# *TR 96/2 - Income tax: taxation implications of arrangements known as financial insurance and financial reinsurance*

This cover sheet is provided for information only. It does not form part of *TR 96/2 - Income tax: taxation implications of arrangements known as financial insurance and financial reinsurance*

This document has changed over time. This is a consolidated version of the ruling which was published on *18 August 1999*

# Taxation Ruling
Income tax: taxation implications of arrangements known as financial insurance and financial reinsurance

contents para

**What this Ruling is about 1**
Class of taxpayers/arrangements 2
**Ruling 6**
What is required for premiums to be deductible for income tax purposes? 6
Significant loss and significant insurance risk 8
Arrangement to be treated as a deposit of funds 9
Application of Part IVA of the ITAA 13
**Date of effect 14**
**Explanations 15**
What is required for premiums to be deductible for income tax purposes? 15
Significant loss and significant insurance risk 18
*Features that may limit the amount of insurance risk transferred 29*
Arrangement to be treated as a deposit of funds 30
Background 31
*Insurance 32*
*Reinsurance 38*
Recent developments 42
Financial reinsurance 45
Alternative views 56
Application of Part IVA of the ITAA 58

*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.*

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

## What this Ruling is about

1. This Ruling sets out the ATO's views on the taxation treatment of payments made under any of the wide range of arrangements commonly known as 'financial insurance' and 'financial reinsurance'.

### Class of taxpayers/arrangements

2. This Ruling applies to a taxpayer who is either engaged in the business of insurance or who is involved in reinsurance activities of insurance business. References in this Ruling to 'financial reinsurance' are equally applicable to 'financial insurance' as if references to reinsurance included insurance. This Ruling does not apply to policies issued by a life insurance company in respect of a class of life insurance business.

3. The Ruling gives guidance as to the circumstances in which insurance and reinsurance arrangements will be acceptable for taxation purposes.

4. A glossary of terms is contained at **Attachment F**.

5. The need for the Ruling arises from the identification by the ATO of a number of arrangements known as 'financial reinsurance' but which, in our view, are solely or predominantly financing arrangements.

# Ruling

### What is required for premiums to be deductible for income tax purposes?

6. A premium paid in respect of reinsurance coverage is deductible only where the contract provides for the transfer of the risk of loss from the occurrence of contingent insured events. The transfer of risk is made through the indemnity to the reinsured in respect of losses which it suffers as a result of it carrying on a business of insurance.

7. Where, however, the arrangement does not transfer the risk of loss to a reinsurer the premiums paid are not deductible as a reinsurance expense of a reinsured.

### Significant loss and significant insurance risk

8. An arrangement will not be accepted as a reinsurance arrangement for taxation purposes where:

(a) it is not possible for the reinsurer to incur a significant loss under the arrangement; **and**

(b) the reinsurer does not assume a significant insurance risk under the arrangement.

### Arrangement to be treated as a deposit of funds

9. Generally speaking the nature of the legal relationship in transactions referred to as financial insurance/reinsurance will be determined having regard to a number of factors including, but not necessarily limited to, the terms of the contractual arrangement entered into and not necessarily to the labels given to the transactions by the parties to it. Where it is considered that a particular arrangement is a financial reinsurance arrangement for taxation purposes it is not accepted that premiums paid constitute allowable income tax deductions. Rather, the payments of 'premiums' under the arrangement will be treated as a deposit of funds with the reinsurer by the reinsured while 'claims' and 'commissions' paid under the arrangement, to the extent that those payments equal 'premium' payments, will be treated as the repayment of funds held by the reinsurer on behalf of the reinsured (see paragraphs 45-55 below for an explanation of financial reinsurance).

10. Where a financial reinsurance arrangement is not accepted as a reinsurance arrangement for taxation purposes, the amounts paid to the reinsurer under the arrangement are not assessable as premium income. Consequently, they are not to be taken into account in

calculating a reinsurer's unearned premium provision or as giving rise to liabilities that form part of the calculation of a reinsurer's outstanding claims provision.

11. Income derived by a reinsurer from the investment of amounts received by the reinsurer from the reinsured is assessable income of a reinsurer under section 6-5 of the *Income Tax Assessment Act 1997* ('the 1997 Act') (formerly subsection 25(1) of the *Income Tax Assessment Act 1936* ('the 1936 Act'). Amounts payable to the reinsured by the reinsurer which represent a return on the amount paid by the reinsured under the arrangement, will be deductible to a reinsurer under section 8-1 of the 1997 Act (formerly subsection 51(1) of the 1936 Act) when the liability to make those payments is incurred and assessable to a reinsured under section 6-5 of the 1997 Act. The taxation treatment of financial reinsurance will follow that of banking and financing arrangements.

12. Amounts paid by a reinsured as financial reinsurance 'premiums' to a reinsurer will not be allowable under section 8-1 of the 1997 Act as deductions to a reinsured. They are not to be taken into account in the calculation of the reinsured's unearned premium provision.

### Application of Part IVA of the 1936 Act

13. The Commissioner may apply Part IVA of the 1936 Act to deny a deduction to an insured for the payment of a premium under arrangements commonly known as 'financial insurance' and 'financial reinsurance'. Part IVA may apply where it can be concluded that, having regard to the available evidence, the dominant purpose of entering into the arrangement was to provide a tax benefit.

## Date of effect

14. This Ruling applies to years commencing both before and after its date of issue. However, the Ruling does not apply to taxpayers to the extent that it conflicts with the terms of a settlement of a dispute agreed to before the date of issue of the Ruling (see paragraphs 21 and 22 of Taxation Ruling TR 92/20). The application of public rulings where a taxpayer has a private ruling is considered at paragraph 19 of Taxation Ruling TR 92/20 and also in Taxation Determination TD 93/34.

# Explanations

### What is required for premiums to be deductible for income tax purposes?

15. The factors for determining whether the payment of premiums under a reinsurance arrangement are deductible are similar to those for determining whether direct insurance premiums are deductible. In a reinsurance arrangement, there must be a transfer of **insurance risk** and the subsequent exposure of the reinsurer to a **significant loss**. A fundamental reason for the existence of insurance and reinsurance is to pass the risk of loss from the insured to an insurer or from the reinsured to the reinsurer.

16. Arrangements that do not involve a transfer of risk of insurance loss (generically referred to as financial insurance/reinsurance) are not accepted as insurance/reinsurance for income tax purposes in the following circumstances:

(a) the insurer/reinsurer does not assume a significant **insurance risk** under the arrangement; **and**

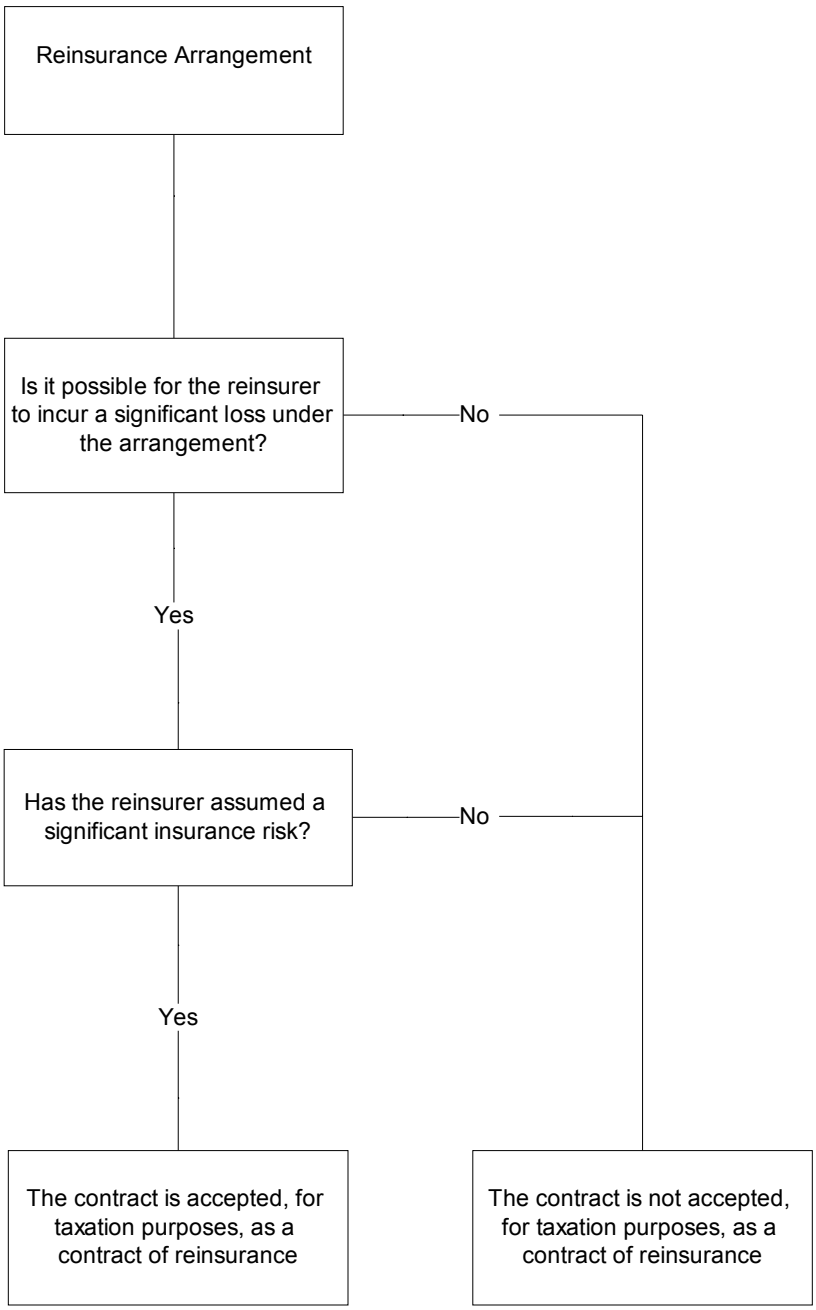
(b) it is not possible for the insurer/reinsurer to incur a **significant loss** under the arrangement.

17. **Insurance risk** can be defined as the risk arising from uncertainties about both:

- the ultimate amount of net cash flows from premiums, commissions, claims and claim settlement expenses paid or incurred under a contract (**underwriting risk**); **and**
- the timing of the receipt or payment of those cash flows (**timing risk**).

### Significant loss and significant insurance risk

18. The acceptance or otherwise for taxation purposes of a reinsurance arrangement can be explained using the flow chart on the following page:


Reinsurance Arrangement
Is it possible for the reinsurer to incur a significant loss under the arrangement?
No
Yes
Has the reinsurer assumed a significant insurance risk?
No
Yes
The contract is accepted, for taxation purposes, as a contract of reinsurance
The contract is not accepted, for taxation purposes, as a contract of reinsurance

19. The determination of whether or not an arrangement, as a whole, exposes the reinsurer to the possibility of incurring a significant loss and that there has been a transfer of a significant amount of insurance risk will depend on an objective assessment of the component parts of the arrangement. Ancillary arrangements, whether written or otherwise, and other relevant factors will also be considered. Ancillary arrangements include arrangements associated with the reinsurance arrangement and need to be included in the assessment of the arrangement as a whole.

20. A contract will not be accepted as a reinsurance contract for taxation purposes if the contract, or other associated contracts or agreements, either directly or indirectly compensate the reinsurer for the reinsurer's losses under the arrangement. Thus, ancillary arrangements need to be examined in conjunction with a purported reinsurance contract to ascertain if a significant amount of insurance risk has been transferred under the arrangement as a whole.

21. The term 'possible' (see paragraphs 16(b) and 18 above) and the phrase 'worst case scenario' (see paragraphs 22 to 24 below) indicate a situation where the chance of the future insured event or events occurring is more than remote but less than likely.

22. It is our view that the evaluation of the possibility of a significant loss is to be based on the present value of all estimated cash flows between the reinsurer and the reinsured under a worst case scenario. This includes cash flows from premiums, commissions, claims adjustable features, etc., regardless of their characterisation in the contract. The reinsurer will need to demonstrate that the present value of estimated cash flows will result in the possibility of a significant loss. The calculation excludes however, third party expenses incurred as a result of the contract. The interest rate used in the present value calculations of each possible outcome tested should be the same.

23. In other words, whether a loss is significant or not will initially be determined by comparing the present value of the payments to be made to the reinsurer by the reinsured with any possible loss to the reinsurer. A loss would arise where the present value of the cash flows from the reinsured would be exceeded by the potential payments under all possible outcomes from the reinsurer to the reinsured. This is to say that a significant loss would arise when the present value of all cash flows under the worst case scenario was negative for the reinsurer.

24. The significance of possible losses under different scenarios should be evaluated by comparing the various calculations of the present value of all cash flows with the present value of the amounts paid or payable to the reinsurer under the contract. If the present

value of the worst case scenario is positive for the reinsurer the arrangement will not have exposed the reinsurer to a significant loss. Consequently, the arrangement will not be treated as a reinsurance arrangement for taxation purposes.

25. If a contract contains termination conditions, the effect of a termination on cash flows between the reinsured and the reinsurer must also be considered when determining if it is reasonably possible for the reinsurer to incur a significant loss under the arrangement.

26. For example, where upon cancellation or expiry of a contract the reinsured is required to reimburse the reinsurer for all losses incurred by the reinsurer under the arrangement, then the reinsurer's exposure to a significant loss would be eliminated. Consequently, the arrangement would fail the first test in paragraph 8 above.

27. In circumstances where the arrangement contractually provides a facility for the reinsured to reimburse the reinsurer where claims exceed premiums and investment income or where claims reduce the reinsurer's return on capital, a contingent liability may be created which may require supporting capital from the reinsured. The effect of this facility needs to be taken into account when considering if it is reasonably possible for the reinsurer to incur a significant loss. In the event of an unexpectedly large claim the facility may result in an actual liability being created which may stand in line with, or even rank ahead of, policyholder claims. It is the potential for the creation of this liability which distinguishes some financing arrangements from reinsurance. In these circumstances where the reinsurer is reimbursed for losses, it cannot be said that it is possible for the reinsurer to incur a significant loss under the arrangement.

28. We are aware of arrangements which attempt to cloak or disguise the existence of financial insurance/reinsurance through the inclusion of some degree of transfer of insurance risk and the creation of a composite arrangement. Where no significant insurance risk has been transferred we consider that the whole arrangement is to be treated as a financial arrangement and not insurance/reinsurance for taxation purposes.

### *Features that may limit the amount of insurance risk transferred*

29. Listed below are some known features that limit the amount of insurance risk transferred to the reinsurer. Each of the features is indicative only, and the list is not intended to be exhaustive. These features may also be present in acceptable reinsurance arrangements and it is for this reason that the arrangement must be considered in its entirety.

- **Experience Account Balance** (EAB). This balance is potentially available to be paid out to the reinsured upon termination. It usually comprises the following:
  - premiums paid.
  - a credit for a portion of the investment income earned by the reinsurer which is added to the premium.
  - claims paid by the reinsurer and the reinsurer's margin which is subtracted from the premium. (Refer to **Attachments D and E** for examples of the operation and effect of an EAB).
- **Cancellation and recapture clauses** (commutation clauses). These clauses operate to return a portion of the EAB if it is positive and to require the reinsured to reimburse the reinsurer if the EAB is negative.
- **Delays in the timely payment** of amounts due under the terms of the contract. If the ultimate timing of payments by the reinsurer is known or the contract provides for other than timely reimbursement of the reinsured (e.g., until the end of the second or third year), then risk has not been transferred. Contractually stipulated payment schedules, accumulating retentions, floating retentions and other adjustable features generally prevent timely reimbursement.
- **Adjustments to premiums** based on the experience of the arrangement. This may occur where, for example, no claims have been made, and consequently, future premiums may be reduced. Conversely, the cover provided may be increased whilst premiums remain stable.
- **Renewal clauses**. These clauses provide for the automatic renewal of the contract if the EAB is in a deficit or if the deficit exceeds a specified amount. In some circumstances coverage may be cancelled and the reinsured is still left with the obligation to pay the remaining premiums.

### Arrangement to be treated as a deposit of funds

30. The transfer of insurance risk in financial reinsurance arrangements, if any, is minimal and the transaction is not in the nature of the reinsurance of insurance risks. Such an arrangement does not indemnify the reinsured. It is considered that financial reinsurance is more akin to a 'banking', 'financing' or 'funding'

arrangement than the historical concept of reinsurance and the transfer of insurance risk. Given that financial reinsurance is more akin to banking or financing arrangements the taxation treatment of financial reinsurance will follow that of banking and financing arrangements. This may also involve the application of Division 16E of the 1936 Act. Specifically, Division 16E may apply to scenario 1 in **Attachments D and E** as the arrangement could be a 'qualifying security' with an 'eligible return'. The arrangements contained in **Attachments D and E** are of the type which would not be treated as insurance arrangements for taxation purposes.

## Background

31. Insurance may be described as a contract of indemnity between a person (the insured) and another (the insurer). Under a contract of insurance the insurer promises that, on the occurrence of an uncertain specified event, the insurer will either indemnify the insured for any loss that the insured may sustain or to pay the insured a certain sum. In return the insured agrees to pay the insurer an ascertainable amount known as the premium (see R L Carter, *Reinsurance*, Kluwer Publishing Limited, 1979, page 3). Insurance enables insurers to spread the potential loss of a few over many. The concept of insurance, as it related to insurance companies, was considered by Menhennitt J in *RACV Insurance Pty Ltd v. FC of T* 74 ATC 4169 at 4176; (1974) 4 ATR 610 at 618:

> 'The essence of insurance business is that, in respect of each class of risk insured against, the insurance company aims to satisfy its liabilities to the policy holders who actually experience the risk primarily out of the total of the premiums paid by all the policy holders, most of whom normally do not experience the risk.'

### *Insurance*

32. The essential elements of insurance or an insurance arrangement are:

- transfer of the risk of loss that may arise from the insured's interest in the subject matter of the insurance to the insurer;
- the exposure of the insurer to the possibility of incurring a significant loss under a particular insurance contract. The concept of significant loss is discussed in detail in paragraphs 22-28 above;

- the distribution of the risk of loss over a number of policies by the insurer; and
- the payment of an amount called a premium by the insured to the insurer for the acceptance, by the insurer, of the risk of loss.

As a consequence of the above the insurer is placed under an obligation to pay a sum of money, or its equivalent, upon the happening of the event insured. The insured must have a legal right to payment which cannot be at the insurer's discretion (*Commercial Union Assurance Company of Australia Limited v. FC of T* 77 ATC 4186; (1977) 7 ATR 435; *Medical Defence Union Ltd v. Department of Trade* [1979] 2 All ER 421; *Oswald v. Bailey & Ors* (1986) 4 ANZ Ins Cas ¶60-704).

33. The main purposes of an insurance arrangement, therefore, is to **transfer the risk** of loss that may arise from the insured's interest in the subject matter of the insurance to the insurer. Individuals, taking out motor vehicle insurance, for example, transfer the risk of experiencing a loss were an accident to happen, to an insurance company through an insurance policy. Under the insurance policy the insurance company undertakes to indemnify the insured person against such a loss. The consideration for that indemnity is the premium paid by the insured to the insurance company. See **Attachment A** for an example of the transfer and distribution of risk under a simple insurance arrangement.

34. The **transfer of the risk** of loss from the insured to the insurer then exposes the insurer to the possibility of incurring a significant loss under a particular insurance contract. The concept of significant loss is discussed in detail at paragraphs 8 and 22-28 above. The loss will be significant compared to the premium paid on the particular policy, however, it may not be significant in terms of the insurer's total business. In the example at **Attachment A** the loss of 1 car @ $20,000 is significant when compared to the premium ($400) paid by the insured. The loss, however, is not significant when compared to the total premiums ($40,000) received by the insurer on its motor vehicle business. But, if a second car is totally destroyed in addition to the two partially damaged, the insurer would be subject to an overall significant loss.

35. The insurer, by accepting other policies which are not expected (on the basis of probabilities) to incur a loss, has effectively **distributed the risk of loss** amongst all the insured parties. The premiums from those parties that do not experience a loss are used to pay for the loss experience of the few. This is the basic concept of the 'law of large numbers' where the probability of insured events occurring is even among all insureds. The greater the number of

insureds, the more the risk can be shared (given reasonable loss probabilities).

36. This **distribution of risk** is also a vital element of any contract of insurance. Refer to **Attachment B** for examples of risk transfer and risk distribution.

37. Where an insurance company cannot meet the claims made against it by those it has insured because it does not have sufficient premium income or reserve assets a spread of losses faced by policyholders has not been achieved. In order to avoid this situation an insurance company similarly takes out insurance to cover its inability to pay. This is called reinsurance. Similar policies taken out by reinsurance companies are called retrocessions.

### *Reinsurance*

38. Generally speaking, reinsurance is the insuring of the risks undertaken by an insurer. Reinsurance is a form of insurance and the principles and practices applying to the conduct of insurance business generally 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).

39. 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 Ins Cas ¶61-185).

40. Historically, a reinsurance contract is described as 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. Reinsurance contracts, therefore, are concerned with providing for the insurance of risks under contracts of insurance.

41. Like insurance arrangements, a reinsurer would indemnify an entity which is subject to the risk that it will incur a loss on the occurrence of a specified event. In reinsurance arrangements the entity indemnified is the insurance company and the reinsurer indemnifies a portion of the risks originally assumed by the insurance

company. Such portions may be in specific proportions to the amount of risk originally assumed or it may provide for protection over and above a specified amount or ratio of claims. Reinsurance thus involves the transfer of insurance risk from an insurer to a reinsurer and this transfer exposes a reinsurer to the possibility of incurring a significant loss under a reinsurance contract.

**Recent developments**

42. Reinsurance in the past has generally followed the type of arrangement described in paragraphs 38-41 above. However, in recent years this type of reinsurance has become increasingly difficult to obtain and more expensive. This reduction in the availability of reinsurance is primarily a result of the huge increase in catastrophe losses faced by insurers and reinsurers over recent years.

43. The difficulty in obtaining reinsurance has had the following consequences:

- a difficulty in obtaining reinsurance for some risks;
- exclusion of some risks in certain locations;
- the insured being required to hold an increased amount of the risk;
- concerns about the viability of parties to the arrangements; and
- a desire to limit exposure to risks whilst still selling a profitable product.

44. This difficulty in obtaining reinsurance has created a gap in an insurer's risk management techniques and a new tool was needed to enable insurers to manage the increased risks they are required to hold. Financial reinsurance appears to have evolved to become such a risk management tool.

**Financial reinsurance**

45. Financial reinsurance has been described by many varying terms, some of which include: Bankers, Rollers, Portfolio Run-Offs, Time and Distance, Islands in the Sun, Accelerators or Redistributors of Income, Alternative Risk Transfers, Funded Covers, Retrospective Aggregates, Prospective Aggregates, etc.

46. Financial reinsurance is a broad term encompassing a number of concepts and has been defined to include everything from a transaction embracing no risk of any type (which is tantamount to a deposit) to transactions that include a number of different types of risk of loss (**timing risk, investment risk, credit risk and expense risk**)

but seek to limit the insurance risk in the underlying risk being reinsured.

47. **Timing risk** is the risk of having to pay a loss before anticipated. Paying a loss earlier than anticipated does not allow for sufficient amounts of income to be generated and accumulated in order to pay the loss.

48. **Investment risk** is the risk that investment earnings will fall short of projected investment earnings. Investment risk is affected by timing risk as well as market fluctuations.

49. **Credit risk** includes: (a) the risk that the reinsured may not pay premiums when due, (b) subrogation rights that may not be enforceable, or (c) a retrocessionaire (the reinsurer's reinsurer) which may be unable to pay amounts due under a retrocession arrangement.

50. **Expense risk** is the risk that acquisition and operating expenses may exceed amounts expected when the reinsurance premium is calculated. Expense risk is primarily a problem of pricing the product.

51. **Underwriting risk** is the risk that there is a clear possibility that the insurer will pay more than premiums expected on any given policy.

52. We are aware of arrangements that involve amounts being described as insurance premiums under an insurance arrangement that does not transfer any risk from the insured to the insurer. These arrangements are in reality no more than financing arrangements in which claims are funded by the insured and appear to have the purpose of cloaking a non-deductible expense as an insurance arrangement to either create a deduction or to bring forward a deduction.

53. An example of this type of arrangement is illustrated in **Attachment C**. Although **Attachment C** is an illustration of financial insurance, the same principles are involved in financial reinsurance. As can be seen from that example, the insured has not transferred any insurance risks to the insurer and it is the insured that actually funds the outgoings. Such an arrangement would not be treated as an insurance arrangement for taxation purposes.

54. The arrangement illustrated in **Attachment C** is an attempt to bring forward a deduction for long service leave payments. This arrangement attempts to overcome the decision of the High Court in *Nilsen Development Laboratories Pty Ltd & Ors v. FC of T* 81 ATC 4031; (1981) 11 ATR 505, which held that provisions for long service were not deductible for income tax purposes and that a deduction is only available when the employer is finally obliged to make the payments. It has also been held in *Ransburg Australia Pty Ltd v. FC of T* 80 ATC 4114; (1980) 10 ATR 663 that payments by a taxpayer

for indemnity against its long service leave liabilities are not deductible. Further, this type of arrangement is an attempt to overcome the operation of section 26-10 of the 1997 Act (formerly subsection 51(3) of the 1936 Act). Such arrangements are not accepted as insurance arrangements for taxation purposes. These types of arrangements are no different from a deposit arrangement with a bank as there is minimal risk to either party. Consequently, the taxation treatment of this type of arrangement will follow that of banking and finance arrangements.

55. The only difference between financial insurance and financial reinsurance is that the former is an arrangement between a non-insurer and an insurer and the latter is between an insurer and a reinsurer.

### Alternative views

56. It has been suggested that the approach adopted in this Ruling is contrary to the decision of the Full Federal Court in *ANZ Savings Bank Limited v. FC of T* 93 ATC 4370; (1993) 25 ATR 369 in that the Ruling adopts a substance over form approach when considering whether or not an arrangement constitutes a contract of insurance.

57. In our view, the question as to whether or not a contract of insurance exists will depend on the legal character of the arrangement. As was said by Hill J in *NM Superannuation Pty Ltd v. Young and Another* 113 ALR 39 at 56:

> 'While it is undoubtedly true that the label used by the parties will not be determinative of the true legal character of their contractual arrangements, it does not follow that the label used between the parties will be totally irrelevant.'

This Ruling assists in determining the true legal character of certain arrangements referred to as financial insurance/reinsurance.

### Application of Part IVA of the ITAA

58. The extent to which the provisions in Part IVA are to be applied to deny a deduction to a party paying premiums under arrangements commonly known as 'financial insurance' and 'financial reinsurance' will need to be considered in light of the facts relevant to a particular case. Part IVA will apply where there is a 'scheme' which produces a 'tax benefit' and after the Commissioner has had regard to all the factors set out in subsection 177D(b) of the 1936 Act it can be concluded that the sole or dominant purpose of entering into the scheme was to obtain a tax benefit. However, in making a decision as to whether the dominant purpose of the arrangement between the parties is to secure a tax benefit, the Commissioner will have regard to

whether there were commercial reasons for entering into the arrangement. Where, for example, complex financial arrangements are entered into which effectively result in a premium paid by the insured to the insurer/reinsurer and those premiums are subsequently passed back to the insured, the arrangement will be one to which the provisions of Part IVA may apply.

59. The provisions of Part IVA will be applied where the arrangement is one which is designed to 'cloak' the actual effect of the arrangement. The application of Part IVA in these circumstances enables the Commissioner to look at the substance and effect of the arrangement when taken as a whole.

**Commissioner of Taxation**

17 January 1996

ISSN 1039 - 0731

ATO references
NO 96/187-6
94/4271-5
BO

Previously released in draft form as TR 94/D23

Price $2.80

FOI index detail
*reference number*
I 1016796

*subject references*
- financial insurance
- financial reinsurance

*legislative references*
- ITAA 1936 177D(b)
- ITAA 1936 Part IVA
- ITAA 1997 8-1
- ITAA 1997 6-5
- ITAA 1997 26-10

*case references*
- ANZ Savings Bank Limited v. FC of T 93 ATC 4370; (1993) 25 ATR 369
- Commercial Union Assurance Company of Australia Limited v. FC of T 77 ATC 4186; (1977) 7 ATR 435
- Farmers Mutual Insurance Ltd v. QBE Insurance International Ltd; American International Underwriters Ltd v. Farmers Mutual Insurance Ltd (1993) 7 ANZ Ins Cas ¶61-185
- Medical Defence Union Ltd v. Department of Trade [1979] 2 All ER 421
- NM Superannuation Pty Ltd v. Young and Anor 113 ALR 39
- Nilsen Development Laboratories Pty Ltd & Ors v. FC of T 81 ATC 4031; (1981) 11 ATR 505
- Oswald v. Bailey & Ors (1986) 4 ANZ Ins Cas ¶60-704
- RACV Insurance Pty Ltd v. FC of T 74 ATC 4169; (1974) 4 ATR 610
- Ransburg Australia Pty Ltd v. FC of T 80 ATC 4114; (1980) 10 ATR 663

**ATTACHMENT A**

**SIMPLE INSURANCE ARRANGEMENT**

(refer to paragraph 34)

ABC insurance company expects to write insurance cover for 100 motor vehicles for an average insured value of $20,000

Statistics suggest that over the next twelve months, 1 car will be totally destroyed and the accident repair bill for two other cars will be $10,000 each. No claims are expected on the other vehicles.

| | | |
|---|---|---|
| LOSS TO CAR OWNERS | 1 car @ $20,000 = | $20,000 |
| | 2 cars @ $10,000= | $20,000 |
| TOTAL LOSS | | $40,000 |

To cover this expected loss, (and if the operating costs, etc., of the insurance company are ignored) car insurance premiums payable by each car owner would be $400 (i.e., $40,000/100).

**NOTE:**

* LARGE NUMBERS are required if an acceptable level of premium is to be charged.
* BENEFIT OF PROTECTION is obtained even though a car is not damaged (premiums are not refunded as they have been used to pay claims).
* EQUALITY OF RISK - where the same premium is charged the assumption is that the risk is substantially equal for each driver. Statistics show that the accident rate for drivers under 25 years of age is much greater than for most other age groups These factors would be reflected in the premium charged to each individual.

**This arrangement has effectively transferred the risk, at a reasonable cost, from each individual owner to the insurer and the insurer has effectively spread the risk amongst the many owners.**

**ATTACHMENT B**

## RISK TRANSFER AND RISK DISTRIBUTION

(refer to paragraph 36)

ABC Insurance Company has the capital to insure $5 million public liability cover. It has several options.

**No transfer and no distribution of the risk**

(A) Insure one risk for $5 million or a number of risks totalling $5 million.

**Transfer but no distribution of the risk**

(B) Insure (say) 9 public liability risks, each for $5 million but enter into a reinsurance arrangement for losses above $5 million, e.g.; a stop loss cover (refer to Attachment F).

ABC might reinsure on the understanding that if total yearly claims on its entire portfolio ($45 million) exceed $555,555, the reinsurer will reimburse 90% of the excess.

This is an example where the underwriting risk has been transferred. With 9 risks insured, ABC had a potential liability of $45 million, but with the stop loss reinsurance cover its liability is limited to $5 million (the first $555,555 of claims plus $4,444,445 being the 10% of the excess of $44,444,445).

In this scenario ABC has transferred $40 million underwriting risk.

**Transfer and distribution of the risk**

(C) Rather than enter into a stop loss arrangement the insurer could enter into a quota share arrangement (refer to **Attachment F**) with several reinsurers. A quota share arrangement simply is where the insurer and the reinsurer agree to accept a fixed percentage of each and every insurance written by the insurance company and within the scope of the arrangement.

ABC could enter into an arrangement with 9 reinsurers whereby ABC and each reinsurer agrees to accept 10% of any risk written by ABC. On the basis that ABC only wishes to accept $5 million then ABC could write $50 million of public liability insurance.

In this scenario ABC has effectively transferred and spread the potential loss evenly between itself and the 9 reinsurers.

**ATTACHMENT C**

## FINANCIAL INSURANCE

**ASSUMPTIONS:**

Company A knows that it will have a liability for long service leave for three of its staff in the next 5 years.

The amount of the long service leave liability for each employee is $10,000.

The interest rate is 6%. The figures represent the present value of cash flows.

Company A is desirous of spreading its liability over the next 5 years and if possible obtain a tax deduction for the provision of that liability.

**This type of arrangement will not be accepted as an insurance arrangement for taxation purposes.**

**OPTION:**

A financial insurance arrangement is suggested with annual premiums of $6,000, expenses of 8% of premiums and participation as to 85% of the profit from the arrangement. The following scenario is suggested to company A.

| COMPANY A | | | | | | |
|---|---|---|---|---|---|---|
| | **Year 1** | **Year 2** | **Year 3** | **Year 4** | **Year 5** | **TOTAL** |
| Premium | 6,000 | 6,000 | 6,000 | 6,000 | 6,000 | 30,000 |
| Charge (8% Prem) | 480 | 480 | 480 | 480 | 480 | 2,400 |
| Balance | 5,520 | 5,520 | 5,520 | 5,520 | 5,520 | |
| B/fwd | | 5,851 | 2,053 | 8,027 | 4,360 | |
| Balance | 5,520 | 11,371 | 7,573 | 13,547 | 9,880 | |
| Interest | 331 | 682 | 454 | 813 | 593 | 2,873 |
| Balance | 5,830 | 12,053 | 8,027 | 14,360 | 10,473 | |
| Claim | | 10,000 | | 10,000 | 10,000 | 30,000 |
| C/fwd | 5,851 | 2,053 | 8,027 | 4,360 | **473** | **Balance** |
| | | | | | | |

With an 85% profit participation Company A would receive $402 (85% of $473). The insurer would retain $71 (15% of 473).

**ATTACHMENT C** (continued)

**RESULT:**

The claimed result of this arrangement (which we dispute by this Ruling) is that Company A obtains an annual tax deduction of $6,000 being its provision for long service leave. Company A also receives $402 as profit participation (a return on the arrangement).

The insurer is also satisfied as it derives commission of $2,400 and also obtains $71 profit without it facing any insurance risk under the arrangement.

A purpose of the arrangement was to enable the insured to claim a tax deductions for the 'premiums' paid to the insurer. Those 'premiums' effectively represents an amount which it might otherwise have retained as a non-deductible provision for long service leave. As mentioned in paragraph 54 of this Ruling, this type of arrangement is not accepted as insurance for taxation purposes.

**ATTACHMENT D**

**FEATURES THAT LIMIT THE TRANSFER OF RISK**

**SINGLE PREMIUM AND SHARING PROFIT COMMISSION**

Single Premium $500

Interest assumption 6%. The figures represent the present value of cash flows.

Experience Account Balance = EAB

Profit Commission Share of EAB

Reinsured 90% Reinsurer 10%

**This type of arrangement will not be accepted as an insurance arrangement for taxation purposes**.

(Refer to attached paragraphs D1-D8 for discussion on each of the following scenarios:)

| | **Year:** | **1** | **2** | **3** | **4** | **5** |
|---|---|---|---|---|---|---|
| **1** | **No Claim** | | | | | |
| | Experience Account Balance | | 490 | 519 | 550 | 583 |
| | Premium | 500 | | | | |
| | Investment Income | 30 | 29 | 31 | 33 | 35 |
| | Charges (8% of Premium) | 40 | | | | |
| | Claim | | | | | |
| | TOTAL | 490 | 519 | 550 | 583 | 619 |
| | | | | | | |
| **2** | **Early Claim** | | | | | |
| | Experience Account Balance | | 90 | 95 | 101 | 107 |
| | Premium | 500 | | | | |
| | Investment Income | 30 | 5 | 6 | 6 | 6 |
| | Charges (8% of Premium) | 40 | | | | |
| | Claim | 400 | | | | |
| | TOTAL | 90 | 95 | 101 | 107 | 113 |
| | | | | | | |

**ATTACHMENT D** (continued)

| | **Year:** | **1** | **2** | **3** | **4** | **5** |
|---|---|---|---|---|---|---|
| **3** | **Late Claim** | | | | | |
| | Experience Account Balance | | 490 | 519 | 250 | 265 |
| | Premium | 500 | | | | |
| | Investment Income | 30 | 29 | 31 | 15 | 16 |
| | Charges (8% of Premium) | 40 | | | | |
| | Claim | | | 300 | | |
| | TOTAL | 490 | 519 | 250 | 265 | 281 |
| | | | | | | |
| **4** | **Excess Claim** | | | | | |
| | Experience Account Balance | | (110) | 42 | 45 | 48 |
| | Premium | 500 | | | | |
| | Investment Income | 30 | 2 | 3 | 3 | 3 |
| | Charges (8% of Premium) | 40 | | | | |
| | Claim | 600 | | | | |
| | Adjustment Premium | | 150 | | | |
| | TOTAL | (110) | 42 | 45 | 48 | 51 |
| | | | | | | |

**ATTACHMENT D** (continued)

## EFFECTS

### Case 1 - No Claim

D1. In this scenario the reinsured pays a single premium of $500 and makes no claims in the 5 year period. At the end of the 5 years the reinsured participates as to 90% of the experience account balance. The experience account balance as at the end of year 5 is $619 so the reinsured receives $557. The reinsured thus receives the premium back together with $57 representing interest earned on the premium.

D2. The reinsurer is also content with the arrangement as it receives $40 up front for its expenses and participates as to 10% of the experience account balance to the extent of $62. The reinsurer thus earns $102 from the arrangement and is not put at risk.

### Case 2 - Early Claim

D3. In this scenario the reinsured pays a single premium of $500 and makes a claim of $400 at the end of the first year. At the end of the 5 years the reinsured participates as to 90% of the experience account balance. The experience account balance as at the end of year 5 is $113 so the reinsured receives $102. Under the arrangement the reinsured receives $400 by way of claim plus $102 share of the experience account balance. The overall effect is that the reinsured receives $2 over and above premiums paid and that $2 represents interest earned on the premium.

D4. The reinsured is also content with the arrangement as it receives $40 up front for its expenses and participates as to 10% of the experience account balance to the extent of $11. The reinsurer thus earns $51 from the arrangement and is not put at risk.

### Case 3 - Late Claim

D5. In this scenario the reinsured pays a single premium of $500 and makes a claim of $300 at the end of the third year. At the end of the 5 years the reinsured participates as to 90% of the experience account balance. The experience account balance as at the end of year 5 is $281 so the reinsured receives $253. Under the arrangement the reinsured receives $300 by way of claim plus $253 share of the

**ATTACHMENT D** (continued)

experience account balance. The overall effect is that the reinsured receives $53 over and above premiums paid and that $53 represents interest earned on the premium.

D6. The reinsurer is also content with the arrangement as it receives $40 up front for its expenses and participates as to 10% of the experience account balance to the extent of $28. The reinsurer thus earns $68 from the arrangement and is not put at risk.

**Case 4 - Excess Claim**

D7. In this scenario the reinsured pays a single premium of $500 and makes a claim of $600 at the end of the first year. This claim causes the experience account balance to go into a negative balance and as such the reinsurer requires the reinsured to pay an adjustment premium of $150. At the end of the 5 years the reinsured participates as to 90% of the experience account balance. The experience account balance as at the end of year 5 is $51 so the reinsured receives $46. Under the arrangement the reinsured receives $600 by way of claim, is required to pay an adjustment premium of $150 and receives $46 as participation in the experience account balance. In this scenario the reinsured is worse off by $4 due to the cost of using $100 of the reinsurer's capital via the excess claim at the end of year 1.

D8. The reinsurer is content with the arrangement as it still receives $40 up front for its expenses and participates as to 10% of the experience account balance to the extent of $5. The reinsurer does pay out an extra $100 due to the excess claim but this is recouped through the adjustment premium in the following year. The reinsurer thus earns $45 from the arrangement and is not put at risk.

**ATTACHMENT E**

## FINANCIAL INSURANCE

## UP FRONT AND ANNUAL PREMIUM WITH PROFIT SHARE COMMISSION

Up front Premium $500

Annual premium $100

Interest assumption 6%. The figures represent the present value of cash flows.

Profit Commission Share of EAB

Reinsured 90%, Reinsurer 10%

**This type of arrangement will not be accepted as an insurance arrangement for taxation purposes**.

(Refer to attached paragraphs E1-E8 for a discussion of the following scenarios:)

| | **Year:** | **1** | **2** | **3** | **4** | **5** |
|---|---|---|---|---|---|---|
| **1** | **No Claim** | | | | | |
| | Experience Account Balance | | 588 | 721 | 863 | 1,012 |
| | Up front Premium | 500 | | | | |
| | Annual Premium | 100 | 100 | 100 | 100 | 100 |
| | Investment Income | 36 | 41 | 49 | 58 | 67 |
| | Charges (8% of Premium) | 48 | 8 | 8 | 8 | 8 |
| | Claim | | | | | |
| | TOTAL | 588 | 721 | 863 | 1,012 | 1,171 |
| | | | | | | |
| **2** | **Early Claim** | | | | | |
| | Experience Account Balance | | 188 | 297 | 413 | 536 |
| | Premium | 500 | | | | |
| | Annual Premium | 100 | 100 | 100 | 100 | 100 |
| | Investment Income | 36 | 17 | 24 | 31 | 38 |
| | Charges (8% of Premium) | 48 | 8 | 8 | 8 | 8 |
| | Claim | 400 | | | | |

| | | | | | | |
|---|---|---|---|---|---|---|
| | TOTAL | 188 | 297 | 413 | 536 | 666 |

**ATTACHMENT E** (continued)

| | **Year:** | **1** | **2** | **3** | **4** | **5** |
|---|---|---|---|---|---|---|
| **3** | **Late Claim** | | | | | |
| | Experience Account Balance | | 588 | 721 | 563 | 694 |
| | Premium | 500 | | | | |
| | Annual Premium | 100 | 100 | 100 | 100 | 100 |
| | Investment Income | 36 | 41 | 49 | 40 | 48 |
| | Charges (8% of Premium) | 48 | 8 | 8 | 8 | 8 |
| | Claim | | | 300 | | |
| | TOTAL | 588 | 721 | 563 | 694 | 834 |
| | | | | | | |
| **4** | **Excess Claim** | | | | | |
| | Experience Account Balance | | (212) | 32 | 131 | 236 |
| | Premium | 500 | | | | |
| | Annual Premium | 100 | 100 | 100 | 100 | 100 |
| | Investment Income | 36 | 2 | 7 | 13 | 20 |
| | Charges (8% of Premium) | 48 | 8 | 8 | 8 | 8 |
| | Claim | 800 | | | | |
| | Adjustment Premium | | 150 | | | |
| | TOTAL | (212) | 32 | 131 | 236 | 348 |
| | | | | | | |

**ATTACHMENT E** (continued)

## EFFECTS

### Case 1 - No Claim

E1. In this scenario the reinsured pays a single premium of $500, annual premiums of $100 and makes no claims in the 5 year period. At the end of the 5 years the reinsured participates as to 90% of the experience account balance. The experience account balance as at the end of year 5 is $1,171 so the reinsured receives $1,054. The reinsured thus receives its premiums back together with $54 representing interest earned on the premiums.

E2. The reinsurer is also content with this arrangement as it receives $80 for its expenses (8% of Premium) and participates as to 10% of the experience account balance to the extent of $117. The reinsurer thus earns $197 from the arrangement and is not put at risk.

### Case 2 - Early Claim

E3. In this scenario the reinsured pays a single premium of $500, annual premiums of $100 and makes a $400 claim at the end of the first year. At the end of the 5 years the reinsured participates as to 90% of the experience account balance. The experience account balance as at the end of year 5 is $666 so the reinsured receives $599. Under the arrangement the reinsured receives $400 by way of claim plus $599 share of the experience account balance. The overall effect is that the reinsured sustains a $1 loss on the arrangement.

E4. The reinsurer is also content with the arrangement as it receives $80 for its expenses (8% of Premium) and participates as to 10% of the experience account balance to the extent of $67. The reinsurer thus earns $147 from the arrangement and is not put at risk.

**ATTACHMENT E** (continued)

**Case 3 - Late Claim**

E5. In this scenario the reinsured pays a single premium of $500, annual premiums of $100 and makes a $300 claim at the end of the third year. At the end of the 5 years the reinsured participates as to 90% of the experience account balance. The experience account balance as at the end of the year 5 is $834 so the reinsured receives $751. Under the arrangement the reinsured receives $300 by way of claim plus $751 share of the experience account balance. The overall effect is that the reinsured receives $51 over and above premiums paid and that $51 represents interest earned on the premiums.

E6. The reinsurer is also content with the arrangement as it receives $80 for its expenses (8% of Premium) and participates as to 10% of the experience account balance to the extent of $83. The reinsurer thus earns $163 from the arrangement and is not put at risk.

**Case 4 - Excess Claim**

E7. In this scenario the reinsurer pays a single premium of $500, annual premiums of $100 and makes a claim of $800 at the end of the first year. This claim causes the experience account balance to go into a negative balance and as such the reinsurer requires the reinsured to pay an adjustment premium of $150. At the end of the 5 years the reinsured participates as to 90% of the experience account balance. The experience account balance as at the end of year 5 is $335 so the reinsured receives $313. Under the arrangement the reinsured receives $800 by way of claim, is required to pay an adjustment premium of $150 and receives $313 as participation in the experience account balance. The overall effect is that the reinsured sustains a loss of $37 on the arrangement.

E8. The reinsurer is content with the arrangement as it still receives $80 for its expenses (8% of Premium) and participates as to 10% of the experience account balance to the extent of $35. The reinsurer thus earns $115 from the arrangement and is not put at risk.

**ATTACHMENT F**

## GLOSSARY OF TERMS

### CEDENT

The name of an insurer who transfers all or part of a risk to a reinsurer.

### COMMUTATION CLAUSE

A clause which provides, by mutual agreement between both parties, for the estimation and complete discharge, by payment by the reinsurer to the cedent of all future obligations for reinsurance loss or losses incurred, regardless of the continuing nature of certain losses. This clause is utilised chiefly in non-proportional liability contracts.

### QUOTA SHARE ARRANGEMENTS

A form of reinsurance under which the cedent is bound to cede, and the reinsurer to accept, a fixed share of every risk which the cedent may insure in an agreed section of its business.

### RETROCEDENT

A reinsurer who retrocedes.

### RETROCESSION

A reinsurance of a reinsurance.

### RETROCESSIONAIRE

A reinsurer who accepts retrocession business.

### STOP LOSS REINSURANCE

A form of reinsurance where the reinsurer is not responsible for the amount by which an individual claim exceeds a fixed sum, but indemnifies the cedent is respect of an annual loss ratio on a particular portfolio in excess of a stipulated level.