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Insurance Accounting Insight
What should tax and finance functions be thinking about now?

Introduction

In this article, we set out issues and challenges to be considered by insurers' tax and accounting managers in the light of recent developments in:

- International Financial Reporting Standard (IFRS) 4 (Phase II); and
- the exposure draft proposals for International Accounting Standard (IAS) 12 Income Taxes.

Both of these are in the proposal stage and management should consider contributing to the feedback on consultation. The Exposure Draft (ED) amending IAS 12 requires feedback by 31 July 2009. The work on IFRS 4 Phase II (Phase II) is ongoing with recent meetings reaffirming a target to issue an ED for comment by December 2009, the final standard to be published by mid-2011 with implementation required one or two years later.

IFRS 4 Phase II

What is it trying to achieve?

The International Accounting Standards Board (IASB) objective is to develop a standard on accounting for insurance contracts that is transparent enough to allow users an understanding of an insurance company's profit sources which is aligned with the IFRS principles underlying the accounting for all other transactions, particularly financial instruments.

Phase I of the IASB insurance accounting project did not deal with these key issues, focussing primarily on contract classification and disclosures. However the definition of an insurance contract introduced with Phase I had a major impact on a number of insurance companies because a significant number of insurance policies were deemed not to be insurance contracts under IFRS. For example many unit-linked life assurance contracts with insignificant insurance risk transfer need to be treated as investment products under Phase I and have been accounted as financial liabilities under a different IFRS. These products will not be affected by any new insurance standard.

Issue 1

The key issue facing the IASB for Phase II is to develop an accounting basis that produces a model for the recognition and measurement of accounting profit that is transparent and as close as possible to the underlying economics. This means that the impact of the proposed accounting regime will need to be considered for any impact on tax, which for UK non-life insurers is based directly on accounting profit. For life insurers, where FSA returns are currently used for tax, there are different considerations.

Nearly at the same time as Phase II will become effective, EU insurers will need to adopt the new EU-wide regulation known as Solvency II. This new regulation is expected to bring significant changes in reporting within the FSA returns and these changes are also expected to align the returns with the new IFRS requirements. The Phase II and Solvency II calculations of profit and solvency capital will reform both presentation and disclosure to provide information in line with the underlying core reported figures. Consideration of these additional dimensions of the future reporting regime is also important for tax because one of the users of accounts is HM Revenue and Customs (HMRC) and tax authorities generally.

What are the key tax issues for insurers?

There are a number of key areas that need review for tax:

- profit recognition – impact on timing of profit and therefore cash tax – for non-life insurers; and
- alignment of FSA returns with IFRS – consultation has recently started between HMRC, HM Treasury (HMT) and the industry about the implications for the tax regime, for both life and general insurance business, of Solvency II. The alignment of the FSA returns under Solvency II with IFRS will be a factor to be addressed in this consultation, and may have implications for both transitional and ongoing aspects.

Profit recognition

The main issue here is the valuation of insurance provisions compared to the current practices. The latest position of the IASB for the accounting of insurance contracts would require provisions to be calculated as a series of explicitly reported building blocks:

- the expected value of future cash flows from in-force policies and claims being the mean of the probability weighted present value of such cash flows; plus
- a risk margin that reflects the uncertainty of the estimated expected value; plus
- if applicable, a service or profit margin expected to be earned for any other contractual obligation (and related cash flows included in the expected value) other than the obligation to bear insurance risk; plus
- a residual margin calculated at the point of sale of the policy if the sum of the elements above is smaller than the premium charged to the policyholder less any associated incremental acquisition costs (e.g. commissions). In the event the sum of the elements above is higher the difference would be taken immediately through income as a loss at the point of sale of the policy.

More details on these elements were set out in our article **"IFRS Phase II and Solvency II – Heading in the same direction?"** (December 2008) and our more recent **Insurance Accounting Newsletters.**

Tax impact

Our expectation is that the existing provision for claims would be lower under the proposals, primarily because of the effect of discounting, whilst the residual margin would produce a similar liability to what is currently reported as the unearned premium after it is reduced by the amount of deferred acquisition costs that relate to those that are incremental. The move to the realistic reserves basis in the FSA returns at the end of 2007 produced a similar effect on the UK life insurance sector and HMRC agreed to spread the additional taxable profits arising over a 3 year period. However, whilst this may give a precedent, any transitional tax measures in respect of the introduction of IFRS 4 Phase II will need to be specifically discussed and agreed with HMRC and HMT – agreeing such measures is likely to be one aspect of the Solvency II/IFRS consultation previously referred to.

The devil is always in the detail and, in particular, the recalculation of the non-life claims liability could be different across companies. In addition the tax impact of the different initial calculation would be coupled with the fact that under the new regime the accounting for the run off pattern will be done remeasuring all of the components above at each balance sheet date producing a different profit pattern. We believe that virtually in all cases non-life insurers would need to undertake a review of their tax position. Time is of the essence in these situations and an earlier assessment of the tax impact of Phase II could be a valuable insight for future tax planning work.

For non-life companies this also has a wider relevance, as HMRC are currently attempting to find a method of accepting accounting provisions for tax purposes but still having a right to challenge over-reserving. After a number of years of tortuous debate between industry, the profession and HMRC/HMT, the current solution is largely based on trying to anticipate the types of base-lining HMRC believe will be in place for IFRS and Solvency II.

The next section of our article explains our point of view on the future role of FSA returns in the computation of tax for UK life insurers.

We believe that it is clear that HMRC are following the IFRS and Solvency II debates closely so they can assess how these may impact on the way UK income tax is calculated.

Alignment of IFRS and FSA returns

All companies subject to UK tax are taxed based on profits presented in their financial statements in accordance with "generally accepted accounting practice", whether that is UK GAAP or IFRS.

For life companies however, HMRC publicly stated in 1995 that the previous well established "convention" that actuarial surplus was the starting point for calculations of trading profits was implicit in the specific tax legislation applying to life companies. That legislation was implemented at a time when actuarial surplus was also, effectively, the measure of recognised profit in the statutory accounts of life companies; the subsequent development of insurance accounting in the UK has since resulted in divergence, and potentially in very different measurement of actuarial surplus and accounting profit. Alignment of the Solvency II regulatory return with IFRS could re-align those measures, particularly as UK GAAP and IFRS themselves converge. Against this background, the question of the appropriate starting point for trading profits calculations for life companies post Solvency II will be a key aspect of the industry consultation. This aspect is discussed further in the **June edition of the IMU.**

Exposure Draft amending IAS 12 Income Taxes (the ED)

A summary of the key proposed changes is set out in the April 2009 *Deloitte IAS Plus Update*.

Conceptually, the goal is to accelerate the convergence of IFRS and US GAAP modifying IAS12 to introduce some of the features from the US FAS 109. Interestingly the FASB has not issued an analogous Exposure Draft to modify FAS 109 because they would prefer to wait the conclusion of the IASB review.

At that point the FASB will decide whether to undertake a project that would eliminate differences in the accounting for taxes by adopting IAS 12 as amended. The FASB has suspended current deliberations on the tax project, pending the results of the IASB review of IAS 12.

The ED retains the temporary difference approach with the deferred tax asset or liability representing the difference between the book value and the tax basis. However the same principle comes with a revised calculation methodology that we believe will be one area of interest to insurers.

The areas likely to be of most concern to insurers will be:

Revised calculation methodology

The tax basis will be calculated based on the tax consequences of selling an asset or settling a liability for its book value at the balance sheet date. This may have significant impact for some life companies in particular, for example in respect of investment properties which will now be dealt with on a CGT basis. Others may have to reconsider what, if any, deferred tax is now required in respect of shareholder retained capital amounts within a long term fund.

Prohibition of backward tracing changes in deferred tax assets and liabilities

The ED deals with the presentation of the changes in deferred tax assets and liabilities when there are events that change them, such as a change in the corporation tax rate. Under the current text of IAS 12 there is a requirement to always present the change in the tax balances in the same component of income statement or equity as the originating transaction. Under FAS 109 the backward tracing is prohibited and these changes are always presented through the income tax line of the continuing operations section of the income statement.

This is a particularly significant issue for insurers with significant investment holdings accounted for as "available-for-sale" under IAS 39. The relevant deferred tax liability on the unrealised gains of these assets has always been backward traced under IAS 12 to recognise the relevant tax credit or debit through equity until the gains are recycled through income. If this practice was prohibited a change in tax rate would be reported through income statement with counterintuitive results displayed due to the usually significant size of the unrealised gains balances.

However, in this particular case the IASB's plan to converge IAS 12 to the FAS 109 approach has been taken more cautiously bearing in mind the existing IFRS practices.

To that extent the ED proposes two alternative sets of text: one that more fully aligns IAS 12 to the FAS 109 prohibition and a second one that attempts to maintain the backward tracing of the current IAS 12 only when "practicable", requiring the accounting through income statement in the continuing operations section in all other cases. We believe that the latter approach is the one that would appear to have the most limited impact on the tax presentation of insurers.

Measurement and disclosure of uncertain tax positions

This will be of wide interest as the proposals move away from the estimate based on the payout associated with the expected outcome when it is "more likely than not" currently being used, to an approach requiring a provision equal to the sum of the weighted average of all likely outcomes.

Large insurance groups and in particular life companies often have many large and complex tax issues outstanding over a period of years and there may be concern about the impact of this change together with changes in disclosure.

Investments in subsidiaries, branches, associates and joint ventures

This will again be of wide interest as the proposals would prevent the recognition of deferred tax liabilities in respect of undistributed profits of a foreign subsidiary or joint venture where that timing difference is expected to be permanent. Deferred tax would however need to be recognised on equivalent profits in domestic subsidiaries, in contrast to the current position which has regard to the parent's ability to control the timing of reversal and the likelihood of such reversal.

Changes to the initial recognition exemption

There are significant changes with the removal of the initial recognition exemption where transactions have no impact on comprehensive income, equity or profits.

The impact on life insurers is on their valuation methods utilised when they acquire a new subsidiary or an insurance portfolio. Currently the "VIF" (value in force) asset can be shown net of tax because of the initial recognition exemption.

The practice to gross up this valuation has been used only by a few UK "bancassurers" which calculate VIF for their insurance contracts as a matter of regular reporting to determine their IFRS profits.

This practice exists with these IFRS reporting entities because they had developed their accounting policies from an embedded value basis prior to the adoption of Phase I. Based on our experience the embedded value models require significant modifications to calculate the VIF asset gross of the related tax.

If the new standard on income tax adopts this proposal all future acquisitions or portfolio transfers would require VIF to be shown gross of tax and the tax relating to it to be adjusted each year. Absent this adjustment the VIF asset "net of tax" will still attract a temporary difference due to its nil tax base that would essentially result in a double counting of the tax impact on the acquired business.

Equally this requirement will apply to VIF on the balance sheet date when the new standard comes into force, creating issues in calculating this effect "retrospectively".

Other open issues

However, other tax accounting issues that are very important for life companies which are not addressed in the ED will remain open:

- the presentation of policyholders' tax (which is income tax under IAS 12) alongside shareholders' tax on the face of the income statement means that the effective tax rates for life companies are often meaningless without taking the dual nature of life insurers' income tax into account; and

- the prohibition on discounting deferred tax balances remains. For insurers, there is an obvious contrast between this prohibition and the requirement to discount insurance provisions under IFRS 4 Phase II. For life companies, the prohibition applies, inter alia, to policyholder tax liabilities relating to deferred tax on unrealised gains of assets backing liabilities to policyholders which are directly affected by the net of tax fair value of these assets. The net of tax value obviously takes into account the time value of money to assess the payment of capital gain tax based on the expected divestment decisions or redemption dates. As the undiscounted tax liability unwinds it creates an artificial charge or credit to the insurer's profit which fluctuates with the market prices of the assets in the policyholders' funds.

Implementation of a revised IAS 12 is expected to be in the second half of 2010.

Conclusion

Potentially, the tax charge for insurers and its presentation in the financial statements will be significantly impacted by IFRS 4 Phase II (particularly taken in combination with the introduction of an IFRS-aligned Solvency II) and by the provisions in the exposure draft for IAS 12.

Companies should keep these developments under review to ensure that they can plan appropriately for the changes that are finally put into place. We would also strongly recommend that companies should participate, directly or via the industry trade bodies, in the ongoing Solvency II consultation with HMRC and HMT. The changes of IFRS 4 Phase II will inevitably form part of that consultation.

Contacts

Global IFRS Insurance Leader
Francesco Nagari
fnagari@deloitte.co.uk

UK Head of Insurance Tax
Anne Hamilton
ahamilton@deloitte.co.uk

Tax Services
Cathy Lynch
clynch@deloitte.co.uk

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