TECHNICAL GUIDANCE TG04/2014

ACCOUNTING TREATMENT OF DEFERRED INCOME TAX FOR LIFE INSURANCE COMPANIES

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Preamble

There have been differing local views on the treatment of deferred income tax on the actuarial surplus for Life Insurance Companies in Kenya. As a result, Life insurance businesses in Kenya have adopted different interpretation of the application of IAS 12 (Income taxes) in the preparation of their financial statements: some have recognised deferred income tax on the actuarial surplus, while others have not.

Because of the inconsistency of the application of IAS 12 (Income taxes) in relation to recognition of deferred income tax on actuarial surplus, the Institute has found it necessary to issue a technical guidance to preparers of financial statements and practitioners on the matter.

Facts and circumstances

Life insurance businesses (assets and liabilities) are managed separately and are ring fenced from a taxation perspective. In the financial statements, life insurance businesses prepare separate statements of comprehensive income and statement of financial position. The profit for the year is transferred to the actuarial surplus (commonly referred to as the statutory reserve) on an annual basis. The net carrying value of assets and liabilities on the statement of financial position is represented by the actuarial surplus (statutory reserve).

The Kenyan Insurance Act requires an annual actuarial valuation of the life fund (the net of the aggregate liabilities relating to the life fund and the corresponding value of assets) to determine the actuarial surplus of the fund, and the actuary, at his discretion, to recommend the amount of any actuarial surplus that can be transferred from the life fund for the benefit of the company's shareholders. Such a transfer is reflected as a credit (net of current income tax) to retained earnings available for distribution to shareholders with a corresponding debit to statutory reserves. The current income tax arising from the transfer is recognised as tax expense in the profit or loss account of the life fund.

The Insurance Act restricts the maximum amount available for transfer in any given year for the benefit of the company's shareholders to 30% of the actuarial surplus. The balance remaining on the statutory reserve is effectively a buffer in the company against any future actuarial losses.

In determining the actuarial surplus of the life fund, the actuary compares the value of future net premiums and the expected return on related investments with the cost of providing contractual policyholders benefits over the period of the policy. The actuarial surplus would be released to the benefit of the shareholders over the life of the policy. Therefore, the actuarial surplus does not remain undistributed in perpetuity.

The Income Tax Act, Section 19(5), stipulates that the amount of actuarial surplus, as determined under the Insurance Act and recommended by the actuary to be transferred from the life fund for the benefit of shareholders forms part of the taxable income of a life insurance business in the year. The amount subject to current income tax in the year is the balance recommended for transfer by the actuary, irrespective of the actual amount transferred to retained earnings for the benefit of shareholders. The actual amount transferred to retained earnings in a particular year cannot exceed the amount recommended by the actuary. If an actuarial surplus arises in a year of income but the same is not recommended for transfer to shareholders, then the surplus is not be subject to current income tax in the year.

The current basis of taxation provides that where an actuarial valuation results in a deficit and the shareholders are required to inject money into the life fund, the amount transferred shall be treated as a negative transfer, i.e. the amount shall be treated as a "loss" and offset against future "profits" i.e. transfers. However the Act states in S 19(5) that: "*the amount of negative transfer shall be limited to the actuarial surplus recommended by the actuary to be transferred from the life fund for the benefit of shareholders in previous years of income.*"

Technical analysis

Most transactions and events recorded in the financial statements have a tax consequence, which may be immediate or may be deferred. Often income is taxable and expenses deductible for tax purposes when incurred. However, the taxation or deduction for tax purposes may be delayed to a later period.

The future tax consequences of transactions and events that have occurred by the reporting date cannot be avoided; the entity may have to pay less or more tax than it would have done if those transactions and events did not happen. Therefore, it is necessary to recognise the tax effects of all income and expenditure, gains and losses, assets and liabilities in the same period in which they are recognised and not in the period in which they form part of taxable profit. This matching of transactions and events with their tax effects gives rise, not only to current tax, but also to deferred income tax balances that meet the Framework definitions of, and recognition criteria for, assets and liabilities.

The concept of temporary differences is central to the computation of deferred income taxes under IAS 12. Temporary differences are defined in IAS 12 as differences between the carrying amount of an asset or liability and its tax base. [IAS 12 para 5].

Some items may have a tax base however, but are not recognised as assets and liabilities on the statement of financial position. Where a transaction occurring during the reporting period does not give rise to an asset or liability on the statement of financial position, but affects taxable profits of future reporting periods, it has a tax base that is calculated by reference to the amount that would affect taxable profits in future periods.

The actuarial surplus in substance represents profits and losses recognised in the income statement of the life insurance business which have not been recommended for transfer for the benefit of shareholders and therefore not taxed. Even though the profits and losses were recognised from an accounting perspective, they only affect taxable profits once recommended for transfer for benefit of shareholders by an actuary. Therefore the difference between the tax base of the actuarial surplus and the carrying amount of nil is a taxable temporary difference that gives rise to a deferred income tax liability. [IAS 12 para 9].

There is a timing difference between the recording of accounting and taxable profit and the profit is merely deferred for tax purposes in the actuarial surplus (statutory reserve). IAS 12.IN2 sets out that all timing differences are also temporary differences and since there are no exemptions from recognising deferred income tax for taxable temporary differences on profit then deferred tax should therefore be recognised.

As there is also no distinction in the Income Tax Act between the tax rate applicable to profit which is not recommended for transfer and the profit that is recommended for transfer, the profit is merely excluded initially from taxable profit and accumulated in the actuarial surplus(statutory reserve), which creates the timing and temporary difference. IAS 12.52A/B is therefore not applicable.

The movement on the deferred income tax liability should be reported in the life business income statement as it relates to items that are themselves reported in income statement.

Conclusion

Having considered the relevant facts, the Institute advises that:-

i. a deferred income tax liability should therefore be recognised on the whole actuarial surplus carried forward, not recommended for transfer for the benefit of shareholders. A deferred income tax asset should be recognised in respect of "negative transfers" i.e. amounts injected into the fund to offset any actuarial deficits to the extent that it is probable that taxable actuarial surplus (profits) will be available against which the deductible temporary differences can be utilised; and,

ii. where deferred income tax on actuarial surplus has not been previously recognised, the company should reflect the change to the above basis of accounting in accordance with IAS 8 (Accounting policies, changes in accounting estimates and errors). This may require a restatement of its financial statements as a correction of a prior period error as defined in IAS 8, because it arises from incorrect application of an accounting policy.

iii. This guide is applicable is with immediate effect for life insurance entities.

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