

IT 109 - General insurance companies: deductions for claims incurred but not reported

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TAXATION RULING NO. IT 109

GENERAL INSURANCE COMPANIES : DEDUCTIONS FOR CLAIMS
INCURRED BUT NOT REPORTED

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GENERAL INSURANCE COMPANIES

51(1)

INSURANCE CLAIMS

IBNR CLAIMS

RACV INSURANCE CO. CASE

OTHER RULINGS ON TOPIC

IT 110

PREAMBLE

Representatives of a company engaged in general insurance sought approval from this office to apply the decision in RACV Insurance Ltd v F.C. of T, 74 ATC 4169, 4ATR 610 in such a way as to obtain a substantial deduction at the end of the year of income of a quantified amount of "incurred but not reported" (IBNR) insurance claims outstanding as at that date. Under the company's proposal, the determination of taxable income of the year in which the decision of the Court was to apply took no account of IBNR's outstanding as at the close of the preceding year of income.

2. Another aspect of the company's submission concerned the acceptance of a formula for the determination of IBNR claims relevant to a year of income and in this way overcome delays with the preparation and lodgment of returns of income.

RULING

3. In replying to the representations, attention was drawn to the fact that the decision in the RACV Insurance Case was based on the finding by the Court that the effect of the relevant law of the State of Victoria in relation to the kind of insurance contract there in question, was to make that company liable to pay compensation from the moment the event insured against occurred, irrespective of whether or not a claim had been lodged. In that particular situation the Court held, in effect, that the company was entitled to deduct under section 51 amounts which represented reasonable estimates of losses incurred by way of accidents to insured property during the year of income.

4. However, the Court did not decide the question whether any deduction would have been allowed in circumstances where an accident had occurred and, under the particular contractual relationship in force, no liability against the company arose until such time as a claim had been made against it. At this stage, therefore, it has been decided to proceed on the assumption that no deduction is allowable in such circumstances unless and until a claim is made or something else is done which

imposes upon an insurer an immediate liability to meet claims under a policy of insurance. In cases where the contractual arrangements and statutory requirements under a policy of insurance are indistinguishable from those of the RACV case, deductions will be allowable for losses arising at the moment of the event insured against occurring.

5. A difficulty facing the department and insurers alike in these circumstances will be in quantifying with reasonable accuracy the estimated amount of IBNR's outstanding against an insurance company at the end of a year of income. In considering this aspect of IBNR claims, it was pointed out that the result which the law requires in these types of cases can be estimated by taking as a starting point the amount paid out by a company on claims during the year of income. To this figure must be added the amount which is a reasonable estimate of the insurer's liability at the end of the year of income on account of insured events in respect of which there is either -

- (i) an immediate liability to compensate, or
- (ii) completion of the actions which made the company immediately liable to compensate.

From this amount should be deducted an estimate, arrived at in the same consistent manner, of the insurer's liability at the beginning of the year of income on account of such insured events.

6. As a starting point in determining an insurer's liability at the end of a year of income, it should be possible for insurance companies, with the advantage of hindsight, to determine fairly accurately IBNR claims outstanding against various classes of insurance at the end of the previous income year. Once agreement is reached as to the reasonableness of these estimates, the calculation of the current year's IBNR claims outstanding at the close of the year should be made separately in respect of each class of insurance business written during the year. By way of example, once a company's liability for IBNR claims in respect of, say, marine insurance for 1973 is agreed upon, the 1974 IBNR claims for this class of business should be estimated by the formula -

$$\frac{1973 \text{ marine IBNR's} \times 1974 \text{ marine premiums}}{1973 \text{ marine premiums}}$$

7. The decision in the RACV Insurance Case is currently being applied not only to the determination of income of statutory third party business but also to income from other general insurance business where it can be shown by those concerned that the legal aspect of the insurance contracts is such that a liability to compensate the insured arises at the time of the accident or other cause of loss, i.e., where the contracts are not worded in such a way as to make it a prerequisite for liability that the insured should make a claim on the insurer.

8. The date of notification of a claim is not necessarily relevant to the "accounting allocation" of a claim into a financial period. Prudent accounting principles dictate that an estimate of future claims be made and provided for in the accounts of an insurance company. However, to allow a deduction for all IBNR claims whether or not they give rise to an immediate liability would be contrary to the interpretation placed on section 51(1) by the full High Court in *FC of T v James Flood Pty Ltd* 88 CLR 492. As pointed out in the cases cited by Menhennitt J. in the RACV Insurance case:

"Commercial and accountancy practice may assist in ascertaining the true nature and incidence of the item as a step towards determining whether it answers the test laid down by section 51(1) but it cannot be substituted for the test."

9. In applying the RACV decision, it is considered that the principle which was applied in the *Henderson* case 119 CLR 612 and the *Country Magazine* case 117 CLR 162, would also apply, where a new interpretation had been established. This means that taxpayers who switch over to the new interpretation must apply it consistently in calculating the adjustments as at both the beginning and the end of the year, so that in the context of insurers, only the increase between the amount attributable to claims which are incurred but not reported at the end of the year and the amount of such claims at the beginning of the year, will be allowable as a deduction.

10. This is consistent with the Supreme Court decision in the RACV case which established that the taxpayer was entitled to deduct amounts expected to become payable in respect of accidents incurred during the year of income. However the decision also established that the taxpayer was not entitled to deduct amounts which had been expected to become payable, as at the beginning of the year of income, in respect of such accidents as had already occurred at that time. These latter amounts would have been, in the light of the RACV decision (and the RACV did not dispute this), properly deductible in the immediately preceding year of income.

11. Referring to "reported but not enough" claims, the inference being that any increase in the estimated liability of allowable IBNR claims as at the end of the accounting period in respect of claims which were included in the previous years' claims and have not been settled by the end of the current accounting period would not be an allowable deduction. Menhennitt J. in the RACV case, said at pages 618 and 4177:

"The passage I have referred to in *Texas Co. (Australasia) Ltd v FC of T* also leads to the conclusion that where an adjustment of an estimate is necessary in the light of later events it is permissible to take the amount into account in the year when it is made."

Accordingly, it is considered that deductions are properly

allowable for any increase in the estimated liability of
allowable IBNR claims in the circumstances described.

COMMISSIONER OF TAXATION

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