IT 2610 - Income Tax: Foreign tax credit system - taxation of Australian resident members of Lloyd's of London

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TAXATION RULING NO. IT 2610

INCOME TAX : FOREIGN TAX CREDIT SYSTEM - TAXATION OF AUSTRALIAN RESIDENT MEMBERS OF LLOYD'S OF LONDON

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I 1012336	FOREIGN TAX CREDIT SYSTEM LLOYD'S OF LONDON	6(1), 20, 51(1), former 51(6), 67, 79D, Div 15, 160AE, 160AF, 160AFD, 221YM TAXATION LAWS AMENDMENT (FOREIGN TAX CREDITS) ACT 1986 - Sec 35

OTHER RULINGS ON TOPIC : IT 2276, IT 2498, IT 2518, IT 2527, IT 2528, IT 2529

PREAMBLE
The purpose of this Ruling is to clarify the operation of the foreign tax credit system (FTCS) in respect of Australian resident members of Lloyd's of London (Lloyd's) as the FTCS operates as at 30 June 1990.

2. Lloyd's is an insurance market where insurance business is transacted between Lloyd's brokers, who seek insurance for their clients, and underwriting agents who accept risks on behalf of Lloyd's underwriting members (referred to as "Names"). Only individuals are admitted as underwriting Names and each Name is required to trade on his or her own account and is subject to unlimited personal liability in respect of risks underwritten in his or her name.

3. Thus, where a Name agrees to take a percentage of a risk, that Name is entitled to a corresponding percentage of the premiums and, conversely, accepts absolute liability for the same percentage of any incurred loss. The Name is not, however, liable for the percentage of any incurred loss allocable to any other Name who may appear on the policy, i.e., liability is several but not joint.

4. There are approximately 30,000 underwriting Names of Lloyd's worldwide, including some 700 who are Australian residents. In order to enable all Names to carry on business in a practical and efficient way, and to facilitate the underwriting of large risks, it is the practice for underwriting agents to establish lists of their Names, with percentages alongside each Name reflecting the underwriting capacity allocated to that Name. Each such list,

known as a syndicate, is established at the beginning of a calendar year and remains unchanged (except for deaths and suspensions) for the duration of that year. There are several hundred syndicates each specialising in a particular type or class of insurance. A Name may be in several such syndicates concurrently (typically not less than 15), the only limitation being the total amount of premium income the Name is eligible to receive, which in turn is based on the Name's means and the value of the Name's "Funds at Lloyd's". The Name's Funds at Lloyd's typically comprise a Deposit held by the Corporation of Lloyd's (the administrative arm of Lloyd's), the Special Reserve Fund and the Personal Reserve Fund.

5. The Lloyd's market is constituted under British Acts of Parliament, primarily the various Lloyd's Acts from 1871 to 1982. Apart from recognising the legal foundations of the Lloyd's market and formalising its structure, the legislation provides the rules governing the activities of underwriting Names, including the fundamental rules requiring that a Name's underwriting business is carried on solely on the Name's own account and that each Name accept unlimited personal liability in respect of risks underwritten by the Name.

6. The United Kingdom legislation governing Lloyd's operations requires each Name to assign to a trust fund all premiums received by the Name in respect of policies written in a year of account (January to December), and all income arising from investment of the premiums while the premiums are held in trust, for the payment of claims upon policies to which the premiums relate. Within the trust fund, premiums from business written in United States dollars and premiums from business written in Canadian dollars are held separately from premiums in respect of business written in other currencies. Any other funds (e.g., a Name's Personal Reserve Funds) held by the Name's agent are also held under trust.

7. Moneys may be withdrawn from the trust fund only to return premiums and pay claims, expenses and reinsurance premiums, and, provided reinsurance has been effected in respect of outstanding claims, to pay any residual surplus to the Name. With the exception of syndicates specialising in stop-loss insurance which have to adopt a 4 year accounting period, all other syndicates adopt a 3 year accounting period, in either case hereinafter called the "Lloyd's standard accounting period".
If there is no surplus there is no distribution to the Name.
If there is a loss the Name will be required to make good the deficit, perhaps before the close of the accounting period.

8. For reasons of practical efficiency, accounting for underwriting is done on a syndicate basis. All the transactions of the syndicate are recorded on a block basis and an individual Name's results are determined by reference to the Name's pro rata participation in the syndicate.

9. As adverted to in paragraph 6, a "year of account" is a calendar year, but it cannot, by virtue of the United Kingdom statutory accounting rule, be closed until the end of the second

year (or for stop-loss syndicates the third year) following that calendar year. The purpose of this rule is to ensure that all claims (actual or potential) in respect of policies written in the year of account have been satisfied by settlement, setting funds aside or reinsuring. Indeed, only after all outstanding liabilities have been covered is the year of account officially closed. Thus the underwriting result of a syndicate, in respect of a year of account, cannot be determined until sometime after the end of the Lloyd's standard accounting period, when all United Kingdom statutory obligations have been fulfilled. Typically, any underwriting account surplus would be distributed some 6 months after the close of the year of account (which would occur at the end of the Lloyd's standard accounting period) i.e., the distribution would occur in approximately June or July of the following year.

RULING
Derivation of Lloyd's income by an Australian resident Name

10. It is accepted that, pursuant to the mandatory United Kingdom requirements in respect of the creation and operation of Premiums Trust Funds and Lloyd's standard accounting period, a Name has no entitlement to underwriting account income, including investment income and gains arising from those Trust Funds, until sometime after the closure of a year of account when the result for the year is finalised and distributed i.e., when paid or credited as per the date of the distribution statement issued to the Name by his or her agent. This will be treated as the time of derivation of that income for Australian income tax purposes. Accordingly, distribution statements dated before the general commencement of the FTCS on 1 July 1987 will not render the distributions assessable to Australian income tax. On the other hand, distribution statements dated on or after that date will result in the distributions being subject to the provisions of the FTCS.

11. Given the nature of the Lloyd's syndicate arrangements and the standard accounting period for the 1984 year of account (which closed on 31 December 1986, prior to the commencement of the FTCS), the first year of account to be affected by the FTCS would generally be the 1985 year of account (assuming the distribution for that account would be the first post-1 July 1987 distribution), which will include stop-loss syndicate accounts for the 1984 year of account and any balances for pre-1985 run-off accounts.

12. Similarly, a loss from carrying on business at Lloyd's in respect of a year of account will be treated as incurred by an Australian resident Name in the relevant year of income in which the Name receives notification from his or her agent of that loss (in accordance with the rules set out in paragraph 10, i.e., as incurred on the date appearing on such notification). Losses notified on or after 1 July 1987 will be subject to foreign loss quarantining under former subsection 51(6) or subsection 79D of the Income Tax Assessment Act 1936 (the Assessment Act), so as to be carried forward for offset against Lloyd's business income of later years of income pursuant to section 160AFD. Losses notified before 1 July 1987 are to be taken into account in

determining the Name's pre-FTCS carry-forward losses (if any) pursuant to section 160AFD of the Assessment Act and section 35 of the Taxation Laws Amendment (Foreign Tax Credits) Act 1986 (the Foreign Tax Credits Act).

13. Having regard to the special nature and operation of the Lloyd's arrangements, it has been decided as a matter of practical administration that a Name's syndicate profits/losses are to be based primarily for Australian income tax purposes on the amount determined for United Kingdom tax purposes, as shown on Inland Revenue forms LL9 and LL200, and/or any other relevant United Kingdom Inland Revenue determination. However, the net profit/loss as per these forms will need to be adjusted by adding-back the amount of any foreign taxes paid which have been allowed as a deduction for United Kingdom tax purposes, other than Australian taxes, e.g., under Division 15 of Part III of the Assessment Act. (This will effectively provide for Australian taxes deducted at source to be treated as a deductible expense, as they are not otherwise able to be recouped.) Further adjustments will also need to be made for items shown on forms LL9 and LL200, and/or any other relevant United Kingdom Inland Revenue determination, which are not allowable deductions or are assessable income under Australian income tax law. An example of such an item would be an amount shown on the form LL9 for premiums paid in respect of the Lloyd's Contingency Estate Protection Plan. Where the results shown on these forms are provisional or estimates, they may be accepted but assessments based thereon will require amendment when the final form LL9 and/or LL200 becomes available.

Premiums Trust Fund Interest and Capital Gains

14. The result of an underwriting account generally consists of the sum of the earned premiums and the income and gains from the investment of the Premiums Trust Fund, less the sum of the claims and expenses incurred in deriving the income and gains. Consistent with relevant case law pertaining to the categorisation of investment income and gains as business income, any interest and capital gains derived by a Name from the investment of the Premiums Trust Fund should be treated as part of the Name's business income from Lloyd's underwriting - Liverpool and London and Globe Insurance Company v. Bennett (1911) 2 KB 577, (1912) 2 KB 41 (CA) and 1913 AC 610 (HL); Colonial Mutual Life Assurance Society Ltd v. FCT (1946) 73 CLR 604; Chamber of Manufactures Insurance Ltd v. FCT 83 ATC 4773 (SC), 84 ATC 4315 (FC); London Australia Investment Company Ltd v. FCT (1977) 138 CLR 106 (see also Taxation Rulings Nos. IT 2276 and IT 2518).

15. As a consequence, any interest derived by an Australian resident Name from the investment of the Premiums Trust Fund should be construed as interest derived by the Name from transactions directly related to the active conduct of a business. In other words, such interest will not constitute interest income, as defined by subsection 160AE(3) of the Assessment Act, for the purposes of paragraphs 160AF(7)(a) and 160AFD(6)(a) of that Act. Accordingly, underwriting account

interest will not be treated separately for the purpose of calculating foreign tax credits under section 160AF; nor will it be treated as a separate class of income for foreign loss quarantining purposes under former subsection 51(6), section 79D or section 160AFD of the Assessment Act (i.e., underwriting account interest will be taken into account in determining the amount of an underwriting account loss).

16. Similarly, any amount which is treated for United Kingdom tax purposes as a capital gain that is derived by an Australian resident Name from the investment of the Premiums Trust Fund should, for Australian income tax purposes, be construed as income according to ordinary concepts. Hence the provisions of Part IIIA (Capital Gains and Capital Losses) of the Assessment Act will not apply in respect of these gains.

17. Further, as all Lloyd's underwriting business must be conducted in the underwriting rooms at Lloyd's in London, an Australian resident Name is, for Australian income tax purposes, considered to be carrying on business at or through a "permanent establishment" (as that term is defined in subsection 6(1) of the Assessment Act) in the United Kingdom. An Australian resident Name's underwriting business thus constitutes a "foreign source" as defined by subsection 160AFD(7), for foreign loss quarantining purposes under the former subsection 51(6), section 79D and section 160AFD.

Other Interest and Capital Gains (Lloyd's Deposits, Personal Reserves and Special Reserve Funds)

18. As noted in paragraph 4, Names are required to lodge Funds at Lloyd's as security against deficiencies in the Name's underwriting account. The quantity of the Funds, along with the Name's declared means, determines the Name's underwriting capacity.

19. To provide additional security for his or her underwriting, a Name may also elect to establish reserves. These may take the form either of what is called a Personal Reserve, agreed by the Name with his or her agent, or a Special Reserve Fund created according to conditions agreed by the United Kingdom Board of Inland Revenue, the assets of which latter fund (as well as any gains from the investment thereof) are specifically dedicated to the funding of underwriting losses, this dedication being irrevocable to death or retirement.

20. A Name's Lloyd's Deposit, Personal Reserves and Special Reserve Fund are, in common with the Premiums Trust Fund, considered to be funds employed in the course of carrying on the Name's Lloyd's underwriting business.

21. It follows that interest income arising from these investments should also not be treated separately for foreign tax credit or foreign loss quarantining purposes (as per paragraph 15) and gains on disposal of the investments should be treated as income according to ordinary concepts (as per paragraph 16). Further, the interest income and gains on disposals should be

treated as derived from the same "foreign source" for foreign loss quarantining purposes as underwriting account income (i.e., from a permanent establishment in the United Kingdom).

22. As the interest income and gains from the investment of these funds will be included in the United Kingdom Inland Revenue determination of income from carrying on business at Lloyd's, such income and/or gains should not be returned separately for Australian income tax purposes unless exempt from United Kingdom tax, in which event the income or gains should be returned as derived (e.g., 3 1/2% War Loan Stock interest).

Run-Off Accounts

23. Sometimes an underwriting account will not be closed at the end of the Lloyd's accounting period because it is not possible at that time to estimate, with any degree of certainty, the outstanding claims so as to enable the requisite closing reinsurance to be effected. Accordingly, such accounts remain open (i.e., are allowed to run-off) until such time as any remaining outstanding claims can be estimated and reinsured to close the account. The annual surplus or loss arising from a run-off account should be treated as derived or incurred in the year of income that the result is included in the relevant distribution statement from the Name's agent (see paragraph 10). Accordingly, distributions of a Name's share of a surplus or loss on each year of a run-off account made on or after 1 July 1987 will be taken into account in the calculation of a Name's assessable income.

Stop-loss Insurance Recoveries received by Names

24. In accordance with prudent underwriting practice, it is common for Lloyd's Names to limit loss exposure by obtaining stop-loss insurance under which the Name is indemnified for losses in excess of a specified amount up to a fixed maximum. Before a recovery can be made the Name must be able to quantify the amount of the loss and hence the recovery might not be received until sometime after the relevant underwriting account has been finalised. Where such recoveries relate to a year of account for which the distribution took place prior to the commencement of the FTCS, the accumulated pre-FTCS losses (if any) available for carry forward under section 160AFD would be reduced by the amount of the recovery. Otherwise such recoveries should be treated as assessable income of the year of income in which they are received.

Expenses incurred in carrying on Lloyd's business

25. Expenses, other than expenses that are already deducted for United Kingdom tax purposes in arriving at the Name's results for a year of account as shown on the form LL9, and/or any other relevant United Kingdom Inland Revenue determination, which are incurred by an Australian resident Name and which are referable to the conduct of that Name's Lloyd's underwriting business, may be claimed as allowable deductions in the year of income in which the expenses are incurred. The following expenses would

generally fall into this category:

- interest paid on loans taken out to cover underwriting account losses (but note that borrowing costs would be deductible in accordance with section 67 of the Assessment Act);

- Australian accounting expenses;

- the costs of visits to the United Kingdom, but only to the extent referable to the Name's underwriting business; and

- the annual membership fee and, subject to the usual requirements of subsection 51(1) of the Assessment Act, the costs of attending meetings of the Association of Lloyd's members or the Australian Association of Lloyd's members.

On the other hand, initial joining fees and initial expenses relating to setting up bank guarantees or letters of credit (both being capital expenditure), and payments into reserve funds (being an appropriation of profits) are not deductible, except to the extent permitted by section 67 of the Assessment Act in relation to letters of credit.

26. The general rule set out in paragraph 25 (which relates to expenses other than those taken into account in arriving at the results shown on the form LL9, and/or any other relevant United Kingdom Inland Revenue determination) as to deductibility of relevant expenses (other than prior year losses - see paragraphs 35 to 38) in the year in which incurred is qualified, however, with respect to such expenses incurred prior to the commencement of the FTCS on 1 July 1987.

27. Those expenses incurred pre-1 July 1987 are to be taken into account in determining carry-forward pre-FTCS losses (if any) under section 160AFD of the Assessment Act and section 35 of the Foreign Tax Credits Act - i.e., in determining the Name's "overall foreign loss" or "overall foreign profit" in respect of the Lloyd's underwriting business for the pre-FTCS years of income in which the expenses were incurred. This rule is to apply pursuant to those sections only in respect of those expenses incurred during the 7 years of income immediately preceding the commencement of the FTCS, i.e., during the year of income that commenced on 1 July 1980 through to the year of income that concluded on 30 June 1987.

28. As indicated earlier, it will be acceptable if a Name includes in his or her return as the income derived from carrying on business as an underwriting member of Lloyd's the amount determined by the United Kingdom Inland Revenue authorities for the relevant year of account, as set out in paragraph 10. This will generally result in the type of allowable expenses for Australian tax purposes described in paragraph 25 only being the subject of a specific claim if such expenditure is not allowable under a provision of United Kingdom income tax law and only if it

is able to be fully supported.

Currency Translation

29. For reasons of practical administration, the guidelines provided by Taxation Ruling No. IT 2498 for the application of the provisions of section 20 of the Assessment Act in relation to currency translations generally are modified to the extent indicated below in relation to Lloyd's business income, expenses and related foreign taxes.

30. As Lloyd's underwriting account income is treated as derived when it is distributed to Names (see paragraph 10), it will be accepted for the purposes of subsection 20(2) as derived during "part of a year of income", that part of the year of income being the day of distribution. Income and gains described in paragraph 22 may be treated similarly. Accordingly, the currency rate applicable on the day of distribution will be accepted as the rate at which the income is to be translated into Australian currency. Similarly, a Name's share of an underwriting account loss for a year of account should be translated at the rate applicable on the date of notification of the loss to the Name (in accordance with paragraph 12).

31. Any other investment income and gains (Lloyd's Deposits, Personal Reserves and Special Reserve Funds) exempt from United Kingdom tax and deductible expenses to the extent shown on forms LL9 and LL200, and/or any other relevant United Kingdom Inland Revenue determination, should be translated in accordance with the rule set out in paragraph 30. Other items not shown on those forms may be translated at the average rate of exchange for the year of income or the actual relevant day where this can be identified, at the Name's option.

32. Foreign taxes (i.e., other than United Kingdom taxes) paid in respect of syndicate income and deducted for United Kingdom tax purposes but brought to account as assessable income for Australian tax purposes (subject to foreign tax credit), are to be translated on the same date as distribution of income occurred - in accordance with paragraph 30.

33. Standard rate United Kingdom taxes deducted on behalf of the Name by the syndicate's agent should also be translated at the date of distribution - in accordance with paragraph 30.

34. Other United Kingdom taxes, apart from higher rate tax, will be accepted for translation on the same basis, at the Name's option, as for the relevant income or gains - in accordance with paragraph 31. Higher rate tax payable by the Name on assessment should be translated at the currency rate applicable on the date paid.

Carry-forward of pre-FTCS losses

35. The effect of section 160AFD of the Assessment Act and the transitional provisions of section 35 of the Foreign Tax Credits Act is to allow the carry-forward of the amount of an overall

foreign loss incurred in relation to a class of foreign income in any of the 7 years preceding the first year of operation of the FTCS, as reduced by an overall foreign profit in a subsequent pre-FTCS year. The amount carried-forward operates to reduce the amount of income of the same class and derived from the same foreign source during that or a subsequent year of income which is to be included in the taxpayer's assessable income.

36. Accordingly, the pre-FTCS years of income losses to be taken into account for the purposes of the 7 year period specified in section 160AFD will be those losses incurred by a Name in relation to the Lloyd's years of account for the 7 years preceding the first Lloyd's year of account which is subject to the FTCS (as determined in accordance with paragraph 10).

37. To illustrate this point, take for example the case of a Name who has always been a member of Lloyd's underwriting syndicates subject to the standard (3 year) accounting period, and whose first Lloyd's syndicate distribution (in the sense described in paragraph 10) after 30 June 1987 was for the 1985 year of account (which closed on 31 December 1987). In that case, the 7 year period for the purposes of measuring the Name's entitlement (if any) to the carry-forward of pre-FTCS losses would be the 1978 year of account (which closed on 31 December 1980), through to the 1984 year of account (which closed on 31 December 1986). In other words, the Name's entitlement in respect of the 1978 year of account will be treated for those purposes as having been derived/incurred in the 1980/81 year of income, and so on. On the other hand, where the first post-1 July 1987 distribution relates to the 1984 year of account, the relevant losses would be those incurred in relation to the 1977 year of account through to the 1983 year of account inclusive.

38. It should be noted, however, with respect generally to the determination of any pre-FTCS carry-forward loss for a Name that the terms of subsection 160AFD(5) of the Assessment Act and subsection 35(2) of the Foreign Tax Credits Act govern the determination for those purposes of an "overall foreign profit" or "overall foreign loss" of a taxpayer for each of the relevant years of income. They provide that the determination be based on what would have been the assessable income of the taxpayer from all sources, and relevant allowable deductions, if the former paragraph 23(q) of the Assessment Act had not applied and without any allowance being made for income which may have already been included in the taxpayer's assessable income for those years - e.g., dividends not exempted by paragraph 23(q) or income or gains not subject to foreign tax. Nor do they preclude for those purposes expense items that have previously been allowed as deductions in the pre-FTCS years of income. Where an amount of foreign income or gains for those years has been subjected to foreign tax, the amount to be treated as "assessable income" for those purposes would be the amount derived by the Name net of payment of the foreign tax.

Foreign Tax Credits

39. The amount of foreign tax to be credited in accordance with

subsection 160AF(1) in respect of a Name's membership of Lloyd's for a year of income will be the total of:

(a) the amount of foreign taxes shown as deductible items on the relevant United Kingdom forms LL9 and LL200, and/or any other relevant United Kingdom Inland Revenue determination; and

(b) the amount of United Kingdom standard rate taxes deducted in respect of distributions of income and/or gains derived from carrying on business at Lloyd's.

This would include United Kingdom taxes assessed in respect of dividends and interest from Australian companies which represent income effectively connected with the permanent establishment of the Name in the United Kingdom;

plus or minus

(c) the net amount of United Kingdom taxes paid or refunded consequent upon the Name being obliged under the laws of the United Kingdom to have his or her liability in respect of that year of income determined by assessment.

40. An amount of United Kingdom higher rate tax (if any) paid by a Name in respect of that income is to be credited when actually paid, with an extension of time to pay the relevant amount of Australian tax being granted (subject to Taxation Ruling No. IT 2528) where payment of the United Kingdom tax liability is to take place after issue of the Australian assessment.

Australian Interest and Dividends (Lloyd's Deposits, Personal Reserves, and Special Reserve Funds)

41. Dividends from Australian companies derived from assets held by trustees pursuant to the deeds constituting the trusts relating to the above Funds which have been franked for Australian tax purposes in whole or in part shall entitle Australian resident Names to the relevant imputation credits.

42. While credit cannot be allowed in respect of Australian withholding tax deducted from relevant dividends and interest, Australian resident Names may apply for exemption from withholding tax from such unfranked dividends and interest, pursuant to section 221YM of the Assessment Act.

Provisional Tax

43. In accordance with normal practice, foreign tax credits will be taken into account in the calculation of any provisional tax payable by Names. Names may apply after issue of an assessment notice for an extension of time to pay that portion of their total Australian tax liability that is represented by an anticipated foreign tax credit entitlement, subject to the requirements of Taxation Ruling No. IT 2528.

COMMISSIONER OF TAXATION
30 August 1990