TD 2004/78 - Income tax: consolidation: general insurance: do subsections 705-75(1) and 705-80(1) of the Income Tax Assessment Act 1997 apply to any part of an accounting liability for outstanding claims for the purposes of working out step 2 of the allocable cost amount for a joining entity that is a general insurance company?

This cover sheet is provided for information only. It does not form part of *TD 2004/78 - Income tax: consolidation: general insurance: do subsections 705-75(1) and 705-80(1) of the Income Tax Assessment Act 1997 apply to any part of an accounting liability for outstanding claims for the purposes of working out step 2 of the allocable cost amount for a joining entity that is a general insurance company?*

This document has changed over time. This is a consolidated version of the ruling which was published on *23 March 2011*

Taxation Determination

Income tax: consolidation: general insurance: do subsections 705-75(1) and 705-80(1) of the *Income Tax Assessment Act 1997* apply to any part of an accounting liability for outstanding claims for the purposes of working out step 2 of 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.*

*[**Note:** This is a consolidated version of this document. Refer to the ATO Legal Database (http://law.ato.gov.au) to check its currency and to view the details of all changes.]*

1. Yes. For the purposes of working out step 2 of the allocable cost amount (ACA), subsections 705-75(1) and 705-80(1) of the *Income Tax Assessment Act 1997* (ITAA 1997)[1] apply to that component of an accounting liability for outstanding claims that represents indirect claims settlement costs.

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

> … adding up the amounts of each thing (an ***accounting liability***) that, in accordance with the joining entity's *accounting principles for tax cost setting, is a liability of the joining entity at the joining time.

3. An entity carrying on general insurance business activities, including general reinsurance, must report its liability in respect of its outstanding claims in accordance with paragraph 5.1 of Australian Accounting Standards Board 1023 (AASB 1023) 'General Insurance Contracts'. Paragraph 5.1 reads:

> An outstanding claims liability shall be recognised in respect of direct business and reinsurance business and shall be measured as a central estimate of the present value of the expected future payments for claims incurred with an additional risk margin to allow for the inherent uncertainty in the central estimate.

[1] All legislative references are to the ITAA 1997 unless otherwise indicated.

4. As a liability for outstanding claims is recognised in the entity's financial statements at the joining time, it must be included in working out step 2 of the ACA under subsection 705-70(1). Consideration must then be given to whether subsections 705-75(1) and 705-80(1) apply to any part of the liability for outstanding claims.

Application of subsection 705-75(1)

5. 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. [emphasis added]

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

6. Consistent with AASB 1023, the accounting liability for outstanding claims is to be measured as the present value of expected future payments, which must include indirect claims handling costs. In accordance with paragraph 5.2.3:

> Indirect handling costs incurred during the reporting period are also expenses of an insurer, and include a portion of the indirect claims handling costs to be paid in the future, being that portion which relates to handling claims incurred during the reporting period. The outstanding claims liability includes these unpaid indirect claims handling costs.

7. For income tax purposes, the liability for outstanding claims is adjusted in accordance with section 321-20. The value arrived at under that section is the 'outstanding claims liability' (OCL). The value of OCL is worked out as follows:

> **Step 1**
>
> Add up the amounts that, at the end of an income year, the company determines, based on proper and reasonable estimates, to be appropriate to set aside and invest in order to meet:
>
> (a) liabilities for outstanding claims under those policies; and
>
> (b) direct settlement costs associated with those outstanding claims.
>
> **Step 2**
>
> Reduce the step 1 amount by so much of it as the company expects at the end of the income year to recover:
>
> (a) under a contract of insurance; or
>
> (b) in any other way.
>
> other than under a contract of reinsurance to which subsection 148(1) of the *Income Tax Assessment Act 1936* (about reinsurance with non-residents) applies.

8. The key difference between the tax and accounting value of the OCL (as far as is relevant for this taxation determination) is in the treatment of unpaid indirect claims settlement costs (synonymous with the term 'indirect claims handling costs'). The accounting value of the liability for outstanding claims (and therefore the step 2 amount of the ACA) is determined as the present value of all expected future payments, including all direct and indirect costs that the insurer expects to incur in settling the claims. In contrast, the value of the OCL for income tax purposes excludes indirect claims settlement costs.

9. The rationale for the different taxation treatment of indirect claims settlement costs is provided in the Explanatory Memorandum to the Taxation Laws Amendment Bill (No. 3) 2002. It is considered that indirect settlement costs do not attach to individual claims and so should not be taken into account in determining the value of OCL (see paragraph 4.28). Consequently, such costs will be deductible under section 8-1 when they are incurred.

10. The OCL is brought to account in the calculation of a general insurance company's assessable income through a process of comparing the value of the OCL at the end of the income year with its value at the end of the previous income year, with any:

- ***increases*** in the value of the OCL over the income year allowed as a deduction under section 321-15; and
- ***decreases*** in the value of the OCL over the income year included in assessable income under section 321-10.

11. The nature of the OCL and the mechanisms contained in Division 321 are such that an existing liability for outstanding claims balance for accounting purposes at the joining time (excluding the amount representing indirect claims settlement costs – see paragraph 8) would have previously been allowed as a deduction to the joining entity before the joining time. The effect of this deduction would be reflected in another step of the ACA, albeit through a lower step 3 amount, a higher step 5 amount or a higher step 6 amount.

12. Accordingly, when subsection 705-75(1) is considered in the context of a general insurance company, because the OCL (excluding indirect claims settlement costs) is allowed as a deduction before the joining time, the subsection does not apply.

13. However, as explained in paragraph 8, the position is different for that part of the OCL representing indirect claims settlement costs. The indirect claims settlement costs will be deductible to the head company when these costs are later incurred for income tax purposes. Accordingly, subsection 705-75(1) will apply to reduce the amount of the accounting liability for outstanding claims taken into account in working out step 2 of the ACA in relation to that part of the liability that represents indirect claims settlement costs.

Application of subsection 705-80(1)

14. Subsection 705-80(1) 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 the joining entity's *accounting principles for tax cost setting …; 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; …

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.

16. As explained in paragraph 8, from an accounting perspective, the value of the liability for outstanding claims is determined by reference to all expected future payments, including direct and indirect costs expected to be incurred in settling the claims. However, for income tax purposes the value of the OCL does not include indirect claims settlement costs. Such costs are deductible under section 8-1 when they are incurred. Therefore, the component of the accounting liability that represents indirect claims settlement costs is, for income tax purposes, taken into account at a later time than is the case in accordance with AASB 1023.

17. Accordingly, for the purposes of working out the step 2 amount of the ACA, subsection 705-80(1) will apply to the extent that the accounting liability for outstanding claims represents indirect claims settlement costs.

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/D55

Related Rulings/Determinations:

TR 92/20

Subject references:

- accounting liabilities
- consolidation
- consolidation – liabilities
- general insurance
- joining entity's accounting principles for tax cost setting
- liability for outstanding claims
- outstanding claims liability

Legislative references:

- TAA 1953 Pt IVAAA
- ITAA 1997
- ITAA 1997 8-1
- ITAA 1997 Div 321
- ITAA 1997 321-10
- ITAA 1997 321-15
- ITAA 1997 321-20
- ITAA 1997 705-70(1)
- ITAA 1997 705-75(1)
- ITAA 1997 705-80(1)

Other references:

- Australian Accounting Standards Board 1023 – General Insurance Contracts
- Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002
- Explanatory Memorandum to the Taxation Laws Amendment Bill (No. 3) 2002

ATO references
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