21 July 2023

The Treasury

By email: insurancetaxconsultation@treasury.gv.au

Dear sir/madam

Taxation of general insurers – Aligning tax treatment of contracts with AASB 17

The Insurance Council of Australia[1] (Insurance Council) welcomes the opportunity to contribute to the alignment of the tax treatment of insurance contracts with Accounting Standard AASB 17 (AASB 17). We offer the below comments on the exposure draft of the *Treasury Laws Amendment (Measures for Future Bills) Bill 2023: income tax amendments for updates to accounting standards for general insurance contracts* (exposure draft) and the bill's explanatory memorandum.

We note that the short consultation period and timing of the consultation has resulted in an inability for the general insurance industry to fully test the implications of the exposure draft. Our submission is made on this basis. All section references are to the *Income Tax Assessment Act 1997* unless specified otherwise.

Proposed changes to Section 321-60 How the value of adjusted liability for remaining coverage is worked out

The Insurance Council is concerned about the proposed calculation of the Adjusted Liability for Remaining Coverage (ALfRC). The draft method statement requires taxpayers to disregard fulfillment cash flows that are neither premiums nor insurance acquisitions cash flows. This approach will exclude several critical cash flows, notably those associated with both General Model (GM) contracts (which is the default measurement model under AASB17), and the Premium Allocation Approach (PAA) contracts.

There are several types of cash flows that are not premiums or acquisition costs but are integral to the financial operations of insurers. These include claim experience adjustments, policyholder services, policy fees, retrospective reinsurance (accounted distinctly from traditional reinsurance), reinstatement fees, cancellation or surrender charges, FX currency adjustments, premium taxes and regulatory fees, and the Contractual Services Margin used in GM contracts.

Disregarding a substantial number of cash flows will result in a deviation from an insurer's financial statements, thereby skewing the income tax obligations and resulting in significant timing difference between accounting and tax treatments. This will cause capital strain on insurers, increase compliance costs and regulatory complexity. It would also be counter to the stated policy objective of reducing compliance costs and creating a simplified regulatory framework for insurers.

There will also be operational complications that arise from the proposed exclusions. Firstly, insurers may find it challenging to distinguish cash flows that are not premiums or acquisition costs, depending

[1] The Insurance Council is the representative body for the general insurance industry in Australia, representing approximately 89% of private sector general insurers. As a foundational component of the Australian economy the general insurance industry employs approximately 60,000 people, generate gross written premiums of $59.2 billion per annum and on average pays out $148.7 million in claims each working day ($38.8 billion per year).

on the chosen computation model and associated software. This difficulty arises from the complex actuarial modelling of an insurer's cash flows. Secondly, the identification of separate cash flows may necessitate judgement. This may become the focus of audit scrutiny, potentially impairing an insurer's ability to achieve justified trust with the Australian Taxation Office. There is a significant risk of inadvertently creating ambiguity and opening avenues for potential dispute.

To remedy this, the Insurance Council proposed an amendment of the method statement to include all cash flows associated with general insurance policies in the calculation of the ALfRC. We believe that this amendment would better reflect the realities of the general insurance industry, align tax laws with AASB17 more effectively and reduce compliance costs.

Definitions

We note the definition of accounting standard AASB 17 (2023) refers to the standard as at 1 January 2023. This will not accommodate any subsequent changes that are made to the standard and will lead to timing differences emerging if and when changes are made to the accounting standard. We recommend that the legislation refers to the relevant accounting standard as is in force. Alternatively, Division 321 could be linked to accounting standard AASB 17 (2023) or the applicable standard as prescribed in the Regulations.

Onerous losses

We note a potential issue that may inadvertently result in the double exclusion of onerous losses from the ALfRC. This concern arises from *Steps 1(a)* and *1(b)* in the method statement within *Section 321-60* of the exposure draft.

Step 1(a) requires that any fulfillment cash flows that are neither premiums nor insurance acquisition cash flows be disregarded. This disregarding effectively reduces onerous losses from the calculation since such losses generally form part of fulfillment cash flows that do not constitute premiums or insurance acquisition costs. Subsequently, *Step 1(b)* of the method statement requires the exclusion of onerous losses from the ALfRC calculation. This appears a duplicate removal of onerous losses, which we believe to be unintentional.

The double exclusion of onerous losses would lead to an understatement of an insurer's liabilities. We therefore recommend an update to the exposure draft. One possible resolution would be to clarify the definition of fulfillment cash flows in *Step 1(a)*. Alternatively, *Step 1(b)* could be modified to avoid any duplicate removal of onerous losses.

At paragraph 1.32, the explanatory memorandum suggests that onerous contracts are to be treated as if they were non-onerous. The treatment of onerous contracts is a key component of AASB 17. It may be beneficial to provide more detail on how to treat onerous contracts as if they were non-onerous. For example, not recognising the loss component of an onerous contract as a liability for tax.

Reinsurance recoveries on onerous losses

The Insurance Council notes that the methods statements in *Sections 321-60* and *321-20* appear to result in inconsistencies in respect of onerous losses and their related reinsurance recoveries. Under *Step 1(b)* of the method statement within *Section 321-60*, onerous contracts are to be excluded when determining the ALfRC. In contrast, *Step 2* of the method statement within *Section 321-20* requires the inclusion of reinsurance recoveries, including reinsurance recoveries with respect to onerous losses, when computing the ALfRC.

This discrepancy could result in a scenario whereby reinsurance recoveries relating to onerous losses are included in the ALfRC calculation and thereby considered as assessable income. Concurrently, the corresponding onerous losses are excluded from the ALfRC computation and thereby considered as non-deductible expenditure.

We recommend uniformity across these calculations to offer an accurate and fair depiction of an insurer's liabilities. Therefore, we suggest that reinsurance recoveries associated with onerous losses should also be disregarded from the ALfRC computation. This approach ensures alignment with the treatment of onerous losses in the ALfRC calculation. To resolve this issue, we recommend modifying the method statement in *Section 321-20*. This could be supplemented with expanded guidance in the explanatory memorandum. Such measures will provide clarity and consistency in the interpretation and application of these provisions.

Transitional adjustment

In the exposure draft, the transitional adjustment on adoption of AASB 17 is brought to tax in the first year that AASB 17 applies. For some general insurers, this is a significant cash tax impost on adoption of the standard. Other insurers may be required to recognise a net tax asset on transition, resulting from an overall increase in their liabilities under AASB 17. This impost has occurred in an environment of intense capital pressure, due to a challenging reinsurance market as a result of more frequency and severe catastrophes.

General insurers now have to accommodate a retrospective tax liability, which may cause some insurers significant detriment. As a matter of fairness for impacted insurers, this tax liability should be spread over time.

We recommend that an option is included in the legislation to spread the transition to AASB 17 over 4 to 5 years for tax purposes. This would allow general insurers with a cash tax liability to model the capital requirements and hold the necessary capital. An optional transitional adjustment is particularly necessary as the exposure draft was released in July 2023, but it applies from 1 January 2023 (or on transition to AASB 17). Up until the release of the exposure draft, general insurers have had no indication of how the transition to AASB 17 would be dealt with for tax purposes. There has not been enough time to plan and model the capital required for this change.

Worked example in the explanatory memorandum

The Insurance Council has concerns over the proposed exclusion of certain fulfillment cash flows in calculating both the ALfRC and Adjusted Liability for Incurred Claims and the interaction of reinsurance contracts held. We are concerned that these changes may unintentionally eliminate crucial cash flows and/or lead to a duplication in the removal of other cash flows, notably those associated with onerous contracts. Such discrepancies can add complexity to and create uncertainty when interpreting and applying the provisions of tax laws. A worked example will serve to mitigate any uncertainties and misinterpretations and contribute to the effective implementation of the amendments to address AASB 17.

We recommend including a detailed worked example in the explanatory memorandum. A worked example would assist in clarifying the intention and intended application of the exposure draft. The worked example should address contracts subject to the default general model and those eligible for the PAA. The worked example should also take into account the broad range of cash flows typically relevant to general insurers to ensure its applicability and usefulness. Key cash flows include premium income, instalment premium income, claims and claims settlement costs (attributable and non-attributable costs), subrogation recoveries, commissions income, reinsurance premiums (both

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proportional and non-proportional), reinsurance recoveries, reinsurance commissions, investment income, policy fees, changes in risk adjustment for non-financial risk, and the effect of discounting and changes in discount rates.

General insurance company branches

The explanatory memorandum provides at paragraph 1.10 that general insurance companies must use the measurement approach they have adopted in their audited financial statements. As branches of general insurance companies are not required to produce audited financial statements, we propose that paragraph 1.10 be extended to include audited yearly statutory accounts prepared in accordance with AASB 17 for the Australian Prudential Regulatory Authority.

Consequential amendments required from the proposed changes to AASB 17

The change in accounting standard to AASB 17 will have consequential impacts on other Australian income taxation laws, notably those associated with the Controlled Foreign Company (CFC) rules. The CFC rules appear, unintentionally, to have not been considered in the exposure draft. This could potentially lead to misalignments, inconsistencies and interpretation difficulties for general insurers.

Our concern specifically pertains to *Subdivision 768-G* and *Part X* of the *Income Tax Assessment Act 1936* (ITAA 1936). These sections currently use language associated with the previous accounting standard (AASB 1023), for instance the term “outstanding claims.” As the transition from AASB 1023 to AASB 17 brings a significant shift in the accounting language and structure, it is crucial to ensure that the tax laws reflect these changes in a consistent and coherent manner. The term “outstanding claims” as used under AASB 1023, serves as a cornerstone for provisions under the CFC rules. It is explicitly referenced in *Section 446* of the ITAA 1936. Furthermore, the Active Foreign Business Asset Percentage rules, under *Subdivision 768-G,* use this term to guide insurers in their calculations. Given the proposed changes under AASB 17, there could be significant ambiguity associated with terms like "outstanding claims." Any misalignment or mismatch in the language can potentially lead to discrepancies in interpretation and application, thereby increasing the complexity and compliance burden for insurers.

To alleviate these concerns, we propose a thorough review and updating of the mentioned sections in line with AASB 17. This would involve redefining key terms such as "outstanding claims" and ensuring their consistent usage across different sections in the income tax legislation. Doing so would improve the clarity and consistency of the tax laws but also make them more manageable and user-friendly for insurers.

We would welcome further engagement with the Government on matters relating to AASB17. To continue this discussion, please contact Mr Eamon Sloane, Policy Advisor, Policy and Regulatory Affairs, at esloane@insurancecouncil.com.au or 0423 671 072.

Regards

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