3 March 2006

Attention: William Potts

The Manager
Taxation of Financial Arrangements
Business Income Division
Revenue Group
Department of the Treasury
Langton Crescent
PARKES ACT 2600

Dear Sir/Madam

Response to Treasury on TOFA 3 and 4 Exposure Draft

The Insurance Council of Australia (ICA) is the representative body of the general insurance industry in Australia.

ICA membership represents more than 90 percent of total premium income written by private sector general insurers.

ICA members provide non life insurance products ranging from those usually purchased by individuals (such as home and contents insurance, travel insurance, motor vehicle insurance) to those purchased by small businesses and larger organisation (such as product and public liability insurance, workers compensation, commercial property, and directors and officers insurance).

ICA members, both insurers and reinsurers, are regulated and licensed by the Australian Prudential Regulation Authority (APRA) and are a significant part of the financial services system. Recently published statistics from APRA show that the private sector insurance industry generates direct premium revenue of $28.4 billion per annum and has assets of $80.1 billion.[1] The industry employs about 43,000 people.

Australian general insurers issue more than 41 million insurance policies annually and deal with 3.5 million claims each year.[2] On average, about $55 million in claims is paid each working day.

[1] APRA, *Quarterly General Insurance Performance, June 2005*.

[2] APRA *Selected Statistics on the General Insurance Industry, Year Ending June 2002*

1. Clarification to ensure that a right or obligation under a general insurance policy is an excluded financial arrangement.

It is debatable that s 230-125 (Exception for short term-arrangements where non-monetary amount involved) would operate to exclude general insurance contract dealings. However, to avoid doubt there should be a specific exclusion for general insurance contracts, similar to that specified in the draft for life insurance policies.

Clearly a general insurance policy would be caught by the broadly drafted catch-all definition of a financial arrangement in s 230-30.

Currently general insurance income and expenses are recognised for tax purposes under a specific taxing code (Division 321). This tax recognition treatment accords, with certain limited exceptions, with the accounting basis for recognising income and expense. The code enshrines a basis of recognition which was formerly dealt with by taxation rulings IT 2663 for general insurers and TR 95/5 for reinsurers (expected to be withdrawn shortly). These rulings were made after lengthy consultation with the insurance industry and generally represent a considered and conclusive basis for taxing income and outgoings arising from general insurance policies.

Life insurance has also had a specific taxing code (Division 320) included in the Tax Act for tax recognition purposes. It is not clear why life insurance has received a clear specific exclusion in s 230-135(4) and general insurance has not.

While on the revenue side it is more often the case that insurance contracts would be for a period not exceeding 12 months, and therefore probably exempt under the short-term exemption provision s 230-125, this is not necessarily the case, and there may be practical exceptions where the term exceeds 12 months. From a practical standpoint a situation where revenue recognition is carved out of Division 321 into Division 230 is unacceptable particularly when there may be difficulties and compliance costs associated with tracking exceptional contracts. Division 321 achieves a completely acceptable result of earning revenue over the life of the contract without recourse to TOFA rules and for this reason should be made another specific exclusion from the regime. Moreover greater complexity is envisaged with the tax recognition of claims accounting under TOFA where invariably claims are paid over periods far exceeding 12 months. The provisions of s 321-15 currently achieve a reflex consistent with the accounting approach for recognising changes in the value of Outstanding Claims Reserve provisions. A TOFA method of recognising claims costs on a compounding accruals method would over elaborate recognition rules and foist banking concepts onto the general insurance industry, where well settled industry accepted practices already exist.

2. Fair value election should permit general insurers to adopt the election where they are required to fair value account under AASB 1023.

S 230-45 only permits a fair value election where financial statement reporting is governed by Chapter 2M of the Corporation Act and the requirements under accounting standard AASB 139. However, as a technical matter the exposure draft should be amended to also permit general insurers to elect fair value tax recognition where they are required to so report under AASB 1023.

This may be in place but confirmation would be appreciated to avoid uncertainty.

3. The scope of TOFA 3 and 4 should be widened to permit character matching hedging

The provisions of Div 230 assist taxpayers, including general insurers, to undertake hedges so as to mitigate the risks associated with certain financial exposures and ensure where an effective derivate transaction is undertaken the risk can be mitigated both on a before tax and after tax basis. This will be so where the financial exposure is an operational risk: one where the gain or loss is on revenue account. However, the restriction in the Exposure Draft to limit the hedge gain/loss to be always be recognised on a revenue basis unduly confines the rules to hedges for risks which have the underlying exposure also being on a revenue account. It is noted that Div 230 generally makes an exception for gains or losses in producing exempt or non-assessable-non-exempt income or losses and hedging of such transactions should also result in such hedge gains/losses also not being assessable/deductible. However, it is envisioned that where derivatives are entered into specifically to hedge the risk of holding investments in downstream foreign shareholdings there should be freedom within the TOFA tax rules to permit the hedge gain/loss, that is designed to match foreign currency translation differences, to be non-assessable/non-deductible.

Clearly it is envisioned that any relief to further relax and permit character matched hedges would be under the same strict obligations, prescribed in s 230-90 regarding documentation and recording of hedges as well as the requirements for effectiveness testing (230-100). These rules apply equally strictly for financial reporting purposes and should be undertaken as a mater of course.

Where FCTR hedges are entered into and foreign shareholdings are disposed of then the tax reflex that applies for the shareholding disposal, if any, should be made to apply equally for any hedge closed out as part of the disposal. Where, for instance, part of the disposal is subject to Div 768 participation exemption any hedge of that part of the foreign shareholding interest should be taxed in a parallel fashion. This outcome would ensure that hedging is matched during the ownership period for FCTR exposure but also at realisation time, when any taxed gain or loss would be hedged accordingly.

Similar examples of character matched hedges could arise in other industries where capital projects are financed in foreign currencies and exposure relief is sought to hedge gains and losses which might be of a capital nature.

4. Sale of Offshore Subsidiaries – Participation Exemption

Under the recently revised CFC regime, profits or losses on sale of offshore subsidiaries may be tax free in Australia because the company had an active business and therefore satisfied the participation exemption. The profit or loss on sale could be split between a FX component and an other component. It is important that the total profit is treated in the same way. It would be inappropriate to treat the FX as taxable/deductible on revenue account and the other gain or loss as exempt under the participation exemption.

5. Transition and interaction arrangements

The Exposure Draft has indicated that introduction of TOFA 3 and 4 will require significant conjunctive legislative changes to adapt other provisions of the Act and to provide for transition arrangements. ICA is most concerned about being asked to comment on only a partially completed package. Certain of the changes needed to carve out other interacting provisions could be significant and sway the ICA's view of the whole package.

ICA also will look with interest at transition concessions planned with the regimes introduction. For general insurers there would not be a predisposition to elect into fair value accounting for tax unless there are seen to be an enticement for generally bringing forward the taxing point earlier that the realisation date that exists now. While there are advantages to making the accounting and tax recognitions consistent it is recognised that there would be a reluctance to elect into such a regime where there is seen to be a financial penalty in doing so. It is noted from an international perspective that the UK introduced a phasing in of tax for elections to be taxed on an unrealised basis. A similar scheme would be sought by general insurers in Australia.

ICA would be pleased to explain further and to engage in further discussion and consultation.

Yours sincerely

Peter Anderson
Manager Policy, Policy Development and Research