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TOFA: What should I consider to make the right decision

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What would you like to grow?

TOFA: what decisions do I need to make?

A key consideration for general insurers is whether they should make the fair value election to align the tax treatment with the accounting treatment.

The new Taxation of Financial Arrangement regime (TOFA) applies from 1 July 2010 for 30 June balancing taxpayers or from 1 January 2011 for 31 December balancing taxpayers, provided certain threshold financial requirements are met. Broadly, TOFA impacts the tax timing of financial arrangements. The way it does this depends on the choices that are made by the insurer. The choices include the following:

(a) Whether to early adopt TOFA (i.e. from 1 July 2009 for June balancing companies or from 1 January 2010 for 31 December balancing companies)

(b) Whether to make the transitional election (i.e. bring pre-TOFA financial arrangements into TOFA)

(c) Whether to make any of the tax timing elections (i.e. Fair Value, Financial Reports, Foreign Exchange, and Hedging elections).

If none of the elective methods are adopted, the default methods will apply (i.e. compounding accruals or realisation).

What is the fair value election?

Broadly, in order to make the fair value election:

(a) You must prepare a financial report in accordance with the accounting standards (or comparable accounting standards under a foreign law)

(b) The financial report is audited in accordance with the auditing standards (or comparable auditing standards made under a foreign law), and

(c) Under the accounting standards the financial arrangements are fair valued through the P&L.

The fair value election allows insurers to align the accounting treatment with the tax treatment in respect of applicable financial arrangements.

What kind of things should I consider?

(a) Making the election will bring unrealised gains/losses to tax. What is the impact on cash flows, tax payments and franking?

(b) Is there a correlation between market value movements in investments and movements in claims reserves which may reduce volatility?

(c) Is there an impact on the capital requirements of the insurer?

(d) What (if any) system changes will be required?

(e) Are compliance benefits meaningful? (Consider the benefits of aligning tax and accounting treatments, and maintaining one consistent tax treatment for financial arrangements.)

(f) Is there a timing benefit of making the fair value election and the transitional election?

(g) Is there still some uncertainty in the law? For example, it is unclear whether the eligibility criteria can be met by branches of foreign insurers.

(h) What is the impact on the financial statements?

(i) How does this election compare with the default methods?

(j) Does it make it more difficult to influence the effective tax rate?

(k) Is the impact on tax planning, such as choosing which investments to realise before year end, a concern?

PwC's comments

The decision whether to make a fair value election will depend on the circumstances of each insurer. Where for example, the volatility on tax payments and cash flows can be mitigated, there may be some attractiveness in aligning tax with accounts. However, it is important to bear in mind that the elective timing methods are irrevocable, so the decision to elect should be carefully considered. Even if the tax timing election is not made in the first applicable income year, the decision to make the election is still open in future years should it become more attractive.