TR 94/D23 - Income tax: taxation implications of arrangements known as financial insurance and financial reinsurance

This cover sheet is provided for information only. It does not form part of *TR 94/D23 - Income tax: taxation implications of arrangements known as financial insurance and financial reinsurance*

This document has been finalised by TR 96/2.

Draft Taxation Ruling
Income tax: taxation implications of arrangements known as financial insurance and financial reinsurance

Draft Taxation Rulings (DTRs) represent the preliminary, though considered, views of the Australian Taxation Office.

DTRs may not be relied on by taxation officers, taxpayers and practitioners. It is only final Taxation Rulings which represent authoritative statements by the Australian Taxation Office of its stance on the particular matters covered in the Ruling.

contents para

What this Ruling is about 1

Ruling 6

What is required for premiums to be deductible for income tax purposes? 6

Significant loss and significant insurance risk 8

Arrangement to be treated as a deposit 9

Date of effect 13

Explanations 14

What is required for premiums to be deductible for income tax purposes? 14

Significant loss and significant insurance risk 17

Arrangement to be treated as a deposit 33

Background 34

Insurance 35

Reinsurance 50

Financial reinsurance 57

What this Ruling is about

1. This Ruling sets out the ATO's views on the taxation implications of payments made under any of the wide range of arrangements commonly known as 'financial insurance' and 'financial reinsurance'.

2. This Ruling applies to a taxpayer who is either engaged in the business of insurance or who is involved in reinsurance activities of insurance business. References in this Ruling to 'financial reinsurance' are equally applicable to 'financial insurance' as if references to reinsurance included insurance. This Ruling will apply to all insurance arrangements other than those involving permanent policies of life insurance.

3. The rulings contained herein will give guidance as to the circumstances in which arrangements will be acceptable for taxation purposes as insurance and reinsurance arrangements.

4. A glossary of terms is contained at **Attachment F**.

5. The need for the Ruling arises from the identification by the ATO of a number of arrangements known as 'financial reinsurance' but which, in the opinion of the ATO, are solely or predominantly financing arrangements. It is understood that the use of financial reinsurance in many other countries is on the increase, and the indications are that Australia may be following that trend.

Ruling

What is required for premiums to be deductible for income tax purposes?

6. A premium paid in respect of reinsurance coverage is deductible only where the contract provides for the transfer of the risk of loss from the occurrence of contingent insured events through the indemnity to the reinsured in respect of losses which it suffers as a result of its carrying on a business of insurance.

7. Where, however, the arrangement does not transfer the risk of loss to an insured the premiums paid to an insurer are not deductible as an insurance expense of an insured.

Significant loss and significant insurance risk

8. An arrangement will not be accepted as a reinsurance arrangement for taxation purposes where:

(a) it is not possible for the reinsurer to incur a significant loss under the arrangement; **and**

(b) the reinsurer does not assume a significant insurance risk under the arrangement.

Arrangement to be treated as a deposit

9. Where a reinsurance arrangement is considered to be a financial reinsurance arrangement for taxation purposes it is not accepted that premiums paid constitute allowable income tax deductions. Rather, the payments of 'premiums' under the arrangement will be treated as loans while 'claims' and 'commissions' paid under the arrangement, to the extent that those payments equal 'premium' payments, will be treated as the repayment of those loans (see paragraphs 57-68 for an explanation of financial reinsurance).

10. Where a financial reinsurance arrangement is not accepted as a reinsurance arrangement for taxation purposes, the amounts paid to the reinsurer under the arrangement are not assessable income. Consequently, they are not to be taken into account in calculating a reinsurer's unearned premium provision or as giving rise to liabilities that form part of the calculation of a reinsurer's outstanding claims provision.

11. Income derived by a reinsurer from the investment of amounts received by the reinsurer from the reinsured are assessable income of a reinsurer under subsection 25(1) of the ITAA. Amounts payable to the reinsured by the reinsurer which represent a return on the amount paid by the reinsured under the agreement, will be deductible to a reinsurer under subsection 51(1) of the ITAA when the liability to make those payments is incurred and assessable to a reinsured under subsection 25(1) of the ITAA as income derived in the course of carrying on the business of reinsurance. The taxation treatment of financial reinsurance will follow that of banking and financing arrangements.

12. Amounts paid by a reinsured as financial reinsurance 'premiums' to a reinsurer will not be allowable under subsection 51(1) of the ITAA as deductions to a reinsured. They are not to be taken into account in the calculation of the reinsured's unearned premium provision.

Date of effect

13. This Ruling applies to years commencing both before and after its date of issue. However, the Ruling does not apply to taxpayers to the extent that it conflicts with the terms of a settlement of a dispute agreed to before the date of issue of the Ruling (see paragraphs 21 and 22 of Taxation Ruling TR 92/20). The application of public Rulings where a taxpayer has a private ruling is considered at paragraph 19 of Taxation Ruling TR 92/20 and also in Taxation Determination TD 93/34.

Explanations

What is required for premiums to be deductible for income tax purposes?

14. The considerations for determining whether the payment of premiums under a reinsurance arrangement are deductible are similar to those for determining whether direct insurance premiums are deductible. In a reinsurance arrangement, there must be a transfer of **insurance risk** and the subsequent exposure of the reinsurer to a **significant loss.** This is a fundamental reason for the existence of insurance and reinsurance, to pass the risk of loss from the insured to an insurer or from the reinsured to the reinsurer.

15. Arrangements that do not involve a transfer of risk of insurance loss (generically referred to as financial insurance/reinsurance) are not

accepted as insurance/reinsurance for income tax purposes in the following circumstances:

(a) the insurer/reinsurer does not assume a significant **insurance risk** under the arrangement; **and**

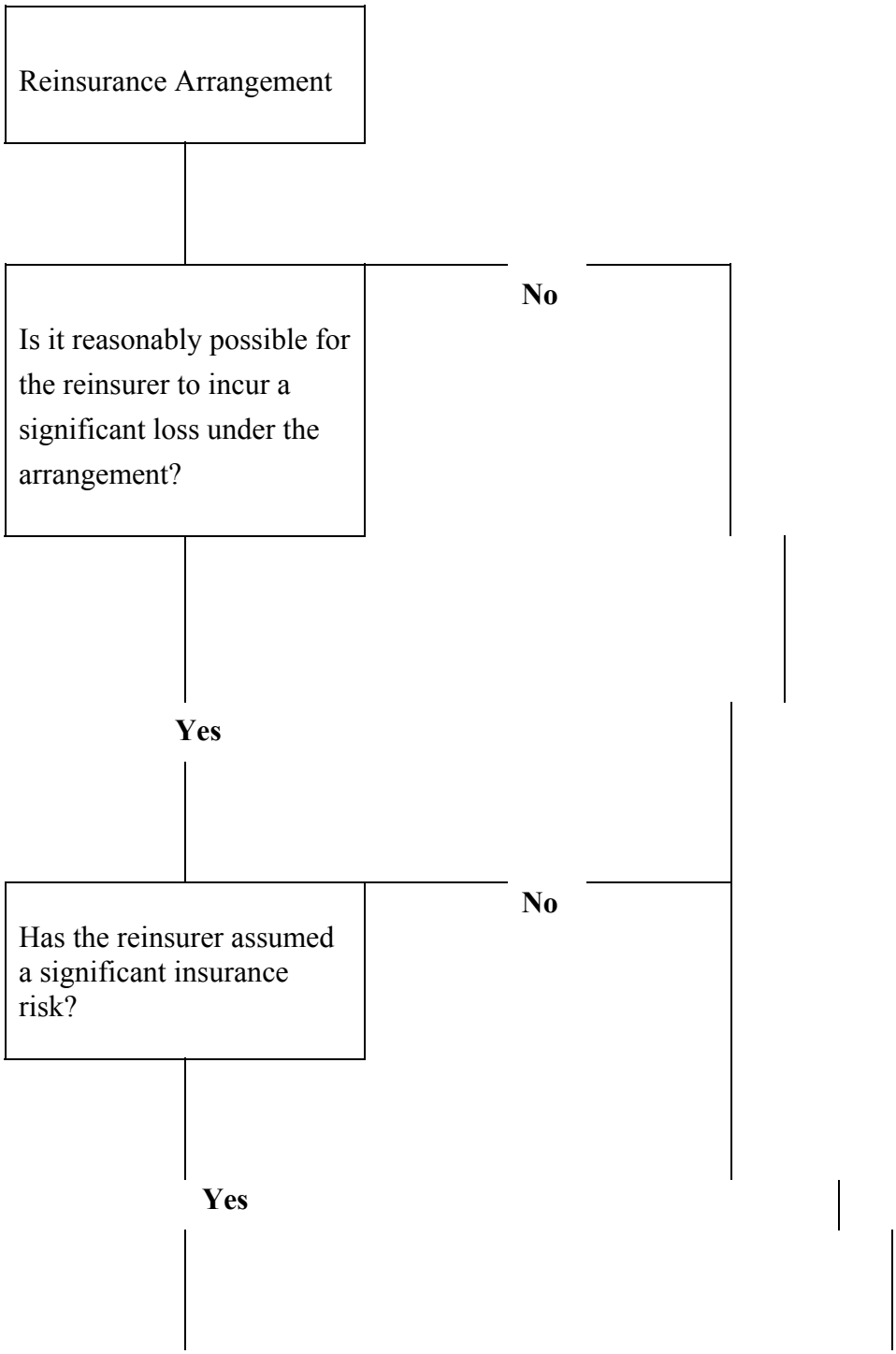
(b) it is not reasonably possible for the insurer to incur a **significant loss** under the arrangement.

16. **Insurance risk** can be defined as the risk arising from uncertainties about both:

- the ultimate amount of net cash flows from premiums, commissions, claims and claim settlement expenses paid or incurred under a contract (**underwriting risk**); **and**
- the timing of the receipt or payment of those cash flows (**timing risk**).

Significant loss and significant insurance risk

17. The acceptance or otherwise for taxation purposes of a reinsurance arrangement can be explained using the flow chart on the following page:


Reinsurance Arrangement
Is it reasonably possible for the reinsurer to incur a significant loss under the arrangement?
No
Yes
Has the reinsurer assumed a significant insurance risk?
No
Yes

The contract is accepted, for taxation purposes, as a contract of reinsurance.	The contract is not accepted, for taxation purposes, as a contract of reinsurance.

18. The possibility of incurring a significant loss as referred to in paragraphs 8, 15 and 17 requires that for an arrangement to be acceptable as reinsurance for taxation purposes the possibility of a significant insurance loss must exist.

19. A reinsured may utilise financial reinsurance to achieve one or more financial goals, rather than obtaining indemnity from insurance risk as its primary purpose. It is common for financial reinsurance to have a lower amount of total insurance risk transfer than has been historically utilised in other reinsurance arrangements. Consequently, the arrangement may not expose the reinsurer to a significant loss and may not provide for the reinsurer to assume significant insurance risk. (Refer to **Attachments D and E** for examples of financial reinsurance arrangements that contain no insurance risks.)

20. If it is not possible for the reinsurer to incur a significant loss under the arrangement that arrangement cannot be held to constitute a reinsurance arrangement for income tax purposes.

21. The term 'reasonably possible' (see paragraphs 15(b) and 17) indicates a situation where the chance of the future insured event or events occurring is more than remote but less than likely.

22. A contract will not have transferred insurance risk if the probability of a significant variation in the amount and timing of the payments by the reinsurer is remote.

23. The evaluation of the possibility of a significant loss is to be based on the present value of all estimated cash flows between the reinsurer and the reinsured under reasonably possible outcomes. This includes cash flows from premiums, commissions, claims adjustable features etc, regardless of their characterisation in the contract. The reinsurer will need to demonstrate that the present value of estimated cash flows will result in the possibility of a significant loss. The calculation excludes however, third party expenses incurred as a result of the contract. The interest rate used in the present value calculations of each reasonably possible outcome tested should be the same.

24. In other words, whether a loss is significant or not will initially be determined by comparing the present value of the payments to be made to the reinsurer by the reinsured with a reasonably possible loss to the reinsurer. A loss would arise where the present value of the cash flows from the reinsured would be exceeded by the potential payments under reasonably possible outcomes by the reinsurer to the reinsured.

25. The significance of possible losses under different scenarios should be evaluated by comparing the various calculations of the present value of all cash flows with the present value of the amounts paid or payable to the reinsurer under the contract. The different

scenarios to be evaluated may include, for example, "Best", "Most Likely" and "Worst" case scenarios. If the present value of the possible outcomes is not significantly different from the present value of the amounts payable to the reinsurer the arrangement will not expose the reinsurer to a significant loss. Consequently, the arrangement will not be treated as a reinsurance arrangement for taxation purposes.

26. If a contract is likely to be terminated under any reasonably possible scenario, the effect of the termination on cash flows between the reinsured and the reinsurer must also be considered when determining if it is reasonably possible for the reinsurer to incur a significant loss under the arrangement.

27. If, for example, where upon cancellation or expiry of a contract the reinsured is required to reimburse the reinsurer for any losses incurred by the reinsurer under the arrangement, then the reinsurer's exposure to a significant loss would be eliminated. Consequently, the arrangement would fail the first test in paragraph 8.

28. In circumstances where the arrangement contractually provides a facility for the reinsured to reimburse the reinsurer where claims exceed premiums and investment income or where claims reduce the reinsurer's return on capital, a contingent liability may be created which may require supporting capital from the reinsured. The effect of this facility needs to be taken into account when considering if it is reasonably possible for the reinsurer to incur a significant loss. In the event of an unexpectedly large claim the facility may result in an actual liability being created which may stand in line with, or even rank ahead of, policyholder claims. It is the potential for the creation of this liability which distinguishes some financing arrangements from reinsurance. In these circumstances where the reinsurer is reimbursed for losses, it cannot be said that it is reasonably possible for the reinsurer to incur a significant loss under the arrangement.

29. The ultimate decision as to whether an arrangement, as a whole, exposes the reinsurer to the possibility of incurring a significant loss will depend on an objective assessment of the component parts of the arrangement, together with any ancillary arrangements, whether written or otherwise, and other relevant factors. Ancillary arrangements include arrangements associated with the reinsurance arrangement and need to be included in the assessment of the arrangement as a whole.

30. We are aware of arrangements which attempt 'to cloak reality' or 'to disguise' the real situation through the inclusion of some degree of transfer of insurance risk and the creation of a composite arrangement. Where there is uncertainty as to whether significant insurance risk has been transferred we consider that the whole arrangement is to be

treated as a financial arrangement and not insurance/reinsurance for taxation purposes.

31. A contract will not be accepted as a reinsurance contract for taxation purposes if the contract, or other associated contracts or agreements, either directly or indirectly compensate the reinsurer for the reinsurer's losses under the arrangement. Thus, ancillary arrangements need to be examined in conjunction with a purported reinsurance contract to ascertain if a significant amount of insurance risk has been transferred under the arrangement as a whole.

Features that may limit the amount of insurance risk transferred.

32. Listed below are some known features that limit the amount of insurance risk transferred to the reinsurer. Each of the features are indicative only, and the list is not intended to be exhaustive. Some of these features may also be present in acceptable reinsurance arrangements and it is for this reason that the arrangement must be considered in its entirety.

- **Experience Account Balance** (EAB).

  This balance is potentially available to be paid out to the reinsured upon termination. It usually comprises the following:

  - premiums paid.
  - Add a credit for a portion of the investment income earned by the reinsurer.
  - Less claims paid by the reinsurer and the reinsurer's margin. (Refer to **Attachments D and E** for examples of the operation and effect of an EAB).

- **Cancellation and recapture clauses** (commutation clauses). These clauses operate to return a portion of the EAB if it is positive and to require the reinsured to reimburse the reinsurer if the EAB is negative.

- **Delays in the timely payment** of amounts due under the terms of the contract. If the ultimate timing of payments by the reinsurer is known or the contract provides for other than timely reimbursement of the reinsured (eg, until the end of the second or third year), then risk has not been transferred. Contractually stipulated payment schedules, accumulating retentions, floating retentions and other adjustable features generally prevent timely reimbursement.

- **Adjustments to premiums** based on the experience of the arrangement. This may occur where, for example, no

claims have been made, and consequently, future premiums may be reduced. Conversely, the cover provided may be increased whilst premiums remain stable.

- **Renewal clauses**. These clauses provide for the automatic renewal of the contract if the EAB is in a deficit or if the deficit exceeds a specified amount. In some circumstances coverage may be cancelled but still leave the reinsured with the obligation to pay the remaining premiums.

Arrangement to be treated as a deposit

33. The transfer of insurance risk in financial reinsurance arrangements, if any, is minimal and the transaction is not, in substance, in the nature of the reinsurance of insurance risks. It is considered that the substance of financial reinsurance is more akin to a 'banking', 'financing' or 'funding' arrangement than the historical concept of reinsurance and the transfer of insurance risk. Given that the substance of financial reinsurance is more akin to banking or financing arrangements the taxation treatment of financial reinsurance will follow that of banking and financing arrangements. This may also involve the application of Division 16E of the ITAA. Specifically, Division 16E may apply to scenario 1 in **Attachments D and E** as the arrangement could be a 'qualifying security' with an 'eligible return'.

Background

34. In order that the rulings contained herein may be better understood, the concepts of insurance, reinsurance, financial insurance/reinsurance and the terminologies used in the industry, as they are understood by the ATO, are explained in this Ruling. The explanations are provided solely with the view of assisting in the understanding of the extent to which this Ruling is intended to apply.

Insurance

35. When considering the concept of insurance we need to look at the reasons individuals and companies take out insurance. Why do people insure their homes, cars, boats etc?

36. The reason for insurance is because both individuals and companies have limited resources. If, for example, a person's home was damaged or destroyed the person would not generally have the resources to repair or replace the home.

37. Insurance of any kind is about the spreading of risk based on the law of large numbers - the many paying for the few. A statute of Queen Elizabeth dated 1601 contained in its preamble a classic definition of insurance. The definition is as follows:

> "By means of a Policy of insurance it cometh to pass that upon the loss or perishing of any ship there followeth, not the undoing of any man, but the loss lighteth rather easily upon many than heavily upon few."

We understand that this is the first time that the subject of insurance is referred to in English Law Books, and these few simple words contain the fundamental principles of insurance. Insurance enables insurers to spread the potential loss of a few individuals over many other individuals. Insurance thus involves the transfer of the potential for a loss from an individual who may be subject to the loss as a result of the occurrence of a adverse event, to an insurance company.

38. Insurance companies also face the same limitation of financial resources and have the same need to protect their assets. The concept of insurance, as it related to insurance companies, was considered by Menhennett J. in *R.A.C.V. Insurance Pty Ltd* v. *FC of T* 74 ATC 4169; (1974) 4 ATR 610; who stated at p 4176:

> "The essence of insurance business is that, in respect of each class of risk insured against, the insurance company aims to satisfy its liabilities to the policy holders who actually experience the risk primarily out of the total of the premiums paid by all the policy holders, most of whom normally do not experience the risk."

39. Where an insurance company can not meet the claims made against it by those it has insured because it does not have sufficient premium income or reserve assets a spread of losses faced by policyholders has not been achieved. In order to avoid this situation an insurance company similarly takes out insurance to cover its inability to pay. This is called reinsurance. Similar policies taken out by reinsurance companies are called retrocessions.

40. Insurance may be described as a contact of indemnity between the insured and the insurer.

> "Under a contract of insurance one party, known as the insurer, promises that on the occurrence of an uncertain specified event he will either indemnify the other party, known as the insured or the policyholder, for any financial loss he may sustain, or pay to him a certain sum, and in return the insured agrees to pay the insurer an ascertainable amount known as a premium."

(R.L. Carter, *Reinsurance*, Kluwer Publishing Limited, 1979, page 3)

41. The essence of insurance is to create a premium pool (from the premiums paid by the many) out of which claims (incurred by a few) and expenses are paid. In addition the providers of the capital required to establish and conduct the business (the insurers) also seek a return on their investment. This concept can be expressed in the following equation:

P = L + E + C + S

Where

P = Policy premiums (the amounts paid by the many).

L = Losses (incurred by a few).

E = Expenses of running the insurance business.

C = Commission costs of obtaining the premiums.

S = Surplus or profit to the insurer of carrying on the business.

42. The main purposes of an insurance arrangement, therefore, is to **transfer the risk** of loss that may arise from the insured's interest in the subject matter of the insurance to the insurer. Individuals, taking out motor vehicle insurance, for example, transfer the risk of experiencing a loss were an accident to happen, to an insurance company through an insurance policy. Under the insurance policy the insurance company undertakes to indemnify the insured person against such a loss. The consideration for that indemnity is the premium paid by the insured to the insurance company. (See **Attachment A** for an example of the transfer and distribution of risk under a simple insurance arrangement.)

43. The **transfer of the risk** of loss from the insured to the insurer then exposes the insurer to the possibility of incurring a significant loss under a particular insurance contract. The concept of significant loss is discussed in detail at paragraphs 8 and 17-31. The loss will be significant compared to the premium paid on the particular policy, however, it may not be significant in terms of the insurer's total business. In the example at **Attachment A** the loss of 1 car @ $20,000 is significant when compared to the premium ($400) paid by the insured. The loss however, is not significant when compared to the total premiums ($40,000) received by the insurer on its motor vehicle business. But, if a second car is totally destroyed in addition to the two partially damaged, the insurer would be subject to an overall significant loss.

44. The insurer, by accepting other policies which are not expected (on the basis of probabilities) to incur a loss, has effectively **distributed the risk of loss** amongst all the insured parties. The premiums from those parties that do not experience a loss are used to pay for the loss experience of the few. This is the basic

concept of the 'law of large numbers' where the probability of insured events occurring is even among all insureds. The greater the number of insureds, the more the risk can be shared (given reasonable loss probabilities).

45. A **transfer of risk** will have occurred if one party has successfully transferred the risk of loss to another. This will happen when policies are written, premiums are paid by the insured to the insurer, and the insurer has the capacity to pay sums insured under policies in the event of claims being made.

46. In return for the acceptance of a risk, consideration in the form of money (known as a premium) must be paid by an insured to the insurer. The insurer must also be under an obligation to pay a sum of money, or its equivalent, upon the happening of the event insured. The insured must have a legal right to payment which cannot be at the insurer's discretion. (*Commercial Union Assurance Company of Australia Limited* v. *FC of T* 77 ATC 4186; (1977) 7 ATR 435; *Medical Defence Union Ltd* v. *Department of Trade* (1979) 2 All ER 421; *Oswald* v. *Bailey & Ors* (1987) 4 ANZ Insurance Cases.)

47. The insurer will be exposed to a significant loss because it will have assumed a significant insurance risk under a particular contract. If the insured event occurs the insurer is liable for the **insurance risk** that the insurer has assumed under the contract of insurance. Insurance risk is discussed in more detail at paragraph 16.

48. Another factor in an insurance arrangement is that of **risk distribution.** This occurs when an insurer pools premiums from many customers to establish a pool of funds to enable the insurer to pay the losses suffered by a few customers. In three recent US Tax Court Cases the Court has held that risk distribution had occurred because a significant percentage of the insurer's business was with companies not related to it (*Amerco and Subsidiaries, and Republic Western Insurance Company* v. *Commissioner of Internal Revenue* 96 T.C. No. 3; *The Harper Group and Includible Subsidiaries* v. *Commissioner of Internal Revenue* 96 T.C. No. 4 and *Sears, Roebuck and Co. and Affiliated Corporations* v. *Commissioner of Internal Revenue* 96 T.C. No. 5).

49. This **distribution of risk** is also a vital element of any contract of insurance. Refer to **Attachment B** for examples of risk transfer and risk distribution.

Reinsurance

50. Generally speaking, reinsurance is the insuring of the risks undertaken by an insurer. Reinsurance is a form of insurance and the principles and practices applying to the conduct of insurance business generally apply equally to reinsurance.

> "A contract of reinsurance is a contract by which an insurer obtains insurance against loss or liability arising under its primary contract of insurance. Reinsurance of liability under a contract of reinsurance ('retrocession') is also possible."

(David Kelly and Michael Ball, *Principles of Insurance Law in Australia and New Zealand*, Butterworths, 1991 page 15)

51. A contract of reinsurance has also been described as an independent contract of insurance. (Barker J. in *Farmers Mutual Insurance Ltd* v. *QBE Insurance International Ltd; American International Underwriters Ltd* v. *Farmers Mutual Insurance Ltd* (1993) 7 ANZ Insurance Cases)

52. Historically, a reinsurance contract is described as a contract of indemnity. Under a contract of reinsurance one party known as the reinsurer, promises to indemnify the other party, known as the reinsured, for any financial losses sustained by the reinsured as a result of the occurrence of an uncertain event originally insured by the reinsured in its business of insurance. Reinsurance contracts, therefore, are concerned with providing for the insurance of risks under contracts of insurance.

53. Like insurance arrangements, a reinsurer would indemnify an entity which is subject to the risk that it will incur a loss on the occurrence of a specified event. In reinsurance arrangements the entity indemnified is the insurance company and the reinsurer indemnifies a portion of the risks originally assumed by the insurance company. Such portions may be in specific proportions to the amount of risk originally assumed or it may provide for protection over and above a specified amount or ratio of claims. Reinsurance thus involves the transfer of insurance risk from an insurer to a reinsurer and this transfer exposes a reinsurer to the possibility of incurring a significant loss under a reinsurance contract.

Recent developments

54. Reinsurance in the past has generally followed the type of arrangement described in paragraphs 50-53 above. However in recent years this type of reinsurance has become increasingly difficult to obtain and more expensive. This reduction in availability of reinsurance is primarily a result of the huge increase in catastrophe losses faced by insurers and reinsurers over recent years.

55. The difficulty in obtaining reinsurance has had the following consequences:

- a difficulty in obtaining reinsurance for some risks;
- exclusion of some risks in certain locations;
- the insured being required to hold an increased amount of the risk;
- concerns about the viability of parties to the arrangements; and
- a desire to limit exposure to risks whilst still selling a profitable product.

56. This difficulty in obtaining reinsurance has created a gap in an insurer's risk management techniques and a new tool was needed to enable insurers to manage the increased risks they are required to hold. Financial reinsurance appears to have evolved to become such a risk management tool.

Financial reinsurance

57. Financial reinsurance has been described by many varying terms, some of which include: Bankers, Rollers, Portfolio Run-Offs, Time and Distance, Islands in the Sun, Accelerators or Redistributors of Income, Alternative Risk Transfers, Funded Covers, Retrospective Aggregates, Prospective Aggregates etc.

58. Financial reinsurance has existed for over twenty years and has its origins in techniques that rely on the time value of money, that is, the impact of interest to produce a benefit.

59. Financial reinsurance is a broad term encompassing a number of concepts and has been defined to include everything from a transaction embracing no risk of any type (which is tantamount to a loan) to transactions that include a number of different types of risk of loss (**timing risk, investment risk, credit risk and expense risk**) but seek to limit the insurance risk in the underlying risk being reinsured.

60 **Timing risk** is the risk of having to pay a loss before anticipated. Paying a loss earlier than anticipated does not allow for

sufficient amounts of income to be generated and accumulated in order to pay the loss.

61. **Investment risk** is the risk that investment earnings will fall short of projected investment earnings. Investment risk is affected by timing risk as well as market fluctuations.

62. **Credit risk** includes: (a) the risk that the reinsured may not pay premiums when due, (b) subrogation rights that may not be enforceable, or (c) a retrocessionaire (the reinsurer's reinsurer) which may be unable to pay amounts due under a retrocession arrangement.

63. **Expense risk** is the risk that acquisition and operating expenses may exceed amounts expected when the reinsurance premium is calculated. Expense risk is primarily a problem of pricing the product.

64. **Underwriting risk** is the risk that there is a clear possibility that the insurer will pay more than premiums expected on any given policy.

65. We have become aware of arrangements that involve amounts being described as insurance premiums under an insurance arrangement that does not transfer any risk from the insured to the insurer. These arrangements are in reality no more than deposit arrangements in which claims are funded by the insured and appear to have the purpose or result of cloaking a non-deductible expense as an insurance arrangement to either create a deduction or to bring forward a deduction.

66. An example of this type of arrangement is illustrated in **Attachment C.** Although **Attachment C** is an illustration of financial insurance the same principles are involved in financial reinsurance. As can be seen from that example, the insured has not transferred any insurance risks to the insurer and it is the insured that actually funds the outgoings.

67. The arrangement illustrated in **Attachment C** is an attempt to bring forward a deduction for long service leave payments. This arrangement attempts to overcome the decision of the High Court in *Nilsen Development Laboratories Pty. Ltd. & Ors* v. *FC of T* 81 ATC 4031; (1981) 11 ATR 505, which held that provisions for long service were not deductible for income tax purposes and that a deduction is only available when the employer is finally obliged to make the payments. It has also been held in *Ransburg Australia Pty Ltd* v. *FC of T* 80 ATC 4114; (1980) 10 ATR 663, that payments by a taxpayer for indemnity against it's long service leave liabilities are not deductible. Further, this type of arrangement is an attempt to overcome the operation of subsection 51(3) of the ITAA. Such arrangements are not accepted as insurance arrangements for taxation purposes. These types of arrangements are no different from a deposit

arrangement with a bank as there is minimal risk to either party. Consequently, the taxation treatment of this type of arrangement will follow that of banking and finance arrangements.

68. The only difference between financial insurance and financial reinsurance is that the former is an arrangement between a non-insurer and an insurer and the latter is between an insurer and a reinsurer.

Commissioner of Taxation

19 May 1994

ISSN 1039 - 0731

ATO references
NO 94/133-6
BO

Not previously released to the public in draft form

Price $2.90

FOI index detail
reference number

subject references
- financial reinsurance

legislative references
- ITAA 25(1), 51(1)

case references

Amerco and Subsidiaries, and Republic Western Insurance Company v. Commissioner of Internal Revenue 96 T.C. No. 3

Australian National Hotels v. FC of T 88 ATC 4627; (1987) 19 ATR 417

Commercial Union Assurance Company of Australia Limited v. FC of T 77 ATC 4186; (1977) 7 ATR 435

Farmers Mutual Insurance Ltd v QBE Insurance International Ltd; American International Underwriters Ltd v. Farmers Mutual Insurance Ltd (1993) 7 ANZ Insurance Cases

FC of T v. Consolidated Fertilisers Ltd 91 ATC 4677; (1991) 22 ATR 281

Medical Defence Union Ltd v. Department of Trade (1979) 2 All ER 421

Nilsen Development Laboratories Pty. Ltd. & Ors v. FC of T 81 ATC 4031; (1981) 11 ATR 505

Oswald v. Bailey & Ors (1987) 4 ANZ Insurance Cases

R.A.C.V. Insurance Pty Ltd v. FC of T 74 ATC 4169; (1974) 4 ATR 610

Ransburg Australia Pty Ltd v. FC of T 80 ATC 4114; (1980) 10 ATR 663

Sears, Roebuck and Co. and Affiliated Corporations v. Commissioner of Internal Revenue 96 T.C. No. 5

Somers Bay Investment Pty Ltd v. FC of T 80 ATC 4114; (1980) 11 ATR 71

The Harper Group and Includible Subsidiaries v. Commissioner of Internal Revenue 96 T.C. No. 4

Usher's Whiltshire Brewery v. Bruce (1915) AC 244

ATTACHMENT A

SIMPLE INSURANCE ARRANGEMENT

(refer to **PARAGRAPH** 43)

ABC insurance company expects to write insurance cover for 100 motor vehicles for an average insured value of $20,000

Statistics suggest that over the next twelve months, 1 car will be totally destroyed and the accident repair bill for two other cars will be $10,000 each. No claims are expected on the other vehicles.

LOSS TO CAR OWNERS	1 car @ $20,000 =	$20,000
	2 cars @ $10,000=	$20,000
TOTAL LOSS		$40,000

To cover this expected loss, (and if the operating costs, etc of the insurance company are ignored) car insurance premiums payable by each car owner would be $400. (i.e., $40,000/100).

NOTE:

* LARGE NUMBERS are required if an acceptable level of premium is to be charged.

* BENEFIT OF PROTECTION is obtained even though a car is not damaged (premiums are not refunded as they have been used to pay claims).

* EQUALITY OF RISK - where the same premium is charged the assumption is that the risk is substantially equal for each driver. Statistics show that the accident rate for drivers under 25 years of age is much greater than for most other age groups These factors would be reflected in the premium charged to each individual.

This arrangement has effectively transferred the risk, at a reasonable cost, from each individual owner to the insurer and the insurer has effectively spread the risk amongst the many owners.

ATTACHMENT B

RISK TRANSFER AND RISK DISTRIBUTION

(refer to paragraph 49)

ABC Insurance Company has the capital to insure $5 million public liability cover. It has several options.

No transfer and no distribution of the risk.

(A) Insure one risk for $5 million or a number of risks totalling $5 million.

Transfer but no distribution of the risk

(B) Insure (say) 9 public liability risks, each for $5 million but enter into a reinsurance arrangement for losses above $5 million eg; a stop loss cover.

ABC might reinsure on the understanding that if total yearly claims on its entire portfolio ($45 million) exceed $555,555, the reinsurer will reimburse 90% of the excess.

This is an example where the underwriting risk has been transferred. With 9 risks insured, ABC had a potential liability of $45 million, but with the stop loss reinsurance cover its liability is limited to $5 million (the first $555,555 of claims plus $4,444,445 being the 10% of the excess of $44,444,445).

In this scenario ABC has transferred $40 million underwriting risk.

Transfer and distribution of the risk

(C) Rather than enter into a stop loss arrangement the insurer could enter into a quota share arrangement with several reinsurers. A quota share arrangement simply is where the insurer and the reinsurer agree to accept a fixed percentage of each and every insurance written by the insurance company and within the scope of the arrangement.

ABC could enter into an arrangement with 9 reinsurers whereby ABC and each reinsurer agrees to accept 10% of any risk written by ABC. On the basis that ABC only wishes to accept $5 million then ABC could write $50 million of public liability insurance.

In this scenario ABC has effectively transferred and spread the potential loss evenly between itself and the 9 reinsurers.

ATTACHMENT C

ASSUMPTIONS:

Company A knows that it will have a liability for long service leave for three of its staff in the next 5 years.

The amount of the long service leave liability for each employee is $10,000.

The interest rate is 6%

Company A is desirous of spreading its liability over the next 5 years and if possible obtain a tax deduction for the provision of that liability.

OPTION:

A financial insurance arrangement is suggested with annual premiums of $6,000, expenses of 8% of premiums and participation as to 85% of the profit from the arrangement. The following scenario is suggested to company A.

COMPANY A

	Year 1	**Year 2**	**Year 3**	**Year 4**	**Year 5**	**TOTAL**
Premium	6,000	6,000	6,000	6,000	6,000	30,000
Charge (8% Prem)	480	480	480	480	480	2,400
Balance	5,520	5,520	5,520	5,520	5,520	
B/fwd		5,851	2,053	8,027	4,360	
Balance	5,520	11,371	7,573	13,547	9,880	
Interest	331	682	454	813	593	2,873
Balance	5,830	12,053	8,027	14,360	10,473	
Claim		10,000		10,000	10,000	30,000
C/fwd	5,851	2,053	8,027	4,360	**473**	**Balance**

With an 85% profit participation Company A would receive $402 (85% of $473).

The insurer would retain $71 (15% of 473).

ATTACHMENT C

RESULT

The claimed result of this arrangement (which we dispute by this Ruling) is that Company A obtains an annual tax deduction of $6,000 being its provision for long service leave Company A also receives $402 as profit participation (a return on the arrangement).

The insurer is also satisfied as it derives commission of $2,400 and also obtains $71 profit without it facing any insurance risk under the arrangement.

A purpose of the arrangement was to enable the insured to claim a tax deductions for the 'premiums' paid to the insurer. Those 'premiums' effectively represents an amount which it might otherwise have retained as a non-deductible provision for long service leave. As mentioned in paragraph 67, this type of arrangement is not accepted as insurance for taxation purposes.

ATTACHMENT D

SINGLE PREMIUM AND SHARING PROFIT COMMISSION

Single Premium $500

Interest assumption 6%

Experience Account Balance = EAB

Profit Commission Share of EAB

Reinsured 90%

Reinsurer 10%

Refer to para 19.

(Refer to attached paragraphs D1-D8 for discussion on each of the following scenarios:)

	Year:	**1**	**2**	**3**	**4**	**5**
1	**No Claim**					
	Experience Account Balance		490	519	550	583
	Premium	500				
	Investment Income	30	29	31	33	35
	Charges (8% of Premium)	40				
	Claim					
	TOTAL	490	519	550	583	619
2	**Early Claim**					
	Experience Account Balance		90	95	101	107
	Premium	500				
	Investment Income	30	5	6	6	6
	Charges (8% of Premium)	40				
	Claim	400				
	TOTAL	90	95	101	107	113

ATTACHMENT D

	Year:	1	2	3	4	5
3	**Late Claim**					
	Experience Account Balance		490	519	250	265
	Premium	500				
	Investment Income	30	29	31	15	16
	Charges (8% of Premium)	40				
	Claim			300		
	TOTAL	490	519	250	265	281
4	**Excess Claim**					
	Experience Account Balance		(110)	42	45	48
	Premium	500				
	Investment Income	30	2	3	3	3
	Charges (8% of Premium)	40				
	Claim	600				
	Adjustment Premium		150			
	TOTAL	(110)	42	45	48	51

ATTACHMENT D

EFFECTS

Case 1 - No Claim

D1. In this scenario the reinsured pays a single premium of $500 and makes no claims in the 5 year period. At the end of the 5 years the reinsured participates as to 90% of the experience account balance. The experience account balance as at the end of year 5 is $619 so the reinsured receives $557. The reinsured thus receives the premium back together with $57 representing interest earned on the premium.

D2. The reinsurer is also content with the arrangement as it receives $40 up front for its expenses and participates as to 10% of the experience account balance to the extent of $62. The reinsurer thus earns $102 from the arrangement and is not put at risk.

Case 2 - Early Claim

D3. In this scenario the reinsured pays a single premium of $500 and makes a claim of $400 at the end of the first year. At the end of the 5 years the reinsured participates as to 90% of the experience account balance. The experience account balance as at the end of year 5 is $113 so the reinsured receives $102. Under the arrangement the reinsured receives $400 by way of claim plus $102 share of the experience account balance. The overall effect is that the reinsured receives $2 over and above premiums paid and that $2 represents interest earned on the premium.

D4. The reinsured is also content with the arrangement as it receives $40 up front for its expenses and participates as to 10% of the experience account balance to the extent of $11. The reinsurer thus earns $51 from the arrangement and is not put at risk.

Case 3 - Late Claim

D5. In this scenario the reinsured pays a single premium of $500 and makes a claim of $300 at the end of the third year. At the end of the 5 years the reinsured participates as to 90% of the experience account

ATTACHMENT D

balance. The experience account balance as at the end of year 5 is $281 so the reinsured receives $253. Under the arrangement the reinsured receives $300 by way of claim plus $253 share of the experience account balance. The overall effect is that the reinsured receives $53 over and above premiums paid and that $53 represents interest earned on the premium.

D6. The reinsurer is also content with the arrangement as it receives $40 up front for its expenses and participates as to 10% of the experience account balance to the extent of $28. The reinsurer thus earns $68 from the arrangement and is not put at risk.

Case 4 - Excess Claim

D7. In this scenario the reinsured pays a single premium of $500 and makes a claim of $600 at the end of the first year. This claim causes the experience account balance to go into a negative balance and as such the reinsurer requires the reinsured to pay an adjustment premium of $150. At the end of the 5 Years the reinsured participates as to 90% of the experience account balance. The experience account balance as at the end of year 5 is $51 so the reinsured receives $46. Under the arrangement the reinsured receives $600 by way of claim, is required to pay an adjustment premium of $150 and receives $46 as participation in the experience account balance. In this scenario the reinsured is worse off by $4 due to the cost of using $100 of the reinsurer's capital via the excess claim at the end of year 1.

D8. The reinsurer is content with the arrangement as it still receives $40 up front for its expenses and participates as to 10% of the experience account balance to the extent of $5. The reinsurer does pay out an extra $100 due to the excess claim but this is recouped through the adjustment premium in the following year. The reinsurer thus earns $45 from the arrangement and is not put at risk.

ATTACHMENT E

UP FRONT AND ANNUAL PREMIUM WITH PROFIT SHARE COMMISSION

Up front Premium $500

Annual premium $100

Interest assumption 6%

Profit Commission Share of EAB

Reinsured 90%, Reinsurer 10%

(Refer to attached paragraphs E1-E8 for a discussion of the following scenarios:)

	Year:	**1**	**2**	**3**	**4**	**5**
1	**No Claim**					
	Experience Account Balance		588	721	863	1,012
	Up front Premium	500				
	Annual Premium	100	100	100	100	100
	Investment Income	36	41	49	58	67
	Charges (8% of Premium)	48	8	8	8	8
	Claim					
	TOTAL	588	721	863	1,012	1,171
2	**Early Claim**					
	Experience Account Balance		188	297	413	536
	Premium	500				
	Annual Premium	100	100	100	100	100
	Investment Income	36	17	24	31	38
	Charges (8% of Premium)	48	8	8	8	8
	Claim	400				
	TOTAL	188	297	413	536	666

ATTACHMENT E

	Year:	1	2	3	4	5
3	**Late Claim**					
	Experience Account Balance		588	721	563	694
	Premium	500				
	Annual Premium	100	100	100	100	100
	Investment Income	36	41	49	40	48
	Charges (8% of Premium)	48	8	8	8	8
	Claim			300		
	TOTAL	588	721	563	694	834
4	**Excess Claim**					
	Experience Account Balance		(212)	32	131	236
	Premium	500				
	Annual Premium	100	100	100	100	100
	Investment Income	36	2	7	13	20
	Charges (8% of Premium)	48	8	8	8	8
	Claim	800				
	Adjustment Premium		150			
	TOTAL	(212)	32	131	236	348

ATTACHMENT E

EFFECTS

Case 1 - No Claim

E1. In this scenario the reinsured pays a single premium of $500, annual premiums of $100 and makes no claims in the 5 year period. At the end of the 5 years the reinsured participates as to 90% of the experience account balance. The experience account balance as at the end of year 5 is $1,171 so the reinsured receives $1,054. The reinsured thus receives its premiums back together with $54 representing interest earned on the premiums.

E2. The reinsurer is also content with this arrangement as it receives $80 for its expenses (8% of Premium) and participates as to 10% of the experience account balance to the extent of $117. The reinsurer thus earns $197 from the arrangement and is not put at risk.

Case 2 - Early Claim

E3. In this scenario the reinsured pays a single premium of $500, annual premiums of $100 and makes a $400 claim at the end of the first year. At the end of the 5 years the reinsured participates as to 90% of the experience account balance. The experience account balance as at the end of year 5 is $666 so the reinsured receives $599. Under the arrangement the reinsured receives $400 by way of claim plus $599 share of the experience account balance. The overall effect is that the reinsured sustains a $1 loss on the arrangement.

E4. The reinsurer is also content with the arrangement as it receives $80 for its expenses (8% of Premium) and participates as to 10% of the experience account balance to the extent of $67. The reinsurer thus earns $147 from the arrangement and is not put at risk.

ATTACHMENT E

Case 3 - Late Claim

E5. In this scenario the reinsured pays a single premium of $500, annual premiums of $100 and makes a $300 claim at the end of the third year. At the end of the 5 years the reinsured participates as to 90% of the experience account balance. The experience account balance as at the end of the year 5 is $834 so the reinsured receives $751. Under the arrangement the reinsured receives $300 by way of claim plus $751 share of the experience account balance. The overall effect is that the reinsured receives $51 over and above premiums paid and that $51 represents interest earned on the premiums

E6. The reinsurer is also content with the arrangement as it receives $80 for its expenses (8% of Premium) and participates as to 10% of the experience account balance to the extent of $83. The reinsurer thus earns $163 from the arrangement and is not put at risk.

Case 4 - Excess Claim

E7. In this scenario the reinsurer pays a single premium of $500, annual premiums of $100 and makes a claim of $800 at the end of the first year. This claim causes the experience account balance to go into a negative balance and as such the reinsurer requires the reinsured to pay an adjustment premium of $150. At the end of the 5 years the reinsured participates as to 90% of the experience account balance. The experience account balance as at the end of year 5 is $335 so the reinsured receives $313. Under the arrangement the reinsured receives $800 by way of claim, is required to pay an adjustment premium of $150 and receives $313 as participation in the experience account balance. The overall effect is that the reinsured sustains a loss of $37 on the arrangement.

E8. The reinsurer is content with the arrangement as it still receives $80 for its expenses (8% of Premium) and participates as to 10% of the experience account balance to the extent of $35. The reinsurer thus earns $115 from the arrangement and is not put at risk.

ATTACHMENT F

GLOSSARY OF TERMS

CEDENT

The name of an insurer who transfers all or part of a risk to a reinsurer.

COMMUTATION CLAUSE

A clause which provides, by mutual agreement between both parties, for the estimation and complete discharge, by payment by the reinsurer to the cedent of all future obligations for reinsurance loss or losses incurred, regardless of the continuing nature of certain losses. This clause is utilised chiefly in non-proportional liability contracts.

QUOTA SHARE ARRANGEMENTS

A form of reinsurance under which the cedent is bound to cede, and the reinsurer to accept, a fixed share of every risk which the cedent may insure in an agreed section of its business.

RETROCEDENT

A reinsurer who retrocedes.

RETROCESSION

A reinsurance of a reinsurance.

RETROCESSIONAIRE

A reinsurer who accepts retrocession business.

STOP LOSS REINSURANCE

A form of reinsurance where the reinsurer is not responsible for the amount by which an individual claim exceeds a fixed sum, but indemnifies the cedent is respect of an annual loss ratio on a particular portfolio in excess of a stipulated level.