Insurance Excesses - Safe Harbour Arrangements -

Insurance Industry Partnership

Insurance excesses – safe harbour arrangements

This publication provides you with the following level of protection:

This publication (excluding appendixes) is a public ruling for the purposes of the *Taxation Administration Act 1953*.

A public ruling is an expression of the Commissioner's opinion about the way in which a relevant provision applies, or would apply, to entities generally or to a class of entities in relation to a particular scheme or a class of schemes.

If you rely on this ruling, the Commissioner must apply the law to you in the way set out in the ruling (unless the Commissioner is satisfied that the ruling is incorrect and disadvantages you, in which case the law may be applied to you in a way that is more favourable for you – provided the Commissioner is not prevented from doing so by a time limit imposed by the law). You will be protected from having to pay any underpaid tax, penalty or interest in respect of the matters covered by this ruling if it turns out that it does not correctly state how the relevant provision applies to you.

Insurance excesses – safe harbour arrangements

Addendum 2 – 12 July 2004

1. Following a period of consultation with the Insurance Council of Australia (ICA), who co-developed the arrangements with the ATO, the existing safe harbour arrangements for apportioning payments of excess have been revised.

2. Changes include:

- revised safe harbour rates
- amendments to safe harbour option 2 (a) to ensure that, in non-mixed settlements, an increasing adjustment is made for the balance of excess once a claim is finalised, and
- other minor changes to ensure that the arrangements extend to excesses covered by Division 79 of *A New Tax system (Goods and Services Tax) Act 1999*.

3. The revised arrangements will apply from 1 October 2004 and will be available to all general insurers and operators of compulsory third party schemes (CTP operators), irrespective of whether or not the insurers or CTP operators are members of the ICA.

4. The existing arrangements will continue to apply to payments of excess up to 30 September 2004 and will be removed from the Insurance Industry Partnership- Issues Register after 21 October 2004.

Revised safe harbour arrangements – 1 October 2004

What this paper is about

5. This paper provides guidelines for apportioning payments of excess under insurance policies and compulsory third party (CTP) schemes for the purpose of calculating increasing adjustments under section 78-18 and section 79-55 respectively of *A New Tax System (Goods and Services Tax) Act 1999*, (the Act). This paper also sets out details of the ATO accepted basis of apportioning excesses – known as a safe harbour.

Background

6. Division 78 of the Act provides special rules for the treatment of insurance settlements. Division 79 and Division 80 modify and extend the operation of these special rules so that they apply to CTP settlements and CTP settlement sharing arrangements. Any insurance or CTP related transactions that are not specifically covered by the special rules in Divisions 78, 79 and 80, fall for consideration under the basic rules of the Act.

7. Section 78-55 and section 79-80 provide that the payment of an excess to an insurer, or to an operator of a CTP scheme (CTP operator), is not consideration for a supply and is therefore not subject to GST. This provides the correct treatment in cases where the insurer or CTP operator settles a claim by making a payment or a supply, because in those cases the excess is taken into account in reducing the insurer's or CTP operator's entitlement to any decreasing adjustment under Divisions 78 and 79 of the Act. (Refer to Step 2 of the method statement in subsection 78-15(4) and subsection 79-95 (3) of the Act).

8. However, insurers and CTP operators will not always settle claims by making payments or supplies and may also make acquisitions in order to settle claims. Where such acquisitions are creditable acquisitions, the insurer or CTP operator will be entitled to an input tax credit under Division 11 of the Act, but the payment of any excess is not taken into account in reducing the input tax credit under the basic rules in the same way that it would have been if the insurer or CTP operator had been entitled to a decreasing adjustment for the settlement under Division 78 or Division 79 of the Act.

9. To ensure that all excesses paid to an insurer or CTP operator are treated the same irrespective of how claims are settled, section 78-18 and section 79-55 of the Act were introduced to provide an increasing adjustment for that part of the excess that relates to creditable acquisitions or importations made directly for the purposes of settling a claim. The effect of these provisions is that insurers and CTP operators are required to apportion the excess between any payments or supplies made in settlement of a claim (Division 78 & 79 settlements) and any creditable acquisitions or importations made directly for the purposes of settling the claim (Division 11 settlements), and then make an increasing adjustment for that part of the excess that relates to the Division 11 settlements.

10. During the course of consultation with the Insurance Council of Australia (ICA) on the introduction of section 78-18, concern was expressed that complying with the requirements of the provision would result in significant administrative costs for insurers. Particularly in relation to 'long tail' claims where the excess may be received in a tax period prior to the final make up of the settlement being known.

11. In such cases, insurers would need to re-apportion the excess and re-calculate their section 78-10 decreasing adjustments and section 78-18 increasing adjustments for each tax period during which any part of a claim is settled until the claim is finalised. The GST treatment of CTP related excesses under Division 79 of the Act poses similar administrative difficulties for CTP operators.

Safe harbour arrangements for insurance and CTP related excesses

12. In recognition of the administrative difficulties faced by insurers and CTP operators, and to reduce the cost of complying with the requirements of section 78-18 and 79-55 of the Act, the ATO will accept a ***once only*** section 78-18 and section 79-55 increasing adjustment based on an industry agreed safe harbour basis of apportioning excess for each class of insurance.

13. Where a safe harbour basis of apportioning excess is adopted to calculate a section 78-18 or section 79-55 increasing adjustment, the balance of the excess must be taken into account in calculating any section 78-10 or section 79-50 decreasing adjustment, as required by Step 2 of the method statements in section 78-15 and section 79-95 of the Act respectively. However, as is the case for increasing adjustments, where a safe harbour is adopted the excess is taken into account ***once only*** in reducing the relevant decreasing adjustment.

14. The classes of insurance covered by these arrangements, and the applicable safe harbours, are set out in the table below. The increasing adjustment under section 78-18 and section 79-55 of the Act will be 1/11th of the apportioned value of the excess and will need to be brought to account in the tax period during which the increasing adjustment liability arises or when the excess is received. The timing of the increasing adjustment under these arrangements depends on which of the two safe harbour options is adopted. Please refer to option 2(a) and option 2(b) at the end of this paper.

15. The agreed basis of apportionment for each class of insurance, referred to as a safe harbour, has been developed in consultation with the ICA and is based on historical claims data provided by ICA member insurers. The safe harbours for each class of insurance, as classified by the ICA, will be reviewed annually to take into account contemporary costs of settling claims.

What is a safe harbour?

16. A 'safe harbour' is an agreed basis for calculating a liability that will be accepted by the ATO as satisfying the requirements of the law. Safe harbours are designed to provide certainty and simplicity for taxpayers and to reduce compliance costs. However, the use of safe harbours is not mandatory. That means that a taxpayer can choose to adopt a safe harbour or calculate a liability for a particular transaction on an actual basis. If a taxpayer chooses to adopt a safe harbour and applies it to a transaction according to the terms in this paper, the taxpayer will be taken to have met their liability for the particular transaction in full.

The agreed safe harbours

17. Insurers and CTP operators may calculate their section 78 -18 and section 79-55 increasing adjustments as follows:

Increasing adjustment = $ value of excess x safe harbour x 1/11th

Class of business	***Safe harbour (as % of excess)***	***Class of business***	***Safe harbour (as % of excess)***
Aviation	0	Marine and aviation (comb)	13
Commercial motor vehicle	48	Marine cargo	2
Consumer credit	0	Marine hull	11
CTP motor vehicle	2	Marine pleasure craft	40
Domestic motor vehicle	60	Mortgage	0
Employers liability	6	Other accident	15
Fire and ISR	15	Professional indemnity	0
HH building	55	Public and product liability	8
HH combined	44	Travel local	1
HH contents	50	Travel overseas	0
Inward treaty	0	Other: Including, extended warranty and gap insurance	18

Notes

(i) The balance of excess remaining, after applying the above safe harbours to calculate a section 78-18 or section 79-55 increasing adjustment, represents the portion of excess that must be taken into account in calculating relevant decreasing adjustments under the method statements in section 78-15 and section 79-95 respectively.

(ii) Where a policy falls into two or more classes of insurance, the allocation used for APRA[1] purposes will be an acceptable basis of allocating the excess for purposes of adopting the above safe harbours.

(iii) These arrangements do not apply to excesses that relate to GST-free insurance policies.

Date of effect

18. The safe harbours shown in the above table may be applied in respect of all section 78-18 and section 79-55 increasing adjustments arising on and from 1 October 2004, and will remain in force until a change is notified by the ATO.

Safe harbour terms

1. Insurers and CTP operators who adopt the above safe harbours according to the terms in this paper will satisfy their GST liability under section 78-18 and section 79-55 of the Act in full. That is, they will obtain the benefit of the protection conferred by section 37 of the *Taxation Administration Act 1953*.

2. Insurers and CTP operators may adopt the safe harbour for a class of insurance or may calculate increasing adjustments under section 78-18 and section 79-55 of the Act on an actual basis.

3. Where an insurer or CTP operator elects to adopt a safe harbour for a particular class of insurance, the insurer or CTP operator must apply the safe harbour to all relevant transactions in that class for a period of at least 12 months. The insurer or CTP operator cannot swap between a safe harbour and an actual adjustment for different transactions in the same class during the period of the election.

4. Insurers or CTP operators, who elect to use a safe harbour for some classes of insurance, but not for others, must keep a contemporaneous record of that election. It is not necessary to send the election to the ATO, but the election must be produced if requested by the ATO to support the basis of calculating any excess related increasing adjustments.

5. The safe harbours apply prospectively and cannot be adopted retrospectively to generate a credit entitlement. If an insurer or CTP operator calculates increasing adjustments on an actual basis and then discovers that adopting a safe harbour would have been more advantageous, the insurer or CTP operator cannot rely on a safe harbour to claim a credit or a refund of any excess GST paid in the past as a result of not using a safe harbour. However, the insurer can, at any time, elect to adopt a safe harbour for future transactions.

Who can use a safe harbour basis of apportionment?

19. The safe harbours outlined above were developed by the ICA on behalf of its members and have been agreed to by the ATO as an appropriate basis for insurers and CTP operators to apportion excess for purposes of sections 78-18, 78-15, 79-55 and 79-95 of the Act respectively. However, membership of the ICA is not a prerequisite to adopting the safe harbours. The same arrangements are available to all general insurers and CTP operators.

Review of safe harbours

20. The safe harbour rates will be reviewed annually in consultation with the ICA, but will remain in force until a change is notified by the ATO.

Explanations

21. Section 78-18 of the Act provides -

78-18 Increasing adjustments for payments of excess under insurance policies

(1) An insurer has an ***increasing adjustment*** if:

(a) there is a payment of an excess to the insurer under an insurance policy; and

(b) the insurer makes, or has made, payments or supplies in settlement of a claim under the policy; and

(c) the insurer makes, or has made, creditable acquisitions or creditable importations directly for the purpose of settling the claim.

(2) The amount of the ***increasing adjustment*** is 1/11 of the amount that represents the extent to which the payment of excess relates to creditable acquisitions and creditable importations made by the insurer directly for the purpose of settling the claim.

(3) An insurer has an ***increasing adjustment*** if:

(a) there is a payment of an excess to the insurer under an insurance policy; and

(b) the insurer makes, or has made, creditable acquisitions or creditable importations directly for the purpose of settling the claim; and

(c) the insurer has not made any payments or supplies in settlement of the claim.

The amount of the increasing adjustment is 1/11th of the amount of the payment of the excess.

22. Section 79-55 of the Act provides –

79-55 Increasing adjustments for payments of excess etc. under compulsory third party schemes

(1) An operator of a compulsory third party scheme has an ***increasing adjustment*** if:

- there is a payment of an excess to the operator under the scheme, and
- the payment relates to a CTP compensation payment or supply that the operator makes or has made, and
- the operator makes, or has made, creditable acquisitions or creditable importations directly for the purpose of making the CTP compensation payment or supply.

(2) The amount of the ***increasing adjustment*** is 1/11 of the amount that represents the extent to which the payment of excess relates to creditable acquisitions or creditable importations made by the operator directly for the purpose of making the CTP compensation payment or supply.

(3) An operator of a compulsory third party scheme has an ***increasing adjustment*** if:

(a) there is a payment of an excess to the operator under the scheme, and

(b) the operator makes, or has made, creditable acquisitions or creditable importations directly for the purpose of making a CTP compensation payment or supply to which the payment of excess would relate, and

(c) the operator has not made any CTP compensation payment or supply to which the payment of excess relates.

The amount of the increasing adjustment is 1/11th of the amount of the payment of excess.

Timing of the increasing adjustment

23. The liability to make an increasing adjustment under the above provisions will only crystallise when both of the following conditions have been met:

- there is a payment of an excess to the insurer or CTP operator, and
- the insurer or CTP operator makes, or has made, a creditable acquisition directly for the purpose of, either settling a claim under an insurance policy, or making a CTP compensation payment or supply.

Meaning of 'directly for the purpose of settling the claim'

24. An acquisition or importation of goods or real property by an insurer will be directly for the purpose of settling the claim if the insurer supplies those goods or real property in settlement of the claim to the insured and the essential character of the goods or real property remains unchanged. That is, if the insurer supplies the goods or real property in order to settle its liability arising under the policy, the acquisition of the goods or real property will be directly for the purpose of settling the claim.

25. Where an insurer acquires something other than goods or real property, it will be directly for the purpose of settling the claim if the acquisition is made to enable the insurer to settle its liability arising under the policy. If the acquisition is made to enable the insurer to determine what that liability is, or represents costs not covered under the terms of the policy, the acquisition will not be directly for the purpose of settling the claim.

26. For example:

- An insurer enters into a contractual arrangement with a supplier for a supply, such as a supply of repair services, to be made to an insured. The supply made by the supplier to the insured will mean that the insurer's liability under the insurance policy will be met.

27. The acquisition of the supply by the insurer will be directly for the purpose of settling the claim.

- An insurer acquires the services of an assessor to assess the claim. The acquisition will enable the insurer to determine its liability under the policy.

28. This will not be an acquisition directly for the purpose of settling the claim. This will also be the case where the insurer acquires legal, engineering or investigator services to enable it to determine its liability under the policy.

29. An insurer acquires a police report after an accident. It also acquires a medical report on the medical condition of the claimant. Both acquisitions are made to enable the insurer to determine its liability under the policy covering the accident.

30. Neither acquisition will be directly for the purpose of settling the claim.

31. Whether or not an acquisition is directly for the purpose of settling the claim does not affect the insurer's entitlement to input tax credits for the acquisition under Division 11 of the Act.

32. The same conditions are applied to the phrase 'directly for the purpose of making a CTP compensation payment or supply' in section 79-55 of the Act. If a CTP operator acquires goods or services and on-supplies those goods or services in order to settle a claim under a CTP scheme, then the acquisition of those goods or services will be regarded as being directly for the purpose of making a CTP compensation payment or supply and will, subject to the payment of an excess, trigger a liability to a section 79-55 increasing adjustment.

33. If an acquisition is made to enable the CTP operator to determine a claim, for example, a medical report, it will not be regarded as being directly for the purpose of making a CTP compensation payment or supply and will not, therefore, trigger an increasing adjustment under section 79-55 of the Act. Again, whether or not an acquisition is directly for the purpose of making a CTP compensation payment or supply does not affect the CTP operator's entitlement to an input tax credit for the acquisition.

Treatment of excesses under the GST Act

34. Settlements of insurance claims are affected by the insured's entitlement to an input tax credit on the premium (ITC entitlement). Settlements of insurance claims will fall for consideration under either Division 78 of the Act, depending on the insured's ITC entitlement – they may give rise to a decreasing adjustment for the insurer, or they may be creditable acquisitions under Division 11 of the Act, which will give rise to an input tax credit for the insurer.

35. The intent of the legislation is that when payment of an excess is received by an insurer, it should affect any credit entitlement that the insurer may have for settling the claim. The method statement in section 78-15 of the Act operates to ensure that any payment of excess to the insurer reduces the amount of the decreasing adjustment available to the insurer in respect of the settlement, while section 78-18 of the Act provides for an increasing adjustment to the insurer to the extent that the excess relates to a settlement that gave rise to an input tax credit.

36. The combined effect of these provisions is that the excess will need to be apportioned to section 78-15 and section 78-18 of the Act in the same proportion as the settlement comprises Division 78 payments or supplies and Division 11 acquisitions. Furthermore, if the excess is received in a tax period prior to the final settlement of a claim, it will need to be re-apportioned each time that any part settlement of the claim is made, until the claim is finally settled in full.

37. The same principles apply to the treatment of CTP related excesses. Where a payment of excess relates to the settlement of a claim under an insurance policy, it will be taken into account under section 78-15 and section 78-18 of the Act to reduce any credit entitlement available to the insurer for settling the claim as discussed above.

38. Where a payment of excess relates to the settlement of a claim for compensation under a CTP scheme, it will similarly be taken into account to reduce any credit entitlement available to the operator for settling the claim. Section 79-95 of the Act will reduce any decreasing adjustment available to the CTP operator for any payment or supply made in settlement of the claim and section 79-55 of the Act will give rise to an increasing adjustment to the extent that the excess relates to a creditable acquisition made by the operator directly for the purpose of settling the claim.

39. As is the case for excesses covered by Division 78 of the Act. Excesses that fall for consideration under Division 79 of the Act will need to be apportioned between section 79-95 and section 79-55 of the Act in the same proportion as the settlement of the claim for compensation comprises payments or supplies covered by Division 79 and acquisitions covered by Division 11 of the Act.

Examples of the GST treatment of excesses under the Act (Scenarios 1-5)

40. The following examples are designed to illustrate the GST consequences of the payment of an excess under an insurance policy. The examples assume that the insurer and the insured are both registered for GST and that the insurer has monthly tax periods.

41. The GST treatment of payments of excess under a CTP scheme, covered by Division 79 of the Act, will be effectively the same as that which applies to payments of excess under insurance policies illustrated in the following examples.

Scenario 1: Excess paid to repairer

42. An insured asset is damaged and the GST inclusive cost of repair is $5,500. The GST associated with this repair is 1/11th of $5,500 or $500. The insurer contracts with the repairer for the repair services and agrees to pay $5,400 towards the total cost of the repair. The Insured is required to contribute the balance or the excess of $100. The policyholder pays the $100 to the repairer.

Input tax credit:

Insurer:

The insurer is entitled to an input tax credit under Division 11 of the Act of up to $490.91 (1/11th of $5,400).

Insured:

The policyholder may be entitled to claim an input tax credit under Division 11 of the Act on their contribution of up to $9.09 (1/11th of $100).

Section 78-18 increasing adjustment:

No increasing adjustment as no excess is paid to the insurer.

Tax invoices:

If requested, the repairer must supply a tax invoice. The amount shown on the tax invoice should equate to what the repairer has collected from the entity making the request.

Insurer:

A tax invoice would be issued to the insurer for $5,400.

Insured:

If requested, a tax invoice would issue to the policyholder for $100.

Scenario 2: Excess paid directly to insurer and the insurer has made a creditable acquisition directly for the purpose of settling the claim

43. An insured asset that is used 100% for business purposes is stolen and the GST inclusive replacement cost is $5,500. The GST associated with the replacement is 1/11th of $5,500 or $500.

44. The insurer contracts with a supplier for the replacement of the goods and agrees to pay the full cost of the supply. $5,500 is paid directly by the insurer to the supplier being the total replacement cost. To assist with the claim, the insurer engages an external loss assessor for a GST inclusive fee of $66. The $100 excess associated with this policy is paid by the insured directly to the insurer.

45. In this scenario the insurer pays the full $5,500 to the supplier and $66 to the loss assessor. Both acquisitions are creditable acquisitions on the part of the insurer.

Input tax credit:

Insurer:

The insurer is entitled to an input tax credit under Division 11 of the Act of up to $506 (1/11th of ($5,500 +$66)).

Insured:

No input tax credit entitlement. The payment of excess to the insurer is not treated as consideration for a supply by virtue of section 78-55 of the Act. The policyholder is therefore not entitled to claim an input tax credit for the excess paid to the insurer.

Section 78-18 Increasing adjustment:

Section 78-18 of the GST Act will operate as the requirements of subsection 78-18(3) have been met. The insurer will have an increasing adjustment equal to 1/11th of the amount of the excess. That is, (1/11th x $100) or $9.09.

The net result of the above transactions is an input tax credit for the insurance claim equal to $496.91 ($506 – $9.09).

Tax invoices:

If a tax invoice is requested:

Insurer:

A tax invoice would be issued to the insurer for $5,500 from the supplier and one from the loss assessor for $66.

No adjustment note is required as the section 78-18 increasing adjustment is not an adjustment event for the purposes of Division 19 of the Act.

Insured:

No tax invoice entitlement. The payment of the $100 excess to the insurer is not treated as consideration for a supply by virtue of section 78-55 of the Act. The insurer is therefore not required to issue a tax invoice to the policyholder.

Scenario 3: Excess paid directly to insurer and the insurer has made a creditable acquisition directly for the purpose of settling the claim

46. An insured asset used 60% of the time for business is damaged and the GST inclusive cost of repair is $7,700. The GST associated with this repair is 1/11th of $7,700 or $700. The insurer contracts with the repairer for the repair services and agrees to pay the full cost of the repair. $7,700 is paid directly by the insurer to the repairer being the total cost of the repair. In addition to the repair cost, the insurer uses an external loss assessor for a GST inclusive fee of $3,300 per month to assess claims. The $100 excess associated with this policy is paid by the insured directly to the insurer.

47. In this scenario the insurer pays the full $7,700 to the repairer and $3,300 to the loss assessor. Both are creditable acquisitions made for the purpose of settling the claim.

Input tax credit:

Insurer:

The insurer is entitled to an input tax credit under Division 11 of the Act of up to $1,000 [(1/11th x $7,700) + (1/11th x $3,300)].

Insured:

No input tax credit entitlement. The payment of excess to the insurer is not treated as consideration for a supply by virtue of section 78-55 of the Act. The insured is therefore not entitled to claim an input tax credit for the excess paid to the insurer.

Section 78-18 increasing adjustment:

Section 78-18 of the Act will operate as the requirements of subsection 78-18(3) have been met. The insurer will have an increasing adjustment equal to 1/11th of the amount of the excess. That is, (1/11th x $100) or $9.09.

The net result of the above transactions is an input tax credit for the claim equal to $990.91 [(1/11th x ($7,700 + $3,300)) – $9.09].

Tax invoices:

If a tax invoice is requested:

Insurer:

A tax invoice would be issued to the insurer for $7,700 from the repairer and one from the loss assessor for $3,300.

No adjustment note is required as the section 78-18 increasing adjustment is not an adjustment event for the purposes of Division 19 of the Act.

Insured:

No tax invoice entitlement. The payment of the $100 excess to the insurer is not treated as consideration for a supply by virtue of section 78-55 of the Act. The insurer is therefore not required to issue a tax invoice to the policyholder.

Scenario 4: Excess paid directly to insurer and the insurer has made both a creditable acquisition and a cash payment directly for the purpose of settling the claim in the same tax period

48. An insured asset used 80% of the time for business is destroyed. To settle the claim the insurer arranges for a cash payment of $8,800 and contracts with a supplier to supply certain goods. The GST inclusive cost of those goods is $2,200. In addition to the repair cost, the insurer uses an external loss assessor for a GST inclusive fee of $770 to assess the claim. The $1,100 excess associated with this policy is paid by the insured directly to the insurer.

49. In this scenario the insurer pays the full $2,200 for the cost of the goods to the supplier and $770 to the loss assessor. Both are creditable acquisitions made for the purpose of settling the claim.

Input tax credit:

Insurer:

The insurer is entitled to an input tax credit under Division 11 of the Act of up to $270 [(1/11th x $2,200) + (1/11th x $770)].

Insured:

No input tax credit entitlement. The payment of excess to the insurer is not treated as consideration for a supply by virtue of section 78-55 of the Act. The insured is therefore not entitled to claim an input tax credit for the excess paid to the insurer.

Decreasing adjustment:

Insurer:

The insurer is entitled to a decreasing adjustment under Division 78 of the Act of 1/11th x settlement amount***** x (1 – extent of input tax credit).

The settlement amount is $8,800 – the excess to the extent it does not relate to the acquisition directly for the purpose of settling the claim multiplied by 11 and divided by (11 – extent of input tax credit on the premium).

As the cash settlement is $8,800 and the acquisition directly for the purpose of settling the claim was for $2,200, the total amount of the settlement is $11,000.

The acquisition directly for the purpose of settling the claim represents 20% ($2,200 is 20% of $11,000) of the total settlement and the cash payment represents 80% ($8,800 is 80% of $11,000) of the total.

Thus the excess relates to the acquisition directly for the purpose of settling the claim to the extent of 20% and to the cash payment to the extent of 80%. The amount of the excess included in working out the settlement amount is therefore 80% of $1,100, which is $880.

The settlement amount is:

($8,800 – $880) x 11/10.2, which is $8,541.18.

The amount of the decreasing adjustment is:

1/11th x 8,541.18 x (1 – 0.8), which is $155.29.

Refer to method statement contained in subsection 78-15(4) of the Act.

Section 78-18 Increasing adjustment:

Section 78-18 of the Act will operate as the requirements of subsection 78-18(1) have been met.

The insurer will have an increasing adjustment equal to 1/11th of the amount that represents the extent to which the payment of excess relates to creditable acquisitions ($2,200/$11,000 or 20%), made by the insurer directly for the purpose of settling the claim. That is, (1/11th x $1,100 x 20%) or $20.

The net result of the above transactions is an input tax credit for the claim equal to $250 [(1/11th x ($2,200 + $770)) – $20].

Tax invoices:

If a tax invoice is requested:

Insurer:

A tax invoice would be issued to the insurer for $2,200 from the supplier and one from the loss assessor for $770.

No adjustment note is required, as the section 78-18 increasing adjustment is not an adjustment event for the purposes of Division 19 of the Act.

Insured:

No tax invoice entitlement. The payment of the $1,100 excess to the insurer is not treated as consideration for a supply by virtue of section 78-55 of the Act. The insurer is therefore not required to issue a tax invoice to the policyholder.

Scenario 5: Excess paid directly to insurer and the insurer has made both cash payments and creditable acquisitions directly for the purpose of settling the claim in different tax periods

50. An insured asset used 80% of the time for business is destroyed. In part settlement of the claim the insurer makes a cash payment of $8,800 on 1 June 2001 and also contracts with a supplier to supply certain goods during the same period. The GST inclusive cost of those goods is $2,200. In addition to the repair cost, the insurer uses an external loss assessor for a GST inclusive fee of $770 to assess the claim. The $1,100 excess associated with this policy is paid by the insured directly to the insurer on 1 June 2001.

51. In this scenario the insurer pays the full $2,200 for the cost of the goods to the supplier and $770 to the loss assessor in June 2001. Both are creditable acquisitions, but only the $2,200 acquisition is considered to be made directly for the purpose of settling the claim. The $770 payment to the loss assessor is made to enable the insurer to determine its liability under the claim. On 15 July 2001 the insurer acquires further goods costing $1,100 to restore the asset to its original condition and settle the claim in full.

52. GST treatment of the settlement

June tax period

Input tax credit:

Insurer:

The insurer is entitled to an input tax credit under Division 11 of the Act of up to $270 [(1/11th x $2,200) + (1/11th x $770)].

Insured:

No input tax credit entitlement. The payment of excess to the insurer is not treated as consideration for a supply by virtue of section 78-55 of the Act. The insured is therefore not entitled to claim an input tax credit for the excess paid to the insurer.

Decreasing adjustment:

Insurer:

The insurer is entitled to a decreasing adjustment under Division 78 of the Act of 1/11th x settlement amount***** x (1 – Extent of input tax credit)

The settlement amount is $8,800 – the excess to the extent it does not relate to the acquisition directly for the purpose of settling the claim multiplied by 11 and divided by (11 – extent of input tax credit on the premium).

As the cash settlement is $8,800 and the acquisition directly for the purpose of settling the claim was for $2,200, the total amount of the settlement is $11,000.

The acquisition directly for the purpose of settling the claim represents 20% ($2,200 is 20% of $11,000) of the total settlement and the cash payment represents 80% ($8,800 is 80% of $11,000) of the total.

Thus the excess relates to the acquisition directly for the purpose of settling the claim to the extent of 20% and to the cash payment to the extent of 80%.

The amount of the excess included in working out the settlement amount is therefore 80% of $1,100, which is $880.

The settlement amount is:

($8,800 – $880) x 11/10.2, which is $8,541.18.

The amount of the decreasing adjustment is:

1/11th x 8,541.18 x (1 – 0.8), which is $155.29.

Refer to method statement contained in subsection 78-15(4).

Section 78-18 Increasing adjustment:

Section 78-18 of the Act will operate as the requirements of subsection 78-18(1) have been met. The insurer will have an increasing adjustment equal to 1/11th of the amount that represents the extent to which the payment of excess relates to creditable acquisitions made by the insurer directly for the purpose of settling the claim. That is, (1/11th x $1,100 x 20%) or $20.

The net result of the above transactions is an input tax credit for the claim equal to $250 [(1/11th x ($2,200 + $770)) – $20].

Tax invoices:

If a tax invoice is requested:

Insurer:

A tax invoice would be issued to the insurer for $2,200 from the supplier and one from the loss assessor for $770.

No adjustment note is required, as the section 78-18 increasing adjustment is not an adjustment event for the purposes of Division 19 of the Act.

Insured:

No tax invoice entitlement. The payment of the $1,100 excess to the insurer is not treated as consideration for a supply by virtue of section 78-55 of the Act. The insurer is therefore not required to issue a tax invoice to the policyholder.

July tax period

Input tax credit:

Insurer:

The insurer is entitled to an input tax credit under Division 11 of the Act of up to $100 (1/11th x $1,100).

Decreasing adjustment:

Insurer:

The insurer is not entitled to a decreasing adjustment under Division 78 of the ACT for the $1,100 creditable acquisition. However, as the make up of the total settlement has changed, the proportion of excess that relates to creditable acquisitions has also changed*. This gives rise to an adjustment event requiring a recalculation of the decreasing adjustment previously made in the June tax period, as follows:

The settlement amount is $8,800 – the excess, to the extent it does not relate to the acquisition directly for the purpose of settling the claim multiplied by 11 and divided by (11 – extent of input tax credit on the premium).

As the cash settlement is $8,800 and the sum of acquisitions directly for the purpose of settling the claim is now $3,300, the excess relates to acquisitions to the extent of 3/11. The amount of the excess included in working out the settlement amount is therefore 8/11 of $1,100, which is $800.

The settlement amount is:

($8,800 – $800) x 11/10.2, which is $8,627.45.

The amount of the decreasing adjustment is:

1/11th x $8,627.45 x (1 – 0.8), which is $156.86.

The calculation results in a higher amount than the previously calculated decreasing adjustment of $155.29.

The additional decreasing adjustment of $1.57 is claimed in the July BAS.

Refer to method statement contained in subsection 78-15(4) of the Act.

Section 78-18 Increasing adjustment:

The insurer does not have a section 78-18 increasing adjustment during this period as no payment of excess was received. However, as the make up of the total settlement has changed, the proportion of excess that relates to creditable acquisitions has also changed. This gives rise to an adjustment event which requires a re-calculation of the section 78-18 increasing adjustment made in June as follows:

1/11th of the amount that represents the extent to which the payment of excess relates to creditable acquisitions ($3,300/$12,100) or 3/11.

That is, (1/11th x $1,100 x 3/11) = $27.27. The recalculated section 78-18 increasing adjustment is $7.27 more than that made in the June tax period. Therefore, a further increasing adjustment of $7.27 needs to be made and included in the July activity statement.

Examples of the GST treatment of excesses adopting a safe harbour basis of apportionment (Scenarios 6 and 7)

Scenario 6: Using the same details as in scenario 5 above -

53. ‘Excess paid directly to insurer and the insurer has made both cash payments and creditable acquisitions directly for the purpose of settling the claim in different tax periods.’

54. Assume that the class of insurance was 'Extended Warranty' and that the insurer has chosen to adopt a safe harbour.

55. An insured asset used 80% of the time for business is destroyed. In part settlement of the claim the insurer makes a cash payment of $8,800 on 1 June 2001 and also contracts with a supplier to supply certain goods during the same period. The GST inclusive cost of those goods is $2,200. In addition to the repair cost, the insurer uses an external loss assessor for a GST inclusive fee of $770 to assess the claim. The $1,100 excess associated with this policy is paid by the insured directly to the insurer on 1 June 2001.

56. In this scenario the insurer pays the full $2,200 for the cost of the goods to the supplier and $770 to the loss assessor in June 2001. Both are creditable acquisitions, but only the $2,200 acquisition is considered to be made directly for the purpose of settling the claim. The $770 payment to the loss assessor is made to enable the insurer to determine its liability under the claim. On 15 July 2001 the insurer acquires further goods costing $1,100 to restore the asset to its original condition and settle the claim in full.

June tax period

Input tax credit:

The insurer is entitled to an input tax credit for creditable acquisitions made in June – [(1/11th x $2,200) + (1/11th x $770)] = $270.

Section 78 -18 increasing adjustment:

The insurer will have an increasing adjustment as it has received payment of an excess and made creditable acquisitions directly for the purpose of settling the claim triggering the operation of section 78-18. The increasing adjustment will be –

[1/11 x ($1,100 x safe harbour (19%)] = $19.

Decreasing adjustment:

The insurer is entitled to a decreasing adjustment under Division 78 of – 1/11th x settlement amount* x (1 – Extent of input tax credit)

The settlement amount is $8,800 minus the excess to the extent that it does not relate to acquisitions directly for the purpose of settling the claim, multiplied by 11 and divided by (11 minus extent of input tax credit on the premium).

Refer to method statement contained in subsection 78-15(4) of the Act.

As the taxpayer has adopted a safe harbour basis of apportioning the excess for purposes of section 78-18 of the Act, the amount of excess to be deducted in working out the settlement amount (that is, the section 78-15 portion of excess), is 81% of $1,100, which is $891.

Therefore, the settlement amount is – [($8,800 – $891) x 11/ (11-0.8)] = $ 8,529.31.

The amount of the decreasing adjustment is – [1/11th x 8,529.31 x (1 – 0.8)] = $155.08.

July tax period

Input tax credit:

The insurer made a creditable acquisition in July of $1100 directly for purposes of settling the claim and is therefore entitled to an input tax credit of – [1/11 x $1,100] = $100

Section 78-18 increasing adjustment:

NIL – The insurer has made creditable acquisitions of $1,100 to which section 78-18 of the Act applies. However, the adjustment that would otherwise need to be made to reflect the changed proportion of excess resulting from the July acquisitions, does not need to be made because a safe harbour was used to calculate the section 78-18 increasing adjustment in the tax period when the excess was first received.

Decreasing adjustment:

NIL – There is no Div 78 settlement in July in relation to the claim, and the adjustment that would otherwise need to be made under section 78-15 of the Act to reflect the changed proportion of excess resulting from the creditable acquisitions of $1,100 made in July is not required under the safe harbour arrangements.

Under the terms of the safe harbour arrangements, the insurer's liability for section 78-18 increasing adjustments is satisfied by a once only increasing adjustment. Therefore, once a section 78-18 increasing adjustment is made using a safe harbour basis of apportionment, no further adjustment for the excess will be required in respect of any subsequent acquisitions made directly for the purpose of settling the claim, which would otherwise change the proportion of excess that relates to creditable acquisitions.

Similarly, under the safe harbour arrangements the excess is apportioned once only for purposes of reducing a decreasing adjustment under section 78-15 of the Act. Therefore, once the safe harbour arrangements are applied to apportion the excess under both section 78-15 and section 78-18 of the Act, any credit entitlements arising from any future settlement of a particular claim will be unaffected by the excess.

In the above example, there will be no need for the insurer to recalculate the Division 78 decreasing adjustment or the section 78-18, increasing adjustment to reflect the creditable acquisitions of $1,100 made in July 2001 and the insurer will be entitled to the benefit of a full input tax credit of $100 for those acquisitions.

If instead of making creditable acquisitions in July, the insurer had made a payment of $1,100 to the insured for purposes of settling the claim, the insurer would have a Division 78 decreasing adjustment for the $1,100. Again, as the excess was previously taken into account using a safe harbour basis of apportionment, the insurer would not need to take the excess into account in calculating its entitlement to a decreasing adjustment for the $1100.

The settlement amount for the payment of $1,100 would be:

(Payments of money – applicable excess) x 11 / (11 – Extent of input tax credit of insured)

[(1,100 – 0) x 11 / (11-0.8)] = $1,186.27

The decreasing adjustment for the $1,100 would be:

1/11 x settlement amount x (1- Extent of input tax credit of insured)

[1/11 x 1,186.27 x 0.2] = $21.56.

Additional option for adopting the safe harbour arrangements

57. Adoption of the safe harbour arrangements outlined in Scenario 6 above relies on the insurers' systems ability to track previous safe harbour apportionments in order to achieve a once only adjustment for excess under both section 78-15 and section 78-18 of the Act. From discussions with the ICA on the implementation of the safe harbour arrangements, it is understood that programming and tracking difficulties may arise where, for example, a claim is progressively settled by a mixture of payments or supplies and creditable acquisitions over a number of tax periods.

58. In such cases, the insurers' systems would need to be able to track payments or supplies and acquisitions made in settlement of a claim and distinguish between settlements relating to claims which have already had the excess applied (for purposes of sections 78-15 and 78-18 of the Act), and settlements relating to claims which have not had the excess applied or taken into account.

59. In recognition of the system difficulties that may arise in certain circumstances, it will also be acceptable for insurers who adopt the safe harbour arrangements for a class of insurance, to calculate their section 78-15[2] and section 78 -18 liabilities in relation to excess on receipt of the excess. The same option is extended to CTP operators to calculate their section 79-95 and section 79-55 increasing adjustments. Insurers and CTP operators who adopt this option will need to make an increasing adjustment for the excess when the excess is received, but can then ignore the excess in the GST treatment of any payments, supplies or acquisitions made in settlement of the claim.

60. The increasing adjustment required under this option from insurers will be 1/11th of the section 78-15, safe harbour portion of the excess, adjusted to take into account the insured's ITC entitlement on the premium. Plus 1/11th of the section 78-18, safe harbour portion of the excess.

61. CTP operators will need to make an increasing adjustment equal to 1/11th of the section 79-95 portion of the excess, adjusted to take into account the applicable average input tax credit fraction[3] instead of the insured's ITC entitlement on the premium. Plus 1/11th of the section 79-55 safe harbour portion of the excess.

62. The formula developed by the ICA and accepted by the ATO for calculating the liability in respect of the section 78 -15, safe harbour portion of the excess is as follows:

Increasing Adjustment = E x (1- S) x (1 – T) / (11 – T)

E = excess.

S = the section 78-18 safe harbour percentage expressed as a decimal.

T = the insured's percentage ITC entitlement on the premium expressed as a decimal.

63. The same formula can be adopted by CTP operators to calculate their liability for the section 79-95, safe harbour portion of excess. Except that instead of 'T' representing the insured's ITC entitlement on the premium expressed as a decimal, it will represent the applicable average input tax credit fraction (AAITCF) expressed as a decimal.

Scenario 7

64. Using the details in Scenario 6 above, the increasing adjustment for the section 78-15, safe harbour portion of the excess would be:

[E x (1 – S) x (1 – T) / (11 – T)]

[1,100 x (1 – 0.19) x (1 – 0.80) / (11 – 0.80)]

[1,100 x 0.81 x 0.2 / 10.2] = $17.47

The section 78-18 increasing adjustment for the excess would be:

[E x S x 1/11]

[1,100 x 0.19 x 1/11] = $19.00

Total increasing adjustment for the excess = $ 36.47

Summary of options

65. Insurers and CTP operators effectively have three choices for calculating adjustments relating to excess:

1. Making actual adjustments under section 78-15, section 78-18, section 79-55 and section 79-95 of the Act for every settlement transaction which triggers the operation of those provisions as per Scenarios 1-5, or

2. Adopting the safe harbour arrangements outlined in this paper. Where insurers or CTP operators adopt the safe harbour arrangements for a class of insurance, they will have two options:

   - Making a once only apportionment of excess under sections 78-15, 78-18, 79-55 and 79-95 of the Act, as the case may be, when the operation of those provisions is first triggered as per Scenario 6, or

   - Calculating the GST liability that arises under sections 78-15, 78-18, 79-55 and 79-95 of the Act in respect of the excess, when the excess is first received as per Scenario 7. Under this option, insurers and CTP operators will need to use the formula to ensure that the insured's ITC entitlement on the premium, or the AAITCF, is taken into account when calculating the increasing adjustment for the section 78-15 or section 79-95, safe harbour portion of the excess.

Notes.

I. Option 2 (a) is only available where the insurer's or CTP operator's systems can adequately track apportionments of excess to payments or supplies and acquisitions made in settlement of a claim.

II. Where the excess relates to a non-mixed[4] settlement, the balance of that excess (the amount remaining after applying the safe harbour rate) must be brought to account under the relevant provision once the claim is finalised.

Footnotes

1	Australian Prudential Regulatory Authority.
2	Excess has the effect of reducing the insurer's entitlement to a decreasing adjustment (see ***Step 2*** section 78-15(4)). Under the terms of the safe harbour arrangements, the reduced entitlement to a Division 78 decreasing adjustment can be brought to account as a Division 19 increasing adjustment.
3	Refer to definition in section 79-95.
4	For purposes of these arrangements the term 'non-mixed settlement' refers to cases where a claim is settled in full, either entirely by way of cash payments or supplies (i.e. Division 78 or 79 settlements), or entirely by way of creditable acquisitions or importations (i.e. Division 11 settlements). This is in contrast to mixed settlements, where claims are settled by a combination of both.

66. End to Addendum 2 – 12 July 2004

ADDENDUM dated 5 September 2002

67. Under the terms of the industry agreed arrangements for apportioning payments of excess for purposes of calculating section 78-18 increasing adjustments, the safe harbours for the various classes of insurance listed in the table under the heading – 'The Agreed Safe Harbours' need to be reviewed annually. Following discussions with the Insurance Council of Australia (ICA), who co-developed the arrangements with the ATO, it has been decided to extend the existing safe harbours to 30 June 2003. The extension applies to all general insurers who have chosen to adopt the safe harbour arrangements, irrespective of whether or not they are members of the ICA.

Safe harbour arrangements

What this paper is about

68. This paper provides guidelines for apportioning payments of excess under insurance policies for the purpose of calculating increasing adjustments under section 78-18 of *A New Tax System (Goods and Services Tax) Act 1999*, (the Act). This paper also sets out details of an Australian Taxation Office (ATO accepted basis of apportioning excesses, known as a safe harbour.

Background

69. Division 78 of the Act provides special rules for the treatment of insurance. Any insurance related transactions that are not specifically covered by the special rules in Division 78 fall for consideration under the basic rules of the Act. Section 78-55 provides that the payment of an excess to an insurer by the insured is not consideration for a supply and is therefore not subject to GST. This provides the correct treatment in cases where the insurer settles an insurance claim by making a payment or a supply, because in those cases, the excess is taken into account in reducing the insurer's entitlement to any decreasing adjustment under Division 78 of the Act. [Refer to Step 2 of the method statement in subsection 78-15(4)]. However, insurers will not always settle claims by making payments or supplies covered by Division 78. Insurers may also make acquisitions in order to settle claims. Where such acquisitions are creditable acquisitions, the insurer is entitled to an input tax credit under Division 11 of the Act, but the payment of any excess to the insurer is not taken into account in reducing the input tax credit in the same way that it would have been if the insurer had been entitled to a decreasing adjustment under Division 78.

70. To ensure that all excesses paid to an insurer are treated the same irrespective of how insurance claims are settled, section 78-18 was introduced by Taxation Laws Amendment Bill (No 8) 2000 to provide an increasing adjustment for that part of the excess that relates to creditable acquisitions or importations made directly for purposes of settling a claim. The effect of the new provision is that insurers are now required to apportion the excess between any payments or supplies made in settlement of a claim (Division 78 settlements) and any creditable acquisitions or importations made directly for purposes of settling the claim (Division 11 settlements), and then make an increasing adjustment for that part of the excess that relates to the Division 11 settlements. Section 78-18 applies retrospectively to the first tax period after the Treasurer's press release of 17 August 2000. For most insurers that means that they will have section 78-18 increasing adjustments on and from 1 September 2000.

71. During the course of consultation with the Insurance Council of Australia ('ICA') on the proposed section 78-18, concern was expressed that complying with the requirements of the provision would result in significant administrative costs for insurers. Particularly in relation to 'long tail' claims where the excess may be received in a tax period prior to the final make up of the settlement being known. In such cases, insurers would need to re-apportion the excess and re-calculate their section 78-10 decreasing adjustments and section 78-18 increasing adjustments for each tax period during which any part of a claim is settled until the claim is finalised.

Safe harbour arrangements for insurance excesses

72. In recognition of the administrative difficulties faced by insurers, and to reduce the cost of complying with the requirements of section 78-18, the ATO will accept a once only section 78-18 increasing adjustment based on an industry agreed safe harbour basis of apportioning excess for each class of insurance. Where a safe harbour basis of apportioning excess is adopted to calculate a section 78-18 increasing adjustment, the balance of the excess must be taken into account in calculating any section 78-10, decreasing adjustments as required by Step 2 of the method statement in section 78-15. However, as is the case for section 78-18 increasing adjustments, where a safe harbour is adopted, the excess is taken into account once only in calculating the decreasing adjustment.

73. The classes of insurance covered by these arrangements and the applicable safe harbours are set out in the table below. The section 78-18 increasing adjustment will be 1/11th of the apportioned value of the excess and will need to be brought to account in the tax period that the excess is received by the insurer.

74. The agreed basis of apportionment for each class of insurance, referred to as a safe harbour, has been developed in consultation with the ICA and is based on historical claims data provided by ICA member insurers. The safe harbours for each class of insurance, as classified by the ICA, will be reviewed annually to take into account contemporary costs of settling claims.

What is a safe harbour?

75. A ‘Safe Harbour’ is an agreed basis for calculating a liability that will be accepted by the ATO as satisfying the requirements of the law. Safe harbours are designed to provide certainty and simplicity for taxpayers and to reduce costs of compliance. However, the use of safe harbours is not mandatory. That means that a taxpayer can choose to adopt a safe harbour or calculate a liability for a particular transaction on an actual basis. If a taxpayer chooses to adopt a safe harbour and applies it to a transaction according to its terms, the taxpayer will be taken to have met its liability for the particular transaction in full.

The agreed safe harbours

76. Insurers may calculate their section 78 -18 increasing adjustments as follows:

Increasing Adjustment = $ value of excess x Safe Harbour x 1/11

Safe harbours

Class Of Business	***Safe Harbour (s. 78-18 component of excess as %)***	***Class Of Business***	***Safe Harbour (s. 78-18 component of excess as %)***
Aviation	N/A	Marine & aviation (comb)	25
Commercial motor vehicle	65	Marine cargo	0
Consumer credit	0	Marine hull	9
CTP motor vehicle	0	Marine pleasure craft	11
Domestic motor vehicle	67	Mortgage	0
Employers liability	10	Other accident	16
Fire and ISR	41	Professional indemnity	5
HH building	47	Public & product liability	0
HH combined	57	Travel local	10
HH contents	29	Travel overseas	0
Inward treaty	0	*Other: Including, extended warranty & gap insurance	19

Notes

I. The balance of excess remaining after applying the above safe harbours to calculate a section 78-18 increasing adjustment, represents the section 78-15 component of the excess.

II. Where a policy falls into two or more classes of insurance, the allocation used for APRA[1] purposes will be an acceptable basis of allocating the excess for purposes of adopting the above safe harbours.

Date of effect

77. The safe harbours shown in the above table may be applied in respect of all section 78-18 increasing adjustments arising on and from 1 September 2000. The safe harbours will be reviewed annually commencing on 1 July 2002.

Safe harbour terms

1. Insurers who adopt the above safe harbours according to the terms in this paper will satisfy their GST liability under section 78-18 in full. That is, they will obtain the benefit of the protection conferred by section 37 of the *Taxation Administration Act 1953*.
2. Insurers may adopt the safe harbour for a class of insurance or may calculate their increasing adjustments under section 78-18 on an actual basis.
3. Where an insurer elects to adopt a safe harbour for a particular class of insurance, the insurer must apply it to all relevant transactions in that class for a period of at least 12 months. The insurer cannot swap between a safe harbour and an actual adjustment for different transactions in the same class during the period of the election.
4. Insurers who elect to use a safe harbour for some classes of insurance, but not for others, must keep a contemporaneous record of that election. It is not necessary for the insurer to send the election to the ATO. But the election must be produced if requested by the ATO to support the basis of calculating section 78-18 increasing adjustments.
5. The safe harbours apply prospectively and cannot be adopted retrospectively to generate a credit entitlement. If an insurer calculates increasing adjustments on an actual basis and then discovers that adopting a safe harbour would have been more advantageous, the insurer cannot rely on a safe harbour to claim a credit or a refund of any excess GST paid in the past as a result of not using a safe harbour. However, the insurer can, at any time, elect to adopt a safe harbour for all future transactions for a class of insurance.

Who can use a safe harbour basis of apportionment?

78. The safe harbours outlined above were developed by the ICA on behalf of its members and have been agreed to by the ATO as an appropriate basis for insurers to apportion excess for purposes of section 78-18 and section 78-15. However, membership of the ICA is not a prerequisite to adopting the safe harbours. The same arrangements are available to all insurers in the general insurance industry.

Review of safe harbours

79. The safe harbours will be reviewed annually. The annual review will be undertaken by the ICA on behalf of its members and referred to the ATO for approval by 30 April each year. The ATO will notify the ICA and other insurers (ie. non-ICA members) of any changes by 31 May each year and the revised safe harbours will take effect on and from 1 July each year.

Retrospective adjustments

80. Section 78-18 of the Act applies retrospectively to the first tax period after the Treasurer's press release of 17 August 2000. For most insurers this means that they will have section 78-18 increasing adjustments from 1 September 2000 onwards. Insurers who have not made increasing adjustments in respect of affected excesses since 1 September 2000 may avail themselves of the relevant safe harbours to calculate those adjustments.

81. The correct procedure for bringing to account adjustments or to correct errors which relate to previous tax periods is for taxpayers to revise their Business Activity Statement (BAS) for the relevant tax periods. However, for purposes of bringing to account any increasing adjustments accrued under section 78-18 since 1 September 2000 and recalculating any affected decreasing adjustments under section 78-15, the ATO will accept a single adjustment, provided that:

- the adjustment is brought to account no later than the BAS due for the month of December 2001, and
- details of the adjustment (monthly summaries will suffice) are forwarded by post or email to either –

  Mr Phil Russo Email: phil.russo@ato.gov.au or

  Mr Andrew Cluff Email: andrew.cluff@ato.gov.au

  General Insurance Segment
  GST Large Enterprise Compliance,
  PO BOX 9990 PARRAMATTA NSW 2123

82. Insurers who experience difficulty meeting the above requirements should contact Mr Phil Russo or Mr Andrew Cluff at the above address to make other arrangements.

Explanations

Section 78-18

83. Section 78-18 of the Act provides -

78-18 Increasing adjustments for payments of excess under insurance policies

(1) An insurer has an increasing adjustment if:

(a) there is a payment of an excess to the insurer under an insurance policy; and

(b) the insurer makes, or has made, payments or supplies in settlement of a claim under the policy; and

(c) the insurer makes, or has made, creditable acquisitions or creditable importations directly for the purpose of settling the claim.

(2) The amount of the increasing adjustment is 1/11 of the amount that represents the extent to which the payment of excess relates to creditable acquisitions and creditable importations made by the insurer directly for the purpose of settling the claim.

(3) An insurer has an increasing adjustment if:

(a) there is a payment of an excess to the insurer under an insurance policy; and

(b) the insurer makes, or has made, creditable acquisitions or creditable importations directly for the purpose of settling the claim; and

(c) the insurer has not made any payments or supplies in settlement of the claim.

The amount of the increasing adjustment is 1/11 of the amount of the payment of the excess.

84. The legislation uses the phrase 'directly for the purpose of settling the claim'.

85. It is the ATO view that an acquisition or importation of goods or real property by the insurer will be directly for the purpose of settling the claim if the insurer supplies those goods or real property in settlement of the claim to the insured and the essential character of the goods or real property remains unchanged. That is, if the insurer supplies the goods or real property in order to settle its liability arising under the policy, the acquisition of the goods or real property will be directly for the purpose of settling the claim.

86. Where an insurer acquires something other than goods or real property, it will be directly for the purpose of settling the claim if the acquisition is made to enable the insurer to settle its liability arising under the policy. If the acquisition is made to enable the insurer to determine what that liability is, or represents costs not covered under the terms of the policy, the acquisition will not be directly for the purpose of settling the claim.

87. For example:

An insurer makes an acquisition of a right to have a supply, such as a supply of repair services, made to the insured. The supply made by the supplier to the insured will mean that the insurer's liability arising from the insurance policy will be met.

- The acquisition of the right by the insurer will be directly for the purpose of settling the claim.

An insurer acquires the services of an assessor to assess the claim. The acquisition will enable the insurer to determine its liability under the policy.

- This will not be an acquisition directly for the purpose of settling the claim. This will also be the case where the insurer acquires legal, engineering or investigator services to enable it to determine its liability under the policy.

An insurer acquires a police report after an accident. It also acquires a medical report on the medical condition of the claimant. Both acquisitions are made to enable the insurer to determine its liability under the policy covering the accident.

- Neither acquisition will be directly for the purpose of settling the claim.

88. Whether or not an acquisition is directly for the purpose of settling the claim does not affect the insurer's entitlement to input tax credits for the acquisition under Division 11 of the Act.

Treatment of excesses

89. Settlements of insurance claims are affected by the insured's entitlement to an input tax credit on the premium (ITC entitlement). Settlements of insurance claims will fall for consideration under either Division 78 where, depending on the insured's ITC entitlement, they may give rise to a decreasing adjustment for the insurer, or they may be creditable acquisitions under Division 11 which will give rise to an input tax credit for the insurer.

90. The intent of the legislation is that, when payment of an excess is received by an insurer, it should affect any credit entitlement that the insurer may have for settling the claim. The method statement in section 78-15 ensures that any payment of excess to the insurer effects a reduction in the amount of the decreasing adjustment available to the insurer, while new section 78-18 provides for an increasing adjustment to the insurer to the extent that the excess relates to settlements that gave rise to an input tax credit.

91. The combined effect of these provisions is that an apportionment of the excess will be required each time that a claim is settled. Furthermore, if the excess is received prior to the final settlement of a claim, it will need to be re-apportioned each time that any part settlement of the claim is made until the claim is finally settled in full.

Examples of the GST treatment of excesses under the law (Scenarios 1-5)

92. The payment of an excess under an insurance policy will have the following GST consequences. In the following examples it is assumed that the insurer and the insured are both registered for GST and the insurer has monthly tax periods.

Scenario 1: Excess paid to repairer

93. An insured asset is damaged and the GST inclusive cost of repair is $5500. The GST associated with this repair is 1/11th of $5500 or $500. The insurer contracts with the repairer for the repair services and agrees to pay $5400 towards the total cost of the repair. The Insured is required to contribute the balance or the excess of $100. The policyholder pays the $100 to the repairer.

Input tax credit:

Insurer:

The insurer is entitled to an input tax credit under Division 11 of the GST Act of up to $490.91 (1/11th of $5400).

Insured:

The policyholder may be entitled to claim an input tax credit under Division 11 of the GST Act on their contribution of up to $9.09 (1/11th of $100).

Section 78-18 increasing adjustment:

No increasing adjustment as no excess is paid to the insurer.

Tax invoices:

If requested, the repairer must supply a tax invoice. The amount shown on the tax invoice should equate to what the ***repairer*** has collected from the entity making the request.

Insurer:

A tax invoice would issue to the insurer for $5400

Insured:

If requested, a tax invoice would issue to the policyholder for $100.

Scenario 2: Excess paid directly to insurer and the insurer has made a creditable acquisition directly for the purpose of settling the claim.

94. An insured asset that is used 100% for business purposes is stolen and the GST inclusive replacement cost is $5500. The GST associated with the replacement is 1/11th of $5500 or $500.

95. The insurer contracts with a supplier for the replacement of the goods and agrees to pay the full cost of the supply. $5500 is paid directly by the insurer to the supplier being the total replacement cost. To assist with the claim, the Insurer engages an external loss assessor for a GST inclusive fee of $66. The $100 excess associated with this policy is paid by the insured directly to the insurer.

96. In this scenario the insurer pays the full $5500 to the supplier and $66 to the loss assessor. Both acquisitions are creditable acquisitions on the part of the insurer.

Input tax credit:

Insurer:

The insurer is entitled to an input tax credit under Division 11 of the GST Act of up to $506 (1/11th of ($5500 +$66)).

Insured:

No input tax credit entitlement. The payment of excess to the insurer is not treated as consideration for a supply by virtue of section 78-55 of the GST Act. The policyholder is therefore not entitled to claim an input tax credit for the excess paid to the insurer.

Section 78-18 Increasing Adjustment:

Section 78-18 of the GST Act will operate as the requirements of subsection 78-18(1) have been met. The insurer will have an increasing adjustment equal to 1/11th of the excess amount ($100) that represents the extent to which the payment of excess relates to creditable acquisitions ($5500/$5500 or 100%) made by the insurer directly for the purpose of settling the claim. That is, (1/11th x $100 x 100%) or $9.09.

The net result of the above transactions is an input tax credit for the insurance claim equal to $496.91 ($506 – $9.09).

Tax Invoices

If requested would issue to:

Insurer:

A tax invoice would issue to the insurer for $5500 from the supplier and one from the loss assessor for $66.

No adjustment note is required as the section 78-18 increasing adjustment is not an adjustment event for the purposes of Division 19 of the GST Act.

Insured:

No tax invoice entitlement. The payment of the $100 excess to the insurer is not treated as consideration for a supply by virtue of section 78-55 of the GST Act. The insurer is therefore not required to issue a tax invoice to the policyholder.

Scenario 3: Excess paid directly to insurer and the insurer has made a creditable acquisition directly for the purpose of settling the claim.

97. An insured asset used 60% of the time for business is damaged and the GST inclusive cost of repair is $7700. The GST associated with this repair is 1/11th of $7700 or $700. The insurer contracts with the repairer for the repair services and agrees to pay the full cost of the repair. $7700 is paid directly by the insurer to the repairer being the total cost of the repair. In addition to the repair cost, the insurer uses an external loss assessor for a GST inclusive fee of $3300 per month to assess claims. The $100 excess associated with this policy is paid by the insured directly to the insurer.

98. In this scenario the insurer pays the full $7700 to the repairer and $3300 to the loss assessor. Both are creditable acquisitions made for the purpose of settling the claim.

Input tax credit

Insurer:

The insurer is entitled to an input tax credit under Division 11 of the GST Act of up to $1000 [(1/11th x $7700) + (1/11th x $3300)].

Insured:

No input tax credit entitlement. The payment of excess to the insurer is not treated as consideration for a supply by virtue of section 78-55 of the GST Act. The insured is therefore not entitled to claim an input tax credit for the excess paid to the insurer.

Section 78-18 Increasing Adjustment:

Section 78-18 of the GST Act will operate as the requirements of subsection 78-18(1) have been met. The insurer will have an increasing adjustment equal to 1/11th of the excess amount (ie $100) that represents the extent to which the payment of excess relates to creditable acquisitions ($7700/$7700 or 100%) made by the insurer directly for the purpose of settling the claim. That is, (1/11th x $100 x 100%) or $9.09.

The net result of the above transactions is an input tax credit for the claim equal to $990.91 [(1/11th x ($7700 + $3300)) – $9.09].

Tax Invoices

If requested *would issue to:*

Insurer:

A tax invoice would issue to the insurer for $7700 from the repairer and one from the loss assessor for $3300.

No adjustment note is required as the section 78-18 increasing adjustment is not an adjustment event for the purposes of Division 19 of the GST Act.

Insured:

No tax invoice entitlement. The payment of the $100 excess to the insurer is not treated as consideration for a supply by virtue of section 78-55 of the GST Act. The insurer is therefore not required to issue a tax invoice to the policyholder.

Scenario 4: Excess paid directly to insurer and the insurer has made both a creditable acquisition and a cash payment directly for the purpose of settling the claim.

99. An insured asset used 80% of the time for business is destroyed. To settle the claim the insurer arranges for a cash payment of $8800 and contracts with a supplier to supply certain goods. The GST inclusive cost of those goods is $2200. In addition to the repair cost, the insurer uses an external loss assessor for a GST inclusive fee of $770 to assess the claim. The $1100 excess associated with this policy is paid by the insured directly to the insurer.

100. In this scenario the insurer pays the full $2200 for the cost of the goods to the supplier and $770 to the loss assessor. Both are creditable acquisitions made for the purpose of settling the claim.

Input tax credit

Insurer:

The insurer is entitled to an input tax credit under Division 11 of the GST Act of up to $270 [(1/11th x $2200) + (1/11th x $770)].

Insured:

No input tax credit entitlement. The payment of excess to the insurer is not treated as consideration for a supply by virtue of section 78-55 of the GST Act. The insured is therefore not entitled to claim an input tax credit for the excess paid to the insurer.

Decreasing Adjustment

Insurer:

The insurer is entitled to a decreasing adjustment under Division 78 of:

1/11th x settlement amount***** x (1 – Extent of input tax credit).

The settlement amount is $8800 – the excess to the extent it does not relate to the acquisition directly for the purpose of settling the claim multiplied by 11 and divided by (11 – extent of input tax credit on the premium).

As the cash settlement is $8800 and the acquisition directly for the purpose of settling the claim was for $2200, the total for settling the claim is $11 000.

The acquisition directly for the purpose of settling the claim represents 20% ($2200 is 20% of $11 000) of the total for settling the claim and the cash settlement represents 80% ($8800 is 80% of $11 000) of the total.

Thus the excess relates to the acquisition directly for the purpose of settling the claim to the extent of 20% and to the cash settlement to the extent of 80%. The amount of the excess included in working out the settlement amount is therefore 80% of $1100, which is $880.

The settlement amount is:

($8800 – $880) x 11/10.2, which is $8541.18.

The amount of the decreasing adjustment is:

1/11th x 8541.18 x (1 – 0.8), which is $155.29.

Refer to method statement contained in subsection 78-15(4).

Section 78-18 Increasing Adjustment:

Section 78-18 of the GST Act will operate as the requirements of subsection 78-18(1) have been met. The insurer will have an increasing adjustment equal to 1/11th of the excess amount (ie $1100) that represents the extent to which the payment of excess relates to creditable acquisitions ($2200/$11000) or 20%, made by the insurer directly for the purpose of settling the claim. That is, (1/11th x $1100 x 20%) or $20.

The net result of the above transactions is an input tax credit for the claim equal to $250 [(1/11th x ($2200 + $770)) – $20].

Tax Invoices

If requested would issue to:

Insurer:

A tax invoice would issue to the insurer for $2200 from the supplier and one from the loss assessor for $770.

No adjustment note is required, as the section 78-18 increasing adjustment is not an adjustment event for the purposes of Division 19 of the GST Act.

Insured:

No tax invoice entitlement. The payment of the $1100 excess to the insurer is not treated as consideration for a supply by virtue of section 78-55 of the GST Act. The insurer is therefore not required to issue a tax invoice to the policyholder.

Scenario 5: Excess paid directly to insurer and the insurer has made both cash payments and creditable acquisitions directly for the purpose of settling the claim in different tax periods.

101. An insured asset used 80% of the time for business is destroyed. In part settlement of the claim the insurer makes a cash payment of $8800 on 1 June 2001 and also contracts with a supplier to supply certain goods during the same period. The GST inclusive cost of those goods is $2200. In addition to the repair cost, the insurer uses an external loss assessor for a GST inclusive fee of $770 to assess the claim. The $1100 excess associated with this policy is paid by the insured directly to the insurer on 1 June 2001.

102. In this scenario the insurer pays the full $2200 for the cost of the goods to the supplier and $770 to the loss assessor in June 2001. Both are creditable acquisitions, but only the $2200 acquisition is considered to be made directly for the purpose of settling the claim. The $770 payment to the loss assessor is made to enable the insurer to determine its liability under the claim. On 15 July 2001 the insurer acquires further goods costing $1100 to restore the asset to its original condition and settle the claim in full.

GST treatment of the settlement

June tax period –

Input tax credit

Insurer:

The insurer is entitled to an input tax credit under Division 11 of the GST Act of up to $270 [(1/11th x $2200) + (1/11th x $770)].

Insured:

No input tax credit entitlement. The payment of excess to the insurer is not treated as consideration for a supply by virtue of section 78-55 of the Act. The insured is therefore not entitled to claim an input tax credit for the excess paid to the insurer.

Decreasing Adjustment

Insurer:

The insurer is entitled to a decreasing adjustment under Division 78 of:

1/11th x settlement amount***** x (1 – Extent of input tax credit)

The settlement amount is $8800 – the excess to the extent it does not relate to the acquisition directly for the purpose of settling the claim multiplied by 11 and divided by (11 – extent of input tax credit on the premium).

As the cash settlement is $8800 and the acquisition directly for the purpose of settling the claim was for $2200, the total for settling the claim is $11 000.

The acquisition directly for the purpose of settling the claim represents 20% ($2200 is 20% of $11 000) of the total for settling the claim and the cash settlement represents 80% ($8800 is 80% of $11 000) of the total.

Thus the excess relates to the acquisition directly for the purpose of settling the claim to the extent of 20% and to the cash settlement to the extent of 80%.

The amount of the excess included in working out the settlement amount is therefore 80% of $1100, which is $880.

The settlement amount is:

($8800 – $880) x 11/10.2, which is $8541.18.

The amount of the decreasing adjustment is:

1/11th x 8541.18 x (1 – 0.8), which is $155.29.

*Refer to method statement contained in subsection 78-15(4).

Section 78-18 Increasing Adjustment:

Section 78-18 of the GST Act will operate as the requirements of subsection 78-18(1) have been met. The insurer will have an increasing adjustment equal to 1/11th of the excess amount (ie $1100) that represents the extent to which the payment of excess relates to creditable acquisitions ($2200/$11000) or 20%, made by the insurer directly for the purpose of settling the claim. That is, (1/11th x $1100 x 20%) or $20.

The net result of the above transactions is an input tax credit for the claim equal to $250 [(1/11th x ($2200 + $770)) – $20].

Tax Invoices

If requested would issue to:

Insurer:

A tax invoice would issue to the insurer for $2200 from the supplier and one from the loss assessor for $770.

No adjustment note is required, as the section 78-18 increasing adjustment is not an adjustment event for the purposes of Division 19 of the GST Act.

Insured:

No tax invoice entitlement. The payment of the $1100 excess to the insurer is not treated as consideration for a supply by virtue of section 78-55 of the GST Act. The insurer is therefore not required to issue a tax invoice to the policyholder.

July tax period –

Input tax credit

Insurer:

The insurer is entitled to an input tax credit under Division 11 of the GST Act of up to $100 (1/11th x $1100).

Decreasing Adjustment

Insurer:

The insurer is not entitled to a decreasing adjustment under Division 78 for the $1100 creditable acquisition. However as the proportion of the excess that relates to creditable acquisitions and the subject of a section 78-18 increasing adjustment has changed*, an adjustment event arises requiring a recalculation of the decreasing adjustment as follows:

The settlement amount is $8800 – the excess, to the extent it does not relate to the acquisition directly for the purpose of settling the claim multiplied by 11 and divided by (11 – extent of input tax credit on the premium).

As the cash settlement is $8800 and the acquisition directly for the purpose of settling the claim was for $3300, the excess relates to the acquisition to the extent of 3/11. The amount of the excess included in working out the settlement amount is therefore 8/11 of $1100, which is $800.

The settlement amount is:

> ($8800 – $800) x 11/10.2, which is $8627.45.

The amount of the decreasing adjustment is:

> 1/11th x $8627.45 x (1 – 0.8), which is $156.86.

The calculation results in a higher amount than the previously calculated decreasing adjustment of $155.29. The additional decreasing adjustment of $1.57 is claimed in the July BAS.

> *Refer to method statement contained in subsection 78-15(4).

Section 78-18 Increasing Adjustment:

The insurer does not have a section 78-18 increasing adjustment during this period as no payment of excess was received. However as the proportion of the excess that relates to creditable acquisitions and the subject of a previous section 78-18 increasing adjustment has changed, an adjustment arises which requires a re-calculation of the increasing adjustment as follows:

> 1/11th of the excess amount (ie $1100) that represents the extent to which the payment of excess relates to creditable acquisitions ($3300/$ 12100) or 3/11.

That is, (1/11th x $1100 x 3/11) = $27.27. The section 78-18 increasing adjustment is $7.27 more than previously calculated and a further increasing adjustment needs to be made. The $7.27 adjustment is included in the July BAS

Example of the GST treatment of excesses adopting a safe harbour basis of apportionment (Scenarios 6 and 7)

Scenario 6: Using the same details as in scenario 5 above – Excess paid directly to insurer and the insurer has made both cash payments and creditable acquisitions directly for the purpose of settling the claim in different tax periods. Assume that the class of insurance was 'Extended Warranty' and that the insurer has chosen to adopt a safe harbour.

103. An insured asset used 80% of the time for business is destroyed. In part settlement of the claim the insurer makes a cash payment of $8800 on 1 June 2001 and also contracts with a supplier to supply certain goods during the same period. The GST inclusive cost of those goods is $2200. In addition to the repair cost, the insurer uses an external loss assessor for a GST inclusive fee of $770 to assess the claim. The $1100 excess associated with this policy is paid by the insured directly to the insurer on 1 June 2001.

104. In this scenario the insurer pays the full $2200 for the cost of the goods to the supplier and $770 to the loss assessor in June 2001. Both are creditable acquisitions, but only the $2200 acquisition is considered to be made directly for the purpose of settling the claim. The $770 payment to the loss assessor is made to enable the insurer to determine its liability under the claim. On 15 July 2001 the insurer acquires further goods costing $1100 to restore the asset to its original condition and settle the claim in full.

June tax period –

Input tax credit

The insurer is entitled to an input tax credit for creditable acquisitions made in June –

[(1/11th x $2200) + (1/11th x $770)] = $270.

Section 78 -18 Increasing Adjustment

The insurer will have an increasing adjustment as it has received payment of an excess and made creditable acquisitions directly for the purpose of settling the claim triggering the operation of section 78-18. The increasing adjustment will be –

[1/11 x (1100 x safe harbour (19%)] = $ 19.

Decreasing Adjustment

The insurer is entitled to a decreasing adjustment under Division 78 of -

1/11th x settlement amount***** x (1 – Extent of input tax credit)

The settlement amount is $8800 minus the excess to the extent that it does not relate to acquisitions directly for the purpose of settling the claim, multiplied by 11 and divided by (11 minus extent of input tax credit on the premium).

*Refer to method statement contained in subsection 78-15(4).

As the taxpayer has adopted a safe harbour basis of apportioning the excess for purposes of section 78-18, the amount of excess to be deducted in working out the settlement amount, ie. the section 78-15 component of excess, is 81% of $1100, which is $891.

Therefore, the settlement amount is –

[($8800 – $891) x 11/(11-0.8)] = $ 8529.31.

The amount of the decreasing adjustment is -

[1/11th x 8529.31 x (1 – 0.8)] = $155.08.

July tax period –

Input tax credit

The insurer made a creditable acquisition in July of $1100 directly for purposes of settling the claim and is therefore entitled to an input tax credit of –

[1/11 x $1100] = $100

Increasing Adjustment

NIL – The insurer has made creditable acquisitions of $1100 to which section 78-18 applies. However, the adjustment that would otherwise need to be made to reflect the changed proportion of excess resulting from the July acquisitions, does not need to be made because a safe harbour was used to calculate the section 78-18 increasing adjustment in the tax period when the excess was first received.

Decreasing Adjustment

NIL – There is no Div 78 settlement in July in relation to the claim, and the adjustment that would otherwise need to be made under section 78-15 to reflect the changed proportion of excess resulting from the creditable acquisitions of $1100 made in July is not required under the safe harbour arrangements.

Under the terms of the safe harbour arrangements, the insurer's liability for section 78-18 increasing adjustments is satisfied by a once only increasing adjustment. Therefore, once a section 78-18 increasing adjustment is made using a safe harbour basis of apportionment, no further adjustment for the excess will be required in respect of any subsequent acquisitions directly for the purpose of settling the claim that would otherwise change the proportion of excess that relates to creditable acquisitions. Similarly, under the safe harbour arrangements the excess is apportioned once only for purposes of calculating a decreasing adjustment under section 78-15. Therefore, once the safe harbour arrangements are applied to apportion the excess under both section 78-15 and section 78-18, future credit entitlements arising from any future settlement of a particular claim will be unaffected by the excess.

In the above example, there will be no need for the insurer to recalculate the Division 78 decreasing adjustment or the section 78-18 increasing adjustment to reflect the creditable acquisitions of $1100 made in July 2001 and the insurer will be entitled to the benefit of a full input tax credit of $100 for those acquisitions.

If instead of making creditable acquisitions in July, the insurer had made a payment of $1100 to the insured for purposes of settling the claim, the insurer would have a Division 78 decreasing adjustment for the $1100. Again, as the excess was previously taken into account using a safe harbour basis of apportionment, the insurer would not need to take the excess into account in calculating its entitlement to a decreasing adjustment for the $1100.

The settlement amount for the payment of $1100 would be:

(Payments of money – applicable excess) x 11 / (11 – Extent of input tax credit of insured)

[(1100 – 0) x 11/(11-0.8)] = $1186.27

The decreasing adjustment for the $1100 would be:

1/11 x settlement amount x (1 – Extent of input tax credit of insured)

[1/11 x 1186.27 x 0.2] = $21.56.

Additional option for implementing the safe harbour arrangements

105. Implementation of the safe harbour arrangements as outlined in Scenario 6 above relies on the insurers' systems ability to track previous safe harbour apportionments in order to achieve a 'once only' adjustment for excess under both section 78-15 and section 78-18. Following discussions with the ICA on the implementation of the safe harbour arrangements, it is understood that programming and tracking difficulties may arise where, for example, a claim is progressively settled by a mixture of payments, supplies or creditable acquisitions, over a number of tax periods. In such cases, the insurers' systems would need to be able to track payments, supplies or acquisitions made in settlement of a claim ('settlements') and distinguish between settlements relating to claims which have already had the excess apportioned (for purposes of sections 78-15 and 78-18) and settlements relating to claims which have not had the excess apportioned.

106. In recognition of the systems difficulties that may arise in certain circumstances, it will also be acceptable to this Office for insurers who adopt the safe harbour arrangements for a class of insurance, to calculate their section 78-15[2] and section 78 -18 liability in relation to excess on receipt of the excess. Insurers who adopt this option will need to make an increasing adjustment for the excess when the excess is received, but can then ignore the excess in the GST treatment of any payments, supplies or acquisitions made in settlement of the claim.

107. The increasing adjustment required under this option will be 1/11th of the section 78-15 safe harbour component of the excess, adjusted to take into account the insured's ITC entitlement on the premium. Plus, 1/11th of the section 78-18 safe harbour component of the excess.

108. The formula developed by the ICA and accepted by the ATO for calculating the increasing adjustment relating to the section 78 -15 safe harbour component of the excess is as follows:

Increasing Adjustment = E x (1- S) x (1 – T) / (11 – T)

E = Excess

S = The section 78-18 safe harbour percentage expressed as a decimal

T = The insured's percentage ITC entitlement on the premium expressed as a decimal

Scenario 7

109. Using the details in the Scenario 6 example above, the increasing adjustment for the section 78-15 safe harbour component of the excess would be:

[E x (1- S) x (1 – T) / (11 – T)]

[1100 x (1 – 0.19) x (1- 0.80)/(11- 0.80)]

[1100 x 0.81 x 0.2 / 10.2] = $17.47

The section 78-18 increasing adjustment for the excess would be:

[E x S x 1/11]

[1100 x 0.19 x 1/11] = $19.00

Total increasing adjustment for the excess = $ 36.47

Summary

110. Insurers will now effectively have three choices for calculating adjustments relating to excess.

1. Making actual adjustments under section 78-15 and section 78-18 for every settlement transaction which triggers the operation of those provisions as per *Scenarios 1-5;* or

2. Adopting the safe harbour arrangements outlined in this paper. Where insurers adopt the safe harbour arrangements for a class of insurance, they will have two options:

   (a) making a 'once only' apportionment of excess under section 78-15 and section 78-18 when the operation of those provisions is first triggered as per *Scenario 6*. This option is available provided that the insurer's system can adequately track apportionments of excess to payments, supplies or acquisitions made in settlement of a claim; or

   (b) calculating the GST liability that arises under section 78-15 and section 78-18 in respect of the excess, when the excess is first received as per *Scenario 7*. Under this option, insurers will need to use the formula to ensure that the insured's ITC entitlement on the premium is taken into account when calculating the increasing adjustment for the section 78-15 component of the excess.

1. Australian Prudential Regulatory Authority.

2. Excess has the effect of reducing the insurer's entitlement to a decreasing adjustment (see *Step 2* section 78-15(4)). Under the terms of the safe harbour arrangements, the reduced entitlement to a Division 78 decreasing adjustment can be brought to account as a Division 19 increasing adjustment.