IT 2663 - Income tax: basis of assessment of general insurance activities

There is an Addendum notice for this document.

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Taxation Ruling
Income tax: basis of assessment of general insurance activities

other Rulings on this topic
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Income Tax Rulings do not have the force of law. Each decision made by the Australian Taxation Office is made on the merits of each individual case having regard to any relevant Ruling.

What this Ruling is about

1. A taxpayer who is a resident of Australia and who is engaged in the business of general insurance is assessed under the general provisions of the income tax law. No special provisions apply. There are, however, some features peculiar to the general insurance industry which present problems in accurately determining, both for income tax and accounting purposes, the amount of income actually derived by a general insurer in any income year and the amount of some expenses that are incurred by a general insurer in an income year.

2. This Ruling deals with :

(a) the assessability under subsection 25(1) of the *Income Tax Assessment Act 1936* of premium income derived by a general insurer (i.e. a taxpayer who carries on a business of general insurance); and

(b) the deductibility under subsection 51(1) of a general insurer's outstanding claims provision.

Part A: premium income

3. In assessing the premium income derived by a general insurer in an income year it is important to calculate the amount of premium income unearned (that is 'unearned premium income') as at the end of that year. Unearned premium income is not derived by a general insurer for income tax purposes until a later year of income.

Unearned premium income as at the end of a year of income (say, the year ended 30 June 1992) is to be ascertained as follows:

Step 1:

Calculate net premium income for the year ended 30 June 1992 (see subparagraph 4(a) and paragraphs 12 to 19).

Step 2:

Apportion the net premium income between the income year ended 30 June 1992 and the later income year(s) to which that income relates to arrive at the net premium income unearned as at 30 June 1992 (see subparagraph 4(b) and paragraphs 20 to 44).

Step 3:

Reduce the amount of net premium income unearned as at 30 June 1992 by any treaty non-proportional reinsurance premiums that relate to risk exposure in any later income year(s) (see subparagraph 5(d) and paragraphs 94 to 97).

4. The two main issues addressed in Part A of this Ruling on the assessability of premium income are:

(a) Net premiums rather than gross premiums need to be apportioned over the years of income in which they are derived in calculating unearned premium income (paragraphs 12 to 19).

(b) In apportioning net premiums over the income years in which they are derived by a general insurer, they are to be apportioned according to risk exposure, i.e., based on the extent to which the net premiums relate to the risk insured against in each income year (paragraphs 20 to 44).

5. Several secondary issues in relation to the assessment of premium income are also dealt with in the Ruling, namely :

(a) What receipts of a general insurer constitute premium income of a year of income (paragraphs 45 to 62).

In this Ruling, the following three categories of premium income are collectively referred to as 'premium income of a year':

. premium income received or receivable in the year for closed business (other than premium income which relates to risk exposure of a later year);

plus

. premium income estimated to be received from unclosed business existing at the end of the year;

plus

. premium income received or receivable in earlier years but unearned in those years (other than premium income which relates to risk exposure of a later year).

(b) As to acquisition costs incurred by a general insurer:

(i) their deductibility under subsection 51(1);

(ii) which acquisition costs must be offset against gross premium income in calculating unearned premium (paragraphs 65 and 74 to 75).

(c) As to reinsurance premiums incurred by a general insurer:

(i) their deductibility under subsection 51(1);

(ii) which reinsurance premiums must be offset against gross premiums in calculating unearned premium income (paragraphs 79 and 90 to 93).

(d) The effect on unearned premium income of an income year of treaty non-proportional reinsurance premiums incurred by a general insurer that relate to its risk exposure in a later income year (paragraphs 94 to 97).

(e) As to reinsurance commissions derived by a general insurer:

. when reinsurance commissions are derived and are to be included in a general insurer's assessable income under subsection 25(1) (paragraphs 98 and 100); and

. which proportional reinsurance commissions need to be taken into account when calculating unearned premium income (paragraphs 99 and 101 to 102).

Part B: outstanding claims provision

6. The main issue addressed in Part B of this Ruling on the deductibility of a general insurer's outstanding claims provision is the appropriate method to adopt to determine the amount of the provision (which is deductible) in a year of income for :

(a) 'long-tail business' (that is, claims which are usually settled more than 12 months after the insured event giving rise to the claim occurs) (paragraphs 103 to 118); and

(b) 'short-tail business' (that is, claims which are usually settled within 12 months of the insured event occurring) (paragraphs 119 to 122).

7. Some inter-related, though secondary, issues in determining the amount of a general insurer's provision for outstanding claims are also dealt with in the Ruling, namely :

(a) It is necessary to take the following matters into account in estimating a provision for outstanding claims for 'long-tail business' :

(i) direct policy costs;

(ii) claim investigation and assessment costs;

(iii) direct claim settlement expenditures; and

(iv) any amounts recoverable by the insurer in respect of the claims

(paragraphs 123 to 129).

(b) Indirect claim settlement costs are not to be taken into account in estimating a provision for outstanding claims for 'long-tail business' (paragraphs 130 to 131).

(c) It is acceptable for income tax purposes, in certain circumstances, for a general insurer to include a margin for prudence in its estimated provision for outstanding claims (paragraphs 132 to 135).

(d) A general insurer compares the amount of its outstanding claims provision at the end of an income year ('the current year') with the amount of the provision at the previous year end and :

(i) any increase in the provision is allowed as a deduction under subsection 51(1) in the current year; or

(ii) any reduction in the provision is included as income assessable under subsection 25(1) in the current year

(paragraphs 136 to 139).

8. This Ruling extends to general insurance activities conducted by a 'life insurer' (i.e. a taxpayer who carries on a business of life insurance, including a 'life assurance company' as defined in subsection 110(1)) to the extent to which the life insurer's contractual

terms and conditions accord with those entered into by a general insurer.

9. The extent to which this Ruling applies to a life insurer where the life insurer's contractual terms and conditions do not accord with those entered into by a general insurer depends on the facts of each particular case. For example, the contractual terms and conditions of an accident and disability policy issued by a life insurer are understood to usually require the life insurer to renew the policy annually. This is not the case with a general insurer. The requirement to renew annually raises different considerations from those in this Ruling in determining the extent to which premium income is derived and assessable in an income year.

10. The activities of a taxpayer who carries on a business of reinsurance is to be the subject of a separate Ruling.

11. This Ruling replaces Taxation Ruling IT 79 in its entirety.

Part A: premium income

Ruling: net premiums not gross premiums

12. A portion of the premium income of a general insurer is unearned at the end of the year of income in the sense that it relates to the insurer's risk exposure in a later year. It therefore needs to be apportioned for income tax purposes into the income years in which it is derived. It is the net premium income (i.e., gross premium after deducting acquisition costs and reinsurance premiums) of the year that needs to be apportioned.

13. Unearned premium income which is derived in a later year of income is calculated for income tax purposes as follows :

. Gross premium income of a year

minus:

Acquisition costs that relate to the gross premium income; and

Reinsurance premiums that relate to the gross premium income

equals

Net premium income of the year.

. Unearned premium income of a later income year is the portion of the net premium income of the year that relates to the insurer's risk exposure in the later year.

Explanations: net premiums not gross premiums

General insurance - definition and scope

14. For the purposes of this Ruling, 'general insurance' means a contract or guarantee under which a general insurer undertakes a liability, contingent on the happening of any specified event, to indemnify an insured for an agreed money value of any loss or damage. It does not include a contract of life assurance.

15. Common forms of general insurance include motor vehicle accident insurance, home or other property insurance, workers' compensation insurance, professional indemnity insurance and mortgage insurance.

16. A general insurer conducts its business by entering into insurance contracts (usually known as insurance policies). An insurance policy is a contract between an insurer and an insured. In return for a fee (a premium) paid by the insured, the insurer provides indemnity protection (cover) against the adverse consequences of the happening of a specified event (insured event) during a specified period (cover period).

How are net premiums calculated?

17. Net premiums of a general insurer are calculated by reducing the insurer's gross premium income of a year by :

(a) acquisition costs that relate to the gross premium income; and

(b) reinsurance premiums incurred by the insurer in the income year that relate to the gross premium income.

18. Details of which expenses may be regarded as 'acquisition costs' for income tax purposes and offset against gross premiums of an income year, are provided at paragraphs 65 and 74 to 75. Similarly, paragraphs 79 and 90 to 93 explain which reinsurance premiums may be offset against gross premium income.

Why are net premiums (not gross premiums) apportioned?

19. In essence, net (rather than gross) premium income of a year is apportioned in determining the extent of unearned premium income that relates to a later year because :

. The amount of unearned premium income that relates to a later year (which is derived for income tax purposes and assessable in that later year) is the portion of premium income of a year that is attributable to the insurer's risk exposure in the later year.

- We do not accept that acquisition costs and reinsurance premiums incurred by an insurer relate to the insurer's risk exposure in the later year.

- Our long-standing practice to apportion net (rather than gross) premiums is based on traditional commercial accountancy practice and is consistent with new accounting standards for general insurers. The practice is to be maintained.

Ruling: apportionment of premium income

20. If the cover period of an insurance contract extends beyond the end of a year of income :

- a portion of the premium income of the year is derived by a general insurer and is assessable under subsection 25(1) in that year; and

- a portion of the net premium income of the year (i.e. unearned premium income) is derived and is assessable in the later year or years.

21. The premium income of a year is assessable in that year to the extent to which it is derived in that year. To the extent that the net premium income relates to risk exposure in a later year (i.e. to the extent it provides a cover for 'unexpired risks'), it is derived for income tax purposes and is assessable under subsection 25(1) in the later year(s).

22. If the risk insured against is evenly spread over time, the basis on which a general insurer consistently calculates (from year to year) its 'unearned premium provision' (UPP) for accounting purposes is to be adopted for income tax purposes. Because most general insurers use the '365ths' or 'daily' basis for accounting purposes, this will be the basis that most insurers should adopt to apportion premium income of a year for income tax purposes. Once adopted for income tax purposes, the '365ths' or 'daily' method is to be used consistently from

one income year to the next and, unless the insurer can demonstrate that it is commercially impracticable to do so, consistently across all lines of general insurance business.

23. If :

(a) the risk insured against is not evenly spread over time; or

(b) a general insurer consistently adopts a basis for calculating its UPP for accounting purposes different from the 365ths or daily basis,

the basis consistently used for calculating UPP for accounting purposes is also to be adopted for income tax purposes in apportioning premium income of a year, provided that the accounting basis of calculation is soundly based and produces a reasonable result.

24. The way in which premium income is to be apportioned over the years of income to which the risk covered by the policy relates if :

(a) the risk insured against is evenly spread over time;

(b) the 365ths or daily basis of calculation is used; and

(c) the period of risk coverage under the policy is 1 year,

is as follows :

(a) **Portion of premium income of a year that relates to the later income year :**

$$\text{Gross premium less relevant acquisition costs and reinsurance premiums} \times \frac{\text{Number of days in the later income year for which the risk is covered}}{365}$$

(b) **Portion of premium income of a year that relates to that income year :**

Gross premium less portion calculated in (a)

25. A method of apportionment to produce a similar allocation of premium income of a year according to risk exposure needs to be adopted in cases where the risk insured against is not evenly spread over time.

Explanations: apportionment of premium income

What is 'unearned premium income'?

26. Premiums received by a general insurer commonly cover the 12 months' period of a policy. In the majority of instances the period of the policy and the insurer's year of income for income tax purposes would not correspond. At the end of the income year, some portion of the premiums therefore relate to cover for unexpired risks. It is in this sense that a portion of premiums are unearned at year end and are referred to in this Ruling as 'unearned premium income'.

27. The term 'unearned premium income' does not extend to a premium in a situation where an insurer's liability under a policy is discharged before the end of a year of income. For example, if an insurance policy provides for the insurer's liability during the cover period to be the amount stated as the sum insured and if that sum is paid out on the happening of an insured event, the insurer is no longer liable for any further amount under the policy. Other situations may also arise where an insurer's liability under a policy expires during the term of the policy.

28. If the period of a policy extends past the end of a year of income and, at year end, the insurer's liability under the policy has been discharged, no unexpired risk exists in relation to the policy. The insurer is not at risk during the later year. In these circumstances, it is not appropriate that any portion of the premium paid on the policy to be deferred to the later year. No part of the premium paid under the

policy constitutes 'unearned premium income' for income tax purposes.

When is unearned premium income derived?

29. Income is often derived either before it is received (e.g. a trader derives proceeds from sales of goods on credit when the sales are made) or when it is received (e.g. salary or wage earners derive their remuneration for their services when it is received).

30. In some instances, however, income is not derived until after its receipt. For example, in *Arthur Murray (NSW) Pty Ltd v. FC of T* (1965) 114 CLR 314; (1965) 14 ATD 98 (the *Arthur Murray Case*) amounts received in advance by the company for dancing lessons to be supplied in the future were held by the High Court of Australia not to have been derived until the lessons were actually given.

31. The High Court in that case said the amounts not only had to be received but had to 'come home' to the company. According to the High Court, each amount of fees received but not earned should be treated as though it was subject to a contingency that the whole or some part of it might have in effect to be paid back (even if only as damages) if the agreed services were not rendered. The possibility of the company having to make a payment back (in practical terms) was seen by the High Court as an inherent characteristic of the receipt itself. While that possibility remained, the amount received had not 'come home' to the taxpayer and in reality it did not have the quality of income derived by the company.

32. The reasons for the decision in the *Arthur Murray Case* also apply to contracts of general insurance. A premium received by a general insurer may relate in part to the cover of a risk in the income year in which it is received and in part to cover risk in a later income year. The coverage of risk by a general insurer seems analogous in all material respects to the provision of services (i.e. dance lessons) in the *Arthur Murray Case*.

33. In *RACV Insurance Pty Ltd v. FC of T* 74 ATC 4169; (1974) 4 ATR 610 (the *RACV Insurance Case*), the Supreme Court of Victoria (Menhennitt J) recognised as appropriate the practice of assessing premium income over the period of the policy (ATC 4176; ATR 618).

34. We accept that some portion of a general insurer's premium income of a year comes home to the general insurer and is derived in that year and some portion of the premium should be treated as coming home and as being derived in a later income year.

What method should be used to apportion unearned premium income for income tax purposes?

35. There is nothing in the income tax law to directly determine the method to use to apportion unearned premium income or the extent of a general insurer's premium income of a year that is to be regarded as being derived in a later year.

36. The *Arthur Murray Case* and the *RACV Insurance Case* considered whether or not any amount of a taxpayer's unearned income may be excluded from one income year and included in a later year on the basis that it is derived in the later year. The cases did not deal with the question how to calculate the amount of the income that is derived in the later year.

37. To resolve this question it is necessary therefore to refer for guidance to other judicial decisions on the matter. According to the courts, the appropriate method to adopt is that which is 'calculated to give a substantially correct reflex of the taxpayer's true income': *The Commissioner of Taxes (South Australia) v. The Executor Trustee and Agency Co. of Australia Ltd (Carden's Case)*(1938) 63 CLR 108 at 154.

38. As a general rule, the amount of unearned income that may be deferred on the basis that it is derived for income tax purposes in a later year of income should be determined by an analysis of individual transactions. Where a great volume of transactions is entered into, making this analysis impracticable, general insurers may adopt a different method of estimating unearned income provided that method can be shown by experience to produce a reasonable approximation of the actual amount of unearned income. The method needs to give a true reflection of the income producing activities for the period.

39. In the case of a general insurer, we accept that the most appropriate method to estimate unearned premium income is to

apportion the insurer's (net) premium income of the year based on the extent to which the risk covered by the policies to which that premium income relates is covered in each year of income concerned.

40. Our long-standing practice in the past in apportioning a general insurer's premium income of a year under general insurance contracts extending into a later income year was to bring into assessable income of the year 60% of the premium income of the year and to carry forward into the later year 40% of the premium income of the year.

41. The method, known as the '40% method', was considered in Taxation Ruling IT 79 and was based on an arbitrary apportionment of risk coverage over time. It was also based on an assumption that in all cases the risk insured against was evenly spread over time.

42. Computer technology now enables a general insurer to accurately determine the extent to which a premium for each policy is for risk coverage in the year the premium is received or in any later income years. The method understood to be used by most general insurance companies in Australia for the purposes of their financial accounts is known as the '365ths' or 'daily' method.

43. Because the '365ths' or 'daily' method is more accurate than the old 40% method and is likely to more accurately reflect a general insurer's true income, it is to be adopted for income tax purposes if the insurer consistently adopts the '365ths' or 'daily' method from year to year for its commercial accountancy purposes. Once adopted for income tax purposes, that method is to be used consistently:

(a) from one income year to the next; and

(b) across all lines of general insurance business, unless the insurer can demonstrate that it is commercially impracticable to do this.

44. If the risk exposure of particular general insurance policies is not evenly spread over time, the '365ths' or 'daily' method would not be appropriate. If, for accounting purposes, a soundly based method of apportionment has been consistently used from year to year, that method is to be used for income tax purposes, provided that it produces a result which truly reflects the extent to which the insurer is exposed to risk in the income years concerned. The method, once

adopted for income tax purposes, needs to be used consistently in the sense described in paragraph 43.

Ruling: what constitutes premium income of an income year

General insurance receipts

45. All amounts received by a general insurer from an insured in connection with the writing of insurance contracts (including stamp duty and fire brigade charges) are income of the insurer assessable under subsection 25(1).

46. The word 'premium', as used in this Ruling, extends to all of these amounts.

Categories of premium income derived in any income year

47. The income tax law provides a scheme of annual taxation based on the income derived by a taxpayer in each year of income. A general insurer derives in each year of income the following categories of premium income (each category being required to be included in the insurer's assessable income under subsection 25(1)) :

(a) premium income received or receivable in the year for closed business (other than premium income from unclosed business of the previous year derived in that year); and

(b) premium income estimated to be received from unclosed business existing at the end of the year; and

(c) premium income received or receivable in earlier years but unearned in those years (other than premium income which relates to risk exposure of a later year).

Explanations: what constitutes premium income of an income year

General insurance receipts

48. The general insurance industry regards a premium as consisting of several components. One component may represent profit. The others relate directly to expenses that the insurer has to pay because the insurance contract has been entered into. These other components include :

(a) for all classes of general insurance business :

(i) an amount to pay claims;

(ii) an amount to meet administration costs;

(iii) an amount to meet commissions or brokerage;

(iv) an amount to pay stamp duty; and

(v) an amount to pay reinsurance premiums;

(b) for fire classes, an amount to pay for fire brigade charges;

(c) for workers' compensation :

(i) an amount to pay dust disease levy; and

(ii) amounts to pay government contribution fund levies.

49. For certain classes of general insurance business, government authorities require the insurer to pay levies, charges or duties such as workers' compensation insurance levies, fire brigade charges and

stamp duty. The insurer, rather than the insured, is liable to pay these government levies, charges or duties. The liability arises under most (if not all) State or Territory legislation on the date the insurance risk commences. The insurer is not compelled to collect these levies, charges, or duties from the insured. However, the insurer is entitled to include in premiums payable by the insured an amount to cover an estimated amount for the levies, charges or duties.

50. Amounts received by a general insurer from an insured for these levies, charges or duties are part of the proceeds of the insurer's business, a product of, or are incidental to the conduct of, the business. They are 'income' according to the ordinary usage of that word and are assessable under subsection 25(1).

Categories of premium income derived in any income year :

. Premiums received or receivable for closed business

51. A general insurer is required by subsection 25(1) to include in its assessable income in each year of income premiums derived in that income year. Premiums :

(a) received in an income year; and

(b) receivable in that year from insurance business with dates of commencement of risk in that year and which are 'closed', or 'booked' as this business is known in the general insurance industry (contrast the term 'unclosed business' as used in paragraph 55) during the year,

are derived for income tax purposes in the year the insurance contract is closed. The premiums are to be included in the general insurer's assessable income of that year and not the year of actual receipt if that is a later year. Premium income received in an income year (the 'current year') being premium income estimated at the end of the previous year to be received from unclosed business and which was derived and included in assessable income in that year, is not derived in the current year.

52. The word 'derived' is not defined in the income tax law. In its ordinary sense the word means 'to draw, fetch, get, gain, obtain' a thing from a source (*Oxford English Dictionary*). The word is not necessarily equivalent in meaning to 'earned' or to 'actually received'. Income may be derived before it is received. Sometimes amounts

may be derived after they are received, as the *Arthur Murray Case* illustrates.

53. The terms and conditions of an insurance contract entered into between a general insurer and an insured in relation to the payment of premiums by the insured are a major consideration in determining when the premium income of the insurer is derived. If the payment of the premium in respect of closed business has matured into a recoverable debt before it is actually received, and the insurer is not obliged to take any further step before becoming entitled to payment of the premium, we regard the premium as having been derived by the insurer : *Henderson v. FC of T* (1970) 119 CLR 612; 70 ATC 4016; (1970) 1 ATR 596, *J Rowe & Son Pty Ltd v. FC of T* (1971) 124 CLR 1; 71 ATC 4157; (1971) 2 ATR 497 and *FC of T v. Australian Gas Light Co* 83 ATC 4800; (1983) 15 ATR 105.

. Premium income estimated from unclosed business

54. An amount which a general insurer estimates each year of income it will receive in a later year as premiums in respect of its year end unclosed business is derived by the insurer. Subsection 25(1) requires that the estimated amount be included in the insurer's assessable income.

55. Delays commonly occur in the general insurance industry between the inception date of a policy (that is the date the risk under the policy commences) and the booking date (that is the date the premium is entered or 'booked' into the insurer's account). Business held during this period is commonly referred to in the industry as 'unclosed business'.

56. Unclosed business may arise when :

(a) an insurer issues a cover note and the 'insured' has not completed or returned the proposal; or

(b) an insurer has issued a renewal notice and the 'insured' has failed to renew before the existing policy expires; or

(c) a broker or agent of an insurer has accepted, on behalf of the insurer, a premium and proposal from an 'insured' but has delayed sending the details to the insurer; or

(d) an insurer has accepted the risk for a particular policy but the final details for the contract of insurance have not been finalised and the premium has not been determined.

57. A general insurer can estimate at the end of an income year the amount of premium income it will ultimately receive in respect of its unclosed business. This estimate can be made with a reasonable degree of accuracy.

58. For both accounting purposes and the Insurance and Superannuation Commission's financial reporting purposes, it is the usual practice in the industry to bring premiums in respect of unclosed business to account in the income year in which the estimate is made.

59. Premiums estimated to be received by a general insurer in respect of its year end unclosed business are derived by the insurer for income tax purposes (in the sense explained in paragraphs 52 and 53) and must be included in its assessable income under subsection 25(1).

60. Estimated premiums for unclosed business are derived :

(a) in the income year in which the estimate is made - to the extent that they relate to the insurer's risk exposure in that year; and

(b) in a later income year - to the extent to which the risk covered by the policy extends to that year.

61. As explained in paragraphs 35 to 44, the method used to apportion estimated premiums in respect of unclosed business needs to be based on the appropriate year in which the premium is derived, according to the insurer's risk exposure in the year.

. Premium income from earlier income years

62. Subsection 25(1) requires a general insurer to include in its assessable income in each year of income the amount of premium income it derives in that year. An insurer may have received premiums in prior income years, or premiums may have been receivable in those years, which relate to the insurer's risk exposure in the current income year or in a later income year. The portion of these premiums, received or receivable, which was unearned in prior years but which relates to risks covered by the policies in the current year, is derived by the insurer in the current year. That portion of the premiums is required to be included in the general insurers assessable income of the current year for the purposes of subsection 25(1). It does not include, however, any portion of premiums received or receivable in earlier years but unearned in those years to the extent that it relates to risk exposure in a later year of income.

Ruling: acquisition costs

Which acquisition costs are deductible?

63. Acquisition costs incurred by a general insurer in obtaining and recording insurance policies are allowable income tax deductions under subsection 51(1).

In which year of income are acquisition costs deductible?

64. Acquisition costs are deductible under subsection 51(1) in the income year in which they are incurred. If the costs are paid by a general insurer in a year of income, they are incurred in that year. If the costs remain unpaid, a liability to pay them will constitute an outgoing incurred, in terms of subsection 51(1), in a year of income if the general insurer is definitively committed or has completely subjected itself to the liability in that year.

Which acquisition costs reduce gross premiums in calculating unearned premium income?

65. All acquisition costs (after reduction by any relevant reinsurance commissions - see paragraphs 99 and 101 to 102) that are incurred by a general insurer in obtaining and recording insurance policies need to be offset against gross premiums in the manner explained at paragraphs 12 to 19.

Explanations: acquisition costs

Which acquisition costs are deductible?

66. Acquisition costs incurred by a general insurer in obtaining and recording insurance policies include :

(a) commission and brokerage fees;

(b) administration costs of processing insurance proposals and renewals and the cost of collecting premiums;

(c) selling and underwriting costs such as risk assessment and advertising;

(d) fire brigade charges;

(e) stamp duty; and

(f) other government or authority charges, levies and contributions which directly relate to policies.

67. Acquisition costs are treated by the general insurance industry as assets for accounting purposes and are spread over the period of a policy in determining the accounting profit of the particular periods to which the policy relates.

68. Acquisition costs, like other normal business expenses incurred by a general insurer in carrying on a business of general insurance, are allowable deductions under subsection 51(1). We accept that they are necessarily incurred in carrying on the business for the purpose of gaining or producing assessable income.

In which year of income are acquisition costs deductible?

69. If acquisition costs are paid (i.e. if there has been an actual disbursement) they are ordinarily incurred and are deductible under subsection 51(1), at the latest, in the year of income in which they are paid. If the costs are pre-paid for a period in excess of 13 months, however, special rules in the income tax law apply to spread the deduction over the period during which the services are to be provided, up to a maximum of 10 years (section 82 KZM).

70. Acquisition costs may be incurred in an earlier year of income if a liability to pay them has become a loss or outgoing 'incurred' in terms of subsection 51(1).

71. A liability for acquisition costs will be an outgoing incurred, even though it remains unpaid, if the general insurer is definitively committed or has completely subjected itself to the liability (see *FC of T v. James Flood Pty Ltd* (1953) 88 CLR 492 at 506).

72. The insurer is 'definitively committed' to a liability in the required sense if it is then under a presently existing liability to pay the costs (see *FC of T v. Lau* 84 ATC 4929, Beaumont J at 4940; (1984) 16 ATR 55 at 68 and *Ogilvy & Mather Pty Ltd v. FC of T* 90 ATC 4836 at 4844-5 and 4864-5; (1990) 21 ATR 841 at 850-1 and 873-4).

73. If, for example, at the end of an income year a general insurer has a present liability to pay commission to an insurance agent and the liability is then due, though payable in the future, the liability is an outgoing incurred in that income year.

Which acquisition costs reduce gross premiums in calculating unearned premium income?

74. For the reasons explained at paragraph 19, net premium income of a year (not gross premium income) must be apportioned in determining the extent of unearned premium income that relates to a later income year. Gross premiums of a year therefore need to be reduced by acquisition costs that relate to those gross premiums.

75. The acquisition costs which reduce gross premiums in calculating unearned premium income are those incurred by a general insurer in obtaining and recording insurance policies including those listed in paragraph 66. Proportional reinsurance commissions, to the extent that they represent a reimbursement of costs, are to be deducted from the total of acquisition costs which reduce gross premium (see paragraphs 99 and 101 to 102).

Ruling: reinsurance premiums incurred by a general insurer

Which reinsurance premiums are deductible?

76. Except for reinsurance premiums paid or credited to a non-resident reinsurer in a situation in which subsection 148(1) operates to preclude an allowable deduction, reinsurance premiums incurred by a general insurer are allowable income tax deductions under subsection 51(1).

77. Subsection 148(1) applies to premiums paid or credited by an insurer carrying on an Australian insurance business to reinsure out of Australia with a non-resident the whole or part of any risk. The subsection operates to preclude the premiums from being an allowable deduction under subsection 51(1) unless the insurer elects that subsection 148(1) not apply.

In which year of income are reinsurance premiums deductible?

78. Reinsurance premiums that are allowable income tax deductions under subsection 51(1) are deductible in the year of income in which they are incurred by a general insurer. If the reinsurance premiums are paid by a general insurer in a year of income, they are incurred, at the latest, in that year. If the reinsurance premiums are pre-paid for a period in excess of 13 months, special provisions in the income tax law apply to spread the deduction over the period during which the insurer is reinsured, up to a maximum of 10 years. If the reinsurance premiums remain unpaid, they are nonetheless incurred in a year of income if the general insurer is definitively committed or has completely subjected itself to the liability in that year to pay them.

Which reinsurance premiums reduce gross premiums in calculating unearned premium income?

79. All reinsurance premiums that are incurred by a general insurer other than :

(a) those to which subsection 148(1) applies; and

(b) treaty non-proportional reinsurance premiums

need to be offset against gross premiums in the manner explained at paragraphs 12 to 19.

Explanations: reinsurance premiums incurred by a general insurer

General background

80. An insurance market is effective only if liability arising from the risks undertaken by insurers are spread as widely as possible. Spreading of liability cushions insurers against the vagaries of unusually large claims, natural disasters and other catastrophes. It also enables the fixing of premiums at a stable rate. The technique of

spreading is known as 'reinsurance' as it reduces an insurer's exposure to risk.

81. In effect, reinsurers set the ultimate rates of premiums and insurance conditions for a particular market. This occurs because an insurer will be able to offer insurance to the market only if adequate cover by way of reinsurance has been arranged.

82. Reinsurance is obtainable in many forms. An insurer may reinsure a particular risk - such as risk associated with the construction of a particular building (known as facultative reinsurance) - or reinsure a class of business - such as all workers' compensation policies held by the insurer (known as treaty or whole of account reinsurance). The reinsurance may be either proportional (where the reinsurance is of a portion of the risk, the portion of the risk being the same as the portion of the premium payable to the reinsurer) or non-proportional (where the reinsurance is not in the same proportion as the premium payable but, rather, is for a specific excess of loss, etc., for example., the insurer may retain the risk of the first $10,000 of each claim and reinsure in respect of the amounts of any claims which exceed that amount).

83. Facultative reinsurance is generally taken out for the same period as the individual insurance policy and the risk is matched during the period. Treaty proportional reinsurance is usually taken out on an annual basis and paid, as a net amount after commissions, following the presentation of a quarterly statement of account by the general insurer (the statement informs the reinsurer of premium, commission, claims details and the net amount due). It is common to negotiate treaty non-proportional reinsurances on an annual basis but payable quarterly in advance, usually effective to 30 June or 31 December.

Which reinsurance premiums are deductible?

84. Reinsurance premiums (other than those to which subsection 148(1) applies) incurred by a general insurer are outgoings necessarily incurred in carrying on a business of general insurance to produce assessable income. They are deductible under subsection 51(1).

85. As to reinsurance premiums paid or credited by a general insurer to a non-resident reinsurer, the provisions of subsection 148(1) operate to preclude the premiums from being an allowable deduction under subsection 51(1) unless the general insurer elects that subsection 148(1) does not apply.

In which year of income are reinsurance premiums deductible?

86. Reinsurance premiums that are allowable income tax deductions under subsection 51(1) are incurred and are deductible, at the latest, in the year of income in which they are paid. If reinsurance premiums are pre-paid for a period in excess of 13 months, the provisions of section 82 KZM apply to spread the allowable deduction over the period during which the general insurer is reinsured, up to a maximum of 10 years.

87. Reinsurance premiums may be incurred in an earlier year of income if a liability to pay them has become a loss or outgoing 'incurred' in terms of subsection 51(1).

88. A liability to pay reinsurance premiums will be an outgoing incurred, even though it remains unpaid, if the general insurer is definitively committed or has completely subjected itself to the liability (see *James Flood Case* 88 CLR at 506).

89. The insurer is 'definitively committed' to a liability in the required sense if it is then under a presently existing liability to pay the reinsurance premiums (see *Lau Case* 84 ATC at 4940; 16 ATR at 68 and *Ogilvy & Mather Case* 90 ATC at 4844-5 and 4864-5; 21 ATR at 850-1 and 873-4).

Which reinsurance premiums reduce gross premiums in calculating unearned premium income?

90. For the reasons explained at paragraph 19, net premium income of a year (not gross premium income) must be apportioned in determining the extent of unearned premium income that relates to a later income year. Gross premiums of a year therefore need to be reduced by reinsurance premiums that relate to those gross premiums.

91. The reinsurance premiums which reduce gross premiums in calculating unearned premium income are those incurred by a general insurer other than :

(a) those to which subsection 148(1) applies: and

(b) treaty non-proportional reinsurance premiums.

92. Subsection 148(1) reinsurance premiums are not taken into account because no income tax deduction is allowable for them. In addition, any sums recovered by an Australian insurer from the non-resident reinsurer for a loss on any reinsured risk do not form part of the assessable income of the Australian insurer. To take such a premium into account would distort the unearned premium income calculation.

93. This matter has been the subject of a previous Taxation Ruling, refer Taxation Ruling IT 2367.

Ruling: treaty non-proportional reinsurance and unearned premium income

94. After determining unearned premium income of a general insurer in accordance with paragraphs 12 to 13 and 20 to 25, the cost of any treaty non-proportional premiums incurred in a year of income needs to be taken into account to the extent to which the cost relates to the period after the end of the year.

95. The amount of unearned premium income otherwise calculated is to be reduced by the relevant part of the treaty non-proportional reinsurance premium that relates to the insurer's risk exposure in the later year.

Explanations: treaty non-proportional reinsurance and unearned premium income

96. Treaty non-proportional reinsurance premiums reduce the overall risk exposure of a general insurer but are not related to any particular premium. These reinsurance premiums are more in the nature of a direct expense applicable to the whole period of the reinsurance cover. Thus, they are not required to be deducted directly from gross premiums in calculating unearned premium income.

97. Sometimes the period of an insurer's treaty non-proportional reinsurance cover extends after the end of an income year. As a result, the risk exposure of the insurer after year end is reduced. This fact is relevant in calculating the amount of unearned premium income of the insurer because that amount is based on risk exposure after year end. Consequently, the amount of unearned premium income otherwise calculated in accordance with paragraphs 12 to 13 and 20 to 25 needs to be reduced by any portion of treaty non-proportional reinsurance premiums already incurred by the insurer which relates to a period after year end. This adjustment is necessary to provide a correct reflex of the amount of unearned premium income that relates to the general insurer's risk exposure after year end.

Ruling: reinsurance commissions and unearned premium income

. When are reinsurance commissions assessed?

98. A general insurer is required by subsection 25(1) to include in its assessable income in each year of income reinsurance commissions derived in that income year.

. Proportional reinsurance commissions and the calculation of unearned premium income

99. Proportional reinsurance commissions reduce the amount of acquisition costs or reinsurance premiums otherwise deducted from gross premiums for the purposes of calculating the unearned premium income of a general insurer for a year of income. They reduce these costs on premiums to the extent that the commissions are paid to a general insurer as a reimbursement of, or contribution for, costs incurred by the general insurer in relation to the policies which are the subject of the reinsurance arrangements.

Explanations: reinsurance commissions and unearned premium income

. When are reinsurance commissions assessed?

100. Reinsurance commissions are assessable income of a general insurer in the income year in which they are derived. Reinsurance commissions are payable by a reinsurer to a general insurer and are based on reinsurance premiums payable by the insurer on reinsurance policies it enters into with the reinsurer (known as 'flat' reinsurance commissions). For the same reasons expressed in paragraph 52 and 53, reinsurance commissions are derived by a general insurer for income tax purposes:

(a) if they have been received by the general insurer; or

(b) if (though not yet received) the reinsurance commissions have matured into a debt recoverable by the general insurer and it is not obliged to take any further steps before becoming entitled to receive the commissions.

Reinsurance commissions receivable (though not yet received) from a reinsurer ordinarily become recoverable under the reinsurance contract at the time the reinsurer becomes exposed to the risk under the reinsurance policy.

. Proportional reinsurance commissions and the calculation of unearned premium income

101. We understand that most reinsurance commissions payable to a general insurer by a reinsurer represent a reimbursement to the general insurer of part of the acquisition cost of the policies the subject of the reinsurance arrangements. They also represent a contribution towards the cost of management of those policies. Such commissions are included in flat reinsurance commissions. Effectively, the commissions result in the sharing of policy acquisition and management costs between the general insurer and the reinsurer.

102. The calculation of unearned premium income is based on risk exposure of a general insurer after year end. To the extent that a general insurer proportionally cedes to a reinsurer its risk under a policy it could not be said to be on risk. In this situation, the reinsurer also shares with the general insurer the costs of acquiring and managing the reinsured policies. This sharing of costs is reflected in the calculation of the general insurer's unearned premium income by reducing the amount of acquisition and reinsurance costs otherwise to be deducted from gross premiums.

Part B: outstanding claims provision

Ruling: determining the amount of the provision for 'long-tail business'

103. To calculate the taxable income of a general insurer for a year of income it is necessary to deduct from the premiums derived in that year :

(a) administration and business operating expenses incurred in the year;

(b) payments actually made during the year to satisfy claims arising from insurance contracts which earned those premiums; and

(c) an appropriate amount or provision, arrived at by reasonable estimate, in respect of claims outstanding at the end of the year (the *RACV Insurance Case* and *Commercial Union Assurance Co. of Australia Ltd v. FC of T* 77 ATC 4186; (1977) 7 ATR 435).

104. Outstanding claims for which provision must be made in a year of income include :

(a) claims which have been communicated to the insurer during the year or in earlier years but not yet paid in full; and

(b) claims incurred but not reported (that is those which have not been communicated to the insurer before the end of the year, but which will later be communicated and paid, and in relation to which the event giving rise to the insurer's liability occurred before the end of the year).

105. The amount deductible in a year of income is a proper and reasonable estimate of claims recognised by a general insurer in the year in situations where insured events have occurred but the liabilities have not yet been extinguished.

106. The method to be used for income tax purposes to arrive at an insurer's proper and reasonable estimate of an appropriate amount of provision in respect of outstanding claims at the end of a year of income is to adopt the amount which the insurer calculates as necessary to set aside in that year out of its premium (and other) income and which, when invested, will provide sufficient funds to pay the claims in the future.

Explanations: determining the amount of the provision for 'long-tail business'

Outstanding claims provision is deductible in principle

107. An outstanding claims provision of a general insurer is an allowable income tax deduction under subsection 51(1): the *RACV Insurance Case* and *Commercial Union Assurance Co. Case*. The outstanding claims at the end of a year of income for which a general insurer is able to provide are :

(a) claims arising from an insured event that occurred in the year or in earlier years which have been reported to the insurer but which have not yet been paid in full; and

(b) claims incurred but not yet reported (that is, those arising from an insured event that occurred in the year for which the insurer is presently liable to pay but which have not yet been reported to the insurer).

Amount of provision not settled by the courts

108. While the *RACV Insurance Case* and the *Commercial Union Assurance Co Case* settled the deductibility of these provisions as a matter of principle, the method to be used to calculate the amount of these provisions was not argued before the courts in these cases and the decisions therefore do not conclusively determine the basis or method to be used.

Appropriate method to calculate amount of provision

109. It is not practicable to calculate, in a strict sense, at the end of a year of income the actual amount that a general insurer can expect to pay to finalise outstanding claims. We accept that an estimation of the amount of the provision is therefore called for. The question becomes what is the most appropriate method to estimate the amount of the provision.

110. We have considered various possible methods to estimate the amount allowable as an income tax deduction for an outstanding claims provision at the end of a year of income. These include :

(a) the additional amount set aside or 'earmarked' each year to pay year end outstanding claims in the future;

(b) a figure which represents the amount which would be required to settle all outstanding claims if they were to be fully paid out at the end of the year of income;

(c) a figure determined by calculating the present value of expected claim payments using expected inflation rates only; or

(d) the amount estimated as the quantum to be finally paid out.

111. The method in subparagraph 110(a) would produce, we believe, a substantially correct reflex of a general insurer's true (net) income in respect of general insurance business it conducts in each year of income, particularly in relation to its outstanding claims for the year.

112. An example is attached to this Ruling to illustrate how the method in subparagraph 110(a) applies. In essence, it entails two broad steps namely :

(a) An estimate is made at the end of a year of income of the total amount a general insurer expects to pay in future years to finalise outstanding claims ($30,000 in the example being the gross liability of $60,000 less reinsurance proceeds of $30,000).

(b) A calculation is then made of the amount of funds that need to be set aside or earmarked at the end of the year which, when invested, will provide the amount (in subparagraph (a)) needed to pay out the claims ($18,000 in the example).

113. The amount deductible for the outstanding claims provision in the income year is the amount arrived at in subparagraph 112(b) ($18,000 in the example).

114. In our view, this method is a proper and reasonable one to use to estimate a general insurer's outstanding claims provision for income tax purposes. We consider that it is the most appropriate for a general insurer to use to produce a true and fair view of the insurer's taxable income for an income year.

Why other methods have not been adopted

115. A present pay-out cost method (subparagraph 110(b)) would ignore the realities of a continuous business being conducted by a general insurer. A present value method (subparagraph 110(c)) is not one calculated by all insurers and it is not used for accounting purposes. An estimated final pay-out method (subparagraph 110(d)) would entail a deduction in the income year of the original estimate for the fully inflated cost of the claims even though any inflation element would be incurred in a later year (see the *Commercial Union Assurance Co Case* 77 ATC at 4197; 7 ATR at 448 and *Owen(H.M. Inspector of Taxes) v. Southern Railway Of Peru Ltd* (1956) 36 TC 602 at 645).

Estimates need to be reasonable and soundly based

116. In determining the amount of a general insurer's outstanding claims provision, it is important that:

(a) the estimate of the amount of the expected final liability of the insurer to pay the claims in the future; and

(b) the calculation of the amount to be set aside or earmarked which, when invested, will yield the expected claims pay-out figure,

be reasonable and be soundly based on experience and trends in the industry.

117. We accept, as a general rule, that an insurer's provision for outstanding claims is reasonable and soundly based if a qualified actuary estimates the insurer's expected final claims liability and calculates the amount to be set aside now to yield a sufficient amount to meet that liability. However, if strong evidence exists to the contrary, the actuary's determination of the provision is not acceptable for income tax purposes. Strong evidence may exist, for example, if the underlying assumptions on which estimates are based for several years have proved to be consistently incorrect and that fact is not adequately reflected in estimates made in later years.

118. Estimates made by people other than actuaries need to be well documented to enable the estimates to be substantiated. The steps used in the estimation process, the factors taken into account and the reasons for the estimate need to be covered. The general insurer needs to be able, if required, to substantiate the estimate. The credentials of the person selected to make the estimate need to be commensurate with the competence needed for the task.

Ruling: determining the amount of the provision for 'short-tail business'

119. Outstanding claims in respect of 'short-tail business' are to be taken into account for income tax purposes on the basis of the amount which the general insurer expects it will have to pay out, net of recoverables, to meet these claims.

120. We do not propose to disturb this practice provided there is no material difference between the net amounts (after recoverables) expected to be paid on these claims and the present value of expected claim payments.

Explanations: determining the amount of the provision for 'short-tail business'

121. Because a claim in respect of 'short-tail business' is usually settled within 12 months of the insured event occurring which gives rise to the claim, it is not as difficult to determine the amount of an outstanding claims provision as it is for 'long-tail business'.

122. We accept that, for 'short-tail business', a proper and reasonable estimate of the amount a general insurer expects to pay on these claims (being the amount of liability under the claim less recoverables - see paragraph 119) produces an appropriate result for income tax purposes.

Ruling: inclusions in outstanding claims provision

123. In estimating a provision at the end of a year of income for outstanding claims for 'long-tail business', we accept that for income tax purposes it is necessary to take into account the following matters to arrive at the expected liability on the claims :

(a) direct policy costs;

(b) claim investigation and assessment costs;

(c) direct claim settlement expenditures;

(d) estimated increased costs of litigation and other direct costs; and

(e) any amounts recoverable by the insurer in respect of the claims.

Explanations: inclusions in outstanding claims provision

124. General insurers, in the course of calculating at year end their provision for outstanding claims arising from their 'long-tail business', estimate what they think will be the amount which they will be called upon to finally pay out in respect of those outstanding claims. They take into account the expected cost of the following factors :

(a) direct policy costs :

. amounts to be paid to the claimant or third party under the policy;

. medical and hospital fees payable under the policy;

. any other amounts payable as a condition of the policy;

plus

(b) claim investigation and assessment costs :

. investigation fees, legal fees and claim assessment costs;

plus

(c) claim settlement expenditures :

. direct costs attributable to a particular claim; and

. indirect costs of settlement (but see paragraphs 126 and 130 to 131);

plus

(d) estimated increased costs of litigation and other direct costs (essentially, trends in claims pay-out experience);

minus

(e) recoverables (see paragraph 127 below), including :

. reinsurances;

. insurance contributions fund entitlements;

. supplemental fund entitlements;

. contribution entitlements from other insurers;

. policy excesses;

. salvage and subrogation.

125. In taking into account the above costs, a general insurer increases them to provide for expected inflation in later years. The insurer then sets aside or earmarks in the current year funds which, when invested, will provide sufficient monies to pay the estimated claims (after taking into account inflation) as they actually fall due for payment.

126. Except for indirect settlement costs (which are addressed in paragraphs 130 to 131), we accept that for income tax purposes it is appropriate to take the above matters into account, and to give recognition to the effects of inflation in estimating the claim payments to be made in later years.

127. As to recoverables, recognition needs to be given to these in estimating the amount expected to be paid in settling outstanding claims in future years. Recoverables such as reinsurance proceeds, etc., are assessable for income tax purposes under subsection 25(1) in the hands of a general insurer as income in ordinary concepts. They represent part of the proceeds of an insurer's business, a product of, or are incidental to the conduct of, the business.

128. To the extent that a general insurer is entitled to recover any amounts on the happening of the insured event, we take the view that the insurer has derived the recoverable amounts. To omit any recoverable amount in estimating the amount the insurer expects to pay in settling outstanding claims in future years would produce a distorted and inappropriate result.

129. In the example attached to this Ruling, the estimated outstanding claim liability of the general insurer as at 30 June 1990 of $30,000 has been calculated in this manner.

Ruling: exclusion from outstanding claims provision

130. Indirect claim settlement costs are not to be taken into account in estimating a provision for outstanding claims for 'long-tail business'.

Explanations: exclusion from outstanding claims provision

131. Indirect claims settlement costs involve such general expenses as the costs of running and administering a general insurer's claims department. They are often referred to as 'claims handling costs'. By their very nature, these costs do not attach to, nor are they attributable to, a particular claim. Liability to pay these costs does not arise when the liability arises to pay a particular claim. Indirect claims settlement costs will, of course, be allowable under subsection 51(1) as an income tax deduction in the income year in which they are incurred. In estimating the amount of a general insurer's outstanding claims

provision, however, we consider that it is inappropriate for these costs to be taken into account. The fact that it is the usual practice for an insurer in the general insurance industry to include these costs in estimating the amount of its outstanding claims provision does not necessarily mean that this practice satisfies the requirements of the income tax law.

Ruling: margin for prudence

132. If an actuary, in estimating a general insurer's expected final claims liability (in the course of determining the amount of the insurer's outstanding claims provision) provides the insurer with an additional level of provision (or a series of additional provisions at specific levels) as a margin for prudence (also referred to as a 'level of adequacy', a 'level of confidence' or a 'comfort margin'), the margin the insurer decides to adopt will be acceptable for income tax purposes if :

(a) the decision reflects the insurer's experience in the industry and is based on sound commercial or business principles; and

(b) the reasons for the insurer's decision are well documented.

133. An arbitrary additional 'top up' of an estimated expected final claims liability, even if it is intended to provide a margin for prudence, is not acceptable for income tax purposes.

Explanations: margin for prudence

134. Actuaries provide a 'central' or 'best' estimate of the amount of a general insurer's expected final liability to pay outstanding claims (that is an estimate with 50% probability of adequacy). Actuaries normally recommend that a general insurer hold a provision higher than a central estimate (that is, a margin for prudence). An actuary may recommend a particular provision above the central estimate or provide levels of provisions at specific levels of adequacy above 50%.

It is for the general insurer to decide, however, the level of provision above the central estimate which it considers to be appropriate for its business based on its experience and the advice of the actuary.

135. We accept that a general insurer, in determining its outstanding claims provision, may include in the estimate of its expected final claims liability an appropriate margin for prudence without prejudicing the deductibility of the provision for income tax purposes. However, the amount of the prudential margin, and how the level of the margin was determined, need to be well documented. The insurer's decision on the level of the prudential margin needs to be made for sound commercial or business reasons and not for income tax reasons.

Ruling: year end adjustment of provision

136. A general insurer compares the amount of its outstanding claims provision at the end of an income year with the amount of the provision at the previous year end and :

(a) any increase in the provision is allowed as a deduction under subsection 51(1) in the income year; or

(b) any reduction in the provision is included as income assessable under subsection 25(1) in the income year.

Explanations: year end adjustment of provision

137. In both the *RACV Insurance Case* (74 ATC at 4176-4177; 4 ATR at 618) and the *Commercial Union Assurance Co Case* (77 ATC at 4197-4198; 7 ATR at 448) the courts recognised that an estimate of a general insurer's outstanding claims provision at the end of one year of income may prove, at the end of a later income year, to be either an under-estimate or an over-estimate.

138. As the Supreme Court of Victoria (Newton J) said in the *Commercial Union Assurance Co. Case* :

> '...an increase in the estimate at the end of any subsequent year for any of those claims which are then still outstanding, is an allowable deduction in calculating the insurer's taxable income for that subsequent year.'

139. And later, his Honour said :

> '...a revised estimate might be less than the original estimate, in which case the amount of the excess would be part of the insurer's taxable income in the year in which the revision was made : ...'

Date of effect

140. This Ruling requires that unearned premium income be included in assessable income on a basis different from the basis we have previously accepted, either in Taxation Ruling IT 79 or a private ruling to a particular insurer. To this extent, the Ruling applies from the income year commencing on 1 July 1991 (or equivalent substituted accounting period) unless the general insurer asks that the method apply to earlier income years. In these circumstances, assessments for earlier years may be amended on request to the extent permitted by section 170.

141. This Ruling also requires salvage and subrogation to be deducted from the estimated costs of outstanding claims when determining the amount to be allowed to a general insurer as an income tax deduction for an income year in respect of outstanding claims (paragraphs 124 and 127). Because we have accepted or approved (at least in some Branch Offices) different tax treatments the decision to take salvage and subrogation into account is to be applied from the income year commencing 1 July 1991 (or equivalent substituted accounting period).

142. In all other respects, this Ruling applies (subject to any limitations imposed by section 170) to years of income commencing both before and after the date on which it is issued. Although this will

generally mean no earlier than the income year commencing 1 July 1986, we do not propose in any event to amend assessments before that year. Nor do we propose to amend assessments to adjust carry forward losses before that year if a general insurer had carry forward losses for income tax purposes as at 30 June 1986 (or equivalent substituted accounting period).

143. The decision in *Country Magazine Pty Limited v. FC of T* (1968) 117 CLR 162; 15 ATD 86 (the *Country Magazine Case*) is relevant if assessments of a general insurer are amended to give effect to this Ruling. The decision in the *Country Magazine Case* means that in calculating the taxable income of a general insurer for an income year ('the current year'), unearned premium income of the previous year, for example, must be brought to account in the current year on the same basis used to calculate unearned premium income of the current year. This is so regardless of the fact that unearned premium income of the earlier year may have been calculated on a different basis. This applies equally to amendments made to assessments to give effect to this Ruling on the incurring of losses or outgoings for the purposes of subsection 51(1) (refer to Taxation Ruling IT 2613).

144. The date of effect provisions of this Ruling are to be applied in conjunction with normal audit settlement guidelines. However, the Ruling is to apply to all general insurers for all income years commencing with the 1991-92 income year.

Additional tax for incorrect returns and interest

145. Section 223 imposes, by way of penalty, additional tax where a person makes a statement in connection with the operation of the taxation law that is false or misleading in a material particular. In the application of section 223, the omission of assessable income derived by a person from a tax return is to be taken as a statement to the effect that the income was not derived (subsection 223(7)). The additional tax imposed by section 223 is equal to double the amount by which the tax properly payable by the taxpayer exceeds the tax that would have been payable if it had been assessed on the basis that the statement was not false or misleading.

146. If a general insurer has made a disclosure in its return in sufficient detail to have enabled the Commissioner to determine whether or not an amount should be included in assessable income or be correctly allowed as a deduction, but treated it as non-assessable or deductible, section 223 is not considered to apply. However, if on the basis of this Ruling assessable income has been understated or a deduction has been incorrectly claimed and an amendment of the taxpayer's assessment is made to increase taxable income accordingly, interest in accordance with section 170AA is payable on the difference between the tax payable on the amended assessment and the tax previously assessed. Section 170AA applies to assessments made on or after 1 July 1986 in respect of 1985-86 and subsequent income years.

147. Where there has not been a sufficient disclosure, penalty tax would be imposed under section 223.

148. Questions relating to disclosure by companies under the self-assessment system are discussed in paragraphs 12 to 18 of Taxation Ruling IT 2624, especially paragraph 15.

149. Broadly, the interest imposed by section 170AA on underpayments of tax is designed to compensate the revenue for the full amount of tax not having been paid by the due date. The interest rate is currently 14.026% per annum. Section 170AA does not operate where the underpayment of tax is subject to additional tax under section 223 for false or misleading statements. This is so even where the additional tax is not actually payable because of the exercise of the Commissioner's discretion to remit the whole of the additional tax.

150. Subsections 227(3) and 170AA(11) give the Commissioner a discretion to remit the whole or any part of section 223 additional tax or section 170AA interest. Any decision to remit needs to take account of the facts of each particular case, as explained in paragraph 8 of Taxation Ruling IT 2517. The following guidelines are provided to assist officers in the exercise of the discretion and to help ensure that taxpayers do not receive inconsistent treatment.

151. In accordance with the general policies outlined in Taxation Rulings IT 2444 and IT 2517 in relation to the remission of additional tax and interest, but subject to the more specific guidelines in those Rulings, the following approach is considered appropriate.

152. If a general insurer voluntarily discloses the omission of assessable income or the incorrect claiming of a deduction, the additional tax imposed by subsection 223(1) would normally be remitted on the basis specified in paragraph 21 of IT 2517, that is, to an extent necessary to reduce the additional tax to an amount equal to 10% per annum of the tax avoided, subject to a maximum of 50% of the tax avoided in any one year. However, in view of:

- the shift of opinion by many general insurers in recent years away from traditional methods of determining unearned premium income and outstanding claims;
- the fact that the issues were identified by ATO audit activity commenced several years ago in the general insurance industry;
- the recent release of new accounting standards for the general insurance industry; and
- the extensive period of consultation between the general insurance industry and the ATO on the issues discussed in this Ruling;

it is considered that the maximum rate of additional tax in any one year should be limited to 20% in lieu of the 50% normally applying.

153. The concessional maximum of 20% is to be applied only in the particular circumstances of this Ruling.

154. Where there had been a disclosure as explained in paragraph 146 above, and the taxpayer voluntarily advises that an underpayment of tax has resulted, any interest payable under section 170AA on the underpayment may be remitted on the basis specified in paragraph 16 of IT 2444, that is, to an amount equal to the lesser of interest calculated at the rate of 10% per annum or 75% of interest otherwise payable. However, the rate of interest in any one year should be limited to 20%. The reasons for this limit are the same as those explained in paragraph 152 in relation to additional tax for incorrect returns.

155. It is important for general insurers to understand that, even though there may have been a disclosure in a tax return they will still need to come forward and request amendment of their assessments to take advantage of the remission of interest outlined in paragraph 154. If they do not do so, interest will be imposed at 14.026% per annum under section 170AA instead of the reduced rate explained in paragraph 154 that will apply in voluntary disclosure cases.

156. Consistent with the policy expressed in paragraph 28 of IT 2517, a general insurer will be considered to have voluntarily disclosed the understatement of taxable income only if no current ATO action concerning the insurer or an associated company has been initiated.

157. New Audit action to give effect to this Ruling will be deferred until 1 April 1992 to allow time for general insurers to make voluntary disclosures. Voluntary disclosures should be marked to the attention of the Complex Audit Manager of the Branch Office at which the general insurer lodges its income tax returns. If a general insurer applies before 1 April 1992 for an extension of time in which to provide the information needed to amend the assessments, a Complex Audit Manager may, to a reasonable extent, allow more time.

158. We recognise that some companies may not have retained sufficient records to factually determine figures for adjustments for earlier years. It will be acceptable for such companies to estimate the quantum of adjustments, provided the estimates are reasonably and soundly based.

159. In cases where an underpayment of tax has occurred and a general insurer has made a subsection 169A(2) request, and sufficient details were provided to enable the determination of the question at the time the assessment was made, interest may be remitted in full provided that the question had not been ruled on previously by the Commissioner in response to a prior subsection 169A(2) request or Advance Opinion request in a way that differs from the position adopted subsequently by the insurer. This is consistent with the policy expressed in paragraph 30 of Taxation Ruling IT 2616.

160. In a case where a general insurer has not voluntarily disclosed the understatement of taxable income, the discretion under subsection 227(3) may be exercised in conformity with the policy expressed in paragraphs 32 to 41 of IT 2517 in relation to 'contentious items' for the period to the date of this Ruling and in relation to 'non-contentious items' after the relevant date. That is, penalty may be reduced to an amount equal to a per annum rate equivalent to that prevailing under section 170AA, plus (as a culpability component) a flat percentage (5% plus a pro rata percentage adjustment for the non-contentious period) of the tax avoided. The pro rata adjustment may be calculated by multiplying the non-contentious rate, as determined under Taxation Ruling IT 2517, minus 5% by the fraction obtained by dividing the non-contentious period by the total period.

161. As mentioned in paragraph 19 of IT 2517, something may be regarded as contentious where the relevant law is unsettled or where, although the principles of law are settled, there is a serious question about the application of those principles to the circumstances of the particular case. The matter could not be treated as contentious from now on. Where a general insurer fails to disclose its correct taxable income in a return of income lodged after the date of this Ruling, the policy set out in paragraphs 31 to 41 of IT 2517 relating to the non-voluntary detection of non-contentious items should be observed.

162. **CONTENTS**

Commissioner of Taxation

20 December 1991

ISSN 0813 - 3662

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NO 91/6961-0
BO

Previously released in draft form as EDR 46

Price $5.004.70

FOI index detail
reference number
I 1012987

subject references
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- additional tax (incorrect return)
- general insurance
- insurance
- outstanding claims provision
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ATTACHMENT

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