



Taxation of insurance companies

Consultation paper on the tax impacts of AASB17, recognition of outstanding claims and tax provisions for health insurers

November 2018

Notes to participants

The issues canvassed in this paper are intended to facilitate consultation by Treasury and have not been endorsed by the Australian Government.

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Consultation Process

Request for feedback and comments

Interested parties are invited to comment on the issues raised in this paper.

While submissions may be lodged electronically or by post, electronic lodgement is preferred.

All information (including name and address details) contained in formal submissions will be made available to the public on the Australian Treasury website, unless it is indicated that you would like all or part of your submission to remain confidential. Automatically generated confidentiality statements in emails do not suffice for this purpose. Respondents who would like part of their submission to remain confidential should provide this information marked in a separate document.

A request made under the *Freedom of Information Act 1982* for a submission marked 'confidential' to be made available will be determined in accordance with that Act.

Closing date for submissions: 31 January, 2019

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Taxation of insurance companies

Context

Why consult on insurance taxation now?

In July 2017, the Australian Accounting Standards Board issued a new accounting standard for insurance contracts, AASB17 *Insurance Contracts* (AASB17). AASB17 adopts the new international accounting standard for insurance contracts IFRS17 issued by the International Accounting Standards Board in May 2017. AASB17 will apply for annual reporting periods beginning on or after 1 January 2021. Early adoption is permitted for entities that apply AASB9 *Financial Instruments* and AASB15 *Revenue from Contracts with Customers* on or before the date of initial application of AASB17.

AASB17 provides, for the first time, consistent accounting treatment of insurance contracts rather than having separate standards for life and general insurance contracts as was the case in the past. This will allow insurance contracts to be compared across companies, contracts and industries.

Objectives

The primary objective of this consultation is to obtain further information and data on the tax impacts of implementing AASB17 to inform the Government's consideration of whether and what changes may be needed to the tax law as a consequence.

Consideration of the tax implications of AASB17 also provides an opportunity to seek comments on two other insurance taxation issues that relate to the operation of the current provisions:

- Firstly, whether the tax law for health insurers should be codified rather than relying on the ordinary principles; and
- Secondly, whether the law should specify how to calculate outstanding claims liabilities for general insurance companies.

Further consultation will occur on the details of any change if it is determined that there is a need to amend the tax law.

We note that Australian Prudential Regulation Authority (APRA) is separately engaging with insurers on prudential impacts. We will be working with APRA and the Australian Taxation Office (ATO) to ensure that tax and prudential impacts are considered holistically.

Background

Tax treatment of insurance companies

The tax system seeks to ensure appropriate taxation outcomes for insurance companies. Broadly this means ensuring that the various income streams of insurers are taxed in a similar manner to companies earning similar income whilst taking into account the unique business models of insurance companies.

Reflecting this, and also reflecting the different business models of each sub-sector and various historical factors, life, general and health insurers are subject to different rules under Australia's income tax laws. Life and general insurers are subject to their own specific regime and the ordinary income tax rules apply to health insurers.

Life insurance companies are taxed under Division 320 of the *Income Tax Assessment Act 1997* (ITAA1997). Division 320 was introduced in 2000 as part of the then Government's response to the Ralph Business Taxation Review. It ensures that the various streams of income earned by life insurers are taxed in a comparable way to other entities with similar types of income. That is, the risk business of a life insurer is taxed on a similar basis as for general insurers; the investment business is taxed on a similar basis as other investment entities; and complying superannuation investment income is taxed like superannuation funds. Annuity investment income is exempt from tax to the extent it is attributable to policyholders, like the pension phase of a superannuation fund, with any shareholder margin being taxable. Before the introduction of Division 320, the tax regime for life insurers was very complex. Income and expenses were allocated to up to four classes of business. Each class was subject to different calculations to assemble assessable income and different tax rates also applied.

General insurance companies are taxed under Division 321 of the ITAA1997, which takes into account their business model. Broadly, the assessable income and deductions flowing from a general insurance company's underwriting results mirror its accounting income and expenses, with some timing differences. The tax provisions for general insurance companies were initially inserted in 2002 as Schedule 2J of the *Income Tax Assessment Act 1936* (ITAA1936) and codified the methodology in Taxation Ruling IT2663. This ruling outlined how outstanding claims were calculated and deducted and how premium income was returned as assessable income. While it had applied since the 1991-92 income year, a law change was required following the High Court of Australia's refusal to grant the Commissioner of Taxation special leave to appeal against the Full Federal Court's decision in the *Commissioner of Taxation v Mercantile Mutual Insurance (Workers Compensation) Ltd* and *Commissioner of Taxation v Mercantile Mutual Insurance (Australia) Ltd*. In 2010, as part of a rewrite of the income tax law, the provisions in Schedule 2J to the ITAA1936 were rewritten to Division 321 of the ITAA1997.

Health insurance can be considered a specific category of general insurance. Indeed, as noted below, both health and general insurance contracts are currently subject to the same accounting standard. The specific general insurance taxation rules of Division 321 do not however apply to health insurers, and instead ordinary principles apply in determining the taxable income of a health insurer. This is in part explained by the changing nature of the health insurance industry. The industry has historically been dominated by not for profit insurers for whom, being tax exempt, tax considerations were not an issue. Today the majority of health insurance is provided by for profit insurers.

Links between tax, accounting and prudential standards for insurers

The way these tax regimes interact with the accounting and prudential standards that apply to each insurance sub-sector is relevant for this consultation.

Currently there are specific accounting standards for life and general insurance contracts. Accounting standard AASB1023 applies to general and health insurance contracts and accounting standard AASB1038 applies to life insurance contracts.

In addition, APRA sets and enforces prudential standards for insurers. APRA has separate prudential standards and guidance relating to each sub-sector: general insurance companies, private health insurance companies and life insurance companies (including friendly societies). The same standards generally apply to reinsurers as to direct insurers.

For largely historical reasons, the accounting, tax and prudential standards in each insurance sector interact differently.

The tax regime applying to life insurance companies links to the APRA prudential valuation standard for life insurance companies. In particular, section 320-85 of the ITAA1997 relating to risk policies of life insurance companies includes a specific link to the APRA valuation standard to calculate when

income and deductions materialise. The link to the prudential standard was included because the accounting standard in place at the time Division 320 was introduced in 2000 was less comprehensive and would have resulted in deductions materialising much earlier than the associated income. The prudential valuation standard is also referenced in other parts of Division 320. This includes in section 320-190 of ITAA1997, to determine the amount of the complying superannuation liabilities of a life insurance company and in section 320-245 of ITAA1997, to determine the values of supporting assets in working out the amount of the exempt life insurance policy liabilities. Since 2000, the accounting and prudential standards applying to life insurers have evolved to be largely aligned, resulting in broad alignment between tax, accounting and prudential treatment.

The tax regime applying to general insurance companies (Division 321) does not include a specific link to the prudential standards for general insurance companies or to the accounting standard for general insurance contracts. General insurers are required to determine the value of their underwriting reserves using proper and reasonable estimates. In practice, this involves an actuarial analysis that closely follows what is required under the accounting standards. For general insurers, the risk of having deductions materialising too early is not as pronounced compared to life insurers. This is because for most classes of business, the terms of their contracts are typically much shorter. Division 321 also applies to companies that self-insure in respect of workers' compensation liabilities.

As noted earlier, health insurance contracts are taxed under the ordinary income tax provisions but are subject to the same accounting standard as general insurance contracts. Broadly, this makes the tax arrangements of health insurers similar to that for general insurers. However, some health insurers use a different basis for reporting premium income and outstanding claims for tax purposes than for accounting purposes.

1 Impact of new accounting standard for insurance contracts AASB17

Early analysis suggests that the primary impact of the new accounting standard on tax outcomes is in relation to a change in the recognition of deferred acquisition costs and the introduction of a risk adjustment for life insurers. These are discussed below. The consultation also seeks feedback on whether industry participants or interested parties have identified other potential taxation implications of adopting AASB17.

Deferred acquisition costs

Deferred acquisition cost refers to costs incurred in obtaining and recording insurance contracts which are deferred and systematically amortised to reflect the economic benefits attributed to the costs. These costs include commissions paid to agents for obtaining the business, selling and underwriting costs such as advertising and risk assessment and administrative costs of recording policy information and premium collection costs.

AASB17 changes how insurance contracts are measured and recognised and, in practice, shortens the period over which the expensing of upfront acquisition costs can be deferred to a maximum of the contract boundary of the initial contract that gave rise to the costs.

The earlier recognition of upfront-acquisition costs for accounting purposes affects profit recognition patterns. This is expected to particularly affect life insurers and to result in lower profits in earlier years and higher profits in later years for each individual contract. Having said this, general and health insurers may also be significantly affected. For example, longer term products offered by general insurers, such as lenders mortgage insurance products will be impacted and even in the case of 'one year' insurance policies, a change to immediate write off and deductibility of acquisition costs

(from the current deferral approach) could result in a bring forward of approximately six months equivalent of acquisition costs.

The change in how upfront acquisition costs are recognised is likely to be transitional in impact. For example, on the assumption that similar new policies continue to be written at a consistent rate, it is expected that there will be a one-off impact on retained earnings on transition to the new standard. On an ongoing basis, lower profits on new policies in the earlier years will be offset by higher profits in older policies which are in their later years, resulting in minimal overall impact of profit each year.

Tax impacts

Where accounting outcomes automatically flow through to tax outcomes, as is predominantly the case for general and health insurers, the expectation is that the actuarial analysis follows the requirements in the new accounting standard and that this will translate to tax outcomes. As a result, tax patterns can be expected to broadly reflect the profit recognition patterns. In the transition period, this will likely mean a smaller level of tax paid initially, with higher levels of tax collected in later years.

For life insurance companies, the change in accounting standards will not automatically translate to a change in tax outcomes. The current link in the tax law to the APRA valuation standard means that without change to one or both, after 2021, life insurers will need to keep two sets of records – one for accounting purposes and another for prudential and tax purposes. Tax payment obligations will also not align with accounting profit.

As noted earlier, Treasury is liaising with APRA as it reviews the prudential impacts of AASB17. If APRA aligns its standards to the new standard for prudential purposes, this effectively translates to adoption of AASB17 for tax purposes (noting that APRA is likely to make prudential adjustments to the accounting basis to ensure that the prudential valuation is fit for that purpose). Another option for adopting AASB17 is to change the tax law to link to the accounting standard rather than the APRA valuation standard.

The Government is seeking feedback on the estimated accounting and tax impacts of the change to how upfront acquisition costs are recognised.

If the tax impacts in the transition period are large, it may be desirable to phase these in over several years. This approach was taken in 2000 when the tax base of life insurers was broadened as part of *The New Business Tax System* reforms. The transitional tax effect of this change was spread over a five-year period.

Risk adjustment

AASB17 introduces a risk adjustment for non-financial risk. It is intended to reflect the compensation the company requires for bearing the uncertainty about the amount and timing of future cash flows that arise from non-financial risk as the entity fulfils insurance contracts. This includes insurance risks, lapse risk and expense risks. Examples of insurance risk include claims arising from events that have occurred by the reporting date (like a motor vehicle accident or death) or claims under existing contracts arising from events that have not yet occurred (for example, future sickness). Lapse risk includes the risk that the policyholder cancels the contract earlier than expected and expense risks refers to risk or unexpected increases in administrative or other costs in servicing the contract, apart from those associated with the insured event.

The risk adjustment is linked to a particular company's risk appetite and requires the company to adjust (increase) the current (present value) estimate by an amount that they determine.

The risk adjustment is relatively similar to the risk margin currently held by general insurers and health insurers under AASB1023 (see section 3). For life insurance companies however, it is a new

accounting component of liabilities. It is expected to push out the time to recognise accounting profit and pay income tax in relation to this business.

The Government is seeking feedback on how the risk adjustment for life insurers should be treated for tax purposes and whether there would be benefits in aligning the treatment across the life, general and health insurance sub-sectors. This also overlaps with questions in section 2 and 3.

Questions

Stage of implementation

- 1.1 Have you commenced an assessment of the financial implications of AASB17?
- 1.2 Have you completed your assessment of the financial implications of AASB17? If not, when do you anticipate your assessment of the financial implications of AASB17 will be complete?
- 1.3 When do you anticipate adopting the standard for the first time?

Financial impacts for accounting and tax purposes

- 1.4 What are the expected financial impacts of AASB17 in the first year of adoption (including any transitional adjustment required on implementation of AASB17) and in subsequent years? Please identify both profit and loss and balance sheet impacts and quantify the impact where possible.
- 1.5 Are the financial impacts outlined in Question 1.4 principally related to the change to the treatment of Deferred Acquisition Costs as described in this consultation paper? If not, what are the main drivers of the financial impacts?
- 1.6 Should the tax arrangements for risk underwriting business be the same for general, life and health insurers (noting that there would need to continue to be separate arrangements for the other components of life insurance business)? Why or why not?
- 1.7(a) What is the estimated impact of risk adjustment in the financial statements?
- 1.7(b) How should the risk adjustment for life insurers be treated for tax purposes? Would there be benefits in aligning the treatment across the life, general and health insurance sub-sectors?
- 1.8 Have you identified other areas where implementing AASB17 results in a change in tax treatment? If so, please describe this change, how it arises and estimate the value of the impact in the financial statements.

Linking tax to accounting standards

- 1.9(a) Is it appropriate for the tax outcomes for insurance contracts to be linked (or aligned) to accounting outcomes under AASB17? Why or why not?
- 1.9(b) What are the implications of linking the tax outcomes to AASB17?
- 1.9(c) What are the implications of **not** linking the tax outcomes to AASB17?
- 1.10 If the tax outcomes are to be aligned with AASB17, are transitional rules required and why? For example, are rules required to prevent any double deductions or non-deductions or to otherwise smooth the impact of the change?

2 Health insurers – should their tax provisions be codified?

Health insurance companies are subject to the same accounting rules as general insurers but are taxed under ordinary principles while life and general insurers are subject to specific taxing regimes. Given that general and health insurance sectors undertake a similar activity of underwriting non-life risks, it may be beneficial if there was greater consistency of tax treatment for this business activity. This would also provide health insurers with consistent and certain tax treatment of premium income, claims and liabilities.

Questions

- 2.1 Should the tax treatment of health insurers be the same as that for general insurers?
- 2.2 Are there any impacts to health insurance companies of aligning their tax treatment to that for general insurance companies (Division 321 of the ITAA1997)?
- 2.3 Are there items specific to the health insurance sector requiring consideration to implement this change?
- 2.4 Are there any other changes that should be made to better streamline or ensure consistency of the insurance tax provisions in the law?

3 Recognition of outstanding claims

The outstanding claims liability (OCL) is a provision for claims incurred on insured events that have not yet been paid. Under AASB17, the OCL is called liability for incurred claims and is a note disclosure. Examples of outstanding claims include claims from an insured event that has occurred and been reported to the insurer but has not been paid in full and claims that the insurer is liable to pay but have not yet been reported.

Currently, section 321-20 of the ITAA1997 outlines how a general insurer is to work out the value of the OCL provision. It is not explicit in how the OCL provision should be derived. In practice, the value of a general insurer's OCL is determined by management in conjunction with actuaries.

Typically, general insurers calculate the value of their OCL provision by increasing the central estimate of expected claims costs by a risk margin. It reflects that it is not practical to calculate in a strict sense the actual amount that a general insurer can expect to pay to finalise outstanding claims. There is flexibility in the tax law over what level of risk margin to apply. Most general insurers report a 75 per cent level of sufficiency for accounting and tax purposes, aligning with prudential standards, however, some larger general insurers have disclosed a level of sufficiency above 90 per cent for accounting purposes. These companies have generally aligned their tax calculations to their OCL for accounts. (A central estimate represents a 50 per cent level of sufficiency and is an amount that is as likely as not to be enough to meet claims).

The effect of specifying a higher level of sufficiency is that this defers a higher amount that the insurance company both recognises as accounting profit and pays income tax on in relation to this business. This is because a general insurance company can claim a deduction for an increase in the OCL balance in an income year and will be assessed on any reduction in the OCL balance. The OCL therefore has an impact on a general insurer's profit and consequently its income tax liability.

The absence of clear criteria in the current law may provide general insurance companies some ability to determine the levels of their OCL balance, accounting expenses and tax deductions for increases in the OCL. It may also make the law harder to administer. The ATO has also observed that often little documentation exists to support how the risk margin is determined and how extraneous factors are accounted for.

Questions

- 3.1 Should the tax laws specify clear criteria for determining the OCL? Why or why not?
- 3.2 Are there other adjustments that should be considered if clear criteria are specified?