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THE PARLIAMENT OF THE COMMONWEALTH OF AUSTRALIA

HOUSE OF REPRESENTATIVES

TREASURY LAWS AMENDMENT (MEASURES FOR FUTURE BILLS) BILL
2023: INCOME TAX AMENDMENTS FOR UPDATES TO ACCOUNTING
STANDARDS FOR GENERAL INSURANCE CONTRACTS

EXPOSURE DRAFT EXPLANATORY MATERIALS

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Glossary

This Explanatory Memorandum uses the following abbreviations and acronyms.

<i>Abbreviation</i>	<i>Definition</i>
AASB 17	Australian Accounting Standards Board Accounting Standard 17 <i>Insurance Contracts</i>
AASB 1023	Australian Accounting Standards Board Accounting Standard 1023 <i>General Insurance Contracts</i>
Bill	Treasury Laws Amendment (Measures for Future Bills) Bill 2023: income tax amendments for updates to accounting standards for general insurance contracts
Commissioner	Commissioner of Taxation
ITAA 1936	<i>Income Tax Assessment Act 1936</i>
ITAA 1997	<i>Income Tax Assessment Act 1997</i>

Chapter 1: Income tax amendments for updates to accounting standards for general insurance contracts

Outline of chapter

Schedule # to the Bill amends the income tax law with respect to general insurance to provide broad alignment with the new AASB 17. This reduces the income tax compliance burden on the general insurance industry caused by the misalignment between the new AASB 17 and the existing ITAA 1997 requirements.

Context of amendments

- 1.1 Division 321 of the ITAA 1997 sets out requirements for calculating tax liabilities that arise from general insurance contracts. Prior to the amendments, the key methodologies in Division 321 broadly align with the requirements of AASB 1023. From 1 January 2023, AASB 17 replaced AASB 1023 as the mandatory methodology for accounting for insurance contracts for financial reporting purposes.
- 1.2 The amendments seek to minimise the regulatory burden facing general insurers following the introduction of the AASB 17, which fundamentally differs from accounting standard AASB 1023. This will allow general insurers to continue using audited financial reporting information as the basis for their tax returns.
- 1.3 Legislative references in this Chapter are made to the ITAA 1997 unless otherwise specified.

Comparison of key features of new law and current law

Table 1.1 Comparison of new law and current law

New law	Current law
Subdivision 321-A – compare the value of <i>adjusted liability for incurred claims</i> at the end of an income year with the value at the	Subdivision 321-A – compare the value of <i>outstanding claims liability</i> at the end of an income year with the value at the end of the

New law	Current law
<p>end of the previous income year to determine if the change in the adjusted liability for incurred claims should be treated as assessable income or as a deduction.</p> <p>The measurement of liability for incurred claims is aligned to the AASB 17, except where an accounting to tax adjustment is necessary. This amount is reduced by estimated recoveries from reinsurance premiums.</p> <p>A general insurance company continues to be able to deduct claims paid during the current year.</p>	<p>previous income year to determine if the change in the liability for outstanding claims should be treated as assessable income or as a deduction.</p> <p>The subdivision sets out a two-step method statement to calculate outstanding claims liability: calculate the present value of the estimated outstanding claims liabilities of a general insurance company and reduce this amount by the present value of estimated recoveries.</p> <p>A general insurance company can deduct claims paid during the current year.</p>
<p>Subdivision 321-B – compare the value of <i>adjusted liability for remaining coverage</i> at the end of an income year with the value at the end of the previous income year to determine if the change in the adjusted liability for remaining coverage should be treated as assessable income or as a deduction.</p> <p>The measurement of liability for remaining coverage is aligned to the AASB 17, except where an accounting to tax adjustment is necessary. This amount is reduced by reinsurance premiums paid or payable with respect to the relevant reinsurance premiums.</p> <p>A general insurance company continues to include premiums received or receivable during the year as assessable income.</p>	<p>Subdivision 321-B – compare the value of <i>unearned premium reserve</i> at the end of an income year with the value at the end of the previous income year to determine if the change in the unearned premium reserve should be treated as assessable income or as a deduction.</p> <p>The subdivision sets out a five-step method statement to calculate unearned premium reserve. The unearned premium reserve at the end of the year is the value that the general insurance company determines based on proper and reasonable estimates, to relate to risks covered by policies in respect of later income years.</p> <p>The assessable income of a general insurance company includes gross premiums received or receivable by the company during the year.</p>

Detailed explanation of new law

Subdivisions 321-A and 321-B – General insurance

- 1.4 Schedule # to the Bill amends Subdivisions 321-A and 321-B to broadly align the income tax treatment for general insurance companies with the AASB 17. The tax treatment of assessable income and deductions in respect of the underwriting account will continue to mirror the taxpayer's accounting income and expenses, with some timing differences.
- 1.5 The main changes are made in relation to:
- Subdivision 321-A – 'outstanding claims liabilities' is updated to 'liability for incurred claims';
 - Subdivision 321-B – 'unearned premium reserve' is updated to 'liability for remaining coverage'; and
 - The respective method statements are updated to broadly align with the AASB 17.

AASB 17

- 1.6 The amendments introduce several definitions, including the reference to the AASB 17 as of 1 January 2023 and relevant terms used in the AASB 17.
- [Schedule #, item 13, subsection 995-1(1)]*
- 1.7 AASB 17 is used for the purposes of calculating the adjusted liability for incurred claims and the adjusted liability for remaining coverage. The relevant version of the AASB 17 is the one that came into effect on 1 January 2023, and can be accessed on the Federal Register of Legislation: <https://www.legislation.gov.au/Details/F2023C00382>.
- 1.8 New Division 321 requires the use of the version of AASB 17 that was effective on 1 January 2023. This incorporation by reference in the legislation ensures that any future changes to the standard do not change the tax outcomes as considered by Parliament at the time these amendments are made.
- 1.9 For tax purposes, the calculation of liability for incurred claims and of liability for remaining coverage requires the use of the methodology set out in the AASB 17 (unless otherwise stated or excluded under in the legislation).

- 1.10 General insurance companies must use the measurement approach they have adopted in their audited financial statements prepared according to AASB 17. The adjustments apply for both measurement approaches.

Liability for Incurred Claims

- 1.11 The concept of liability for incurred claims comprises the fulfilment cash flows related to past services allocated to the relevant group of contracts at that date.
- 1.12 To align the ITAA 1997 with current the accounting standard, the concept of ‘outstanding claims liability’ is replaced with the ‘liability for incurred claims’ as referred to in the AASB 17. The accounting value for liability for incurred claims is however, adjusted for tax purposes.
- 1.13 The provisions compare the value of a general insurance company’s adjusted liability for incurred claims at the end of an income year with the value of those adjusted liabilities at the end of the previous income year.
- If the value of the adjusted liability for incurred claims at the end of an income year is less than the value at the end of the previous income year, the difference is included as assessable income.
 - If the value of the adjusted liability for incurred claims at the end of an income year exceeds the value at the end of the previous income year, the excess is recognised as deductible.

[Schedule #, items 1, 2, 3 and 4, sections 321-10 and 321-15]

- 1.14 The method for valuation of a general insurance company’s adjusted liability for incurred claims is principally incorporated by reference to the AASB 17.
- 1.15** The first step in the method statement is to measure the liability for incurred claims at the end of the income year using the AASB 17. The company must measure their liability for incurred claims using the approach adopted for accounting purposes.

[Schedule #, item 5, step 1 in the method statement in section 321-20]

- 1.16 However, the measurement of liability for incurred claims is adjusted for tax purposes, to exclude certain accounting values from the calculation of liability for incurred claims, including claims handling costs that are not attached to, nor directly attributable to, a particular claim.
- 1.17 The tax adjustment replicates the previous tax treatment, by including only settlement costs directly associated with the relevant claim. Indirect settlement costs, also known as indirect claims handling costs, include the general expenses of running and administering a general insurer’s claims department. These types of costs do not attach to, nor are they attributable to, a particular claim, so should not be included in the calculation of the liabilities for a

particular claim. Examples of indirect settlement costs could include items in paragraphs B65(f) and (l) of the AASB 17. For the purposes of the tax law amendments, the term ‘direct settlement costs’ has been replaced by the term ‘claims handling costs that are neither attached to, nor directly attributable to, a particular’, to align with the terminology used in the AASB 17. That is, the previous law included direct settlement costs whereas the new law achieves a similar result by disregarding ‘indirect’ claims handling costs.

- 1.18 The second step in the method statement is to reduce the step 1 amount by the amount that the company expects to recover under a contract of reinsurance held by the general insurance company, as measured using the AASB 17.
[Schedule #, item 5, step 2 in the method statement in section 321-20]
- 1.19 However, the step 1 amount is not reduced by the amount that the company expects to recover under a contract of reinsurance to which subsection 148(1) of the ITAA 1936 applies.
[Schedule #, item 5, step 2 in the method statement in section 321-20]
- 1.20 Subsection 148(1) applies, so far as is relevant, to a reinsurance policy taken out by a general insurance company carrying on business in Australia with a non-resident company. If the subsection applies, broadly:
- the Australian general insurance company cannot deduct premiums paid in respect of the policy and is not assessable on any reinsurance recoveries; and
 - the non-resident reinsurance company is not assessed in Australia on the premiums received or receivable
- 1.21 Under step 2 in the method statement, the value of the reinsured company’s liability for incurred claims is not reduced by the amount the company expected to recover under a reinsurance contract to which subsection 148(1) applies. If step 2 was reduced by this amount, the reinsured company’s taxable income would effectively be increased by the amount of the expected reinsurance recoveries. This would be inconsistent with the objective of subsection 148(1).

Payment of claims

- 1.22 The amendments do not alter the taxation treatment of general insurance companies in respect of the payment of claims.
- 1.23 A general insurance company can deduct the amounts paid during an income year in respect of claims under general insurance policies.

- 1.24 In this context, a claim is taken to be paid by a general insurance company in an income year even though the funds have not actually been disbursed at the end of the income year provided that:
- the amount of the claim is settled in that income year;
 - the relevant liability is no longer reflected in the company's liability for incurred claims at the end of that income year; and
 - the claim is payable by the company at the end of that income year.

Liability for Remaining Coverage

Gross Premiums

- 1.25 Gross premium income received or receivable in respect of general insurance policies in an income year is unchanged from the previous law. Gross premiums are included in a general insurance company's assessable income.

Liability for Remaining Coverage

- 1.26 Under the amendments, the liability for remaining coverage comprises the fulfilment cash flows related to future services allocated to the relevant group of contracts at that date.
- 1.27 To align the ITAA 1997 to the current accounting standard, the concept of 'unearned premium reserve' is replaced with the 'liability for remaining coverage' as referred to in the AASB 17. The accounting value of the company's liability for remaining coverage is however, adjusted for tax purposes. The general insurance company's liability for remaining coverage for insurance policies relate to risks covered by those policies in respect of later income years. The value of the liability must be worked out at the end of each income year.
- 1.28 The provisions compare the value of a general insurance company's adjusted liability for remaining coverage at the end of an income year with the value of the liability at the end of the previous income year.
- If the value of the adjusted liability for remaining coverage at the end of an income year is less than the value at the end of the previous income year, the difference is included as assessable income.
 - If the value of the adjusted liability for remaining coverage at the end of an income year exceeds the value at the end of the previous income year, the excess is recognised as deductible.

[Schedule #, items 6, 7, 8, 9, 10, 11, sections 321-50 and 321-55]

- 1.29 The first step in the method statement is to measure the liability for remaining coverage at the end of the income year using the AASB 17. The company must measure their liability for remaining coverage using the approach adopted for accounting purposes.
[Schedule #, item 12, step 1 in the method statement in section 321-60]
- 1.30 However, the measurement of liability for remaining coverage is adjusted for tax purposes, to exclude certain accounting values in the calculation of liability for remaining coverage including:
- Fulfilment cash flows that are neither premiums nor insurance acquisition cash flows, within the meaning of AASB 17; and
 - The treatment of onerous contracts within the AASB 17.
- 1.31 The fulfilment cash flows are limited to premiums and insurance acquisition cash flows, as this restricts the liability for remaining coverage to the premium elements of the general insurance contract, net of acquisition costs. The measurement of the liability for remaining coverage in the accounting standard includes cash flows additional to premium cash flows. These cash flows are not applicable for taxation purposes where assessable income is calculated in the current year by gross premiums received or receivable (see section 321-45).
- 1.32 The treatment of onerous contracts in AASB 17 immediately expenses any losses for accounting purposes on recognition. This is not applied for tax purposes. Instead, the loss or outgoing is deductible only when it is incurred, as per general income tax principles. That is, the AASB 17's treatment of onerous contracts is disregarded for tax purposes. To determine the value of the adjusted liability for remaining coverage for tax purposes, such contracts are treated the same as non-onerous contracts, resulting in the release of the loss component to the profit or loss over the contract service period.
[Schedule #, item 12, step 1 in the method statement in section 321-60]
- 1.33 The second step in the method statement is to reduce the step 1 amount by any asset for insurance acquisition cash flow. The assets arise where acquisition cash flows have occurred but cannot be identified against a contract group.
[Schedule #, item 12, step 2 in the method statement in section 321-60]
- 1.34 The third step in the method statement is to reduce the result from step 2 by the premiums paid or payable by the company, in that or an earlier income year, under a contract of reinsurance held by the general insurance company, as measured using the AASB 17, other than:
- reinsurance premiums that the company cannot deduct because of subsection 148(1) of the ITAA 1936; and
 - reinsurance premiums that were paid or payable in respect of a particular class of insurance business, where, under the contract of

reinsurance, the reinsurer agreed to pay, in respect of the loss incurred by the company that is covered by the relevant policy, some or all of the excess over an agreed amount.

[Schedule #, item 12, step 3 in the method statement in section 321-60]

- 1.35 The treatment of reinsurance premiums in step 3 is consistent with the treatment of reinsurance premiums for remaining coverage prior to the amendments.
- 1.36 The fourth step is to increase the result from step 3 by the amount of any reinsurance commissions received or receivable by the company that relate to the relevant reinsurance premiums in step 3.

[Schedule #, item 12, step 4 in the method statement in section 321-60]

Consequential amendments

- 1.37 The amendments update references in the ITAA 1997 consistent with the concepts adapted from the AASB 17 and with the above amendments.
[Schedule #, items 14, 15, 16, 17, 18 and 19, sections 10-5 and 12-5, paragraphs 705-70(IAC)(c), 713-70(a), section 713-710 and note to section 713-710]
- 1.38 Consequential amendments are made in relation to the rules applying to income tax consolidation. The basis for working out the value of the liability for incurred claims and the liability for remaining coverage under the income tax law is adjusted compared to the calculation of liabilities under the AASB 17. These differences cause distortions to arise under the tax cost setting rules.
- 1.39 Differences that are reflected in the accounting standard but not in the income tax treatment of general insurance companies include:
- Assets for insurance acquisition cash flows to the extent they are used to measure the company's liability for remaining coverage;
 - Deferred reinsurance expenses to the extent that they are used to measure the company's liability for remaining coverage;
 - Recoveries receivable or potential recoveries to the extent they relate to insurance contracts or reinsurance contracts;
 - Claims handling costs that are neither attached to, nor directly attributable to, a particular claim, to the extent these costs are used to measure the company's liability for incurred claims; and
 - The loss components on onerous contracts to the extent that they are used under the standard to measure the company's liability for remaining coverage.

[Schedule #, item 20, subsection 713-725(4)]

- 1.40 The tax cost setting rules are modified to reflect these differences where a general insurance company joins or leaves a consolidated group and brings or takes with it these things that exist in the referenced accounting standard.
- 1.41 The amendments also repeal the definition of ‘outstanding claims’ as the term is no longer used in the ITAA 1997.

[Schedule #, item 21]

Commencement, application, and transitional provisions

- 1.42 The amendments apply to income years starting on or after 1 January 2023. This is consistent with the general application of the referenced AASB 17.
- [Schedule #, item 22]***

Transitional arrangements for the general insurance industry

- 1.43 Under the amendments, transitional arrangements ensure that no permanent tax differences arise for general insurance companies on adoption of AASB 17.
- 1.44 In effect, for the first income year to which the amendments apply, the transitional arrangements require a comparison between the values worked out under the amendments, with the values worked out under the provisions immediately prior to the amendments:
- with respect to the application of Subdivision 321-A for the first income year starting on or after 1 January 2023, general insurance companies will apply the method statement and treatment of liability for outstanding claims in force immediately before the commencement of this Schedule; and
 - with respect to the application of Subdivision 321-B for the first income year starting on or after 1 January 2023, general insurance companies will apply the method statement and treatment of unearned premium reserve in force immediately before the commencement of this Schedule.

[Schedule #, item 23]