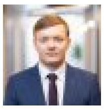
Impact of IFRS 17 on insurers’ transfer pricing 3/31/24



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The first year of audit has ended since insurance and reinsurance companies and foreign insurers’ branches started preparing their accounts and consolidated accounts according to International Financial Reporting Standard No. 17, Insurance Contracts (IFRS 17) with significant amendments. The new approach to measuring income from insurance contracts has transformed taxpayers’ accounting records and affected their transfer pricing (TP) policies. As the deadline for submitting TP files for FY23 is approaching, it’s time to assess how IFRS 17 affects insurers’ transactions with related parties.

The implications of changes to financial statements

The new standard applies to financial periods beginning from 1 January 2023 and drastically changes the procedures for measuring insurers’ assets and liabilities, as well as the approach to revenue recognition. The new standard is based on the principle that a profit is not recognised until the underlying services have been in fact provided.

Although IFRS 17 does not change the total profitability derived from insurance contracts, applying this standard may cause unexpected capital and revenue fluctuations. An insurer making transactions with related parties may estimate his operating margin or markup levels inaccurately because:

- Changes to the accounting records of the group and its members and to the procedures for preparing financial statements can adversely affect the comparability of financial data, leading to inaccurate conclusions about transfer prices being arm’s length.
- An incorrect assessment may be made of comparability with third-party financial statements that are used as a baseline in evaluating the arm’s length nature of transactions with related parties.

This issue becomes particularly relevant to life insurance service providers, whose products have a longer period of revenue generation compared to non-life insurance products.

So the new standard, which combines determining the present value of future cash flows (discounting) with recognising revenue in the period of services, creates the need to adjust the financial data of the tested party or comparable companies. The adjustment ensures the financial data audited before the adoption of IFRS 17 is comparable with the accounting data disclosed according to the applicable standard.

The implications of restructuring

The basic objective of TP analysis is to determine whether related companies have mutually agreed on terms and prices that would be agreed between unrelated parties entering into an identical or comparable transaction.

Where IFRS 17 affects the recognition of capital or income, the taxpayer needs to consider whether the parties to a controlled reinsurance transaction would still be willing to continue the contract on the previous terms. If the parties face potential capital or profitability fluctuations, as well as additional reserve requirements, then either party can consider other options (e.g. changing the deposit structure, recovering the insurer commission or revising applicable interest rates to reflect changes to the capital and reserve requirements). Also, new reinsurance structures and retrospective reinsurance measures can be adopted to replace the existing reinsurance contracts, and therefore restructuring considerations important for TP analysis can become particularly relevant.

The OECD guidelines[1] describe a case where an insurance contract is sold to an unrelated company. In certain circumstances, this leads to a higher margin compared to similar transactions. A benchmarking study conducted in this situation should consider the circumstances that create a higher level of profit, such as the availability of alternatives.

As the deadline for submitting TP files for FY23 is approaching, it’s useful for insurers to revise their intragroup reinsurance contracts and consider additionally analysing the restructuring options actually available to related parties. Note that this will be a retrospective analysis because it applies to options that were available in FY23.

Insurers’ intragroup management and support services

The potential impact of IFRS 17 on TP is also seen in the provision of intragroup management and support services. Insurers typically use financial data for the past year (e.g. gross underwritten premiums) to allocate certain costs incurred by the service provider with respect to a related party that benefits from the services.

This data can be displayed differently than what IFRS 17 currently mandates, making the taxpayer to:

- consider alternative cost allocation criteria, or
- provide arguments in his TP file to justify the future use of cost allocation criteria.

This can be particularly important if the taxpayer continues to prepare his local financial statements according to local GAAP, which are later evaluated for corporate income tax and TP compliance purposes.

Restoring data comparability

The new standard offers the following approaches to financial data transition:

- The complete retrospective approach involves rewriting past financial statements as if IFRS 17 had always been in force.
- The modified retrospective approach permits adjusting data for long-term historical contracts.
- The fair value approach provides for recognising assets, liabilities and revenues at present value.

Since a benchmarking study conducted as part of TP analysis is usually based on the latest available data, it might be necessary to align the financial data of comparable independent companies (before adopting IFRS 17) with the tested party’s financial data (after applying IFRS 17) and vice versa to mitigate TP non-compliance risks.

Please reach out to the PwC Latvia transfer pricing team or email your questions to identify your obligations arising from the applicable statutory requirements for taxes and TP.

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[1] The OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, paragraphs 10.224–10.226