PwC Tax Alert

IFRS 17 – Some Key Tax Considerations for Nigerian Insurers

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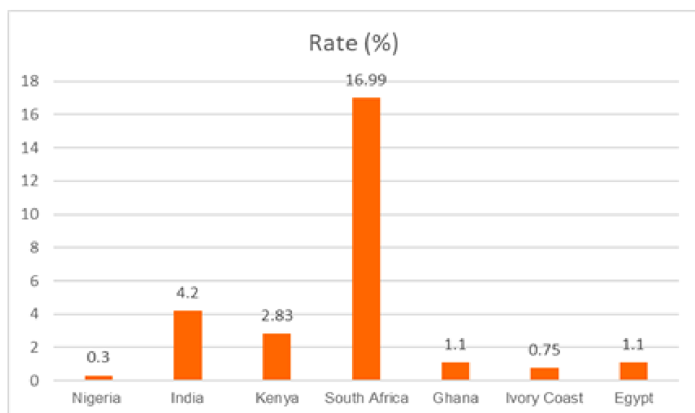
Background/Introduction to IFRS 17

The Nigerian insurance sector is still largely untapped with significant opportunities both for micro insurance and in terms of diversity of products. The insurance sector generated a total premium of N630 billion in 2021 according to the National Insurance Commission (NAICOM). To demonstrate the growth potential of the sector, between 2016 to 2019, the Insurance Industry premium grew by 31%. The advent of the coronavirus pandemic resulted in a downturn in 2020. However, a 22.57% growth was recorded in 2021. The sector currently contributes about 0.3% to Nigeria's real GDP.



Insurance penetration rate in select countries (2018). Source: Statista.com

In May 2017, the International Accounting Standards Board introduced the International Financial Reporting Standard (IFRS) 17 to replace IFRS 4. IFRS 4 posed some challenges in determining the profitability of insurance contracts (i.e., contracts between the Insurers and policyholders). IFRS 17 addresses this by aligning the measurement of these contracts with the fundamental principles of the IFRS framework (which requires prudency in profit and loss recognition) and makes comparison with peers easier.
IFRS 17 covers insurance and reinsurance contracts issued, insurance contracts held and investment contracts with discretionary participation features. For fixed fee service contracts, there is the option of applying either IFRS 15 or IFRS 9. The Standard is effective for annual reporting periods beginning on or after 1 January 2023 with earlier application permitted if IFRS 9 is also applied.
IFRS 17 will not just impact insurance companies but include other entities such as health management organisations (HMOs), companies that administer third party warranties in any sector, government institutions that manage insurance policies or guarantee settlement of insured funds (such as the Nigerian Deposit Insurance Corporation), etc.
NAICOM has inaugurated sub-working groups to ensure seamless transition to IFRS 17 for Nigerian Insurance Companies. There has not been much activity from the National Health Insurance Authority (NHIA). The tax implication is probably something that the Regulators need to pay close attention to and perhaps come up with specific legislation for.

Recap on accounting for IFRS 17

Under IFRS 17, insurance revenue is no longer equal to the premium received in the period. Revenue will be recognised as the reduction in liability as the risk attached to insurance services are released (i.e., amortisation over the contract life).
Insurers may sell products that have insurance and non-insurance components. As a requirement, such products will have to be unbundled with the non-insurance component being recognised under a separate standard (e.g., IFRS 9 or IFRS 15). Insurance contracts are to be categorised under three broad components as shown below:

<table>
<tr><td>Contracts that at inception have no significant possibility of becoming onerous subsequently</td><td rowspan="2">Unearned profit is recognised as a liability and is released as insurance services are provided</td></tr>
<tr><td>Other profitable contracts</td></tr>
<tr><td>Contracts that are onerous at inception</td><td>A loss is recognised in P/L</td></tr>
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Each portfolio will also be further separated into contracts of one year or less and other contracts.
The standard further provides three measurement models for the accounting of insurance contracts.

- General Measurement Model (GMM)—or Building Block Approach (BBA),
- the Premium Allocation Approach (PAA) and
- the Variable Fee Approach (VFA).

BBA is the default model to measure insurance contract liabilities under IFRS 17.
Under the BBA model, any losses at inception of the contract will be recognised in the profit or loss statements while the gains from the contract are booked in the statement of financial position (SFP). The outstanding amount owed to the policy holder over the life of the contract will also be recognised as a liability in the SFP. These amounts are assessed by discounting the best estimates of cashflow over the life of the contract with an adjustment for risk. VFA is a modification of BBA for contracts with direct participation features i.e., contracts that include investment-related services which are sold and integrated together with the insurance coverage such that the insurance provider receives a variable fee for its services.
The PAA approach is a more simplified model that is available for contracts with a coverage period of 12 months or less (mostly general insurance) that have little variability. Under this approach, acquisition costs for the contracts may be expensed rather than capitalised. Also, liabilities that will be settled within one year do not need to be discounted but are recognised at face value in the SFP. However, any losses (e.g., from groups of loss-making contracts), must be recognised upfront.

Overview of current tax provisions covering Insurance Companies

Under the current rules applicable to insurance companies, taxable profits are determined based on revenue and reserves determined under IFRS.

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Section 16 of the Companies Income Tax Act (CITA) provides the basis for calculating taxable profits for insurance companies and segregates them into Life and Non-life businesses. While Insurers can offer both life and non-life businesses as a composite, the tax returns for each business must be prepared and filed separately.

- Life Insurers are subject to Companies Income Tax (CIT) at 30% of investment income earned from shareholders' funds less management expenses and commissions. Premiums and income from policyholders' funds are outside the scope of corporate tax. Other available tax deductions are a general reserve fund for policies in force, a special reserve fund in line with the Insurance Act, and normal business outgoings. Minimum tax may apply at 0.5% of gross income.
- Non-life businesses are taxed on gross premium and other income earned. Tax deductions can be taken for reinsurance expenses, reserve for unexpired risks, claims and outgoings. Minimum tax may apply at 0.5% of gross premium and other income.

Tax considerations for the implementation of IFRS 17

Companies would have to assess the impact of the new standard on their deferred tax and their effective tax rate. Regulators and government authorities need to assess the impact of the changes on revenue and whether the law needs to be updated to mitigate any adverse impact.

1. **Tax impact on transition from IFRS 4 to IFRS 17**:
When adopting IFRS 17, balances may be restated to account for any retrospective difference as if IFRS 17 had always been applied. Differences are booked in retained earnings. Adjustments could arise for example, due to changes in the interest rate used to discount the liabilities or the immediate recognition of losses relating to onerous contracts. Without a simulation, it is difficult to predict how these adjustments would impact profit and tax.
Recognition of additional retrospective losses or liabilities could adversely impact retained earnings. This would be a concern for Regulators like NAICOM that is trying to improve the capitalisation of the industry. Retained earnings was one of the options to recapitalise under NAICOM's previous plan which was challenged in court. Insurers who intend to augment their capital base with retained earnings will have to reevaluate their approach and may need to consider alternative capital sources to boost their balance sheet.
From a tax perspective, Insurers are generally allowed to take a deduction for losses and liabilities. However, since the impact is not going through the profit or loss account, they may need to make a special case to bring those retrospective adjustments into their future tax returns.
If the retrospective adjustments result in an increase in retained earnings, this could give rise to distributable profits which were never taxed in prior tax returns. Without any clear transition rules, the tax authorities may pursue an adjustment of the current year profit to reflect the additional profit and tax them accordingly or tax them through excess dividend tax.
Adjusting or taxing these retrospective adjustments in one year could be adverse for taxpayers and tax authorities. Tax transition rules should be provided for in the Finance Act 2022 that would provide clarity on the treatment of retrospective adjustments. Alternatively, the FIRS may come up with a circular in collaboration with the industry for tax consequences to be realised proportionately over a reasonable period, like what is being considered in other jurisdictions.

2. **The scope of IFRS 17 vs those taxed as Insurers**:
Some entities that are not traditional Insurers are brought into scope of IFRS 17. For example, those that provide third party warranty services and HMOs. Those that provide fixed fee service contracts may also be within scope if they provide services for a fixed fee or compensate customers by providing services as against making cash refunds to customers. For such contracts, including retainers, entities have an accounting policy choice to account for these contracts using either IFRS 15 or IFRS 17 subject to meeting certain conditions.
Section 16 of CITA applies specifically to "all Insurance businesses". Consequently, entities that are not licensed by NAICOM may demonstrate characteristics of insurance businesses. The tax laws may need to be amended to define what is an insurance company for the purposes of Section 16 which may be different from the IFRS definition of insurance contracts.

3. **Change in revenue recognition:**
As noted earlier in the report, revenue will no longer be equal to the premium received in the period, but on services provided i.e., top line revenue "gross earned premium" will now be called "insurance revenue". Generally, the tax laws need to be changed or companies would have to prepare separate books under the old standard to file their tax returns. Some specific issues are highlighted below:

a) The taxation of life insurance business will not be affected as premiums are not recognised as taxable income for life insurance under CITA. However, for non-life businesses, the tax law should be updated such that income tax is determined on the "insurance revenue" for the period instead of "premium income" which is the current language in the tax law. Insurance revenue will cover both premium amortised for the period for the PAA and Contractual Service Margin (CSM) amortised for the period for the non-life contracts measured using the general measurement model.

b) The tax treatment of the CSM component of insurance reserves should also be evaluated as it would either accelerate or defer taxable income. Currently, the tax laws exclude unexpired risk reserves from tax and although some other jurisdictions intend to treat the CSM reserve as taxable, it will be useful to obtain guidance from the tax authorities on permitted tax reserves that will be deductible.

c) Losses from onerous contracts are to be recognised in the P/L immediately they arise (without the option of offsetting against profitable contracts unless they are within the same group). This creates an imbalance with profits (CSM reserve) being "gradually released" and losses being recognised in the P/L as soon as they arise. The tax treatment for onerous contracts should take into consideration how the CSM reserve is treated as both represent recognition of actual insurance contracts.

Life businesses are taxed on investment and commission income, so there will be no significant tax consequence of IFRS 17 on life insurance business with respect to how revenue is recognised and treated. Nonetheless, for clarity, the law should be updated to exclude CSM released into the income statement from the income that will be subject to tax for Life Insurers. In the same vein, losses should also not be tax deductible.

For non-life businesses, the most logical option will be for the CSM reserve to be taxed as it is released into the income statement while the onerous losses will be tax deductible on recognition. Understandably, this could create a deferred tax liability for Insurers.

Conclusion

Transitional adjustments, revenue measurement and recognition and potential deferred tax issues can create complexities for taxpayers. Adjustments to profits and retained earnings (also retrospectively) will create deferred tax implications that can have significant regulatory implications as the minimum capital base could be impacted.
The implementation journey for IFRS 17 requires alignment and participation of relevant stakeholders to ensure there is no significant disruption to the activities and reporting of insurance companies. Insurers will require upskilling as well as a review of staff capabilities. IFRS 17 will present more complex issues than IFRS 4 and will have a far-reaching impact on the insurance industry. It is important that the legislators are proactive in reviewing the tax laws to assist companies determine on time, the tax implication of the changes. Ordinarily, tax authorities should be worried about how IFRS 17 could impact on revenue from the industry, but this should not be the most important factor when the Regulators are considering improvements to the tax law.
Regulators such as NAICOM and the NHIS should ensure to send technical recommendations to the Federal Government and National Assembly in earnest which will serve as a guide for the enactment of new regulatory and tax provisions before the full implementation of IFRS 17 in January 2023. This will ensure there is no uncertainty for entities that deal in insurance products within the country.

The FIRS can begin to issue regulatory guidance to ensure there is no lacuna in tax compliance from the 2023 financial year.

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