HKIISG submission - Allowance for income taxes in fair value measurement

26 January 2021

Objective

The purpose of this paper is to facilitate discussion on how preparers are currently allowing for income taxes when determining the fair value measurement of insurance contracts for deriving the CSM under fair value approach (FVA) as at transition date.

Background

IFRS 17 vs IFRS 13

When determining the fulfilment cash flows (FCF) under IFRS 17 income taxes are excluded (B66f), with the effect that CSM is a pre-tax amount The exception to this is where income taxes are paid in a fiduciary capacity or where they are specifically chargeable to the policyholder under the terms of the contract (one of the changes in the final amendments released by IASB at the end of Jun 2020). The implications of this exception are covered in Question 3 of this paper. Income tax is not defined under IFRS 17 (and is defined in IAS 12 only in the context of that standard) however the general market approach would appear to be one of defining income taxes in the context of IFRS 17 in alignment with those in scope of IAS 12.

IFRS 17 C5(b) provides for the determination of the CSM on transition using a fair value approach (FVA) when it is impracticable to apply IFRS 17 fully retrospectively.

When applying the fair value approach, CSM for a group of contracts (GOC) is determined as the difference between the fair value of the GOC measured in accordance with IFRS 13 *Fair Value Measurement* and the FCF determined in accordance with IFRS 17.

In determining the fair value of a GOC in accordance with IFRS 13, the cash flows and discount rate should reflect the assumptions that market participants would use when pricing them. To the extent there are differences between the cash flows assumed in the IFRS 13 measurement and those forecast in the IFRS 17 FCF this will impact the CSM of the GOC i.e. CSM arises on transition where the value of the IFRS 13 liability is higher than the value of the IFRS 17 FCF.

Typically in pricing a block of insurance contracts, a market participant's assumptions would make allowance for income taxes, although IFRS 13 does not prescribe how this should be done other than that the measurement should be internally consistent (i.e. if assumed tax expenses are explicitly allowed for in the cash flows – i.e. the cash flows are post-tax – then discount rates and any compensation for taking on the obligation should also be on a post-tax basis, and vice versa). [IFRS 13, B14(d)].

Basis for determining taxes in Hong Kong

A further complication of this issue arises from the two different bases of assessment among the Hong Kong life insurance market.

Income arising from long-term insurance business falling under classes A, B, C and E is assessable under section 23 of the Inland Revenue Ordinance. The taxable profits of these businesses are deemed to be 5% of the premiums ("premium based approach") but an insurer may make an irrevocable election to be assessed based on the adjusted surplus approach ("adjusted surplus approach").

Under the premium based approach, taxes in relation to these classes are effectively set equal to [premiums * 5% * 16.5%] while the adjusted surplus approach is more complex.

Nonetheless, following IFRS 13, B14(d) if taxes are explicitly forecast in the cash flows, then the allowance for the time value of money and any additional expected compensation for taking on the obligation should be on a post-tax basis to avoid double counting. Where taxes are not explicitly projected in the fair value cash flows (i.e. the cash flows are pre-tax), it is likely adjustments would be needed to be made to market derived cost of capital percentages so to make them on a pre-tax basis.

Potential for diversity in practice

There appear to be different interpretations of the standard's requirements on what should be included in the fair value of the GOC on transition under the FVA. Some believe that the fair value of the GOC should include the same cash flows as included in the IFRS 17 FCF per B65 and B66, meaning that where income taxes are not included in the IFRS 17 FCF they should not be included in the fair value of the GOC. This is analogous to the discussion around the consistency of the contract boundary requirements between the FVL and the FCF under the context of FVA, as previously discussed at the HKIISG in April 2019.

Others think that pursuant to the general principles of IFRS 13, a market participant would not be bound by the requirements in IFRS 17 when setting a price for a group of insurance contracts. Under this view, the allowance for income taxes will contribute to the CSM under FVA if the income taxes are not allowed as IFRS 17 FCF per B65 and B66. If the income taxes are specifically chargeable to policyholders and have been included in the IFRS 17 FCF, the shareholder's portion of the allowance for income taxes would contribute to the CSM.

The following factors may also present additional causes of diversity in practice, although these are not specific to IFRS 17:

- Different bases of tax assessment permitted under Section 23 of the Inland Revenue Ordinance;
- The fact that IFRS 13 does not prescribe how income taxes should be allowed for in a present value calculation; and
- Possible scope for interpretation in which taxes are considered Income Taxes in scope of IAS 12, for example withholding taxes.

Questions

Considering the potential for diversity in practice, views are sought across three scenarios:

1. Where Section 23 taxes are payable on a premium based approach
2. Where Section 23 taxes are payable on an adjusted surplus approach
3. Differences in approach where Section 23 taxes are specifically chargeable to the policyholder

Views are also sought on taxes other than those payable under Section 23 of the Inland Revenue Ordinance.

1. Where Section 23 taxes are payable on a premium based approach

How are different preparers allowing for income taxes in the fair value measurement?

I. Not allowed for in any way
II. Explicitly forecast in cash flow projections
III. Allowed for in discount rate / expected return by adjusting these to be pre-tax
IV. Implicit / other approach

2. Where Section 23 taxes are payable on an adjusted surplus approach

How are different preparers allowing for income taxes in the fair value measurement?

I. Not allowed for in any way
II. Explicitly forecast in cash flow projections
III. Allowed for in discount rate / expected return by adjusting these to be pre-tax
IV. Implicit / other approach

3. Where Section 23 taxes are specifically chargeable to the policyholder

The extent to which taxes are specifically chargeable to the policyholder will depend on the contractual terms and business practices of different insurers but may apply to certain par business where the company's tax expenses are shared with the policyholder.

In theory, in a scenario where tax expenses are shared with the policyholder the projected policyholder dividends (cash outflows in the fair value measurement) will be lower than a scenario where tax expense is not shared with the policyholder, meaning a lower fair value of the liability. In practice however other factors will impact dividends and it is unlikely the standalone impact of this could be observed.

Observations welcomed on current working assumptions on where taxes are specifically chargeable to policyholders and any additional factors incorporated into the fair value measurement related to this.

4. *Treatment of taxes other than those payable under Section 23 of the Inland Revenue Ordinance*

In the course of undertaking insurance business, insurers typically pay a number of different taxes and charges to tax authorities. In Hong Kong, examples of taxes other than those payable under Section 23 of the Inland Revenue Ordinance might include withholding taxes (for example, on investments), stamp duties etc.

4.1 How are different preparers allowing for such taxes in the fair value measurement?

I. Not allowed for in any way
II. Explicitly forecast in cash flow projections
III. Allowed for in discount rate / expected return by adjusting these to be pre-tax
IV. Implicit / other approach

4.2 Are the different approaches being taken dependent on whether the taxes are either paid in a fiduciary duty or specifically chargeable to the policyholder (i.e. within scope of the IFRS 17 FCF)?