PAPER 4

Submission form for potential implementation question on HKFRS/IFRS 17

Potential implementation question

1. In Hong Kong, income arising from long-term insurance businesses falling under Classes A, B, C and E are assessable under section 23 of the Inland Revenue Ordinance (IRO). The taxable profits of these businesses are deemed to be 5% of the premiums, but the company may make an irrevocable election to be assessed based on the adjusted surplus. For business falling under other classes, income are assessable under section 14 or 23A of the Inland Revenue Ordinance. A legal entity can offset the profits and losses of its different businesses.

2. This paper discusses whether profits taxes assessed under section 23(1)(a) of the IRO on a deemed basis should be included in the estimation of fulfilment cash flows. Treatments of profits taxes assessed under section 14, 23(1)(b) (adjusted surplus basis) or 23A of the IRO and premium levies collected by the Insurance Authority are beyond the scope of this paper.

3. When estimating the fulfilment cash flows, the IFRS 17 Standard requires transaction-based taxes and income taxes paid by the insurer in a fiduciary capacity to be included, and income taxes not paid in a fiduciary capacity to be excluded. It is not immediately clear which category profits taxes on a deemed basis (referred as "premium-based profits taxes" hereafter) fall into and whether they should be included in the estimate of fulfilment cash flows under IFRS 17.

4. The decision will lead to very different profit emergence pattern. Excluding the premium-based profits taxes from the fulfilment cash flows is expected to defer profit recognition, as the taxes are recognised in profit or loss over the premium paying term while the additional CSM is recognised in profit or loss over the entire coverage period.

5. Question for HKIISG members: Should premium-based profits taxes be included in the estimate of fulfilment cash flows?

Paragraph of HKFRS/IFRS 17 *Insurance Contracts*

6. Paragraph B65 of the IFRS 17 Standard states that cash flows within the boundary of an insurance contract are those that relate directly to the fulfilment of the contract and include:
   (i) transaction-based taxes (such as premium taxes, value added taxes and goods and services taxes) and levies (such as fire service levies and guarantee fund assessments) that arise directly from existing insurance contracts, or that can be attributed to them on a reasonable and consistent basis.
   (j) payments by the insurer in a fiduciary capacity to meet tax obligations incurred by the policyholder, and related receipts.
   (m) any other costs specifically chargeable to the policyholder under the terms of the

contract.

7. Paragraph B66 of the Standard lists out the cash flows that should not be included in fulfilment cash flows, which include:
   - (d) cash flows relating to costs that cannot be directly attributed to the portfolio of insurance contracts that contain the contract, such as some product development and training costs. Such costs are recognised in profit or loss when incurred.
   - (f) income tax payments and receipts the insurer does not pay or receive in a fiduciary capacity. Such payments and receipts are recognised, measured and presented separately applying IAS 12 Income Taxes.

8. Paragraphs B65(j) and B65(f) were first introduced to the revised Exposure Draft published in 2013 and retained in the final Standard published in 2017. The IASB explained in the staff paper submitted to the meeting in February 2013 that the cash flows excluded from the fulfilment cash flows are the income tax payments and receipts attributable to policyholders that do not arise directly as the insurer fulfils the contracts.

9. On subsequent measurement, paragraphs B96(a) and B113(a) of the Standard state that experience adjustments arising from premiums received in the period, and related cash flows such as insurance acquisition cash flows and premium-based taxes, relate to future service and, applying paragraphs 44(c) and 45(c), adjust the CSM.

Analysis of the question

View 1A: Premium-based profits taxes should be treated as transaction-based taxes and included as part of the fulfilment cash flows.

10. Paragraphs B65(i) and B66(d) are clear that if payments can be directly attributed to the insurance contracts, they should be included in the fulfilment cash flows. Otherwise, they should be excluded.

11. Unlike profits taxes under the adjusted surplus basis, premium-based profits taxes under the deemed basis are clearly directly attributable to the insurance contracts. As such, premium-based profits taxes in substance are transaction-based taxes listed under paragraph B65(i) and should be included as part of the fulfilment cash flows. This is also consistent with the treatment of current estimate of future cash flows under HKRBC Second Quantitative Impact Study.

View 1B: Premium-based profits taxes should be treated as income taxes that are either paid by the entity in a fiduciary capacity or chargeable to the policyholder and therefore should be included in the estimate of fulfilment cash flows.

12. Premium-based profits taxes are income taxes with assessable profits proxied by 5% of the

premiums instead of transaction-based taxes. At the same time, there is customary business practice that the premium-based profits taxes are charged to the underlying items of the insurance contracts, which has been communicated with the policyholders. As such, premium-based profits taxes arise directly from and are clearly attributable to existing insurance contracts, and should be included in the fulfilment cash flows following paragraph B65(j) or B65(m).

13. As the IASB explained, the intention of paragraph B66(f) is to exclude the income tax payments attributable to policyholders that do not arise directly as the insurer fulfils the contracts. Hence, the premium-based profit taxes do not fall under this category.

View 2: Premium-based profits taxes should be treated as income taxes not paid in a fiduciary capacity and excluded in the estimate of fulfilment cash flows.

14. Premium-based profits taxes are the insurer's own income tax obligations instead of tax obligations paid in a fiduciary capacity. Following paragraph B66(f), premium-based profits taxes should not be included in the estimation of fulfilment cash flows under IFRS 17 and should be accounted for applying IAS 12 Income Taxes and presented as tax expense instead of insurance service expense in the statement of profit or loss.

Conclusion

15. IFRS 17 is principle-based. Professional judgement needs to be used to apply the principles to transactions specific to the industry to provide a faithful representation of the economics of those transactions. The Standard would not cover all sorts of income taxes across different jurisdictions and the corresponding treatments.

16. We interpret that paragraph B66(f) only applies to income tax payments/receipts that cannot be attributed to insurance contracts on a reasonable and consistent basis or those that can be attributed to policyholders but do not arise directly as the insurer fulfils the contracts.

17. View 1A does not consider the fact that premium-based profits taxes are the insurer's own income tax obligations and a legal entity can offset the profits and losses of its different businesses. On the other hand, view 2 does not consider the fact that premium-based profits taxes are attributable to and arise directly from the insurance contracts.

18. As such, where there are customary business practices to charge the premium-based profits taxes to the underlying item, paragraph B65(j) or B65(m) should be applied to include such taxes as part of the fulfilment cash flows (view 1B).

Appendix – Illustrative Statement of Profit or Loss under View 1 and View 2

1. Consider a group of traditional single-pay, non-participating 5-year endowment insurance contracts measured using GMM:

   - Initial premium = 100,000
   - Premium-based profits tax = 825 (16.5% × 5% × 100,000)
   - Maturity benefit = 113,000

   For simplicity, there are no surrenders or deaths before maturity.

2. Assuming 3% discount rate, on initial recognition, the entity measures the group of insurance contracts and estimates the BEL and CSM as follows:

   - PV maturity benefit = 97,475
   - BEL under view 1 (tax included) = –1,700 (97,475 + 825 – 100,000)
   - BEL under view 2 (tax excluded) = –2,525 (97,475 – 100,000)
   - Initial CSM is set as negative BEL assuming no risk adjustment for simplicity

3. Further assuming:

   - Straight line amortisation for CSM and insurance acquisition cash flows, and
   - 3% fund earn rate,

   the entity measures the carrying amount of assets and insurance contracts at the end of each subsequent year as follows:

Time		Initial recogn	Y1	Y2	Y3	Y4	Y5
View 1	Asset		102,150	105,215	108,371	111,622	1,971
	BEL	-1,700	100,399	103,411	106,513	109,709	0
	CSM	1,700	1,401	1,082	743	383	0
	Net asset	0	350	721	1,115	1,531	1,971
	Profit		350	371	393	416	440
View 2	Asset		102,150	105,215	108,371	111,622	1,971
	BEL	-2,525	100,399	103,411	106,513	109,709	0
	CSM	2,525	2,081	1,607	1,104	568	0
	Net asset	0	-330	196	754	1,345	1,971
	Profit		-330	526	558	591	626

In year 1, asset increases by 100,000 and reduces by 825 as premium is received and tax is paid. Investment return has further increased the asset by 2,975. The tax payment is offset by the unwind of BEL under view 1 but not view 2 where the premium-based profits tax is excluded from the fulfilment cash flows.

4. The amounts presented in the statement of profit or loss corresponding to amounts analysed in the table above are as follows:

Statement of profit or loss	View 1A						View 1B						View 2						Total difference	
	Y1	Y2	Y3	Y4	Y5	Total	Y1	Y2	Y3	Y4	Y5	Total	Y1	Y2	Y3	Y4	Y5	Total	View 2 - View 1A	View 2 - View 1B
CSM amortisation	350	361	372	383	394	1,859	350	361	372	383	394	1,859	520	536	552	568	585	2,762	902	902
Expected incurred claims and other ISE	-	-	-	-	-	-	825	-	-	-	-	825	-	-	-	-	-	-	-	(825)
Recovery of acquisition cash flows	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Insurance revenue	**350**	**361**	**372**	**383**	**394**	**1,859**	**1,175**	**361**	**372**	**383**	**394**	**2,684**	**520**	**536**	**552**	**568**	**585**	**2,762**	**902**	**77**
Actual incurred claims and other ISE	-	-	-	-	-	-	(825)	-	-	-	-	(825)	-	-	-	-	-	-	-	825
Amortisation of acquisition cash flows	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Insurance service expenses	**-**	**-**	**-**	**-**	**-**	**-**	**(825)**	**-**	**-**	**-**	**-**	**(825)**	**-**	**-**	**-**	**-**	**-**	**-**	**-**	**825**
Insurance service result	**350**	**361**	**372**	**383**	**394**	**1,859**	**350**	**361**	**372**	**383**	**394**	**1,859**	**520**	**536**	**552**	**568**	**585**	**2,762**	**902**	**902**
Investment return	2,975	3,065	3,156	3,251	3,349	15,796	2,975	3,065	3,156	3,251	3,349	15,796	2,975	3,065	3,156	3,251	3,349	15,796	-	-
Insurance finance income (expense)	(2,975)	(3,054)	(3,135)	(3,218)	(3,303)	(15,684)	(2,975)	(3,054)	(3,135)	(3,218)	(3,303)	(15,684)	(3,000)	(3,074)	(3,151)	(3,229)	(3,308)	(15,762)	(77)	(77)
Investment result	**-**	**11**	**22**	**33**	**46**	**112**	**-**	**11**	**22**	**33**	**46**	**112**	**(25)**	**(10)**	**6**	**23**	**40**	**34**	**(77)**	**(77)**
Profit before tax	**350**	**371**	**393**	**416**	**440**	**1,971**	**350**	**371**	**393**	**416**	**440**	**1,971**	**495**	**526**	**558**	**591**	**626**	**2,796**	**825**	**825**
Income tax expense	-	-	-	-	-	-	-	-	-	-	-	-	(825)	-	-	-	-	(825)	(825)	(825)
Profit after tax	**350**	**371**	**393**	**416**	**440**	**1,971**	**350**	**371**	**393**	**416**	**440**	**1,971**	**(330)**	**526**	**558**	**591**	**626**	**1,971**	**-**	**-**

(a) Compared to view 1:

- The CSM on initial recognition under view 2 is 825 higher as premium-based profits tax is excluded from the fulfilment cash flows, hence the amount of CSM amortised is higher under the same coverage unit pattern. On the other hand, view 2 has a one-off outgo under income tax expense line.
- Profit recognition is deferred under view 2, as the taxes are recognised in profit or loss over the premium paying term while the additional CSM is recognised in profit or loss over the entire coverage period. While the entity makes a loss in the first year under view 2, the total profit over the entire coverage period remains the same under both views.
- The insurance finance expense under view 2 is 77 higher, reflecting the additional interest accretion on CSM due to exclusion of premium-based profits taxes from the fulfilment cash flows.

(b) Under both views, the entity calculates the total insurance revenue for the group of insurance contracts as the amount of premiums paid to the entity adjusted for the financing effect and excluding the investment component. Compared to view 2:

- The total insurance revenue under view 1A is 902 lower as premium-based profits tax is excluded from the amount of premiums received.
- The total insurance revenue under view 1B is 77 lower due to lower CSM interest accretion as the tax is included in the fulfilment cash flows.

(i.e. 1,859 = 100,000 – 825 + 15,684 – 113,000 for view 1A, 2,684 = 100,000 + 15,684 – 113,000 for view 1B, and 2,762 = 100,000 + 15,762 – 113,000 for view 2.)