other items of a similar nature are known as nonledger assets and liabilities and are controlled outside the general ledger through subsidiary records and inventory listings.

As the first step in developing accrual-basis financial data, worksheets are prepared to record the cash-basis ledger assets and liabilities (recorded in the general ledger) and the nonledger assets and liabilities (recorded in subsidiary records and listings) together with operating accounts.

Consideration must next be given to other statutory accounting and reporting practices affecting the presentation of financial data in the Annual Statement. Broadly speaking, this aspect relates to valuation matters, a topic briefly alluded to in connection with unrealized appreciation. Certain assets recorded in the general ledger, such as advances to agents (debit balances) and furniture and equipment, are deemed to have no asset value for statutory financial reporting purposes. Such items are designated as nonadmitted assets, excluded from the balance sheet, and accounted for as a direct reduction of the insurer's surplus. Investments in bonds, stocks, and various types of loans (mortgage, policy, collateral, etc.) must be stated in the insurer's financial statements on the basis prescribed by the National Association of Insurance Commissioners or the pertinent sections of the state insurance laws. To the extent that recorded ledger or nonledger amounts exceed the prescribed valuation amounts, the differences are excluded from balance sheet assets and accounted for as unrealized losses or nonadmitted assets that reduce the insurer's surplus. Upon completion of the just-described process, the Annual Statement can be prepared and filed with the appropriate state insurance departments.

The preceding comments were designed to illustrate statutory accounting and reporting. It should, of course, be recognized that there are many underlying technical complexities that must be dealt with in actual practice.

## OTHER FINANCIAL REPORTING CONSIDERATIONS

In addition to the separate entity reports filed with insurance regulatory authorities, the captive insurer's assets, liabilities and operations must be accounted for in the published financial reports of the noninsurance parent and its other affiliates. On the basis of the attendant circumstances, captive may be included on a fully consolidated basis in the financial statements of the parent group of companies or may be presented as an unconsolidated subsidiary accounted for under the equity method of accounting. In the latter case, parent's investment should be adjusted for captive's undistributed earnings and losses since formation or acquisition, and those amounts should generally be shown as a separate item in parent's income statement. Further, if the assets, liabilities, and operating results of the unconsolidated captive are material in relation to the consolidated financial position or operating results of the parent group of companies, summarized financial information or separate financial statements should be presented for captive.

Since captive has been specified to be a controlled subsidiary, the previously mentioned attendant circumstances considered in selecting the most meaningful financial presentation would relate primarily to captive's materiality and the heterogeneity of the affiliated group's operations. There are many examples of both full consolidation and the equity method of reporting with respect to insurance company subsidiaries in the published financial reports of noninsurance corporations.

Most likely, parent will be subject to annual and periodic reporting requirements under the Securities Acts administered by the Securities and Exchange Commission. In this regard, there are special rules relating to the consolidation of insurance subsidiaries, and Article 7A of Regulation S-X prescribes the form and content of the insurer's financial statements.

The financial results of controlled insurers have been generally included in parent company financial statements on the basis of statutory accounting practices which, as previously mentioned, differ in some respects from generally accepted accounting principles followed by other commercial enterprises. For a number of years, professional and industry groups have been concerned with identifying and resolving the major issues giving rise to such differences. Recommendations which would eliminate their effects from financial reports issued to persons other than insurance regulatory authorities are currently under consideration by various interested parties.

One significant reason for the concern with fundamental issues is that difficulties are encountered in evaluating the impact on earnings of certain conservative statutory accounting practices that may not properly match revenues and expenses in appropriate time periods. For example, premiums are often received on policies covering a number of years; however, the costs of acquiring and issuing policies, such as high first-year commissions, medical and inspection report fees, and underwriting department expenses are charged against first-year premiums. Those charges together with policy-reserve requirements may, and often do, exceed the related first-year premiums. Accordingly, reported earnings are depressed or, perhaps, losses are incurred in periods of increasing production. Various rule-of-thumb formulas have been used to eliminate from life insurance company reported earnings the effects of immediate expensing of acquisition costs and other statutory accounting practices. In general, these methods and their results tend to be confusing to stockholders and are not acceptable for use in adjusting earnings for financial statement reporting purposes. From the standpoint that the basic postulates and broad principles of accounting comprehended in the term generally accepted accounting principles apply to insurance companies, independent accountants have been concerned with resolving differences in accounting issues and reporting practices because of their responsibilities under professional reporting standards.

It is against this background that the AICPA Committee on Insurance Accounting and Auditing in December 1970 issued an exposure draft on Audits of Life Insurance Companies. It is difficult to generalize, but, in substance, the audit guide acknowledges that, for the purpose of demonstrating the solvency of life insurance companies to regulatory authorities, conservative statutory accounting practices may be appropriate. The audit guide also sets forth the recommended accounting and financial reporting, in conformity with generally accepted accounting principles, for use in reports issued to stockholders and the public other than insurance regulatory authorities.

A comprehensive description of the variances between regulatory accounting and generally accepted accounting principles involves many technical issues beyond the scope of this presentation. Adjustments recommended in the audit guide to conform the two bases are as follows:

Deferral of policy acquisition costs and amortization thereof over the period in which revenue is recognized.

Calculation of policy reserves using estimates of expected mortality, interest, and withdrawal assumptions which may produce reserves that differ in amount from those reported for statutory purposes.

Recognition and reporting of deferred income taxes applicable to timing differences between amounts reported for adjusted financial statement and income tax purposes.

Restoration of nonadmitted assets, less appropriate reserves, to assets reported in the balance sheet.

Inclusion in income of realized gains and losses on sales of investments and, possibly, unrealized appreciation or depreciation on investments, as contrasted with the statutory practice of including those items in surplus.

Various other adjustments as explained in the audit guide.

As referred to earlier, these recommended adjustments would have an effect on the financial results of captive insurers included in parent company financial statements. It should be remembered that, at this time, the audit guide recommendations are in exposure draft form and are subject to change prior to formal issurance, but they do represent the trend of current thinking on this vital subject.[1]

## FEDERAL INCOME TAX MATTERS

As has been true with respect to other matters commented on, for Federal income tax purposes a captive life insurer is treated differently from most other commercial enterprises. The differences are so extensive that a separate section of the Internal Revenue Code is directed exclusively to taxation of the insurance industry. To receive the economic benefit that can be derived through operating as a life insurance company, the law requires that certain conditions be satisfied. The first essential is that the company be an insurance company, which in most instances is not a subject of controversy. An important feature is that the company must be engaged in the business of issuing life insurance or annuity contracts. Also, life insurance reserves, including reserves on noncancellable contracts of health and accident insurance, as defined in the Internal Revenue Code, must exceed 50 per cent of the company's total reserves.

A stock company meeting the requirements of the law and qualifying as a life insurance company is entitled to certain tax benefits. First, it is allowed to exclude 50 per cent of gain from operations in excess of taxable investment income from life-insurance-company taxable income. This provision recognizes the difficulties of determining taxable income in view of the long-term nature of insurance contracts. The excluded portion of gain from operations flows into a special policyholders' tax surplus account and is effectively sheltered from tax until such account exceeds a prescribed maximum or until (when and if) distributions to stockholders (other than stock dividends) are made therefrom. The financial reports of most insurers indicate that the likelihood of incurring tax on the sheltered policyholders' surplus is remote. The possibility of triggering tax thereon, however, should be kept in mind in connection with tax planning. Also, a life insurance company is afforded certain statutory deductions not available to other corporations. These are:

Small business deduction

Deduction for certain nonparticipating contracts

Deduction for certain accident and health and group life insurance contracts

The small business deduction permanently shelters income up to a

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[1] *In view of the differences of opinion that have arisen in the profession with respect to certain aspects of the December 1970 exposure draft on "Audits of Life Insurance Companies" (audit guide), the chief accountant of the Securities and Exchange Commission issued a letter on December 14, 1971 to the chairman of the AICPA Committee on Insurance Accounting and Auditing. In substance the letter states that life insurance companies that heretofore have not made adjustments from a statutory to a generally-accepted-accounting-principles basis of financial reporting in registration statements or annual reports under the various securities acts should refrain from doing so until such time as the audit guide is published in its final form.*

maximum amount of $25,000 a year. The other special deductions flow into the policyholder surplus account, thereby sheltering income equal to the amount of the deduction until the occurrence, if ever, of a taxable distribution. In addition, for purposes of the Internal Revenue Code, the captive is not considered to be a member of an affiliated group of corporations if the other members are noninsurance companies. Therefore, a complete $25,000 surtax exemption is available without penalty unless the affiliated group elects the 100-per-cent-dividend-exclusion provision of the law allowing captive to distribute earnings in the form of tax-free dividends to the parent corporation. Although life companies are taxed at usual corporate rates, the foregoing provisions can result in an effective tax rate ranging downward from usual corporate rates to 25 per cent.

A company may fail to qualify as a life insurer for federal income tax purposes if reserves applicable to certain contracts, which do not meet the test of life reserves, exceed the aforementioned 50 per cent of total reserves. In this case, it would be treated like any other corporation for tax purposes in computing income and deductions in the usual manner without the benefit of the tax shelter and special deductions available to a qualified life insurance company. In some instances, this could be the preferable treatment. If the company sustains losses in its early years, such losses may be offset against the income of the profitable members of the group in a consolidated tax return.

For tax purposes, life insurance companies are limited, generally, to the accrual method of accounting, except as otherwise permitted in the regulations, and are required to use the calendar year. In general, the accounting followed in the Annual Statement is used for tax computations. Accordingly, previous comments relative to the adjustment of statutory accounting to a generally accepted accounting principles basis should not be construed as being applicable to tax reporting.

## CONCLUSION

Captive insurers are subject to a number of factors that are considerably different from those pertaining to the noninsurance parent group of companies. To summarize, the principal differences relate to:

Mechanical aspects of recording accounting transactions

Statutory accounting and reporting practices

Adjustment of financial data from a statutory to a generally accepted accounting principles basis

Federal income taxation

Although the underlying issues are technical and complex, they are certainly within the scope of control and management by the noninsurance parent. ●