IT 2367 - Income tax : reinsurance with non-residents : calculation of premiums paid and unearned premium reserve

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TAXATION RULING NO. IT 2367

INCOME TAX : REINSURANCE WITH NON-RESIDENTS : CALCULATION OF PREMIUMS PAID AND UNEARNED PREMIUM RESERVE

F.O.I. EMBARGO: May be released

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REFERENCE NO:	SUBJECT REFS:	LEGISLAT. REFS:
I 1209082	REINSURANCE PREMIUMS UNEARNED PREMIUM RESERVE	148(1)

OTHER RULINGS ON TOPIC IT 79

PREAMBLE This office has recently been asked for advice on two matters relating to the operation of sub-section 148(1) of the Income Tax Assessment Act.

2. Sub-section 148(1) provides that, where an Australian insurer reinsures out of Australia with a non-resident the whole or part of any risk, premiums paid or credited in respect of the reinsurance are not allowable as income tax deductions nor are they included in the assessable income of the non-resident reinsurer. It is further provided in the sub-section that any amount recovered by the Australian insurer from the non-resident reinsurer in respect of a loss on any risk reinsured shall not form part of the assessable income of the Australian insurer.

3. The question has been raised whether commission payable to the Australian insurer by the non-resident reinsurer based on the amount of reinsurance directed to the non-resident reinsurer by the Australian insurer should be taken into account in determining the amount of premiums paid or credited, i.e. whether the expression "premiums" means gross premiums or premiums net of commission.

4. The second matter relates to the method of calculating the unearned premium reserve of a company where sub-section 148(1) operates. General insurance companies are permitted to defer an amount of their premium income as an unearned premium reserve. The amount so deferred is not regarded as income derived in the year of receipt of the premiums - it is brought into assessable income in the succeeding year. As Taxation Ruling No. IT 79 indicates, one of the acceptable methods of deferment is 40% of premiums, i.e. total premiums less reinsurance premiums. Advice has been sought whether, in a situation to which sub-section 148(1) applies, the reference to reinsurance premiums includes premiums paid to a non-resident

reinsurer.

RULING 5. In order to understand the significance of the first question it is necessary to understand the practical effect of sub-section 148(1). It was originally inserted into the income tax law because of difficulties associated with securing full and complete returns from non-resident reinsurance companies which engaged in reinsurance business out of Australia with Australian resident insurers.

6. Where sub-section 148(1) operates the taxable income of the Australian insurer is ascertained without any reference to reinsurance premiums paid to non-resident reinsurers or any amounts recovered from the non-resident reinsurer. The reinsurance transactions are ignored. The practical effect is that the Australian insurer is required to bring to account in its income tax returns profits and losses arising from every risk insured, i.e. it will return as assessable income premiums received in respect of the risk insured and claim as income tax deductions any losses arising under the insurance contract.

7. The treatment of commissions and expenses paid to Australian insurers under reinsurance contracts with non-residents was considered in 1939 after consultation with representatives of Australian insurance companies. It was argued on behalf of the Australian insurance companies that the commissions and expenses should be set off against reinsurance premiums, i.e. that the expression "premium" in sub-section 148(1) should be interpreted as "premiums net of commission". It was further argued that, unless it was interpreted in this way, commissions payable to the Australian resident insurer would constitute assessable income and the object of the sub-section would be frustrated, i.e. any loss on a contract of insurance would be reduced by the amount of the commission and any profit increased by the amount of it. As the non-resident reinsurer would not be able to obtain an income tax deduction for the commission, i.e. because the reinsurance premiums were not assessable income, the true results of the insurance contract would not be brought to account.

8. The decision was taken at the time that, for the purposes of sub-section 148(1), premiums paid or credited in respect of reinsurance premiums referred to net premiums and that commissions and expenses paid to the Australian insurer under the terms of a reinsurance agreement with a non-resident reinsurer could be taken into account in determining the amount of net premiums paid or credited to the non-resident reinsurer.

9. The decision was reached in the light of the terms of the typical reinsurance agreement then in operation. It is understood that there has not been any material change in this respect to the terms of reinsurance agreements now in force. The decision applies to the normal fixed amount of "commission" provided for in a reinsurance agreement. It does not extend to overriding or other forms of profit commissions for the provision of services which constitute separate items of assessable income.

10. This means that commissions and expenses paid to an Australian insurer under the terms of a reinsurance agreement with a non-resident insurer are not required to be brought to account as separate items of assessable income by the Australian insurer. As a result the purpose of sub-section 148(1) is achieved.

11. The second matter does not involve a question of statutory interpretation. The deferring of 40% of premiums received on the basis that, to that extent, the premiums do not represent assessable income of the year of receipt, is a practice which has grown up in the insurance industry. In the application of this practice in a situation where sub-section 148(1) operates, the expression "gross premiums less reinsurances" means gross premiums less local reinsurance premiums - premiums paid to non-resident insurers are not taken into account.

COMMISSIONER OF TAXATION
29 September 1986