Paper 2

Accounting treatment for premium-based profits tax on life insurance business of Hong Kong insurers

Background

In Hong Kong, corporations are taxed at the rate of 16.5% of their assessable profit (also referred to as 'taxable profit' in this paper). Assessable profit is defined in the Hong Kong Inland Revenue Ordinance (IRO) as "the profits in respect of which a person is chargeable to tax for the basis period for any year of assessment, calculated in accordance with the provisions of Part 4". The IRO provides life insurance corporations two options to calculate the assessable profits. The guidance, as set out in Section 23 of the IRO, is as follows:

The assessable profit is determined applying ***either*** *of the following basis:*

(a) deemed to be 5% of the premiums[1] *from life insurance business in Hong Kong of the corporation during the basis period for that year ("premiums-based profits tax");* ***or***

(b) as an irrevocable election, that part of the adjusted surplus determined in accordance with the provisions of subsections (2) to (7) deemed to arise in the basis period for that year less any dividend received which is required to be excluded by virtue of section 26(a).

Section 23(e) further provides that until such part of the adjusted surplus is ascertained, the assessable profits shall be calculated provisionally in accordance with item (a) above and tax charged and collected as if no such election has been made. An extract of the sections/sub-sections mentioned above is included in the Appendix to this paper.

Currently, life insurers in Hong Kong that calculates their tax amount due applying the premiums-based profits tax approach account for the tax as an income tax expense in the profit or loss statement applying HKAS 12, *Income Taxes* and no deferred taxes are recognised under current practice when applying this approach.

It should be noted that in some jurisdictions, there are other types of premium-based taxes specifically chargeable to the policyholders[2] in addition to the premiums being charged. This would be an example of premium-based taxes that are unlikely to meet the definition of an income tax because these are transaction-based tax unrelated the assessable profit of the insurance company. This type of premium-based taxes are in addition to any income tax imposed on the insurer on its assessable profit.

This paper analyses:

1. whether a premium-based profits tax is within the scope of HKAS 12, *Income Taxes*, and
2. whether deferred taxes could arise as a result of applying a premium-based profit tax approach

The reason why this analysis is important at this juncture is the upcoming implementation of the HKFRS 17 requirements in Hong Kong and the need for Hong Kong insurers to have a clear basis for the accounting adopted under HKFRS 4 and HKAS 12 in order to assess if the accounting treatment under HKAS 12 needs to change or not in the eventuality that the tax laws on the assessable profit of life insurers and how it is taxed do not change in the same timeframe.

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[1] Net of reinsurance

[2] For example the "insurance premium tax" in the UK: https://www.gov.uk/guidance/insurance-premium-tax

A secondary reason for this analysis to be completed and debated is the fact that the Hong Kong Insurance Authority has given firm indications that they intend to regulate the solvency capital of Hong Kong insurers using a new set of valuation rules that are currently referred to as the "pillar 1" of the new Hong Kong Risk-based Capital (HKRBC) regime. These valuation rules make explicit reference to the application of HKAS 12 for the calculation of the income tax balances to be reported in the HKRBC balance sheet. The current regime that the HKRBC replaces has been utilised extensively by Hong Kong insurers to develop their HKFRS accounting policies under HKFRS 4 and it is also the basis for the IRO taxation of the life insurance companies' assessable profit under Section 23(b) of the IRO. The adoption of HKRBC will be mandatory at a future date that has not yet been finalised but it is expected to be from 1 January 2024. The Hong Kong Insurance Authority has also given indication that it would issue provisions that will enable voluntary early adoption of the HKRBC.

Given these expected changes, reaching clarity on the current basis for the accounting of income tax in the life insurance companies' financial statements under HKFRS, the author of this paper believes that such clarity is a highly desirable goal that could be achieved most effectively by first discussing this paper at the HKICPA Insurance Implementation Support Group. The discussion would naturally offer the platform to engage most of the impacted stakeholders and enable the laying out of the appropriate next steps.

Analysis

1. ***Whether premium-based profits tax is within the scope of HKAS 12, Income Taxes***

The author believes that the answer to this question is affirmative.

HKAS 12 defines income taxes as including all domestic and foreign taxes which are based on taxable profits. Taxable profit (tax loss) is defined as "the profit (loss) for a period, determined in accordance with the rules established by the taxation authorities, upon which income taxes are payable (recoverable)".

The premium-based profit tax basis is an election for a method to calculate the assessable profit that the Inland Revenue Department (IRD) permits in the IRO. The method uses premiums as an amount from which assessable profits can be derived. Effectively, it assumes that: a) insurance contracts are expected to be profitable contracts, b) it is logical to calculate a percentage of premiums to represent the net profit that would arise from all income sources (e.g. premiums, investment return and recoveries from reinsurance contracts) and cost sources (e.g. insurance claims, insurance benefits, reinsurance premiums due, acquisition and operating expenses), and c) no reference to the actual profit or loss derived from insurance contract would be considered in the final amount of income tax due.

In accordance with the guidance provided under HKAS 8:13, given that the nature of the transaction between a premium-based profits tax and a tax calculated based on the adjusted surplus are the same, i.e. being a tax on profits of the insurer as a corporation, consistent accounting treatment should be applied for taxes calculated applying these two bases.

It cannot be the case that a tax calculated based on 5% of premiums will not be within the scope of HKAS 12 and consequently accounted for applying other HKAS/HKFRS while the tax amount calculated by applying the alternative calculation basis of adjusted surplus will be accounted for applying HKAS 12.

In the *March 2006 IFRIC Update*, IFRIC (now IFRS Interpretations Committee) provided factors to consider when determining whether a tax is an income tax. These factors include, but are not limited to, whether:

(1) the 'starting point' for determining the taxable amount is based on taxable profits rather than another metric (e.g. units of production);
(2) the tax is based on a 'taxable profit' notion, implying a net rather than a gross amount;
(3) the tax is based on actual income and expenses rather than a notional amount (e.g. on a tonnage capacity);
(4) the legal description or characteristics of the tax imply that the tax is calculated based on taxable profits; and
(5) there is any withholding related to the tax.

The determination as to whether a particular tax is an income tax should be made on a case-by-case basis.

The key characteristic that defines an income tax is that it is a tax based on a measure of taxable profit. We set out below our analysis, taking into consideration the factors enumerated above (March 2006 IFRIC Update) when determining whether a tax is an income tax. Factor (5) above is considered not relevant and it is not analysed in this paper.

In analysing the premiums-based income tax applying factors (1) and (4) above, we note that the option to calculate the taxable income based on 5% of premiums produces a tax that meets the definition of income tax under HKAS 12 and it is also regarded as income tax by the relevant laws. The premiums-based income tax is a form of tax in which the IRD imposes income tax to insurance corporations as set out in section 23 of the IRO. The wording in section 23 of the IRO indicates that the calculation of the assessable profits can be based on either of two methods and that the resulting amount calculated applying either of the two bases is considered the assessable profits for the tax payer. Thus, the legal description or characteristics of the premiums-based profits tax clearly demonstrate that it is a tax calculated based on taxable profits.

The author is privy to the fact that in an outreach activity carried out by the Standard Setting Department Staff of HKICPA to the IRD to inquire on the nature of the premium-based profits tax, the IRD responded and confirmed that despite the different bases, the profits calculated using both bases (i.e. premiums-based profits tax and adjusted surplus) have the same nature, that is, as assessable profits chargeable to profits tax under the IRO. The response letter from the IRD was circulated among the member of the Insurance Regulatory Advisory Panel (IRAP) during its meeting on 14 October 2020.

In analysing the premiums-based income tax applying factors (2) and (3) above, some stakeholders argue that the premium-based profits tax is akin to charging income tax based on both a gross amount and a notional amount and that the accounting treatment would be similar to that for tonnage taxes as discussed in the May 2009 IFRIC Agenda decision. However, the fact that the IRD provides the two calculation bases as alternatives to the same common purpose of taxing the assessable profit of a particular tax payer demonstrates that, because the adjusted surplus calculation is clearly on a net profits basis, the calculation based on 5% of premiums is intended to be considered, in form and substance, as a net basis. In addition, the IRO specifies that the premiums-based profits are calculated by deducting the reinsurance premium due in the same tax year as the insurance premiums are due to be received from policyholders. Finally, the premiums-based profits income tax is calculated unlike the tonnage taxes which are based on a notional amount derived from tonnage capacity, the calculation based on 5% of premiums is a proxy for profits equivalent to the net of the taxpayer income and expenses.

Based on the analysis above, the premiums-based profits tax is an income tax within the scope of HKAS 12 and it is a tax based on a measure of taxable (assessable) profit.

2. Whether any form of deferred taxes would arise from applying the premiums-based profits tax approach

The author believes that the answer to this question is negative.

HKAS 12 focuses on the statement of financial position by recognising the tax effects of temporary differences, i.e. deferred taxes. The recognition of deferred tax in respect of temporary differences relies on two central concepts: (a) tax base; and (b) temporary differences. Temporary differences are determined by reference to the carrying amount of an asset or a liability and arise when the carrying amount of an asset or a liability differs from its tax base for a temporary period of time. The tax base of an asset or a liability is the amount attributed to that asset or liability for tax purposes.

In Hong Kong, life insurance business would generally issue insurance contracts that require the payment of premiums according to different bases:

- Single premium – single payment that covers the entire cost of an insurance policy and is payable and due on the date of the inception of the insurance policy or before an insurance policy can be issued.
- Regular premium or regular pay – the premium payment is recurring and is scheduled on a regular basis (e.g. monthly, semi-annually, and annually). These are payable throughout the life on the insurance policy or until a certain point in time (e.g. payable for 10 years) for limited pay life insurance contracts.

Under current practice applying HKFRS 4, Hong Kong life insurers generally recognise premiums as revenue when due from the policyholders. Thus, when applying the premiums-based profits tax, this would mean that the recognition of income tax follows the actual premium invoicing/payment profile. For example, on the single premium contracts, income tax arises in the year the contract incepts. For regular premium contracts, income tax arises in the periods during which premiums are due.

When applying the premium-based profits tax the only deductible expense is from reinsurance premiums due in the same period as insurance premiums. Under HKFRS 4, life insurers generally recognise as expense the reinsurance premiums when due to reinsurers. All other categories of income and expenses are never subject to tax and their net amount is replaced by the 5% profit proxy mandated in the IRO as it applies to the assets and liabilities associated with insurance premiums received and reinsurance premiums paid. Thus, there are no potential sources of a temporary difference because the tax basis and the accounting basis of the relevant account balances recognised in the statement of financial position relating to life insurance business are the same.

Consider a scenario where an insurer recognises a premium receivable of HK$100,000 and a reinsurance payable of HK$25,000 in the statement of financial position as at 31 December 20x1. Because the related insurance revenue and the related reinsurance expense have already been included in the taxable profit for 20x1, the respective tax bases of the premium receivable and the reinsurance payable are equal to their carrying amounts, hence, no temporary difference exists. Consequently, there is also no deferred tax to be recognised in relation to these two account balances. This accounting treatment is aligned with the guidance set out in IAS 12:7, Example 3.

	Statement of financial position – Carrying Amount	Tax Base	Temporary Difference
Premiums receivable	*100,000*	*100,000*	*nil*
Reinsurance premium payable	*25,000*	*25,000*	*Nil*

Other categories of income and expenses relating to life insurance business which result in the recognition of or increases/decreases in the corresponding balances in the statement of financial position, for example:

- income or expenses from changes in insurance liabilities other than those for reinsurance premiums payable;
- expenses from the amortisation of tangible and intangible assets;
- investment income and capital gains/losses from financial assets;
- employee benefits expense from liabilities for employment contracts; and
- acquisition or other expenses from other liabilities.

All of the categories above are in substance taken into account in the calculation of assessable profits when applying the premiums-based profits tax approach. Hence, the corresponding accounting balances recognised in the statement of financial position will have no future tax effects because the accounting basis is considered equal to the tax basis, giving rise to nil temporary difference.

An alternative analysis leading to the same conclusion that there are no temporary differences when applying the premium-based income tax is that the allowable expenses are always assumed to be 95% of the same revenue recognised under the HKFRS 4 and tax rules. The differences with the actual expenses less investment income would never reverse, thus creating no temporary differences.

Appendix – Extract of relevant sections of the Insurance Revenue Ordinance

23. Ascertainment of assessable profits of life insurance corporations

(1) **The assessable profits for any year of assessment of a corporation** [*emphasis added*], whether mutual or proprietary, from the business of life insurance, shall—

- (a) be deemed to be 5% of the premiums from life insurance business in Hong Kong of the corporation during the basis period for that year; **or** [*emphasis added*]
- (b) should the corporation so elect, be that part of the adjusted surplus ascertained in accordance with the provisions of subsections (2) to (7) deemed to arise in the basis period for that year less any dividend received which is required to be excluded by virtue of section 26(a):

Provided that—

- (i) any such election once made shall be irrevocable and in addition shall be deemed to apply to all future years of assessment; and
- (ii) until such part of the adjusted surplus is ascertained, the assessable profits shall be calculated provisionally in accordance with paragraph (a) of this subsection, and tax charged and collected as if no such election had been made.

(2) A corporation which elects to be assessed in the manner provided in subsection (1)(b) shall submit to the Commissioner a certified true copy of the latest abstract of the report of the actuary submitted to the Insurance Authority under section 18 of the Insurance Ordinance (Cap. 41).

(3) Any election under subsection (1)(b) shall be effective only if the actuarial report is submitted not later than 2 years after the end of the period in respect of which it is made. Where an effective election has been made it shall be lawful to give effect to such election notwithstanding the provisions of section 70.

(4)

- (a) The surplus shall be the amount by which the life insurance fund exceeds the estimated liability of the corporation on the life insurance fund at the end of the period in respect of which any actuarial report is made.
- (b) The adjusted surplus shall be ascertained by adding to the surplus—
  - (i) any deficit in respect of a period prior to the period in respect of which the relevant actuarial report is made where such deficit is included in such report;
  - (ii) any outgoing or expense charged against the life insurance fund in the relevant actuarial report which is not such that it would be allowed as a deduction in ascertaining assessable profits under the provisions of section 16;
  - (iii) any expense disbursement or loss charged against the life insurance fund in the relevant actuarial report which is such that it would not be allowed as a deduction in ascertaining assessable profits by reason of the provisions of section 17;
  - (iv) any income or profits of the corporation arising in the period in respect of which the relevant actuarial report is made, not being profits from the business of insurance other than life insurance, and not credited to the life insurance fund in such report;
  - (v) any appropriations of profits or transfers to reserve charged against the fund during the period in respect
  - (va) the amount of a balancing charge directed to be made under Part 6;

and by deducting therefrom—

(vi) any surplus disclosed by a previous actuarial report which has been retained in the life insurance fund in the relevant actuarial report;

(vii) any transfer or appropriation to policy holders in their capacity as such, effected during the period in respect of which the relevant actuarial report is made where such transfer or appropriation has not been charged against the life insurance fund in such report;

(viii) any outgoing or expenses not charged against the life insurance fund during the period in respect of which the relevant actuarial report is made which is such that it would be deducted in ascertaining assessable profits under the provisions of section 16;

(ix) any receipt of a capital nature, or transfer from reserve, credited to the life insurance fund during the period in respect of which the relevant actuarial report is made;

(x) the allowances provided by Part 6 to the extent to which the relevant assets are used in the production of the adjusted surplus.

(5) Notwithstanding anything contained in subsection (4) the adjusted surplus of a corporation which transacts life insurance business both within Hong Kong and elsewhere shall be the adjusted surplus ascertained in accordance with the provisions of the said subsection (4) less that portion of such adjusted surplus as is not deemed under the provisions of subsection (6) to be profits arising in or derived from Hong Kong.

(6) Where a corporation transacts life insurance business both within Hong Kong and elsewhere, the portion of the adjusted surplus ascertained in accordance with the provisions of subsection (4) which shall be deemed to be profits arising in or derived from Hong Kong is the amount which bears the same proportion to the adjusted surplus so ascertained as the aggregate of the premiums from life insurance business in Hong Kong for the period of the relevant actuarial report bears to the aggregate of the premiums from the whole of the corporation’s life insurance business for that period.

(7) Any adjusted surplus ascertained in accordance with the foregoing provisions shall be deemed to arise during the years or other periods which make up the period in respect of which the relevant actuarial report is made in the proportion which the aggregate of the premiums from life insurance business in Hong Kong in each such period bears to the aggregate of such premiums for the total period in respect of which the relevant actuarial report is made.

(8)

(a) Where the making of the adjustments required by subsection (4) results in a deficit, such deficit shall be deemed to be the loss sustained by the corporation during the period in respect of which the relevant actuarial report is made.

(b) In ascertaining for the purposes of sections 19 and 19C what part of such loss so calculated is attributable to activities in Hong Kong the provisions of subsections (5) and (6) shall apply mutatis mutandis.

(c) Any such loss attributable to activities in Hong Kong shall be deemed to have been sustained during the years which make up the period in respect of which the relevant actuarial report is made in the proportion which the aggregate of the premiums from life insurance business in Hong Kong in each such year bears to the aggregate of such premiums for the total period in respect of which the relevant actuarial report is made.

26. Exclusion of certain dividends and profits from the assessable profits of other persons

For the purposes of this Part—

(a) a dividend from a corporation which is chargeable to tax under this Part shall not be included in the profits in respect of which any other person is chargeable to tax under this Part; and

(b) save as otherwise provided no part of the profits or losses of a trade, profession or business carried on by a person who is chargeable to tax under this Part shall be included in ascertaining the profits in respect of which any other person is chargeable to tax under this Part.

Paper 2

Supplement

Assume an amount of $100 on initial recognition for all items.

	Journal entry on initial recognition	Carrying amount	Tax base	Note	Temporary difference	Deferred tax
Assets						
Premiums receivable	Dr premiums receivable; Cr revenue	100	100	(1)	-	-
Financial assets (held for investment purposes)	Dr financial assets; Cr Bank	100	100	(2)	-	-
Intangible/intangible assets	Dr assets; Cr Bank	100	-	(3)	100	IRE
Prepaid acquisition costs	Dr prepaid acquisition costs; Cr Bank	100	-	(4)	100	IRE
Liabilities						
Reinsurance premium payable	Dr reinsurance premiums (expense); Cr payable	100	100	(5)	-	-
Insurance liabilities	Dr expense; Cr insurance liabilities	100	100	(6)	-	-
Employment contract liabilities and other liabilities	Dr expense; Cr liabilities	100	100	(6)	-	-

IAS 12.7 and 8 definition of tax base
Asset:

- amount deductible in the future.
- if amount will not be taxable in the future, then tax base equals carrying amount.

Liability:

- carrying amount less amount deductible in future.

Notes

1) Premiums are taxable in the period they are due. 95% of the premiums is never taxable and 5% is taxed in the current year. Hence the entire 100 will not be taxable in the future; hence TB = CA.
2) Under the premiums-based tax regime, none of the investment income or capital gains/losses on the financial assets will be taxable or deductible. The carrying amount of the financial asset will be recovered through repayment of capital and return via interest/dividends, neither of which is taxable. Hence TB = CA.
3) As the IRD does not allow any capital allowances for these assets related to life insurance, the amount deductible in the future is nil, so TB = 0. The resulting taxable TD of 100 is again subject to the IAS 12.15 IRE.
4) As the IRD does not allow any deductions for the acquisition costs, TB = 0. Again the IAS 12.15 IRE applies.
5) Reinsurance premiums due/payable are deducted from gross premiums due/receivable before the net amount is subject to the 5% premiums-based tax. This means that effectively 95% of the reinsurance premiums due/payable are never deductible and 5% is deductible in the current year. Hence amount deductible in future is nil. TB = 100 - 0 = 100.
6) The claims, losses and other expenses recognised are never deductible under the premiums-based tax regime. As such, the amount deductible in future is nil. TB = 100 - 0 = 100.

Temporary differences that are subject to the IRE will be carried forward over the life of the account; i.e. if the carrying amount reduces in the future resulting in a reduction in the temporary difference, the IRE will still apply.
For items where TB = CA on initial recognition, that will continue to be the case over the life of the account because no matter how:

- the asset balance reduces (for premiums receivable and financial assets), the amounts will not be taxed in the future so TB will always = CA.
- the liability balance reduces, the amounts will not be deductible in the future so TB always = CA.