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# Hong Kong Tax Analysis

## IFRS 17: Tax issues in Asia Pacific

Author:

**Hong Kong**
**Jonathan Culver**
Tax Partner
Tel: +852 2852 6683
Email: joculver@deloitte.com.hk

### What is IFRS 17?

IFRS 17 is the new International Financial Reporting Standard (IFRS) for insurance and reinsurance contracts. IFRS 17 has been issued by the International Accounting Standards Board (IASB) in May 2017. It will replace IFRS 4, which was issued in March 2004 as an interim standard when it becomes effective for financial years beginning on or after 1 January 2021. The new IFRS aims to eliminate inconsistencies and weaknesses in existing practices and improve comparability between reporting entities that issue insurance contracts and that prepare financial statements under IFRS.

The new IFRS is expected to be adopted without any amendments across the Asia-Pacific region, with few exceptions, and to be effective in most jurisdictions as from 1 January 2021[1]. IFRS 17 will fundamentally change the income statement and balance sheet, including the recognition and measurement of profits and losses from insurance contracts.

[1] Thailand and Indonesia are currently expected to adopt with an effective date of 1 January 2022. Taiwan is expected to adopt with an effective date of 1 January 2024.

IFRS 17 reflects the following three key differences from IFRS 4:

1. Technical provisions will be the sum of (discounted) best estimate liabilities, an explicitly reported risk margin and a contractual service margin (CSM), also explicitly reported. The CSM is designed to represent the expected profit an insurance contract would generate. It would be released to the income statement and be a key component of insurance revenue so that insurers consistently recognize the provision of services over the life of the contracts they sell. The CSM is designed to defer the expected profits at initial recognition and to have them released by the end of the expected coverage period. The CSM guiding principle is that there should be no gain on day 1 of the contract, as insurance services have not yet been provided, but losses on day 1 are immediately recognized in the income statement in compliance with the general IFRS treatment of all onerous contracts (i.e. those where the expected inflows are lower than the expected outflows).

2. Certain changes in technical provisions that relate to future cash flows for any remaining coverage will adjust the CSM before being recognized in the income statement. These changes may be positive (i.e. increase the expected profit/CSM) or negative (i.e. decrease the expected profit/CSM). When these changes are larger than the residual CSM balance the excess over the CSM balance would be reported as a loss immediately in the income statement. This is to comply with the same principle regarding onerous contracts described above. The only difference being that this is reported after the initial recognition date as a result of subsequent changes in technical provisions.

3. IFRS 17 mandates a current measurement basis for all variables affecting the cash flows of an insurance contract. However, it also offers an option to account for changes in discount rates through other comprehensive income (OCI), rather than through the income statement, to present in the income statement a measure of time value of money that is not dependent on the level of market interest rates. Technical provisions on the balance sheet will always be presented using a full set of current assumptions including a current and market consistent discount rate yield curve. This OCI accounting option can mitigate short term volatility in the income statement, which the IASB has acknowledged may not be meaningful for long-duration insurance contracts.

The new IFRS will be applied retroactively as if IFRS 17 had always applied, up to the point in time that this is impracticable. As such, upon adoption, large transitional adjustments may arise, reversing profits or losses previously recognized in the accounts under IFRS 4.

Significant tax issues will arise from IFRS 17, particularly in jurisdictions that use accounting profit as a basis for taxation. While IFRS 17 is a complex IFRS and the tax issues that arise from IFRS 17 may be equally complex, they generally can be categorized into the following broad areas.

1. Transition issues – in particular, whether increases or decreases in retained earnings arising upon adoption will be taxable or deductible, and if so over what time period;

2. Profit recognition and measurement issues – whether the new basis of profit measurement and recognition under IFRS 17 will be respected for tax purposes; and

3. Tax accounting issues – tax issues that arise as a result of the above issues (e.g. a change in deferred tax asset recognition as a result of a change in the basis of taxation).

## Key tax issues

**Transition issues**
Upon adoption of IFRS 17, comparative figures will be restated to account for the difference between the profits previously reported in the accounts and the profits that would have been reported had IFRS 17 always applied.

IFRS 17 gives companies some flexibility in how these comparative figures are calculated. While a full retrospective approach must be used as far back until it becomes impracticable, a "modified retrospective" or "fair value" approach can be chosen beyond that point. However, whichever approach is taken beyond the point in time of impracticability, there could always be a large transitional adjustment upon adoption that will be recognized as an adjustment to retained earnings.
The direction and magnitude of the adjustment to retained earnings will vary between companies. However, we anticipate that the several companies will discount their liabilities at a lower discount rate under IFRS 17 than currently is the case. This should lead to an increase in their liabilities upon adoption and an immediate decrease in their retained earnings. This transitional adjustment would then be offset in future years, since the unwinding of the interest rate expenses over the coverage period in respect of the restated liabilities should lead to an increase in profitability when the insurer is able to earn returns from its investments that are higher than the IFRS 17 discount rate.

If companies are taxed on the basis of both movements in their retained earnings and their profitability, the above scenario could result in a favorable timing mismatch. However, in a number of countries that tax insurance companies based on their accounts, movements in retained earnings are disregarded, while profit reflected in the income statement is taxed. In these jurisdictions, the above scenario would result in a permanent increase in cash tax payable as the initial decrease in retained earnings would not attract a tax deduction, while future increases in profitability would be taxed.

Conversely, companies that expect to recognize an increase in retained earnings (e.g. they would use a higher discount rate in IFRS 17 than in IFRS 4 or they would have reduced their prudency margins beyond the excessive levels permitted in IFRS 4 to a more “normal” level as dictated by the IFRS 17 risk adjustment liability component) upon adoption of IFRS 17 and a reduction in future profits could benefit from a reduction in cash tax payable over a number of years. This, however, is on the assumption that tax authorities do not seek to amend their rules to tax the upfront increase in retained earnings as it arises, which could lead to an unfavorable timing mismatch.

Depending on the tax system in each jurisdiction, there are various outcomes companies could face beyond those discussed above and it is important for companies to fully understand the possible implications across each jurisdiction in the Asia Pacific region. Armed with such an understanding, companies could consider engaging in a dialogue with the tax authorities either not to make changes or to introduce transitional measures to reduce adverse implications.

**Ongoing profit recognition issues**
Under IFRS 17, the manner in which profits are recognized and measured will fundamentally change, and it is currently unclear how the majority of accounts-based tax regimes will apply to these changes. A wide range of potential issues exist, several of which are discussed below:

- **Contractual service margin (CSM)**
  The most significant change to the income statement relates to the recognition and measurement of profits during the coverage period. Profits will no longer be recognized upfront, but deferred and spread over a number of years (the expected coverage period) through a gradual release to profit of the CSM. The implication of this is a smoothing of profits and likely a smoothing of tax liabilities. There may be a slight deferral of taxable profits, particularly in markets where insurers are experiencing rapid growth in profitability.

- **Immediate recognition of losses**
  While profits will be spread over the coverage period of a contract, losses from onerous contracts will be recognized immediately as they arise and without offset against profitable contracts other than the from those other contracts that would have been aggregated in the same "group of insurance contracts" at initial recognition date. This effectively will create a timing mismatch that accelerates losses and defers profits. There is a question as to whether the immediate recognition of losses will be respected for tax purposes[2].

  The introduction of "groups of insurance contracts" are a critical new requirement in IFRS 17. Each group must not include more than twelve months of issued contracts at portfolio level and must be differentiated by reference to their profitability and sensitivity. IFRS 17 mandates three groups every twelve months for each portfolio: the group of contracts that are onerous at initial recognition (if any), the group of contracts that are profitable at initial recognition but have a "significant possibility of becoming onerous subsequently" and the profitable group that does not have such possibility. Groups are defined at initial recognition and never changed in subsequent periods until the last contract in the group has been derecognised.

- **Mismatches from reinsurance contracts held compared to the insurance contracts they reinsure**
  Reinsurance contracts are largely accounted for in the same manner as insurance contracts. However, there are circumstances where this will not be the case; for example, where a loss is immediately recognized in respect of the insurance contract, but the profit on the reinsurance contract is not recognized in the same period, which could lead to timing, or even permanent differences[3] for the taxpayer. Mismatches also may arise where the insurance contract and reinsurance contract have different terms and, therefore, are accounted for using different IFRS 17 measurement approaches, which may result in temporary or permanent tax differences.

- **Discount rate OCI election**
  Companies will have the ability to elect for discount rate changes caused by fluctuations in market interest rates to be recognized in either the income statement or split between the income statement and OCI. Profits and losses relating to coverage (impacted by non-financial variables) should generally be recognized through the CSM up to the expiry of the expected coverage period and the majority of profits and losses from financial factors still will be recognized through the income statement. However, the ability to elect to recognize profitability changes arising from discount rate changes in the OCI rather than in the income statement may have tax implications, particularly in jurisdictions that measure taxable profit based on the income statement and disregard the OCI.

**Tax accounting issues**

- **Deferred tax**
  To the extent the recognition, measurement and timing of taxable profits changes as a result of IFRS 17, deferred tax recognition may be affected. A deferral or acceleration of taxable profits could impact deferred tax balances, which could have consequential regulatory impacts. For example, a deferral of taxable profits that causes a deferred tax asset to be derecognized could increase the amount of regulatory capital an insurer is required to hold as a result of a decrease in the total loss absorption capacity of that deferred tax asset.

- **Effective tax rate**
  There is significant uncertainty in many Asia Pacific jurisdictions as to what tax measures will be taken with regard to IFRS 17. Where jurisdictions harmonize their tax regimes with IFRS 17 effective tax rate volatility is likely to be the lowest. However, where jurisdictions do not adjust their tax system and, for example, continue to use IFRS 4 for tax purposes, or adopt a regime based on solvency measurements

[2] If onerous contracts subsequently are revalued and become profitable, the initial expenses recognized in the income statement associated with the contract becoming onerous should be immediately unwound and any profit recognized should be deferred and spread through the CSM only after the historical loss has been fully reversed through profit or loss.
[3] Permanent differences could arise as a result of a number of factors; e.g. the inability to carry forward losses for a sufficient period of time to offset against profits.

not aligned with IFRS 17, effective tax rate volatility is likely to be higher, at least in the transition period.

## Preparing for IFRS 17

With the majority of jurisdictions in Asia Pacific due to adopt IFRS 17 from 1 January 2021, insurance companies already have begun making implementation preparations. Tax departments need to ensure that they fully understand the anticipated changes to profit profiles across each jurisdiction and how these could impact them from a tax perspective.

It will be important to educate tax authorities across each jurisdiction in the coming months and to begin an active dialogue with them to ensure that appropriate transition measures are implemented. A timely dialogue is particularly important given the complexity of IFRS 17 and given that industry positions will not necessarily converge on these complex issues given the fragmented starting point of IFRS 4 reporting.

Ensuring that tax is well represented in implementation projects will also be particularly important. Tax departments will need to ensure that sufficient resources are directed towards implementing IFRS 17 from a tax perspective and, in particular, that flexible systems are implemented to be able to cope with multiple different outcomes.

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**Beijing**
**Andrew Zhu**
Partner
Tel: +86 10 8520 7508
Fax: +86 10 8518 7326
Email: andzhu@deloitte.com.cn

**Chengdu**
**Frank Tang / Tony Zhang**
Partner
Tel: +86 28 6789 8188
Fax: +86 28 6500 5161
Email: ftang@deloitte.com.cn
tonzhang@deloitte.com.cn

**Chongqing**
**Frank Tang / Tony Zhang**
Partner
Tel: +86 23 8823 1208 / 1216
Fax: +86 23 8859 9188
Email: ftang@deloitte.com.cn
tonzhang@deloitte.com.cn

**Dalian**
**Bill Bai**
Partner
Tel: +86 411 8371 2816
Fax: +86 411 8360 3297
Email: bilbai@deloitte.com.cn

**Guangzhou**
**Victor Li**
Partner
Tel: +86 20 8396 9228
Fax: +86 20 3888 0121
Email: vicli@deloitte.com.cn

**Hangzhou**
**Qiang Lu**
Partner
Tel: +86 571 2811 1900
Fax: +86 571 2811 1904
Email: qilu@deloitte.com.cn

**Harbin**
**Jihou Xu**
Partner
Tel: +86 451 8586 0060
Fax: +86 451 8586 0056
Email: jihxu@deloitte.com.cn

**Hong Kong**
**Sarah Chin**
Partner
Tel: +852 2852 6440
Fax: +852 2520 6205
Email: sachin@deloitte.com.hk

**Jinan**
**Beth Jiang**
Partner
Tel: +86 531 8518 1058
Fax: +86 531 8518 1068
Email: betjiang@deloitte.com.cn

**Macau**
**Raymond Tang**
Partner
Tel: +853 2871 2998
Fax: +853 2871 3033
Email: raytang@deloitte.com.hk

**Nanjing**
**Rosemary Hu**
Partner
Tel: +86 25 5791 6129
Fax: +86 25 8691 8776
Email: roshu@deloitte.com.cn

**Shanghai**
**Maria Liang**
Partner
Tel: +86 21 6141 1059
Fax: +86 21 6335 0003
Email: mliang@deloitte.com.cn

**Shenzhen**
**Victor Li**
Partner
Tel: +86 755 3353 8113
Fax: +86 755 8246 3222
Email: vicli@deloitte.com.cn

**Suzhou**
**Kelly Guan**
Partner
Tel: +86 512 6289 1297
Fax: +86 512 6762 3338
Email: kguan@deloitte.com.cn

**Tianjin**
**Bill Bai**
Partner
Tel: +86 411 8371 2816
Fax: +86 411 8360 3297
Email: bilbai@deloitte.com.cn

**Wuhan**
**Gary Zhong**
Partner
Tel: +86 27 8526 6618
Fax: +86 27 6885 0745
Email: gzhong@deloitte.com.cn

**Xiamen**
**Charles Wu**
Partner / Director
Tel: +86 592 2107 055
Fax: +86 592 2107 259
Email: chwu@deloitte.com.cn


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**National Tax Technical Centre**
Email: ntc@deloitte.com.cn

**National Leader**
**Ryan Chang**
Partner
Tel: +852 2852 6768
Fax: +852 2851 8005
Email: ryanchang@deloitte.com

**Southern China (Hong Kong)**
**Ryan Chang**
Partner
Tel: +852 2852 6768
Fax: +852 2851 8005
Email: ryanchang@deloitte.com

**Northern China**
**Julie Zhang**
Partner
Tel: +86 10 8520 7511
Fax: +86 10 8518 1326
Email: juliezhang@deloitte.com.cn

**Southern China (Mainland/Macau)**
**German Cheung**
Director
Tel: +86 20 2831 1369
Fax: +86 20 3888 0121
Email: gercheung@deloitte.com.cn

**Eastern China**
**Kevin Zhu**
Partner
Tel: +86 21 6141 1262
Fax: +86 21 6335 0003
Email: kzhu@deloitte.com.cn

**Western China**
**Tony Zhang**
Partner
Tel: +86 23 8823 1216
Fax: +86 23 8859 9188
Email: tonzhang@deloitte.com.cn


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