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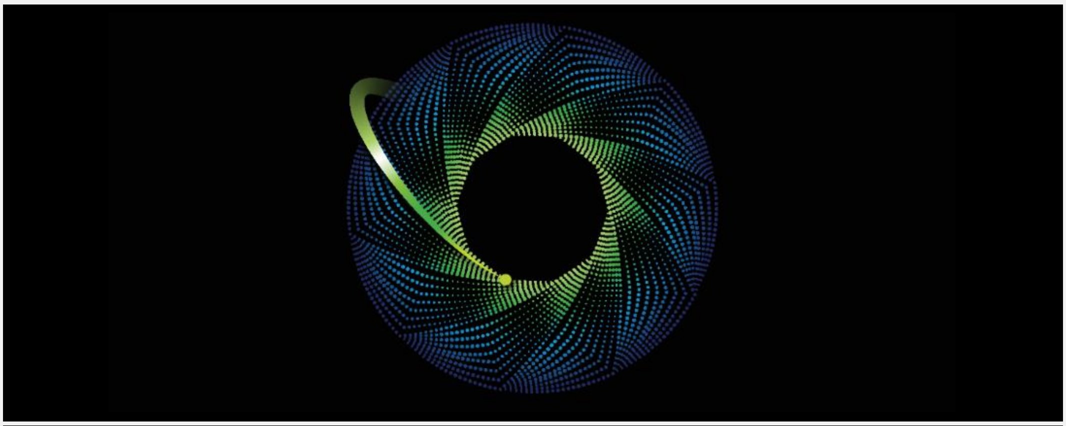

Hong Kong Tax Newsflash

Proposed tax treatment regarding implementation of Risk-based Capital (RBC) regime for insurance industry

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On 19 April 2023, the Hong Kong Government introduced to the Legislative Council the *Insurance (Amendment) Bill 2023* (Bill), which provides the legal framework for the implementation of the RBC regime for the insurance industry. In particular, the Bill seeks to amend the Inland Revenue Ordinance (IRO) to provide for a spreading over arrangement to assess the one-off increase in assessable profits arising from the implementation of the RBC regime over five years.

What is RBC?

RBC regime is an international standard for assessing the capital adequacy of an insurer. Currently, insurers of Hong Kong are subject to a rule-based capital adequacy regime. Positioning as an international financial centre, Hong Kong proposes to implement the RBC regime to align with international regulatory requirements in 2024. Capital requirements for an insurer will be determined in relation to the level of risk that it is bearing. As the valuation method for determining an insurer’s liabilities will change under the RBC regime, it is expected that there could be impact on taxation for some insurers.

Current tax treatment for insurance businesses

The assessable profits of a life insurance corporation are currently determined based on 5% of premium or adjusted surplus (i.e., life insurance fund minus the estimated liability) according to section 23 of the IRO.

For a business of insurance other than life insurance, which the IRO terms as non-life insurance business, the assessable profits are calculated based on the gross premium with adjustments in reserve for unexpired risks and other adjustments as stipulated in section 23A of the IRO.

Key proposed amendments to the IRO

Spreading over arrangement

Under the proposed RBC regime, the valuation method for determining an insurer's liabilities will change. In particular, prudence margins currently embedded in the insurance liabilities of some insurers will be released. If the assessable profits of an insurer are calculated with reference to liabilities, e.g., life insurance corporations assessed on an adjusted surplus basis and non-life insurance corporations, there may be a one-off increase in assessable profits arising from the implementation of the RBC regime.

To alleviate cash flow pressure on affected insurers, it is proposed that the IRO will be amended to provide for a spreading over arrangement whereby the one-off increase in assessable profits arising from the implementation of the RBC regime would be assessed over a period of five years. In other words, only the timing of profits tax receipts in relation to certain insurance products would be different, while the overall assessable profits of the affected insurers will remain unchanged.

A written election for the spreading over arrangement is required. Once the election is made, it is irrevocable.

Non-life long term insurance business

The IRO currently splits the insurance businesses into two categories – life insurance business and non-life insurance business. The Bill now proposes there to be three categories - life, non-life long term and general insurance businesses.

There is no amendment to the definition of life insurance business, which refers to the businesses of Class A (life and annuity), B (marriage and birth), C (linked long term) and E (tontines) as specified in Part 2 of Schedule 1 of the Insurance Ordinance (IO).

The Bill defines non-life long term insurance business to mean the businesses of Class D (permanent health), F (capital redemption), and I (retirement scheme) as specified in Part 2 of Schedule 1 of the IO. The assessable profits of these business classes were previously ascertained under the non-life insurance business category and taxed under section 23A of the IRO. The Bill provides that non-life long term insurance business should now be ascertained based on the adjusted surplus basis per section 23 of the IRO.

Apportionment formula for life insurers using adjusted surplus basis

For the computation of the one-off transitional adjustment for life insurers who adopt the adjusted surplus basis, an apportionment formula is proposed to identify the net asset value (NAV) of the life and non-life long term businesses. The apportionment formula uses the premiums of life and non-life long term businesses as a ratio to the NAV of the insurance fund.

Our observations

Spreading over arrangement

While the overall tax liabilities for insurers should remain unchanged, we welcome the proposal which takes into consideration of the cash flow impact brought to the insurers by the implementation of the RBC regime.

RBC early adopters

For the spreading of the one-off impact in assessable profit arising from the implementation of the RBC regime, the Bill clarifies that for insurers who early adopt the RBC regime, the spreading should begin in the year of assessment of which the insurers early adopt the RBC regime.

With regards to insurers who early adopt RBC in the middle of a year, rather than at the start of a year, there is a potential issue with the validity of statements, reports or information submitted to the authorities. The IO generally requires the statements, reports or information submitted to be audited. The figures, such as the tax computation of surplus, of early adopters who implemented the RBC regime in the middle of the year are however unlikely to be substantiated by an annual audited financial statement or an annual audited RBC return. Therefore, authorities should provide clarification on whether unaudited financial information and unaudited quarterly RBC returns would be acceptable from insurers who early adopt RBC in the middle of a year for the first six months of assessment, or whether such insurers can make an election to apply RBC retrospectively from the start of that assessment year in order to provide audited financial information to the authorities.

Non-life long term insurance business

The "non-life long term insurance business" category is new to the IRO. The change of taxation basis of the non-life long term insurance businesses from gross premium with adjustments from section 23A of the IRO to the adjusted surplus basis under section 23 affects insurers with non-life long term insurance businesses in many aspects, for example data collection, system changes, tax computations etc.

To alleviate the administrative and monetary burden of insurers, the IRD could consider an irrevocable election for insurers to choose between the current taxation basis under section 23A of the IRO and the proposed adjusted surplus basis in respect of non-life long term insurance business.

Apportionment formula for life insurers using adjusted surplus basis

The apportionment formula proposed in the Bill for the computation of the one-off transitional adjustment for life insurers who adopt the adjusted surplus basis seeks to identify the NAVs of the life and non-life long term businesses by comparing their respective amount of premiums. This approach seems to have assumed that the comparison of premiums is the most appropriate method in identifying the NAVs of the life insurance business and non-life long term insurance business. However, to the extent insurers have the NAV of the different lines of business readily available, then using the NAV directly should be more accurate than the premium apportionment method proposed in the Bill. In cases where actual data is available, the IRD could consider allowing insurers an election to use the actual data instead of adopting the proposed apportionment method in the Bill.

If you have any questions, please contact our professionals:

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