Hong Kong Tax Alert

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New tax treatments for insurers upon adoption of a risk-based capital regime in Hong Kong

Today, on 6 July 2023, the Insurance (Amendment) Bill 2023[1] (the Bill) passed its third reading in the Legislative Council and the Bill as passed is expected to be gazetted on 14 July 2023 to formally become law (the new law) in Hong Kong.

Apart from introducing a risk-based capital (RBC) regime for insurers of Hong Kong under the Insurance Ordinance (IO), the new law also amends the Inland Revenue Ordinance (IRO) to (i) allow spreading over the tax liabilities of a one-off transitional adjustment upon the adoption of the regime over five years; and (ii) change the basis of taxation for non-life long term insurance business (a new category of insurance business for tax purposes) from the "formulaic method" to the "adjusted surplus method".

RBC regime introduced to align Hong Kong with the international regulatory requirements

The International Association of Insurance Supervisors, which is the global standard-setter for the insurance industry, issued in 2011 the Insurance Core Principles in relation to capital adequacy. This document prescribed principles for a risk-based framework to fully reflect the risk profile of individual insurers. Many other jurisdictions including mainland China, the European Union, the United Kingdom, and Singapore have already implemented RBC regimes.

Currently, insurers of Hong Kong are still subject to a rule-based capital adequacy regime under the IO. The capital required under this rule-based regime is linked to the amount of premium income or level of insurance liabilities. This rule-based regime however does not consider certain risk profiles of each individual insurer, such as potential risks associated with the nature of products offered and with investments made.

1. The Bill can be retrieved from: https://www.legco.gov.hk/yr2023/english/bills/b202304062.pdf

The RBC regime introduced by the new law will align Hong Kong with the international regulatory requirements. This regime takes a modular approach for an assessment more sensitive to each insurer's risk profile consisting of market risk, life and general insurance risks, operational risk etc. The RBC regime will therefore incentivize insurers to strengthen their risk management culture, as insurers with solid risk management measures and better asset and liability management will shoulder lower capital requirements.

The new law prescribes the adoption of the RBC regime on its commencement date in respect of (i) life insurance business; (ii) non-life long term insurance business; and (iii) general insurance business.

Consequential tax changes upon the adoption of the RBC regime

One-off transitional adjustments allowed to be evenly spread over five years

Upon adopting the RBC regime, the liabilities of many insurers, after considering their individual specific risk profiles, are expected to be reduced (albeit some may be increased). Under the general tax principles, such a one-off adjustment will be taxable or deductible in full for the transitional year.

To relieve cash-flow burdens, insurers are allowed to make an irrevocable election to evenly spread over such one-off transitional adjustments over five years for tax purposes, commencing from the year of adoption of the RBC regime (including early adoption).

The new law also provides that where the relevant insurance business which has made such an election ceases business within the five-year spread-over period, the balance of the one-off transitional adjustment that has not been adjusted in the previous tax returns will then be accounted for in full for tax purposes for the year of cessation of the business.

Taxation of non-life long-term insurance businesses

In contrast to the current provisions of the IRO which categorize insurance businesses into two, namely life and non-life, under the new law they will be categorized into (i) life insurance business; (ii) non-life long term insurance business; and (iii) general insurance business[2].

Current tax treatment

Currently, life insurance business is taxed under section 23 of the IRO (i) by default based on the deemed "5% premium method" or (ii) by the "adjusted surplus method" upon making an irrevocable election for such tax treatment. Non-life long term insurance business is taxed under section 23A of the IRO under the "formulaic method" as non-life insurance business.

Briefly, the "formulaic method" prescribes a formula for ascertaining the assessable profits of a non-life insurance business starting with the net gross premiums, together with the movement of the reserve for unexpired risks and other necessary tax adjustments.

On the other hand, the "adjusted surplus method" prescribes a formula for ascertaining the assessable profits of a life insurance business by reference to the movement of the balance of the surplus of the life insurance fund together with other necessary tax adjustments.

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2. The definition of "life insurance business" under the new law remains unchanged, which means the business of any one of the following classes of insurance business specified in Part 2 of Schedule 1 to the IO:
   (a) Class A (life and annuity)
   (b) Class B (marriage and birth)
   (c) Class C (linked long term)
   (d) Class E (tontines)

   The new law defines non-life long term business to mean the business of any of the following classes of insurance business specified in Part 2 of Schedule 1 to the IO:
   (a) Class D (permanent health)
   (b) Class F (capital redemption)
   (c) Class I (retirement scheme management category III)

   General insurance business is defined to have the meaning given by section 14AB(1), namely the business of a class specified in Part 3 of Schedule 1 to the IO.

Tax treatment under the new law

Under the new law, the taxation of the life insurance business will generally remain the same. Non-life long term insurance business, currently categorized as non-life insurance business taxed under section 23A of the IRO based on the “formulaic method”, will then be taxed based on the “adjusted surplus method” under section 23 of the IRO, i.e., the same section that currently only governs the taxation of life insurance business.

General insurance business other than life insurance business and non-life long term insurance business will continue to be assessed under section 23A, except that any one-off transitional adjustments will also be allowed to be spread over a five year period under the new law.

The new law also specifies that where an insurance fund is maintained for both life insurance business and non-life long term insurance business, the net asset value (NAV) of the fund will be apportioned between the two insurance businesses by reference to the ratio of their respective premiums for the purposes of ascertaining their respective assessable profits under the “adjusted surplus method”.

Where the life insurance business is taxed based on the deemed “5% premium method”, such an apportionment will then only be relevant to ascertaining the assessable profits of the non-life long term insurance business.

Relevant sections of the IRO that give effect to the above tax changes under the new law

Section 23 – refined to cater to the fact that this section will under the new law govern the taxation of both life insurance business and non-life long term insurance business.

Section 23AAA – introduced into the IRO such that the taxation of non-life long term insurance business will also be taxed based on the “adjusted surplus method” under section 23 of the IRO.

Section 23AAAB to 23AAAE – introduced into the IRO to provide for evenly spreading a one-off transitional adjustment upon adopting the RBC regime over a five-year period for the life insurance business and non-life long term insurance business.

Section 23A and 23AB – amended to give effect to how the “formulaic method” will be applied to ascertaining the assessable profits of general insurance business and general reinsurance business.

Section 23AD – introduced into the IRO to provide for evenly spreading a one-off transitional adjustment upon adopting the RBC regime over a five-year period for the general insurance business.

Section 23AE – introduced into the IRO to provide for the transitional provisions for ascertainment of assessable profits from life insurance business, non-life long term insurance business and general insurance business.

Government's responses to submissions made to the Bills Committee on taxation arrangements

Several industry players made submission to the Bills Committee when the Bill was scrutinized during the legislative process. These submissions included the following.

Spreading over of the transitional adjustments should also be applicable to Classes G and H insurance businesses

Under the Bill, Classes G and H insurance businesses as defined under the IO were not included in any one of the three categories of insurance businesses referred to above. As a result, the provisions for spreading over of the transitional adjustments contained in the Bill would not be applicable to these two classes of insurance businesses.

Some industry players considered that there could be transitional adjustments relating to these two classes of insurance businesses and requested that such amounts should also, on election, be eligible for spreading over a five-year period for tax purposes.

The Government however explained that under the prevailing financial reporting standards, business of Classes G (retirement scheme management category I) and H (retirement scheme management category II) are not treated as insurance businesses because their contracts do not have the principal objective of the provision of insurance but investment management activities. Likewise, for profits tax purposes, Classes G and H insurance businesses under the IO are also not regarded as insurance businesses for tax purposes. Hence, the assessable profits derived from Classes G and H insurance businesses are ascertained in accordance with section 14 of the IRO instead of the specific provisions for insurance businesses.

As such, the Government considered that the adoption of the RBC regime would not affect the accounting profit or loss recognised for Classes G and H insurance businesses in accordance with the generally accepted accounting principles. Accordingly, there would not be a one-off increase in the accounting profits of these two classes of insurance businesses upon the implementation of the RBC regime and so the proposed spread-over arrangement would not be applicable to them.

Actual results over apportionment basis for the NAV of an insurance fund

An apportionment of the NAV of an insurance fund that covers both life insurance business and non-life long term insurance business, including a further apportionment of the onshore and offshore parts of such businesses, by reference to the ratios of the respective premiums involved was mandated by the Bill. Such an apportionment would be required for ascertaining the assessable profits of the life insurance and non-life long term insurance businesses respectively under the "adjusted surplus method" under the Bill.

Some industry players however indicated that they kept separate records and accounts for different parts of such a fund. They submitted that they preferred to be able to ascertain their assessable profits for the two insurance businesses based on the actual results of the respective parts of the fund or sub-funds rather than the apportionment method mandated by the Bill.

The Government responded that as an insurance fund would be maintained for different classes of businesses, the investment income derived from such fund should not be separable and therefore an apportionment of such investment income would be required. In addition, there would not be statutory requirements for such sub-funds to be established by insurers (e.g., requirement to maintain sufficient assets to meet corresponding liabilities). As such, it would not be appropriate to ascertain the assessable profits of the respective insurance businesses based on the results of such unregulated sub-funds.

The Government also noted that the aggregate of non-life long term insurance business constituted only 1% of the total long term insurance business in terms of premiums.

An option for non-life long term insurance business to continue to be assessed under the "formulaic method"

Some industry players submitted that they be given the option that the assessable profits of their non-life long term insurance business be continued to be ascertained based on the current "formulaic method " rather than the mandatory "adjusted surplus method" under the Bill.

The Government responded that under the RBC regime, the premium liabilities, one of the variables under the "formulaic method " would no longer be applicable to non-life long term insurance business. In addition, given that the same fund would be involved for life insurance business and non-life long term insurance business, it would be reasonable to ascertain their respective assessable profits both based on the "adjusted surplus method".

Acceptance of unaudited quarterly returns/ actuarial reports for filing of profits tax returns

The Bill provided for the early adoption of the RBC regime in the middle of a financial year.

As such, the tax computations and returns for early adopters would likely need to be based on unaudited financial information in the form of unaudited quarterly returns and actuarial reports filed with the Insurance Authority. Industry players therefore sought confirmation whether such unaudited quarterly returns and actuarial reports would be acceptable for supporting the tax returns filed.

The Government noted that, in general, supporting documents for ascertainment of assessable profits would not be required to be audited unless it was required under other legislations. As such, such unaudited quarterly returns or actuarial reports would not need to be audited just for tax filing purposes.

In addition, the Government also reassured that apart from the amendments under the Bill, the existing interpretation and practices of the Inland Revenue Department in relation to the provisions of the IRO applicable to insurance businesses would remain unchanged.

Extending the spread-over period of one-off transitional adjustments from five to ten years

Given that the one-off transitional adjustments could be very substantial in certain cases, some industry players requested the Government to consider extending the spread-over period from five to ten years.

The Government responded that the proposed spread-over of the one-off transitional adjustments had already set a new precedent in the IRO to allow an amount, which would otherwise have been fully taxable in a year, to be spread over in a number of years. The proposed five-year spread-over period was also similar to that allowed in certain other overseas jurisdictions, including Singapore, which is our major competitor in the region.

As such, the Government considered that the proposed five-year spread-over period would be reasonable, which strikes a balance between the financial burden on the affected insurers and the Government's revenue.

As a result, no Committee Stage Amendments were made, and the original bill introduced on 6 April passed its third reading in the Legislative Council on 6 July 2023 without any changes.

Commentary

We welcome the new law which introduces the RBC regime for Hong Kong insurers. The RBC regime will incentivize insurers to better manage their risks, assets and liabilities and align Hong Kong with the international regulatory requirements. Such a move will enhance the status of Hong Kong as a premier international insurance and asset management center.

Equally welcome is the legislation to allow insurers to spread over the potential tax liabilities of the one-off transitional adjustments upon adopting the RBC regime over a five-year period.

However, the changes of the taxation of non-life long term insurance business from the "formulaic method" to the "adjusted surplus method", including the apportionment of the NAV of an insurance fund that covers both life insurance business and non-life long term insurance business could be complicated.

Clients who have any questions on how the new law would impact their tax liabilities, including the early adoption of the RBC regime for the 2022-23 profits tax returns due to be filed soon, can contact their tax executives.

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