Insurance Insights

Taxing issue of IFRS 4 Phase II

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Now that the exposure draft for IFRS 4 Phase II has been published, insurance companies can get a better understanding of its implications and consider how they would need to adjust their insurance related balances. However, the impact on tax, both current and deferred, is more uncertain.

Although it is difficult to predict how or when different fiscal authorities will react, insurers need to understand the potential impact on tax of the conversion to IFRS 4 Phase II. Even where there is no change to current tax, IAS 12 will require deferred tax to be addressed where differences arise between the book basis and the tax basis. This will impact the deferred tax amounts recorded.

At the very least, insurers should closely monitor developments to the tax regime in this area and maintain close contact with local regulators and fiscal authorities to keep on top of any developments.

IFRS 4 Phase II: what might happen to tax?

Across Europe, each country is responsible for the corporate tax regime. In the case of insurance, regimes can vary considerably from country to country. Some countries use regulatory surplus under Solvency I as the measure of taxable profits. Others use local GAAP, and there are still others that have methods of determining profits bespoke to tax. So determining the tax impact will not be consistent from country to country.

Each country is likely to have to reassess whether or not to change the tax base when IFRS 4 Phase II becomes effective. Even if the change to IFRS 4 Phase II does not directly result in a change, Solvency II may give rise to such a change by removing Solvency I as the basis for local GAAP or as the tax base itself.

The adoption of IFRS 4 means that companies will probably have to apply the standard to insurance contracts at each of the two previous reporting dates with restatement of balance sheets and income statements. For accounting purposes, retained earnings are adjusted by the cumulative difference at the start of the comparative period.

Because of the potential for double taxation, or for profits falling out of tax altogether, from a change from local GAAP to IFRS 4 Phase II, taxing the cumulative difference needs to be considered if, and when, there is a change in the tax base. Fiscal authorities and/or governments could respond to such a difference in three ways:

- Tax the entire adjustment
- Tax part of the adjustment
- Leave the adjustment out of account for tax

If the authorities choose either of the first two options, they need to decide whether to provide relief in cases where the restated IFRS retained earnings is lower than the previous numbers. If they are higher, they will have to decide whether to demand all the tax immediately or spread it over time. This would give rise to a transitional adjustment increasing taxable profits.

Unless the fiscal authorities change the basis and leave the adjustment out of account for tax, tax will need to be recognized on the taxable amount of the difference between the current tax base and IFRS 4 Phase II. This will be current tax if the tax basis is changed and the amount is brought into tax. Otherwise, it will be deferred tax.

Thus, the tax implications of the IFRS 4 Phase II reporting will differ from country to country. In the UK, for example, insurance companies are already taxed by reference to their financial statements, so a company reporting under the new standard would have to change the basis on which it pays tax. Other countries' fiscal authorities may apply adjustments to local GAAP or amend the way that liabilities are measured for tax purposes.

What does this mean for companies?

From a tax perspective, a major concern with any new reporting regime is volatility of earnings, which may have an impact on volatility of taxable income. For example, if, having switched to IFRS 4 Phase II, an insurer makes profits in earlier periods followed by losses in later periods, there could be significant tax costs if there is not an adequate mechanism for the carryback of losses for tax purposes. The same may be true for the opposite case if there is not an adequate mechanism for tax loss carryforwards.

IT costs are a further consideration. If the tax base does not change for IFRS 4, and tax continues to be calculated based on existing taxing structure, insurers will have to keep two separate systems running to ensure they have the appropriate information for their tax returns. This would become three if Solvency II came into effect and there were still no changes to the tax base. Insurers are already making system changes to accommodate Solvency II Pillar 3. They may want to think more carefully about when to make systems changes so as to avoid going through multiple change programs in a short time, preferring to address IFRS 4 Phase II and Solvency II in a single exercise.

Country profiles

While all jurisdictions will be impacted in some shape or form, France, Germany and the UK are used as examples here.

France

Taxable profits of insurance companies in France are based on financial statements under local GAAP. French GAAP is based on Solvency I and included in the French insurance code, which also provides for French-specific rules for insurance business.

We understand that the current intention is to extract the accounting rules from the current insurance code and issue a specific tax accounting regulation that will maintain the old rules based on historical values.

The implementation of IFRS 4 Phase II is not expected to impact French GAAP or the tax code and so there is likely to be very small current tax impact, as French taxes will not be based on IFRS accounts. Deferred tax will, however, need to be addressed where there are temporary differences between the tax base and the IFRS balance sheet.

The use of Solvency I in French GAAP is not expected to change to Solvency II.

Germany

In Germany, taxable profits of insurance companies are based on financial statements under German GAAP, with tax adjustments, including those relating to the value of technical reserves/case reserves which must be valued "more realistically", meaning that they must be less conservative than in German GAAP financial statements. They must be also discounted using an interest rate of 5.5%. There is a special rule for life insurers, saying that any special valuation rules that might apply to investments for tax purposes are ignored and that valuation under German GAAP is decisive.

In Germany, required capital under Solvency I is a function of the financial statements, in particular of the reserves, premiums earned and written, and claims. It is unlikely that the implementation of IFRS 4 Phase II will impact German GAAP.

In Germany, accounting changes are within the scope of responsibility of the Department of Justice, whereas taxes are within the scope of the Ministry of Finance. As an example, when Germany changed the legal requirements on financial reporting to bring them more in line with IFRS in some respects,[1] the Government said that this would have no impact on taxation. However, in a subsequent change of mind, the tax authorities decided that

1 The German Accounting Modernization Bill shifted the focus from creditor protection (which entailed understatements of assets and overstatements of liabilities) to better reflecting the financial situation of the company, thus implementing some IFRS principles. This was enacted in 2009.

there should be an impact after all. This demonstrates that government attitudes can change, but also that there can be a time lag between the passing of an accounting law and subsequent changes to tax laws or regulations.

United Kingdom

Profits of insurance companies in the United Kingdom are based on company financial statements. If IFRS is used at company level, these will follow IFRS. Otherwise, they will follow UK GAAP.

Current UK GAAP uses the regulatory (Solvency I) valuation basis as a starting point to determine the value of insurance contract liabilities in the financial statements. Since IFRS 4 Phase I grandfathered previous GAAP, UK GAAP was carried forward under IFRS 4 Phase I by insurance companies in the UK. At the start of 2013, the Financial Reporting Council issued changes to the UK financial reporting framework that will impact all entities currently reporting under UK GAAP.

The shift away from current UK GAAP will require all large entities and groups to report in accordance with a new UK standard or IFRS. The first mandatory UK GAAP financial statements will be required for 31 December 2015 year-ends, with a 1 January 2014 transition balance sheet. The insurance contracts standard under UK GAAP is expected to be similar to IFRS 4 Phase I and to include current UK GAAP as reporting guidance. Companies currently using UK GAAP are therefore not expected to change the basis of accounting for insurance contracts when UK GAAP is replaced.

When Solvency II comes into effect, both UK GAAP and IFRS reporters are likely to have the choice either to retain their existing Solvency I-based accounting policies, or to change them. Under IFRS 4, accounting policies for insurance contracts may be changed if the new policies will produce information that is more relevant and no less reliable, or more reliable and no less relevant, to the decision making needs of users of financial statements. Insurers might therefore seek to base insurance contract liabilities on the new Solvency II regulatory basis.

Whether companies decide to change their accounting policies for the introduction of Solvency II is likely to be influenced by the adoption date of the new IFRS 4 standard (Phase II) as well as the decision by the FRC whether to introduce IFRS 4 Phase II into new UK GAAP or not.

This means that there is the potential for insurance companies to change their accounting policies for insurance contracts twice: upon the introduction of Solvency II; and upon adoption of IFRS 4 Phase II. The changes could result in significant changes to liability valuation and, therefore, to reported shareholders' equity.

UK tax legislation would bring any transitional adjustment into tax in the year of adoption of a new standard or policy. However, the historical attitude of HMRC as the UK tax authority is to legislate for the spreading of significant adjustments, in particular those resulting from restatement of long-term business liabilities. This will be addressed in consultation between the industry and HMRC.

What should insurers do next?

There are a number of issues for insurers to consider in determining which framework to adopt and when to convert. Conversion projects require careful management to ensure that decisions on accounting policies align with the entity's strategic direction.

Insurers should start the process of understanding and assessing the tax implications of technical accounting differences between the current accounting framework and the new framework, and the impact on retained earnings, tax payments and the related tax charge. With so much uncertainty over future tax, companies should ensure that their tax teams are aware of potential changes and able to calculate the impact of different tax scenarios.

In particular:

- Tax can affect capital requirements, so tax should become part of the calculation and reporting processes.
- Tax data and systems will need to be integrated with those of finance and actuarial.
- Tax calculations and related controls should be an integral part of the reporting conversion.

Companies may want to stay close to decision makers and provide input to the legislative process to influence the tax treatment of transitional adjustments and the future measure of taxable profits.

How EY can help

We can help you with:

- Training by subject matter professionals in financial accounting, tax and actuarial matters covering the impact of IFRS 4 Phase II on current tax and tax reporting by company and country.
- Design and implementation of tax reporting and filing processes reflecting the change in accounting standards.
- Modeling the impact of the adoption of IFRS 4 Phase II on the income statement tax charge and current and deferred tax balances over the life of in-force business.
- Assistance with approaching fiscal authorities and governments on an individual group or company, or on a collective industry basis, to facilitate a smooth transition to IFRS 4 Phase II from a tax perspective.

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