TD 2004/77 - Income tax: consolidation: general insurance: are accounting liabilities for unearned premiums adjusted under subsections 705-75(1) and 705-80(1) of the Income Tax Assessment Act 1997 for the purposes of working out the allocable cost amount for a joining entity that is a general insurance company?

Taxation Determination

Income tax: consolidation: general insurance: are accounting liabilities for unearned premiums adjusted under subsections 705-75(1) and 705-80(1) of the *Income Tax Assessment Act 1997* for the purposes of working out the allocable cost amount for a joining entity that is a general insurance company?

Preamble

The number, subject heading, date of effect and paragraph 1 of this document are a 'public ruling' for the purposes of Part IVAAA of the ***Taxation Administration Act 1953*** *and are legally binding on the Commissioner.*

1. No. Accounting liabilities for unearned premiums are not adjusted under either subsection 705-75(1) or subsection 705-80(1) of the *Income Tax Assessment Act 1997* (ITAA 1997) for the purposes of step 2 in working out the allocable cost amount (ACA) for a general insurance company.

2. The step 2 amount of the ACA is worked out under subsection 705-70(1) of the ITAA 1997 by:

> … adding up the amounts of each thing (an ***accounting liability***) that, in accordance with accounting standards, or statements of accounting concepts made by the Australian Accounting Standards Board, is a liability of the joining entity at the joining time that can or must be recognised in the entity's statement of financial position.

3. In accordance with paragraph 4.2.1 of Australian Accounting Standards Board 1023 (AASB 1023) 'Financial Reporting of General Insurance Activities':

> Premium revenue is to be recognised in the financial report only when it has been earned.

In addition, paragraph 4.2 states that premium revenue:

> …must be recognised in accordance with the pattern of the incidence of risk or, where the result will not be materially different, evenly over the period of the policy (for direct insurance) or period of indemnity (for reinsurance).

4. As a consequence, unearned premiums represent a proportion of gross premiums that will be recognised as being earned in a subsequent accounting period. Consistent with the requirements of Statement of Accounting Concepts 4 (SAC 4) 'Definition and Recognition of the Elements of Financial Statements', with respect to the recognition of revenues, paragraph 114 states:

> Revenues arise once control over the future economic benefits has been achieved, provided that there has not been an equivalent increase in liabilities.

5. In a general insurance context, unearned premiums represent a liability in the form of an obligation to provide insurance cover over a future period of risk.

6. Therefore, in accordance with the requirements of paragraph 4.2.1 of AASB 1023 and SAC 4 (see paragraphs 3 and 4 above), unearned premiums represent an accounting liability of the joining entity at the joining time that can or must be recognised in the entity's statement of financial position for the purposes of step 2 in working out ACA (see subsection 705-70(1) of the ITAA 1997). Hence, consideration must be given to whether subsections 705-75(1) and 705-80(1) of the ITAA 1997 apply.

Application of subsection 705-75(1) of the ITAA 1997

7. The Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002 states at paragraph 5.70 that:

> If some or all of a liability will be a deduction to the head company when the liability is discharged, the amount of the liability to be taken into account is reduced by the amount that will be a deduction multiplied by the general company tax rate. This is so that only the net cost to the group of the liability is taken into account as a cost of acquiring the entity.

The need for a reduction under subsection 705-75(1) of the ITAA 1997 depends, therefore, upon whether some or all of the accounting liability for unearned premiums will be a deduction to the head company when the liability is discharged.

8. Consistent with AASB 1023, the accounting value of unearned premiums represents the proportion of gross premiums received that has not yet been 'earned' and which, in accordance with the pattern of the incidence of risk, relates to a future financial period within the period of insurance.

9. From an income tax perspective, gross premiums in respect of general insurance policies are included in assessable income in the income year in which they are received or receivable (see section 321-45 of Schedule 2J of the *Income Tax Assessment Act 1936* (ITAA 1936)). However, where part of the gross premiums received or receivable relates to risk exposure of subsequent years an amount, determined in accordance with section 321-60 of Schedule 2J of the ITAA 1936, is allocated to the 'unearned premiums reserve' (UPR) and the taxation of that part of the gross premiums is deferred. The UPR is brought to account in the calculation of a general insurance company's assessable income by a process of comparing the value of the UPR at the end of the income year with the value at the end of the previous year of income, whereby:

> ***increases*** in the value of the UPR over the income year are allowed as a deduction. This ensures that net premiums that relate to exposure in subsequent years are appropriately deferred; and
>
> ***decreases*** in the value of the UPR over the income year are included in assessable income. This ensures that net premiums that relate to risk exposure in the current year are included in assessable income.

10. The nature of the UPR and the mechanism contained in Division 321 of Schedule 2J of the ITAA 1936 are such that an existing UPR balance at the joining time would have previously been allowed as a deduction to the general insurance subsidiary member prior to the joining time. A deduction to the head company in a subsequent income year only arises where there is an increase in the value of the UPR. Such an increase will be directly associated with the recognition of a new liability and obligation, in the form of unearned premiums, to provide insurance cover for an unexpired period of risk and does not relate to the amount of unearned premiums in existence at the joining time.

11. Unearned premiums in existence at the joining time will not result in a future deduction to the head company for the purposes of subsection 705-75(1) of the ITAA 1997. Moreover, the existence of a liability for unearned premiums will result in the inclusion of assessable income in the future for the head company.

12. Therefore, an accounting liability for unearned premiums does not require an adjustment under subsection 705-75(1) of the ITAA 1997.

Application of subsection 705-80(1) of the ITAA 1997

13. Subsection 705-80(1) of the ITAA 1997 applies if:

(a) for income tax purposes, an accounting liability,… is taken into account at a later time than is the case in accordance with accounting standards or statements of accounting concepts…; and

(b) assuming that, for income tax purposes the accounting liability or change were taken into account at the same time as is the case in accordance with those standards or statements, the joined group's allocable cost amount would be different; …

14. As explained in paragraph 9, for income tax purposes, the UPR is brought to account at year end through a process of comparing the value of the UPR at the end of the income year with its value at the end of the previous income year. Similarly, from an accounting perspective, the value of unearned premiums is brought to account for year end financial reporting purposes, thus giving effect to the requirement in AASB 1023 to recognise premium revenue only when it is earned.

15. The application of subsection 705-80(1) is premised on the condition that for income tax purposes, an accounting liability is taken into account at a later time than is the case in accordance with accounting standards. As the liability for unearned premiums is taken into account at the same time for income tax purposes as for AASB 1023, it necessarily follows that the first limb of subsection 705-80(1) of the ITAA 1997 will not be satisfied.

16. The method for determining the value of the UPR and the fact that certain costs and expenses relating to gross premiums are an allowable deduction when they are incurred (in the income year in which the premiums are received), results in the same outcome for income tax purposes as that achieved through the application of AASB 1023.

17. Therefore, an accounting liability for unearned premiums does not require an adjustment under subsection 705-80(1) of the ITAA 1997.

Date of Effect

18. This Determination applies to years commencing both before and after its date of issue. However, it does not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Determination (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

Commissioner of Taxation
15 December 2004

Previous draft:

TD 2004/D43

Related Rulings/Determinations:

TR 92/20

Subject references:

- accounting liabilities
- consolidation
- consolidation – liabilities
- general insurance
- unearned premium reserve
- unearned premiums

Legislative references:

- TAA 1953 Pt IVAAA
- ITAA 1936 Sch 2J Div 321
- ITAA 1936 Sch 2J 321-45
- ITAA 1936 Sch 2J 321-60
- ITAA 1997 705-70(1)
- ITAA 1997 705-75(1)
- ITAA 1997 705-80(1)

Other references:

- Australian Accounting Standards Board 1023 – Financial Reporting of General Insurance Activities (1996)
- Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No.1) 2002
- Statement of Accounting Concepts 4 – Definition and Recognition of the Elements of Financial Statements (1995)

ATO references
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