



NATIONAL ALLIANCE OF LIFE COMPANIES
An Association of Life and Health Insurance Companies

DEFERRED ACQUISITION COST (SECTION 848)

The National Alliance of Life Companies (NALC) is a national trade association of more than 250 life and health insurance companies which do business in all 50 states and the District of Columbia. Smaller insurance companies suffer under the current system of taxation; specifically, the following tax provision.

The Deferred Acquisition Cost (DAC Tax), was intended to act as a proxy for amortization of a portion of acquisition costs. Congress determined that a certain percentage of net premiums must be amortized for either 60 or 120 months, depending on the size of the company. This differs greatly from the method of accounting utilized by state regulators, which requires accounting on a modified cash basis. Statutory accounting is a modified cash basis of accounting. Expenses are written off when paid, whether the asset is admitted or not. For instance, computer software is an example of a non-admitted asset in most states.

The DAC Tax does not allow insurers to deduct expenses incurred in putting business on the books, even though the expenses are actual. These expenses often exceed the premiums paid in the early years of a policy. Therefore, insurers are taxed on the premiums paid before any profits are made. This is a phantom tax on nonexistent money. The formula artificially inflates the taxable income of insurers for the current year by deferring expenses to future years. In theory, after an insurer starts to recoup the deferred expenses, a credit is issued toward the current year's tax bill, which is inflated as a result of the current year's DAC. However, the only way for the insurer to even approach break even is to stop growing. Otherwise, the dissipation of surplus restricts an insurer's ability to write new business and it reduces funds needed for product development.

The impact of this growth-inhibiting, regressive tax on smaller companies is dramatic. This tax policy has disproportionately retarded the growth of the smaller insurers. These companies have the ability and need for greater growth than the larger companies. While larger companies, which have mature surpluses, may opt for a slow growth or no-growth strategy in order to counter the effects of the DAC Tax, this option is not available to smaller companies. In fact, some small companies are paying Federal Income Tax well in excess of 100% of statutory income.

Small insurance companies have traditionally been the leaders in product innovation in the marketplace. These companies have filled the niche markets and forged new channels of distribution that larger companies have not traditionally pursued. These niche products are vital to many consumers, particularly those who can afford only modest coverages to protect their families from loss. The small insurers are traditionally family run companies which do not lay off workers to trim budgets. As small as they are, they may even be the largest employer in the town in which they are located. These smaller companies should be encouraged by Federal tax

policy to strengthen their balance sheets by the growth of their businesses, rather than being prohibited from doing so by the continued application of this regressive taxation.

The removal of the DAC Tax burden from these insurers will save jobs, and encourage real growth for the first time since the imposition of this burden. Therefore, over time, the relief would actually be revenue positive, which would have the additional benefit of saving, as well as creating jobs for Americans.