

TR 95/5 - Income tax: basis of assessment of reinsurance activities

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Taxation Ruling

Income tax: basis of assessment of reinsurance activities

other Rulings on this topic

IT 2613; IT 2663

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*This Ruling, to the extent that it is capable of being a 'public ruling' in terms of Part IVAAA of the **Taxation Administration Act 1953**, is a public ruling for the purposes of that Part. Taxation Ruling TR 92/1 explains when a Ruling is a public ruling and how it is binding on the Commissioner.*

What this Ruling is about

Class of person/arrangement

1. This Ruling applies to the activities of a company engaged in arrangements known as reinsurance. Generally speaking, reinsurance is the insuring of the risks undertaken by a direct insurer. It is a form of insurance and many of the principles applying to the conduct of insurance business apply to reinsurance.

Summary of this Ruling

2. This Ruling deals with:
 - (a) the assessability under subsection 25(1) of the *Income Tax Assessment Act 1936* (the Act) of premium income derived by a reinsurer (i.e., a taxpayer who carries on a business of reinsurance); and
 - (b) the deductibility under subsection 51(1) of the Act of a reinsurer's outstanding claims provision.
3. Arrangements which constitute financial reinsurance arrangements will be the subject of a separate Ruling.
4. This Ruling should be read in conjunction with Taxation Ruling IT 2663 which deals with the taxation of general insurance activities. The extent to which IT 2663 applies to reinsurance activities is set out below.
5. This Ruling extends to general reinsurance activities conducted by a 'life reinsurer' to the extent to which the life reinsurer's

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

6. The extent to which this Ruling applies to a life reinsurer where the life reinsurer's contractual terms and conditions do not accord with those entered into by a general reinsurer depends on the facts of each particular case. The requirement to renew annually (a life reinsurance arrangement) raises different considerations from those in this Ruling in determining the extent to which premium income is derived and assessable in an income year.

Ruling

Application of IT 2663

7. Subject to specific items dealt with in this Ruling, the principles outlined in IT 2663 are equally applicable to reinsurance activities as if references to insurers included reinsurers and IT 2663 is to be read in conjunction with this Ruling.

Apportionment of (net) premium income

8. A portion of the premium income of a reinsurer is unearned at the end of a year of income in the sense that it relates to the reinsurer's risk exposure in a later year. Premium income needs to be apportioned for income tax purposes into the income years in which it is derived.

- **(Note:** It is the net premium income of the year that needs to be apportioned (see paragraphs 12 to 19 of IT 2663). Net premium income may be defined as gross premium less acquisition costs, treaty proportional and facultative retrocession premiums. Non-proportional treaty retrocession premiums are not deducted from gross premium income. In accordance with IT 2663, the amount of unearned premium income otherwise calculated is to be reduced by the unexpired portion of non-proportional treaty retrocession premium existing at the end of the year (refer to paragraphs 94 to 97 of IT 2663)).

9. If the cover period of a reinsurance contract extends beyond the end of a year of income:

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

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

10. The premium income of a year is assessable in a year to the extent to which it is derived in that year. To the extent to which 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).

11. If the risk reinsured against is evenly spread over time, the basis on which a reinsurer consistently calculates (from year to year) its 'unearned premium provision' (UPP) for accounting purposes is to be adopted for income tax purposes. We believe the most appropriate basis that reinsurers should adopt to apportion premium income of a year for tax purposes is the '365th's' or 'daily' basis. However, it is recognised that the '365th's' basis may be less appropriate than other methods for proportional treaty reinsurance as the reinsurer receives premium in bulk, usually on a quarterly basis.

12. Where:

- (a) the risk reinsured against is not evenly spread over time; or
- (b) a reinsurer consistently adopts a basis for calculating its UPP for accounting purposes which is different from the '365th's' or 'daily' basis;

the reinsurer should adopt a method of apportionment to produce an allocation of premium income of a year according to risk exposure.

13. Where it can be demonstrated that the '365th's' or 'daily' basis is inappropriate and a soundly based method of apportionment has been consistently used from year to year, such as the '8th's' method, that method may be used for income tax purposes, provided that it is based on the pattern of risk to which the reinsurer is exposed in the income years concerned.

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

Unclosed business

15. An amount which a reinsurer estimates in each year of income, that it will receive in a later year as premiums in respect of its year end unclosed business, is derived by the reinsurer. Subsection 25(1) requires that the estimated amount that has been earned is to be included in the reinsurer's assessable income of the year that has just ended.

Proportional treaty reinsurance

16. Premiums from unclosed business are included in assessable income because the reinsurer is on risk and therefore it has derived part of those premiums. The amount included in assessable income is the amount that is reasonably capable of estimation by the reinsurer.

17. Proportional treaty premiums are to be brought to account as income in the period in which it becomes due and receivable. Where a reinsurer has not been notified of premium income ceded to it at the time of finalising its accounts, it must include an estimate of premium income which it anticipates has become due.

Facultative reinsurance

18. A reinsurer derives premium income from facultative reinsurance arrangements entered into during the year of income even though the business may not have been closed at the end of the year of income.

19. In relation to premium income from unclosed business, the principles discussed in paragraphs 54 to 61 of IT 2663 are applicable to facultative business of reinsurers.

Non-proportional treaty reinsurance

20. In respect of non-proportional treaty reinsurance arrangements there is generally no unclosed business and therefore no amount in respect of unclosed business is required to be included in a reinsurer's assessable income of the year. This is because the treaty is generally negotiated prior to the commencement of a year of income for taxation purposes.

Premium income: adjustment premiums

21. Where reinsurance premiums are subject to adjustment on the basis of premiums written or loss experience of the reinsured, those adjustment premiums are to be included in the reinsurer's assessable

income. Where documentation is received to support an adjustment premium, that amount is to be included in the reinsurer's assessable income. Where documentation is not received to support an adjustment premium a reasonable estimate of that premium should be included in the reinsurer's assessable income.

22. Such adjustment premiums are derived by a reinsurer when the particular event (level of premiums or loss experience of the reinsured) occurs that gives rise to their entitlement. Such adjustment premiums form part of a reinsurer's assessable income under subsection 25(1) in that year.

Acquisition costs

23. Acquisition costs incurred by a reinsurer in obtaining and recording reinsurance arrangements are allowable income tax deductions under subsection 51(1). The types of acquisition costs which are deductible for income tax purposes are explained in paragraphs 66 to 75 of IT 2663.

24. All acquisition costs that are incurred by a reinsurer in obtaining and recording reinsurance contracts need to be offset against gross premiums before those premiums are to be apportioned in the manner explained in paragraphs 37 to 44.

25. Acquisition costs are to be afforded the same treatment as contained in IT 2663 at paragraphs 63 to 75 which outlines which acquisition costs are deductible, the year in which the acquisition costs are deductible and which acquisition costs reduce gross premiums in calculating unearned premiums.

Outstanding claims

26. The case of *Commercial Union Assurance Co of Australia Ltd v. FC of T* 77 ATC 4186; (1977) 7 ATR 435, establishes the principle that the cost to an insurer of the earned premiums in any year is the amount of all claims arising out of the insurances in respect of which those premiums were earned, plus administration and like expenses incurred in that year of income. The case also considered that the costs to the insurer include an appropriate amount or provision, arrived at by reasonable estimate, in respect of claims outstanding at the end of the year. We accept, that for the purposes of subsection 51(1) an estimation of the amount of the claims provision is therefore appropriate provided that the expense has been incurred.

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Margin for prudence

27. A reinsurer may incorporate a margin for prudence in calculating its claims reserves, providing the guidelines in paragraphs 132 to 135 of IT 2663 are followed.

28. As with general insurers, it will only be acceptable for taxation purposes for a reinsurer to adopt a margin for prudence where:

- (a) the decision reflects the reinsurer's experience in the industry and is based on sound commercial or business principles; and
- (b) the reasons for the reinsurer's decision are well documented.

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

Date of effect

30. This Ruling provides guidelines for the calculation of a reinsurer's taxation liability. Because we have accepted or approved (at least in some Branch Offices) different methods for the calculation of a reinsurer's tax liability, the guidelines contained in this Ruling are to be applied to the first income year commencing on 1 July 1995 (or equivalent substituted accounting period) and all subsequent years. A reinsurer may request that the Ruling apply to an earlier year. In those circumstances assessments for earlier years may be amended to apply this Ruling, in full, on request to the extent permitted by section 170.

31. The decision in *Country Magazine Pty Limited v. FC of T* (1968) 117 CLR 162; 15 ATD 86 (the *Country Magazine* case) is relevant to assessments of a reinsurer which give effect to this Ruling. The decision in the *Country Magazine* case means that in calculating the taxable income of a reinsurer 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).

32. 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 reinsurers for all income years commencing with the 1995-96 income year.

Explanations

Background: reinsurance

33. Generally speaking, reinsurance is the insuring of the risks undertaken by an insurer. Reinsurance is a form of insurance and many of the principles and practices applying to the conduct of insurance business apply equally to reinsurance.

'A contract of reinsurance is a contract by which an insurer obtains insurance against loss or liability arising under its primary contract of insurance. Reinsurance of liability under a contract of reinsurance ("retrocession") is also possible.'

(David Kelly and Michael Ball, *Principles of Insurance Law in Australia and New Zealand*, Butterworths, 1991, page 15.)

34. A contract of reinsurance has also been described as an independent contract of insurance. (Barker J in *Farmers Mutual Insurance Ltd v. QBE Insurance International Ltd*; *American International Underwriters Ltd v. Farmers Mutual Insurance Ltd* (1993) 7 ANZ Insurance Cases at 61:185.)

35. A reinsurance contract is a contract of indemnity. Under a contract of reinsurance one party known as the reinsurer, promises to indemnify the other party, known as the reinsured, for any financial losses sustained by the reinsured as a result of the occurrence of an uncertain event originally insured by the reinsured in its business of insurance. In return for this indemnity, the reinsured agrees to pay the reinsurer an amount known as a premium. Reinsurance contracts, therefore, are concerned with providing for the reinsurance of risks under contracts of insurance.

36. A reinsurer indemnifies an insurance company under a contract of reinsurance against risk(s) originally assumed by the insurance company under a contract of insurance. A reinsurance contract provides that the reinsurer will indemnify a portion of the risk in specific proportions to the amount of risk originally assumed or alternatively they may provide for protection over and above a specified amount or ratio of claims. Reinsurance involves the transfer of insurance risk from an insurer to a reinsurer and this transfer exposes a reinsurer to the possibility of incurring a loss under a reinsurance contract as it relates to the risk assumed by the reinsurer.

Apportionment of (net) premium income

37. Premiums received by a reinsurer commonly cover a 12 month period. In certain instances the period of the reinsurance contract and the reinsurer's year of income for tax purposes do not correspond. At the end of the income year, some portion of the premiums will 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'.

- **(Note:** It is the net premium income (i.e., gross premium after deducting allowable acquisition costs and retrocession premiums) of the year that needs to be apportioned (refer to paragraphs 12 to 19 of IT 2663)).

38. If the period of a reinsurance contract extends past the end of a year of income and, at year end, the reinsurer's liability under the policy has been discharged, no unexpired risk exists in relation to the reinsurance contract. The reinsurer is not at risk during the later year. In these circumstances, it is not appropriate that any portion of the premium paid on the reinsurance contract is deferred to the later year. No part of the premium paid under the reinsurance contract constitutes 'unearned premium income' for income tax purposes. This situation would occur under a catastrophe reinsurance contract which does not allow for automatic reinstatement of the policy in the event of the losses being in excess of the cover provided. **For example**, where there is an excess of loss contract for \$10M in excess of \$10M and the reinsured incurs a claim of \$30M, the reinsurer is only liable to pay the reinsured \$10M and its liability under that particular reinsurance contract is discharged. As the reinsurer has become liable to pay \$10M in the year of income, no part of the premium in relation to the reinsurance contract may be deferred to the later year as the reinsurer is no longer exposed to any risk in that later year.

39. A premium received by a reinsurer may relate in part to the cover of risk in the income year in which it is received and in part to cover risk in a later income year. Some portion of a reinsurer's premium income of a year is derived in the current year (the amount that relates to the risk coverage of that year) and some portion of the premium income should be treated as being derived in a later income year to the extent that it applies to risks of that later year.

40. The decision in *Arthur Murray (NSW) Pty Ltd v. FC of T* (1965) 114 CLR 314; (1965) 14 ATD 98 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 that later year. The decision in *RACV Insurance Pty Ltd v. FC of T* 74 ATC 4169; (1974) 4 ATR 610 mentioned this issue but because the Commissioner and the taxpayer settled this issue before

the case came to court the judge did not see it as an issue for him to offer any comment. The cases did not deal with the question of how to calculate the amount of income that is derived in a later year.

41. 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 (Cardens Case)* (1938) 63 CLR 108 at 154.

42. In the case of a reinsurer, we accept that the most appropriate method to estimate unearned premium income is to apportion the reinsurer's net premium income of the year based on the extent to which the risk covered by the reinsurance contract to which that premium relates is covered in each year of income concerned.

43. In the case of facultative and non-proportional treaty business, we consider that, where the risk exposure under the reinsurance contract is evenly spread over time, the '365ths' or 'daily' method is the most appropriate method to apportion premium income.

44. In the case of proportional treaty business, where details of the earnings patterns of policies closed to a treaty are not provided to the reinsurer, it is accepted that some other soundly based method of apportionment, such as the '8th's' method, may be used for income tax purposes, provided that:

- it produces a result which fairly accurately reflects the extent to which the reinsurer is exposed to risk in the income years concerned; and
- it has been used consistently from year to year for accounting and tax purposes.

Unclosed business

Proportional treaty reinsurance

45. Proportional treaty reinsurance describes all forms of reinsurance in which the reinsurer and the reinsured share an agreed portion of the actual premiums and claims of the reinsured.

46. The general principle in proportional treaty reinsurance contracts is that the reinsurer follows the fortunes of the reinsured. The 'follow the fortunes' clause in proportional reinsurance contracts expresses the intention to set up a relationship where the reinsurer shares whatever fortune, good or bad, befalls the reinsured. Consequently, the

principles established in IT 2663 for unclosed business are equally applicable to proportional treaty reinsurance business of reinsurers.

47. In proportional treaty arrangements the liability of the reinsurer commences simultaneously with that of the reinsured.

48. Unclosed business may arise when the reinsured is on risk at year end but has not paid the reinsurance premium in relation to that risk to the reinsurer until after year end.

49. In proportional treaty reinsurance arrangements we understand that it is industry practice for the reinsured to provide the reinsurance company with quarterly statements in arrears. These statements advise the reinsurer of how much premium it is entitled to receive under the reinsurance arrangement for the preceding quarter. **For example**, if the reinsured derived \$2M in premium for a quarter and the reinsurance proportional treaty arrangement was to reinsure 20% of the reinsured's risks the reinsurer would be entitled to \$0.4M for that quarter under the reinsurance arrangement.

50. The proportional treaty reinsurance contract stipulates that accounts be rendered by the reinsured within a fixed period after the close of each quarter, normally one to three months.

51. To the extent that some statements are not received by the reinsurer until after they have closed their accounts, the reinsurer must estimate at the end of an income year the amount of premium income it will ultimately receive in respect of the reinsurer's risk exposure in that year. It is that amount that has been derived by the reinsurer that represents its unclosed business and is to be included in the reinsurer's assessable income. The delay in notification does not alter the fact that the premiums have been derived in the year of income as the reinsurer is on risk in respect of those premiums.

52. The following is an example of how a reinsurer should account for its unclosed business for a proportional reinsurance arrangement:

X insurance company enters into a proportional reinsurance arrangement with Y reinsurance company for the twelve months from 1 January 1993 to 31 December 1993. Y's taxation year of income ends on 30 June. X is to pay premiums to Y on a quarterly basis on 31/3/93, 30/6/93, 30/9/93 and 31/12/93. X issues Y with a statement and pays the premium owing to Y one month after the close of each quarter. Y would have to leave its books open or take up an estimate of premium it will receive from X on 31/7/93 for the quarter ended 30/6/93. This amount is Y's unclosed business and is to be included in Y's assessable income for the year ended 30/6/93.

53. It is also to be noted that Australian reinsurers are required by the Insurance and Superannuation Commission for statutory reporting

purposes, in order to determine solvency requirements, to bring estimated premiums in respect of unclosed business to account as income of the year. Similar requirements, in order to present a correct picture of the financial position of the reinsurer, exist for accounting purposes (see Accounting Standards Review Board Statement ASRB 1023 - Financial Reporting of General Insurance Activities).

Facultative reinsurance

54. Facultative reinsurance is the reinsurance of individual risks wherein a reinsurer has the ability to accept or reject each risk offered by an insurer.

55. In practice a reinsurer may agree to hold the reinsured covered, for a period of time, under a facultative reinsurance arrangement without formal renewal of the policy. Where this 'held covered' facility exists, it may also give rise to unclosed business.

56. In cases of facultative reinsurance, a reinsurer may accept an offer to reinsure a direct insurer before the end of the year of income but the direct insurer may not have forwarded any confirmation or premium until the subsequent year of income. In this circumstance the reinsurer is at risk from the date of acceptance of the business. This would give rise to unclosed business of the reinsurer.

57. In some cases, the insurer may delay obtaining reinsurance and may request the reinsurer to take up the risks from the date that the direct insurer was at risk, i.e., to back-date the reinsurance.

A reinsurer may agree to accept a back-dated reinsurance on the basis that the reinsured provides the reinsurer with a warrant of 'no known claims'. In these circumstances the reinsurer is still at risk under the reinsurance agreement from the date that the reinsured is on risk. However, premium income in this circumstance is derived by the reinsurer in the year in which the risk is accepted, rather than at the time of the inception of the risk. This is because the reinsurer only becomes liable to indemnify the reinsured at the time the risk is accepted.

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

Non-proportional treaty reinsurance

59. Non-proportional treaty reinsurance generally applies to a specified branch of a reinsured's business and it ranges over the whole

of that business without particular reference to any separate policies which make up that business. It is however possible to have facultative excess of loss insurance. Non-proportional treaty reinsurance generally applies only to claims that exceed a specified amount or percentage and the reinsurer's liability is limited to a particular period for losses above that particular amount or percentage specified in the contract. Non-proportional treaty reinsurance effectively protects the reinsured from losses over a specified amount or percentage and limits the reinsurer's risk to a higher level or specified amount.

60. **For example**, an insurance company may insure motor vehicles of \$50,000 or less in value. In order for the insurer to limit its exposure to risk that a single event may give rise to a large loss, the insurer enters into a reinsurance arrangement that limits its exposure to \$1 million for any one loss. The reinsurance arrangement may be for \$5 million in excess of \$1 million. Thus, if 60 cars insured by the insurer for \$50,000 each were damaged in a hailstorm (total liability of \$3 million) the reinsurer would pay the reinsured the \$2 million that is in excess of the \$1 million. As such, the reinsured has limited its exposure to \$1 million and the reinsurer's exposure is limited to \$5 million.

61. The extent of the reinsurer's liability is different to that of the reinsured, i.e., the reinsurer becomes exposed to claims at a higher level (or rate) of loss. The reinsurer has no liability until the claims exceed that specified level (or rate) of loss. In the above example if only 15 cars were damaged in the hailstorm the reinsurer would have no liability as the loss would not have exceeded the \$1 million specified limit. The reinsurer is liable for losses resulting from extraordinary events, which occur less frequently but may be potentially very large (e.g., a hailstorm).

62. Under a non-proportional treaty reinsurance arrangement, a reinsurer is only liable to indemnify the reinsured for events that occurred during the reinsurance year.

63. It is our understanding that it is industry practice for non-proportional treaty contracts to be generally entered into on a calendar or financial year basis. Negotiations in relation to the contracts commence well before the commencement of the contract and as such the level of premiums will be set well before the commencement of the contract. As the terms and conditions of the contracts will be known before the commencement of the contract there should not be any unclosed business for non-proportional treaty reinsurance arrangements.

Adjustment premiums

64. No insurance portfolio is static and consequently, the risks accepted by a direct insurer may alter considerably over time. This variation in risks may also flow through to the reinsurer. Because of this variability of risks, it is industry practice to include methods for adjusting premiums in reinsurance contracts to compensate for fluctuations of risks. Such adjustments are achieved by the payment of additional premiums (called 'adjustment premiums').

65. Adjustment premiums are commonly found in non-proportional treaty reinsurance. In proportional treaty reinsurance arrangements, where the reinsurer is entitled to the proportion of the reinsured's premiums and is also liable to indemnify the reinsured for that proportion of claims made there is no need for adjustment premiums.

66. We understand that the two main methods of incorporating adjustment premiums into non-proportional treaty reinsurance arrangements are:

- (a) an adjustable premium where a fixed premium rate is applied to the reinsured's '**gross net**' premium income (the 'fixed premium' method).
- (b) an adjustable premium by applying to the reinsured's '**gross net**' premium income a rate which is automatically adjusted on the basis of the reinsurance arrangement's loss experience (the 'variable' method).

67. '**Gross net**' premium income is the reinsured's gross premiums less returns, cancellations and premiums paid for other reinsurances which pass to the benefit of the reinsurance arrangement.

68. Under the fixed premium method the reinsured pays a deposit premium (which is normally a minimum deposit premium). At the end of the year the final premium is calculated by applying a specified rate to the reinsured's '**gross net**' premium income for the year. If the amount so calculated is greater than the minimum deposit premium the reinsured is required to pay an adjustment premium to the reinsurer. Where the deposit premium is not a minimum and the premium calculated at the end of the year is less than the deposit premium, the reinsured may be entitled to a refund of the difference (see paragraph 71 below for an example of such an arrangement). Where this system is used on an instalment basis, an adjustment account is normally rendered after the year end.

69. The variable method may be based on a minimum deposit premium which is paid quarterly. The reinsurer is always entitled to the minimum deposit premium and any adjustment to the premium would only be to increase it above the minimum deposit premium.

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Thus, from the outset of the treaty the reinsurer knows the minimum premium that will be derived under the treaty.

70. As the adjustment premium is calculated on the basis of premiums written (risks insured) by the reinsured during the period of the reinsurance agreement, the adjustment premium also relates to the period of the reinsurance agreement. Where the reinsurer becomes aware of an entitlement to an adjustment premium in the year of income, it will have derived that premium in the year of income in which it became aware of its entitlement to that adjustment premium.

71. The following is an example of a fixed premium clause:

The reinsured shall pay a deposit premium of \$50,000 in two equal half yearly instalments of \$25,000 in advance at 1 July 1992 and 1 January 1993. As soon as possible after the expiry of this agreement, the above deposit premium shall be adjusted to an amount equal to a rate of 0.275% applied to the reinsured's Gross Net Premium Income (GNP), subject, however to a Minimum Premium of \$40,000.

The following possibilities, as at 30/6/93, occur under this clause:

<i>GNP</i>	<i>x rate</i>	<i>= Premium</i>	<i>Dep Prem</i>	<i>= Adj Premium</i>
(1) \$20M	0.275%	55,000	50,000	5,000
(2) \$15M	0.275%	41,250	50,000	(8,750)
(3) \$10M	0.275%	27,500	50,000	(10,000)

In (1) the reinsured would have to pay the reinsurer an adjustment premium of \$5,000. In (2) the reinsurer would have to refund \$8,750 to the reinsured. In (3) the reinsurer would have to refund \$10,000 only as the premium would not be adjusted below the minimum premium of \$40,000.

72. In this example the reinsurer would include in assessable income any adjustment premium under the arrangement because that amount has been derived by the reinsurer as at the end of the year of income (30/6/93). Some reinsurers may hold their accounts open until they receive information about adjustment premiums from the reinsured. Others will simply estimate the adjustment premiums receivable. Such amount or estimate is to be included in the reinsurer's assessable income under subsection 25(1) in that year. Any adjustment premium paid by the reinsured to the reinsurer would be deductible to the reinsured under subsection 51(1) when the liability to pay the adjustment premium is incurred.

73. We understand that under the variable method the reinsurance premium can be adjusted regularly and gradually to changes in the reinsured's loss experience. This type of method is also known as the 'burning cost' method. The aim of this method is to tie the premium to the underlying trend of losses reinsured. The advantage of this method is that the reinsurer obtains increased premiums when losses are high and the reinsured obtains reduced premiums when losses are low. This method provides an incentive for the reinsured to minimise its losses and hence the reinsurer's losses.

74. Burning cost adjustment is an additional amount that will be paid to the reinsurer where the reinsurer becomes liable for claims, under the reinsurance treaty, on the basis of the experience of the treaty. **For example**, once a claims figure goes over a fixed level in the treaty, for every dollar of the claim over that amount, the reinsured becomes liable to pay to the reinsurer an additional amount of premium. This is designed to ensure that the reinsured keeps control of its claims and that expectations under the treaty are reasonable.

75. The following example may help to clarify this method:

Company A enters into a reinsurance agreement with reinsurer B. Minimum deposit premium is set at \$400,000. It will take 4 years for all claims to be finally settled. The reinsurer's burning cost loading figure is 50%.

<i>Year</i>	<i>Gross Net premium for year 1</i>	<i>Year 1 Claims paid and outstanding to end of year</i>	<i>Percentage claims/premium</i>	<i>Burning Cost</i>
1	\$10M	\$300,000	3%	4.5%
2		\$400,000	4%	6.0%
3		\$500,000	5%	7.5%
4		\$400,000	4%	6.0%

Reinsurance premium for year 1

<i>Year</i>	<i>as calculated at end of year</i>	<i>Adjustment premium</i>
1	\$10M x 4.5% = \$450,000	\$ 50,000
2	\$10M x 6.0% = \$600,000	\$150,000
3	\$10M x 7.5% = \$750,000	\$150,000
4	\$10M x 6.0% = \$600,000	(\$150,000)

76. In this case, if the burning cost adjustment is known at the end of year 1 before the reinsurer closed its books then the \$50,000 adjustment premium is to be included in assessable income of year 1 since it is derived in that year. The adjustment premium relates to outstanding claims expectations for year 1 and consequently the adjustment premium relates to year 1 and is derived by the reinsurer in year 1. The subsequent adjustment premiums should be brought to account for taxation purposes when they are derived as they relate to changes in outstanding claims expectations as a result of information obtained in subsequent years.

77. From the reinsurer's point of view the adjustment premium would have to be brought to account as assessable income of years 1, 2 and 3 respectively as that is the point in time in which the adjustment is made and consequently, that is when the income is derived. In year 4, the reinsurer would be entitled to a deduction under subsection 51(1) as the liability to reimburse the reinsured is incurred in year 4. Similarly, from the reinsured's point of view the adjustment premiums in year 1, 2 and 3 would be deductible as the liability is incurred in those years. In year 4 the reinsured would have to include the refunded adjustment premium in its assessable income of year 4 as the income is derived in year 4.

Acquisition costs

78. It has been submitted, on behalf of reinsurers, that acquisition costs should be limited to brokerage and reinsurance commissions as reinsurers do not incur large amounts in marketing and processing premiums. Although it may be the case in practice that acquisition costs other than brokerage and commissions are not substantial, those costs must nevertheless be included as acquisition costs for taxation purposes. We are of the view that a reinsurer's acquisition costs should include all costs directly incurred by a reinsurer in obtaining and recording reinsurance arrangements.

79. Brokerage is the remuneration paid to a reinsurance broker by a reinsurer for the broker's services in obtaining reinsurance business for the reinsurer.

80. Reinsurance commissions (sometimes referred to as exchange commissions) are commissions paid by the reinsurer to the reinsured as a contribution towards the reinsured's acquisition and other costs. These reinsurance commissions effectively result in the sharing of policy acquisition and management costs between the reinsured and the reinsurer. IT 2663 provides that the direct insurer's acquisition costs are reduced by the amount of such reinsurance commissions on

the basis that the reinsurance commission is a reimbursement of those acquisition costs.

81. It will generally be the case that brokerage and reinsurance commissions will be the only acquisition costs of a reinsurer, however, in proportional treaty arrangements it may be the case that a reinsurer will actively seek participation in a proportional treaty. Any costs incurred in seeking participation in a proportional treaty, such as the preparation of contracts, examinations of proposals and issues relating to the proposals etc, should also be included as acquisition costs.

82. Where a reinsurer retrocedes a share of its reinsurance risks (i.e., where the reinsurer reinsures part of the risk with another reinsurer) and as a result obtains a retrocession commission, such a commission would reduce acquisition costs otherwise deducted from gross premiums for the purposes of calculating the unearned premium of the reinsurer for a year of income. This is on the same basis as outlined in paragraphs 101 and 102 of IT 2663 because the acquisition costs of the first reinsurer are effectively shared with the second reinsurer.

Outstanding claims

83. The case of *Commercial Union Assurance Co of Australia Ltd v. FC of T* 77 ATC 4186; (1977) 7 ATR 435 establishes the principle that a taxpayer who carries on a business of general insurance is entitled to a deduction in respect of the insurer's liability to pay claims where the loss event giving rise to those claims has occurred in the year of income. An insurer is also entitled to a deduction in a year of income for administration and the like expenses incurred in that year of income. This was because commercial reality was that the taxpayer recognised the majority of such claims and did not rely on the notification requirement. However, in those cases where it did so rely no deduction was available under this case. The principle applies to the insurer's liability to pay claims regardless of whether they have been reported to the taxpayer. The principle also acknowledges that the amount of the deduction to be claimed in respect of such claims liabilities will necessarily be an estimate until the outcome of the claim can be known with more certainty. We accept that an estimation of the amount of the claims provision is therefore appropriate provided that the expense has been incurred.

84. The above principle applies equally to the reinsurance business of a reinsurer, although the practical application of it raises particular problems, especially with regard to non-proportional treaty business of the reinsurer because of the nature of the risks reinsured.

85. An estimate of the outstanding claims provision required to meet future claims payments involves predicting future claims payments by

reference to past events using statistical methods or by an experienced appraisal of the particular circumstances of each individual claim.

86. The estimate of the outstanding claims provision required by a reinsurer is often based on the actuarial concept of a 'central estimate'. Expressed in terms of a probability statement, it can be said that there is a fifty percent chance that the amount of claims finally paid will not exceed this central estimate. The concept of the 'central estimate' is acceptable for taxation purposes in the estimating of a reinsurer's outstanding claims.

Margin for prudence

87. The addition to claims reserves to ensure that they will be sufficient to meet claims payments in the normal run of events is commonly referred to as a prudential margin or comfort margin. In paragraph 132 of IT 2663, it is accepted that an insurer is entitled to a deduction for a prudential margin where the decision to include the margin:

- reflects the insurer's experience in the industry and is based on sound commercial principles; and
- the reasons for the decision are properly documented.

88. As mentioned in paragraph 86 above, actuarial methods provide for a 'central' estimate of the amount of a reinsurer's expected final liability to pay outstanding claims. It is for the reinsurer to decide the level of provision above a central estimate which it considers to be appropriate for its business based on its experience and any advice provided by an actuary.

89. We accept that a reinsurer, 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 reinsurer'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.

90. In the case of insurance risks where there is a large quantity of data which can be used to estimate future claims payments and where the pattern of claims is reasonably uniform, the amount of the prudential margin as a percentage of the central estimate is expected to be relatively small. However, in the case of reinsurance of non-proportional treaty business, actual claims experience may deviate greatly from claims estimates due to a number of factors, including:

- the lack of historical data which can be used to predict future claims payments;
- the nature of excess of loss events which, by their very nature, tend to be at the limits of normal experience; and
- the long tail nature of excess of loss business (i.e., where claims in respect of such business are not normally settled within 12 months of the insured event occurring) which means that in addition to other factors, a reinsurer must be able to predict future trends in court awards for damages and future investment income which the reinsurer can expect to earn on its funds prior to settlement.

91. Reinsurance of liabilities under non-proportional treaty arrangements can be based on an accumulation of losses or on individual perils. It has been suggested that these bases make it difficult to calculate the quantum of outstanding claims under either of those bases. As a result, it is suggested that it has often been necessary to establish a claims reserve equal to premiums received less expenses until experience under the arrangement enables the reinsurer to recognise any profit derived from the arrangement. This system has been referred to as 'book to nil'. Other similar methods are also used which provide for a similar result.

92. We do not consider that these methods are appropriate for taxation purposes. In terms of the *RACV Insurance* case, the amounts need to have been incurred and capable of reasonable estimation, which is considered to mean a reasonable estimate of the liability of the insurer under the policy in terms of the insured events which have happened. However 'book to nil' methods do not involve the making of a reasonable estimate on the basis of the available information.

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