KPMG submission

Treasury Consultation Paper

Taxation of Insurance Companies

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Executive Summary

KPMG welcomes the opportunity to respond to Treasury's discussion paper *Taxation of insurance companies* ("the Paper").

In this Executive Summary, we seek to outline our thoughts on a very complex issue concisely.

KPMG supports an approach to the taxation of insurance companies, in the context of the introduction of AASB17, that would provide certainty and consistency across the different sub-sectors of insurance business and align tax outcomes with statutory accounting outcomes.

We understand that IASB is considering possible changes to IFRS 17. In addition, the Australian Prudential Regulatory Authority ("APRA") is reviewing the interaction of prudential standards with the changes that AASB 17 is likely to bring about.

KPMG urges Treasury to continue to work with APRA such that the prudential standards for life insurance can align with the statutory accounting changes contained in the ultimate version of AASB 17. Consultation with stakeholders should continue as we see further developments from the IASB.

Comments on specific legislative points

1) If AASB 17's proposed exclusion of deferred acquisition costs ("DAC") from policy liabilities represented an impediment to alignment of the tax and accounting outcomes, then we would suggest a transitional approach for tax purposes to phase in this change.
2) We see no imperative for harmonisation of the tax rules across the life, general and health insurance sub-sectors. However if harmonisation could occur in a manner that increased simplicity and reduced compliance costs, this would be beneficial.
3) The tax law should respect the robustness of the accounting standards in terms of insurers' calculation of their risk adjustments and outstanding claim liabilities ("OCL"). The commercial disadvantages of overstating risk adjustments or OCL are significantly greater than any tax advantages that might result.

Detailed comments

1. General

1.1 KPMG welcomes the opportunity to comment on the consultation paper *Taxation of insurance companies* published by Treasury in November 2018.

1.2 KPMG supports an approach to the taxation of insurance companies, in the context of the introduction of AASB17, that would provide certainty and consistency across the different sub-sectors of insurance business and align tax outcomes with statutory accounting outcomes.

1.3 In November 2018 the International Accounting Standards Board (“IASB”) announced the likely deferral of mandatory application of IFRS 17 until accounting years commencing on or after 1 January 2022, with expected flow-on consequences for the mandatory adoption of AASB 17.

1.4 We understand that IASB is considering possible changes to IFRS 17. In addition, the Australian Prudential Regulatory Authority (“APRA”) is reviewing the interaction of prudential standards with the changes that AASB 17 is likely to bring about.

1.5 KPMG urges Treasury to continue to work with APRA such that the prudential standards for life insurance can align with the statutory accounting changes contained in the ultimate version of AASB 17. Consultation with stakeholders should continue as we see further developments from the IASB.

1.6 Questions 1.1 to 1.4 relate to the impacts on specific insurance companies, rather than the overarching policy and legislative issues, and therefore we have not addressed these four questions.

2. KPMG responses to discussion questions

Question 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 the consultation paper? If not, what are the main drivers of the financial impacts?

2.1 The change in the treatment of Deferred Acquisition Costs ("DAC") is the principal impact on life insurance companies, and is expected to be significant. The impacts for other insurance companies are expected to be modest due to the shorter terms of their contracts.

2.2 The exclusion of acquisition costs from existing policy liability values under AASB 17 would have the effect of bringing forward tax deductions for DAC to the year in which the insurer actually incurred the DAC. This is due to the fact that Division 320 refers to policy liability values (e.g. paragraph 320-15(1) (h) and section 320-85 and we have assumed that AASB 17 and APRA's Prudential Standards will align on the calculation of policy liabilities relating to DAC, noting that Division 320 currently links to LPS 340 and not accounting standard AASB 1038). We appreciate that this timing change may be of concern to Treasury.

2.3 The deductions for DAC in respect of existing policies would be appropriate in order to recognise acquisition costs that have been incurred in prior periods. The deferral of deductions for acquisition costs in the life insurance sector is unusual by comparison to other industry sectors and if acquisition costs are no longer deferred for accounting/prudential purposes there seems no particular reason why they should also be deferred for tax purposes. Ordinarily a business deducts the costs of selling new products or services in the year that it incurs those costs.

Question 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?

2.4 The current regimes for the taxation of each sub-sector are well understood by business, operate effectively and produce reasonably consistent outcomes between the sub-sectors. Consequently, there is no overriding need to merge the regimes into one. However there may be benefits in harmonising the regimes, provided it brings greater certainty and compliance simplification.

2.5 If the regimes were to be harmonised with each other, then such harmonisation should at least follow the principle of seeking to align statutory accounting and tax outcomes across the sub-sectors.

2.6 The experience with the taxation of financial arrangements ("TOFA") legislation is a good example of where alignment with accounting standards promised simplification benefits. However the legislative framework in Division 230 ITAA 97 departs from accounting standards as it imposes substantial additional tax requirements in order to address perceived integrity concerns (e.g. documentation requirements under the hedging election). Experience has demonstrated that those integrity concerns were, perhaps, overstated and the promised simplification benefits have not arisen.

2.7 Financial statements contain appropriate integrity safeguards where they are audited and unqualified – for example paragraphs 230-395(2) (b) and (c) contain these requirements in order to make the reliance on financial reports election under TOFA. Accordingly, if harmonisation occurs this should be aligned with accounting requirements, without the overlay of substantial tax requirements for integrity reasons.

Question 1.7a: 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?

2.8 Currently and in future, an insurance company's risk adjustments in its statutory accounts are subject to external audit for compliance with the accounting standards. In our experience, insurance companies do not change assumptions in their risk adjustment models in order to achieve a certain tax outcome. The robustness of audited financial accounts is recognised elsewhere in the tax legislation, as stated earlier.

2.9 Equally, whilst we are aware of potential concerns from the Australian Taxation Office ("ATO") regarding the calculation of the risk adjustment, we are not aware of the ATO taking action which has resulted in a change to an insurance company's risk adjustment on the grounds that the ATO considers the adjustment to be excessive.

2.10 A higher risk adjustment has a direct and immediate impact on accounting profit, whereas the tax benefit arising from increasing the risk adjustment is an indirect (and only 30%) impact on profit. There remains a net 70% reduction to profit from increasing the risk adjustment level, which is an important commercial disincentive for insurance companies to increase their risk adjustment for purely tax reasons.

2.11 Therefore, consistent with the principle of aligning statutory accounting and tax outcomes, it would be appropriate to ensure that the taxation rules for life insurance companies align with other insurers. Increases / decreases to the accounting liability arising under AASB17, incorporating the risk adjustment, should be deductible / assessable for income tax purposes. This could occur whether or not there is one harmonised taxation regime for all of the sub-sectors.

Question 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.

2.12 When a life insurer exits or enters a tax consolidated group, the tax consolidation provisions in Division 713 ITAA 97 calculate the entity's net risk liabilities for allocable cost amount ("ACA") purposes in a different manner to the one used in Division 320 to calculate the consolidated group's ongoing net risk liabilities for annual income tax purposes.

2.13 All other policy liability values are calculated in the same way for the purposes of Divisions 713 and 320. As part of the current review of the insurance tax provisions, we therefore recommend that Division 713 should be modified to align with Division 320 with respect to the net risk liability calculation method.

2.14 To prevent mismatches, the current Division 713 rules could continue apply to all entities on exit from a tax consolidated group which had entered the tax consolidated group since the provisions commenced and prior to the change recommended in paragraph 2.13 above.

Question 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?

2.15 This is generally an appropriate outcome and the current rules for each sub-sector broadly achieve this, with some exceptions.

2.16 A key benefit of the alignment is that companies can more easily explain their before-tax and after-tax financial positions to investors and lenders.

2.17 A drawback of not having the two things linked would be the greater complexity that would arise in interpreting the financial position of an insurance company.

2.18 The current position could be seen as a consequence of the intersecting history of the development of accounting and prudential standards, rather than deliberate tax policy. Life insurance tax rules follow the prudential standards, which came into force before the current accounting standard.

2.19 However the tax rules for general insurers have fallen broadly into line with accounting standards. The notable exception to this relates to indirect costs of claim settlement, which the industry accepted through the process of development of taxation ruling IT 2663 (on which Division 321 is now based).

2.20 It would be sensible to have alignment of the tax rules for calculating underwriting profit with those for accounting (but not for other life insurance business such as investment, superannuation, etc). This is subject to our abovementioned caveat that the robustness of audited financial accounts should be respected and additional tax integrity requirements should not be imposed lest they override the simplification benefits.

Question 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?

2.21 It may be reasonable to apply transitional rules to deal with potentially anomalous consequences of aligning tax outcomes with the new AASB17 accounting outcomes.

2.22 If revenue concerns were an impediment to aligning tax rules with accounting, then the impact of the change could be smoothed by means of a transitional tax measure. Such a measure could require the spreading of the DAC deduction over a period.

2.23 We note that four- or five-year transition periods have applied for other measures such as the commencement of Division 230 and some of the changes introduced by Division 320.

2.24 We understand that in late January the IASB has expressed support for a new approach to acquisition costs, 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 are incorporated into the consultation process.

Question 2.1: Should the tax treatment of health insurers be the same as that for general insurers?

2.25 The tax position for health insurers currently produces broadly similar outcomes to the specific rules that apply to the general insurance sub-sector. Consequently we consider that it is not imperative for the rules governing the taxation of health insurers to be specifically codified.

2.26 However any such codification should seek to align tax outcomes with statutory accounting outcomes.

Question 2.2: Are there any impacts to health insurance companies of aligning their tax treatment to that for general insurance companies (Division 321 of ITAA 97)?

2.27 We do not believe that expanding Division 321 ITAA 97 is necessary in order to achieve an appropriate tax outcome in relation to the health insurance sub-sector.

2.28 The principal impact for these companies would be the additional administrative and technology costs of complying with a new set of tax rules. If there were to be new law, then transitional measures should be considered where appropriate.

Question 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?

2.29 There are specific rules contained in the tax legislation dealing with when an insurer joins and leaves a tax consolidated group. There rules are contained in Division 713 ITAA 1997.

2.30 One of the purposes of these rules is to ensure that when the opening value of OCL is set for a joining entity, and that value is different to the closing value of the joining entity prior to it joining the purchaser's tax consolidated group, the purchaser's group should be entitled to a deduction for the increase to the OCL/be assessed on any reduction to the OCL. The differences may be due to different assumptions impacting the calculation of the liability value between the purchaser and vendor. The liability has previously been incurred but its measurement has changed. The rules in subdivision 713-M should be clarified to make clear this is the intended result.

Question 3.1: Should the tax laws specify clear criteria for determining the OCL? Why or why not?

2.31 There is no need to codify the criteria for determining the OCL. The most reasonable approach is for it to remain based on the actuarial calculations of the taxpayer, which will be reflected in the accounting numbers under AASB 17.

2.32 However, a legislative amendment should be introduced to confirm that the probability of adequacy used in determining the OCL for accounting purposes is to be used for tax purposes. This would ensure there is no divergence between accounting and tax numbers, reflecting the principles stated in our response to question 1.7 above. It would also be consistent with our understanding of the original intent of Treasury when Division 321 was drafted (as discussed in industry forums addressing this consultation paper), for the OCL to be determined in accordance with accounting.

Question 3.2: Are there other adjustments that should be considered if clear criteria are specified?

2.33 We are not aware of any other significant adjustments requiring consideration at this time. However, as there are a number of aspects of IFRS 17 under consideration by the IASB, and APRRA is continuing to perform its review, further adjustment issues may emerge and we recommend that Treasury seek to consult with industry on the nature and impact of such issues as they arise.