Taxation of insurance companies

Submission to Treasury

FSC FINANCIAL SERVICES COUNCIL

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About the Financial Services Council

The FSC is a leading peak body which sets mandatory Standards and develops policy for more than 100 member companies in Australia’s largest industry sector, financial services.

Our Full Members represent Australia’s retail and wholesale funds management businesses, superannuation funds, life insurers, financial advisory networks and licensed trustee companies. Our Supporting Members represent the professional services firms such as ICT, consulting, accounting, legal, recruitment, actuarial and research houses.

The financial services industry is responsible for investing almost $3 trillion on behalf of more than 14.8 million Australians. The pool of funds under management is larger than Australia’s GDP and the capitalisation of the Australian Securities Exchange, and is the fourth largest pool of managed funds in the world.

Introduction

The FSC welcomes the opportunity to provide a submission on insurance taxation and the interaction with the new insurance accounting standard, Australian Accounting Standards Board (**AASB**) standard 17, which adopts IFRS 17 as issued by the International Accounting Standards Board (**IASB**).

We commend Treasury for engaging widely across different stakeholder groups, including the Australian Prudential Regulation Authority (**APRA**), the Australian Taxation Office (**ATO**), the AASB, industry bodies and companies. We understand that the consultation paper issued on 5 November 2018 represents one part of consultation as mandatory adoption of AASB 17 approaches and APRA determines its prudential approach. We recommend that Treasury continues to adopt a coordinated approach across these groups to ensure any reforms are coherent, consistent across insurance sectors and achieve simplicity benefits to the maximum extent possible.

General comments

Deferral of IFRS 17 and status of APRA's review

As a preliminary matter, we note that the IASB tentatively decided on 14 November 2018 to defer by one year the mandatory effective date of IFRS 17 for accounting years beginning on or after 1 January 2022. As a result, it is expected that the mandatory application date for AASB 17 will similarly be deferred. However, early adoption of AASB 17 is currently permitted and therefore the FSC considers consultation on the taxation impacts of the insurance accounting changes should continue.

The IASB is considering discussing stakeholder concerns and implementation challenges raised since IFRS 17 was issued, including whether there is a need to amend the Standard. The IASB's website identifies that there are 25 topics for potential changes, of which 15 were considered at its November 2018 and December 2018 meetings. We understand the remaining issues will be considered by the IASB early in 2019, following which greater clarity will be available on the likely impacts for AASB 17.[1]

APRA is also considering the implications for its prudential standards, including LPS 340 Valuation of Policy Liabilities, on which the taxation of life insurance net risk business is based under Division 320 of the *Income Tax Assessment Act 1997* **(ITAA)**. APRA has announced that its work program will span 2018 to 2021 with key milestones including:

- Q3 2019: Initial consultation on principles for aligning the prudential framework with AASB 17
- Q2 2020: Response paper on consultation on revised draft prudential standards / Quantitative impact study

[1] See: https://www.ifrs.org/news-and-events/calendar/2019/january/international-accounting-standards-board/

- Q1 2021: Release final prudential standards

Accordingly, while further changes to AASB 17 are possible and the nature of changes to APRA's prudential standards are unknown, we have based our submission on AASB 17 as currently drafted and issues that have been identified to date by the FSC's members. We look forward to discussing these with Treasury, as well as any further issues that arise once details of any changes to AASB 17 are known and as APRA releases details on its program of work.

Detailed matters addressed in this submission

The Treasury consultation paper issued on 5 November 2018 (the **Consultation Paper**) raises a series of questions on the impact of AASB 17 on individual insurance businesses, including the stage of implementation and financial impacts. The FSC is not commenting on these issues in this submission. Instead, individual members of the FSC may make their own submissions relating to the stage of implementation and financial impacts.

However, we encourage Treasury to exercise strong caution in the use of these financial impacts as recent and proposed regulatory changes have and may occur to the industry that will dramatically affect the value of commissions paid to advisers and the overall size of the industry — including the impact of the *Protecting Your Super* (**PYS**) legislation which is currently before Parliament.

The uncertainty caused by these changes is in addition to the uncertainty due to potential changes to AASB 17 itself – as noted elsewhere in this submission some of these accounting changes could have substantial tax implications.

The above points means the data provided by life insurers in response to the current consultation process should be treated with caution.

Response to questions

This submission groups the response to questions below as they relate to the same or similar matters of policy. The responses primarily relate to life insurance companies, as this is the industry segment that the FSC represents. However, we have also noted related considerations for general or health insurers.

Alignment of tax with accounting standards and alignment of risk underwriting business – Questions 1.6 and 1.9

As noted in the Consultation Paper, the taxation framework for life insurance companies in Division 320 currently links to APRA's prudential standards in a number of ways:

- The underwriting result on the net risk components of life insurance policies is taxed based on the movement in policy liabilities, as measured under LPS 340;
- Annual transfer value calculations for the complying superannuation asset pool and segregated exempt asset pool are based on policy liability values under prudential standards; and

- Tax consolidation cost resetting provisions in Part 3-90 currently adopt policy liability values under prudential standards.

It appears that the link to APRA's prudential standards exists, in part, because they are more comprehensive than the current insurance accounting standard (AASB 1038). This appears to be a consequence of history, as APRA first issued detailed prudential standards prior to the adoption of AASB 1038:

- The Life Insurance Actuarial Standards Board (now APRA) issued its first regulatory reporting standard in October 1996, being AS1.01 a precursor to LPS 340.
- AASB 1038 was issued in November 1998, effective from 31 December 1999 and contained a higher degree of detail and references to principles from regulatory reporting.

As a result, AASB 1038 both followed and is consistent with existing APRA prudential standards. However, AASB 17 changes this position as it has been issued prior to APRA revising its prudential standards and AASB 17 comprehensively addresses the measurement and disclosure of insurance contracts. Accordingly, at least part of the historic basis for life insurance taxation linking to APRA's prudential standards no longer stands.

Similarly, for general insurance the taxation regime in Division 321 reflects its historic links, as it effectively codified prior practice as outlined in Taxation Ruling IT 2663.

The introduction of a new accounting regime represents an opportunity to realign insurance taxation with accounting standards. The FSC supports the alignment of accounting with the taxation of underwriting risk business on the basis that this should provide earlier certainty to life insurance companies of the taxation consequences of the new accounting standard.

Alignment of tax and accounting for life risk underwriting business would also allow alignment between life and other types of insurance and the FSC is supportive of the potential to combine relevant aspects of Divisions 320 and 321 into a single regime for the taxation of life, general and health insurance. This position is subject to any appropriate exceptions that emerge from consultation to cater for any unique aspects of each sector.

The FSC welcomes Treasury's statement in Question 1.6 that separate arrangements will continue to be necessary for other components of life insurance business. The FSC considers the taxation of investment, complying superannuation and exempt life insurance business is well established, robust and commonly understood through the long-standing provisions in Division 320. AASB 17 represents a major transition for many life insurers and will require large and costly implementation projects, with substantial system changes. In order to minimise the impact, costs and time required to undertake transition projects for AASB 17, we recommend in principle that no changes are made to the taxation of other business.

An area potentially requiring further consideration is for policies that contain bundled risk and investment components. At present, Division 320 separately applies to the "net risk component" of such policies by taxing them on an underwriting basis, with investment components taxed on a non-risk basis (i.e. investment income less deductible expenses). Changes to accounting under AASB 17 may mean that the information needed to determine

the "net risk component" of such policies is not available or requires further actuarial work (that is not needed for accounting purposes). Accordingly, given that AASB 17 will require profit reporting on a whole of contract basis, for bundled contracts it may be sensible to align tax with accounting profit without dissecting the contract into risk and non-risk components.

This position is based on the FSC's preference for alignment between accounting, prudential and taxation of risk business in order to simplify reporting and ensure transparency. Alignment with accounting standards is a well understood concept and exists in other parts of income tax legislation (such as TOFA in Division 230). This reflects that financial statements contain appropriate integrity safeguards where they are audited and unqualified – for example subsections 230-395(2) (b) and (c) contain these requirements in order to make the reliance on financial reports election under TOFA.

Transitional impacts – Question 1.10

The Consultation Paper correctly identifies that the transition impacts of adopting AASB 17 will depend on whether the taxation of life insurance underwriting business links to prudential or accounting standards.

Any life insurers that adopt AASB 17 early, prior to clarity on changes to LPS 340, will be faced with a misalignment between the valuation of continuous disability policies for income tax purposes including deferred acquisition costs (**DAC**) and for accounting purposes (excluding DAC), with consequences including:

- Financial accounts will be prepared under AASB 17 but include current and deferred tax amounts calculated on a different basis under LPS 340 (with life insurers also needing to prepare policy valuations on different bases for financial accounting vs APRA reporting purposes) – this would mean tax balances in AASB 17 compliant accounts would be inconsistent with the basis of other parts of those financial statements; and
- The deduction of acquisition costs for income tax purposes will no longer align with the accounting treatment as policy liabilities under AASB 17 will exclude many acquisition costs but a deduction will not be available for those costs until a later time.

This issue can be overcome by aligning the taxation of life underwriting business to AASB 17, as discussed earlier. We acknowledge Treasury's concerns that that the exclusion of acquisition costs from existing policy liability values under AASB 17 will bring forward tax deductions for DAC within existing policy liabilities because Division 320 applies by reference to policy liability values (e.g. Sections 320-15(1)(h) and 320-85). We note the availability of such deductions appropriately reflects acquisition costs that have been incurred in prior periods and the effective deferral of deductions for acquisition costs by Division 320 is unusual for life insurance compared to other industries, where deductions for the costs of acquiring new business are commonly available when incurred. Given the timing of deductions for DAC are currently aligned with accounting (and prudential) treatment, changes to recognise such expenses immediately for accounting purposes would mean the existing basis for spreading DAC deductions no longer exists.

FSC members are considering how best to provide Treasury with relevant data to assess the transition impacts. We submit that flexibility is needed for dealing with this timing difference,

such as allowing a life insurance company the choice between simplicity (deducting outstanding DAC in the year of transition, which would not require further amendments to Division 320 if it is changed to align with accounting) or to phase deductions for DAC over a short period such as a 4-5 year period as this is consistent with previous transition measures for new tax regimes (e.g. 4 year spread of TOFA transition amounts on the commencement of Division 230 for pre-existing financial arrangements or the 5 year period adopted for some changes introduced by Division 320).

We understand that one of the consultation issues being considered by the IASB is whether the treatment of acquisition costs should be changed in IFRS 17. At the time of writing we became aware that the IASB expressed support for a new approach which we understand could effectively spread deductions through the recognition of an asset from that expenditure. We are monitoring these developments and recommend that any potential changes from the IASB/AASB which affect either transitional DAC or ongoing acquisition costs be incorporated into the consultation process.

Treatment of risk adjustments – Question 1.7

As detailed in the Appendix, under the current tax rules there is a fundamental difference in taxation of the underwriting activities of life insurance and general insurers, in that general insurers are allowed to include a specific risk margin in their tax deductible reserves, whereas life insurers are not allowed an equivalent deduction.

Risk adjustment should be deductible for tax purposes

As shown in the Appendix, the Risk Adjustment for general insurers is deductible for taxation purposes (and has been treated as so at least since the introduction of IT 2663, which was a response to the then new accounting standard AASB 1023). The inclusion of the "prudential margin", as it was referred to in IT 2663, was acceptable to the Commissioner of Taxation:

- in terms of judicial precedents on the deductibility of estimated claims liabilities in *RACV Insurance Pty Ltd v FC of T* 74 ATC 4169 and *Commercial Union Assurance Company of Australia Ltd v. FC of T* 77 ATC 4186 (see paras 103, and 132 to 135 of IT 2663;
- in terms of judicial precedents on the correct reflex of income (see comments in *RACV* where his Honor quotes from the decision in *C of T v Manufacturers' Mutual Insurance Ltd*).

The introduction of Division 2J and then Division 321 codified these principles.

In the same way, the majority of the Risk Adjustment in AASB 17 will merely be a component of the insurer's estimate of the costs of ultimately paying for claims under risk policies, and should therefore be deductible for tax purposes.

Specific items mentioned in Treasury paper[2]

The Treasury paper specifically mentions:

[2] Taxation of insurance companies, November 2018

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a) examples of insurance risk as including claims arising from events that have occurred by the reporting date (like a motor vehicle accident or death) or claims under insurance contracts arising from events that have not yet occurred (for example, future sickness)
b) examples of lapse risk as including the risk that the policyholder cancels the contract earlier than expected; and
c) expense risk as being the risk of unexpected increases in administrative or other costs in servicing the contract, apart from those associated with the insured event.

While some parts of these examples may not have qualified as “incurred expenses” under ordinary tax concepts, they are factors that may increase the risk of increased claims costs and therefore the risk that reserves are understated. Accordingly, FSC argues that they should be included as deductible for taxation purposes.

Further, it is expected that allowances for these specific risks should constitute a relatively small proportion of the overall Risk Adjustment. Excluding the part of the risk margin represented by these risks would create complexity, as it may be difficult to bi-furcate the overall Risk Adjustment in this way.

Risk business of life insurer should be taxed the same way as general insurers:

We have been unable to identify any policy justification for taxing the risk business of a life insurer differently to the risk business of a general insurer. In fact, the Explanatory Memorandum to the Bill that introduced Division 320 stated this was in fact the intent of the new provisions. In particular, para 5.8 of the Explanatory Memorandum (EM) to the New Business Tax System (Miscellaneous) Bill (No.2) 2000[3] stated:

> “Discrepancies in treatment between life insurance companies and other entities are removed so that:
>
> - the taxable income from the risk business of life insurance companies is calculated on the same basis as the taxable income of the risk business of general insurers …”

It therefore appears that the difference in tax treatment was unintentional.

While the divergence in treatment between life and general insurance (**GI**) risk business appears to have been a result of differences between the relevant accounting/actuarial standards, there appears to be no justification for divergence once both are governed by the same accounting standard.

Legislation should not restrict Risk Adjustment:

Under AASB 17, companies are free to set their Risk Adjustment having regard to their own evaluation of risk. As stated in the Treasury paper (at page 5, “Risk Adjustment”), this is similar to the GI Risk Adjustment.

[3] Act 89 of 2000

The ATO has long expressed concern with the ability of the GI industry to determine their Risk Adjustment, on the basis that they see this as a way for a general insurer to change the amount of tax that they pay.

However, the impact on profits of choosing a higher Risk Adjustment is far greater than any related tax benefit. This is because any tax deferred will only be 30% of the impact on profit. Therefore, despite past ATO past claims to the contrary, there is no incentive to manipulate the probability of adequacy (**POA**) to gain a tax deferral.

Further, in 2001, HIH Insurance (a GI insurer) was placed into liquidation. The company's accounts showed policy holder liabilities at only 50% POA (equivalent to the life insurance best estimate). These proved spectacularly insufficient, resulting in the HIH group being liquidated.

Post-HIH, APRA imposed a minimum 75% POA for GI companies not in runoff (99% if in runoff i.e. ceased writing new business). There have been many GI examples where the claims paid have far exceeded the reserves previously set at APRA's 75% minimum POA level, and even cases where the 99% POA has proven insufficient for companies in runoff.

Therefore, like the accounting standard, the tax legislation should not impose an artificial constraint on management's assessment of risk, and its need to reserve appropriately.

Other implications – Question 1.8

The adoption of AASB 17 and potential for alignment of underwriting results between accounting and tax also raises the opportunity to align relevant tax consolidation provisions as they relate to underwriting business.

Specifically, Sections 713-520(5) for Step 2 of an entry allocable cost amount (**ACA**) calculation and 713-580(6) for Step 4 of an exit ACA calculation require that on entry or exit from a tax consolidated group, the policy liability value used for net risk liabilities is the current termination value (CTV). Unlike the prescribed policy liability values for other types of business, the use of CTV for net risk liabilities differs to the basis of valuation used for ongoing taxation under Division 320 (broadly, the value under LPS 340, which is equal to the accounting value, refer to subsection 320-15(1)(h) and Section 320-85).

A key difference between these two values is that the CTV does not include (DAC) amounts, whereas the LPS 340 value does. As a result, the tax consolidation entry and exit provisions noted above can affect tax outcomes by increasing the entry ACA available to reset the cost base of assets and decreasing exit ACA (effectively, denying a vendor the benefit of acquisition costs it has incurred in calculating the cost base of the shares sold). As noted above, all other policy liability types use the same valuation basis between Division 320 and tax consolidation (Sections 713-520 and 713-580).

Reform of Division 320 presents an opportunity to harmonise the treatment under tax consolidation and Division 320 of net risk liabilities. Accordingly, we recommend that Treasury considers amending subsections 713-520(5) and 713-580(6) to align the policy liability values for net risk business with the values used in Division 320 (i.e. accounting values under AASB 17).

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We acknowledge that a number of tax consolidated groups contain life insurance companies where entry calculations were undertaken under existing rules and changes to the policy liability values may result in asymmetry between entry and future exit outcomes. In order to ensure symmetry of outcomes, we recommend Treasury considers a transitional approach to any changes, where life insurance companies that are currently members of tax consolidated groups should remain subject to the existing rules for exit calculations if they exit their current group in future. Any new entry events for life insurance companies can be subject to our proposed changes to align tax and accounting policy values. This transition approach is similar to the approach adopted for changes to the treatment of deductible liabilities, whereby the amounts recognised in step 4 of an exit calculation under Section 711-45 depend on the treatment of the liability on entry (*Treasury Laws Amendment (Income Tax Consolidation Integrity) Act 2018*).

Since taxpayers will have made decisions on transactions based on the current law, any change in the law relating to entry and exit should only apply to transactions agreed after the change is legislated.

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Appendix

Risk Adjustment for Non-financial risk

AASB 17 requires all types of insurers to make a Risk Adjustment for non-financial risk. The adjustment is the compensation that an entity requires for bearing the uncertainty about the amount and timing of the cash flows that arises from non-financial risk as the entity fulfils the insurance contract.

The Risk Adjustment for non-financial risks must be measured explicitly. Further, insurers will be required to disclose the confidence level to which the Risk Adjustment corresponds.

The time value of money is independent from the estimate of future cash flows, so the risk of changes in discount rates is not part of the Risk Adjustment. For example, reinvestment rates for long-term bonds to determine an appropriate discount rate for liabilities will not affect the amount of the Risk Adjustment. Further, the Risk Adjustment should not reflect the risks that do not arise from the insurance contract, such as general operational risk.

AASB 17 does not require entities to use any specific technique to estimate the Risk Adjustment. Examples of the techniques that insurers might use include confidence level, conditional tail expectation and cost of capital.

To reflect the compensation that the entity would require for bearing the non-financial risk, the Risk Adjustment for non-financial risks should have the following characteristics:

(a) risks with low frequency and high severity will result in higher Risk Adjustments for non-financial risk than risks with high frequency and low severity;

(b) for similar risks, contracts with a longer duration will result in higher Risk Adjustments for non-financial risk than contracts with a shorter duration;

(c) risks with a wider probability distribution will result in higher Risk Adjustments for non-financial risk than risks with a narrower distribution;

(d) the less known about the current estimate and its trend, the higher the Risk Adjustment for non-financial risk; and

(e) to the extent that emerging experience reduces uncertainty about the amount and timing of cash flows, Risk Adjustments for non-financial risk will decrease and vice versa.

We note that the risk adjustment is comparable with what general insurers hold as risk margins under AASB 1023. The concept is however new for life insurance companies.

Comparison with current accounting standards

Accounting standard AASB 1038 (life insurance) requires obligations arising from life insurance contracts to be recognised based on “best estimates”. So far as relevant, paragraph 8.1 of the standard provides that the liabilities be measured as:

> "(a) the net present value of future receipts from and payments to policyholders, including participating benefits, allowing for the possibility of discontinuance before the end of insurance contract periods, plus planned margins of revenues over expenses relating to services yet to be provided to policyholders, on the basis that are best estimates and using a discount rate determined in accordance with …"

AASB 1038 does not separately require a Risk Adjustment for non-financial risks.

Additionally, paragraph 8.8.1 of the standard provides that:

> "In applying paragraph 8.7, the discount rates adopted are not intended to reflect risks inherent in the liability cash flows, which might be allowed for by a reduction in the discount rate in a fair value measurement, **nor are they intended to reflect the insurance and other non-financial risks and uncertainties reflected in the life insurance liabilities**…"

Section 114 (2) of the Life Insurance Act requires that "a valuation of policy liabilities referable to a statutory fund must be made in accordance with the prudential standards". Further, paragraph 17.10 of AASB 1038 requires disclosure in notes whether an "actuary is satisfied as to the accuracy of data from which the amount of policy liabilities has been determined"

Accounting standard AASB 1023 (general insurance) specifically requires the inclusion of a risk margin in reserves. Paragraph 5.1.6 of the standard provides:

> "The outstanding claims liability includes, in addition to the central estimate of the present value of the expected future payments, a risk margin that relates to the inherent uncertainty in the central estimate of the present value of the expected future payments."

Further, at paragraph 5.1.11, the standard provides:

> "Risk margins adopted for regulatory purposes may be appropriate risk margins for the purposes of this Standard, or they may be an appropriate starting point in determining such margins."

Therefore, unlike AASB 17, the current accounting treatment for life insurers is different from that applicable to general insurers.

Current tax treatment

Deductible risk reserves for life insurers are generally based on policy liabilities calculated under the "Valuation Standard" (para 320-(1)(h); ss320-85(4) *Income Tax Assessment Act 1997 ("ITAA")*). Valuation Standard is defined as:

> "any prudential standard made under section 230A of the *Life Insurance Act 1995* that:
>
> (a) provides for a valuation of the policy liabilities mentioned in subsection 114(2) of the *Life Insurance Act 1997;* and
> (b) is in force under that Act.

The relevant prudential standard is APRA Prudential Standard LPS 340 on the Valuation of Liabilities. Broadly, under the standard, risk policy liabilities are based on “Best estimates” i.e. they are equal to the sum of the “Best Estimate Liability”, plus the “Value of Future Best Estimate Bonuses”, plus the “Value of future Best Estimate Shareholder Profits”.

LPS 340 is the codification of the relevant actuarial standard (1.04), as required by section 114 of the Life Act. Amongst other things, the standard prescribes a set of principles and associated actuarial methodology for the valuation of policy liabilities for both life insurance and investment contracts. The valuation of policy liabilities for life insurance and investment contracts are presented to generally comply with the requirements of the relevant accounting standards.

Division 321 of the ITAA, which is effectively a codification of Taxation Ruling IT 2633, contains specific rules for taxing general insurers. Neither Division 321 nor IT 2663 are specifically linked to accounting standards. However, subject to some minor exceptions (such as internal claims handling costs), the calculation of taxable income from underwriting under Division 321 is equivalent to the calculation of net underwriting income under AASB 1023.

In particular, movements in “outstanding claims” are deductible (for an increase, s321-15) or assessable (for a decrease, s321-10). The first step in determining the value of the outstanding claims is to:

> “add up the amounts that … the company determines, based on proper and reasonable estimates, to be appropriate to set aside and invest in order to meet:
>
> (a) liabilities for outstanding claims under those policies; and
> (b) direct settlement costs associated with those outstanding claims.” (s321-20)

Further, both IT 2663 and the relevant Explanatory Memorandum acknowledged the inclusion of a risk margin (see paras 132 to 135 of IT 2663, and paras 4.24 and 4.25 to the Explanatory Memorandum to Taxation Laws Amendment Bill (No.3) 2002, which introduced Division 2J of the *Income Tax Assessment Act 1936*, being the predecessor to Division 321).