

Mr William Potts
Taxation of Financial Arrangements
Business Income Division, Revenue Group
Department of the Treasury
Langton Crescent
PARKES ACT 2600

5th March 2007

Dear Mr Potts

Insurance Council Submission on TOFA 3 and 4 Exposure Draft

Further to our previous submission of 3 March 2006, the Insurance Council of Australia Limited¹ (the Insurance Council) welcomes the opportunity to comment upon Treasury's TOFA 3 and 4 exposure draft. The ongoing opportunity to liaise with Treasury on taxation matters relating to the industry via Mr Tony Regan is also greatly appreciated

We understand that detailed responses are being submitted by professional bodies and other industry associations – in this submission we will be confining our comments to matters concerning the general insurance industry.

In our previous submission of 3 March 2006 we submitted that the general insurance transactions should be excluded from TOFA provisions in the same way that life insurance as defined in Division 320 is excluded under section 230 – 135(4). Section 230, as drafted, does not appear to achieve this. Suggestions as to how this may be resolved are set out under point 1 below.

¹ The Insurance Council of Australia Limited is the representative body of the general insurance industry in Australia. Our members represent more than 90 percent of total premium income written by private sector general insurers.

Insurance Council 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).

Insurance Council 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. APRA's 2007 published statistics show that the private sector insurance industry generates gross premium revenue of \$28.2 billion per annum and has assets of \$82.2 billion (*refer APRA, Half Yearly General Insurance Bulletin, February 2007*). The industry employs approx 60,000 people (Australian Bureau of Statistics).

Australian general insurers issue more than 42 million insurance policies annually and deal with 3.5 million claims each year (*refer APRA, Selected Statistics on the General Insurance Industry, Year Ending June 2002*). On average, about \$70 million in claims is paid each working day.

1. General insurance policy – an excluded financial arrangement (sub-section 230-315(6) of ITAA 1997)

While we note the drafting of this item has not changed since the previous draft, a further review raises concerns.

Sub-section 230-315(6) provides a proposed exclusion for a right or obligation under a general insurance policy unless the policy is a derivative financial arrangement. The extent of this exclusion is very vague as noted in the following comments:

- a. We question whether a "right or obligation" refers to the whole of the general insurance transaction or simply the claims component of the transaction? Rights and obligations noted in the exclusion could be interpreted as only the rights **after** the payment of the premium to make a claim (i.e. the right of the insured to make a claim and the obligation of the insurer to pay the claim). The general insurance transaction also includes the payment of premium by the insured to the insurer and the earning of that premium by the insurer. Both the premium and the claims components of the general insurance transaction are covered in Division 321. The insurance industry was hopeful that the exclusion would cover all transactions currently covered by Division 321. It is suggested that the exclusion should apply to the whole of the general insurance transaction including premium and claims.
 - b. The Explanatory Material ("EM") (at 3.81) further narrows the definition of general insurance to only cover property and casualty contracts (with examples provided). It is suggested that the full definition of general insurance as detailed in the Insurance Act 1973 (refer to Appendix 1), be used in the EM to ensure that all general insurance is covered by the exclusion.
 - c. Section 321-60 also covers other transactions involved in the general insurance process including the following:
 - Commission and brokerage fees.
 - Administration costs of processing insurance proposals and renewals.
 - Administration costs of collecting premiums.
 - Selling and underwriting costs.
 - Fire brigade charges.
 - Stamp duty.
 - Other charges, levies and contributions imposed by governments and governmental authorities that directly relate to general insurance policies.
 - Reinsurance premiums.
 - Reinsurance commission.
- It is suggested that as these items are all covered by the rules in Division 321, they should be included in the exclusion.
- d. Point 1(a) only notes issues relating to outstanding claims. Reinsurance recoveries (consistent with section 321-20), should also be covered by this exclusion.

- e. Taxation Ruling 96/2 ("TR 96/2") provides guidance on the type of reinsurance transactions which are financial reinsurance and therefore should be ignored for taxation purposes. It is presumed that the principles outlined in TR 96/2 will apply to the exclusion for general insurance.
- f. Surety products are generally treated as being included in the definition of general insurance despite their non inclusion in the Insurance Act 1973. It is suggested that surety products be specifically included in the exclusion (possibly in the EM).
- g. Division 321 covers general insurance companies which in turn covers insurance business. "Insurance business" is defined in section 995-1 of the ITAA 1997 which is referenced back to the meaning in the Insurance Act 1973. A simple solution is to state that all issues covered by Division 321 are excluded.
- h. If the exclusion does **not** include **all** general insurance items covered under Division 321, there will be complications associated with parts of the general insurance covered under Division 230 and the other parts covered under Division 321.
- i. Contractual arrangements between insurers and insureds are generally referred to as "insurance policies", whereas such contractual arrangements between insurers and reinsurers are referred to as "reinsurance contracts". It is submitted that the exclusion should encompass both, so that references to insurance policies should also refer to reinsurance contracts.

2. Timing for SAP entities to make an election

An entity which has adopted a substituted accounting period ("SAP") (eg year ended 31 December 2007 in lieu of year ended 30 June 2008), can adopt Division 230 from 1 January 2008 by election or otherwise 1 January 2009.

An election is required to be made by 15 July 2007 (i.e. the first lodgement date on or after 1 July 2007), if the entity decides to apply Division 230 to all income years commencing on or after 1 July 2007 (Schedule 1, sub item 21(2)). This means the election will be made 5 months before the rules apply and probably before the Bill receives Royal Assent.

It is suggested that elections be required **at the time** of lodging the income tax return for the tax year in which Division 230 applies as there is no real opportunity for tax avoidance.

3. The "overall gains or losses" requirement under the election to rely on financial reports

Section 230-270 sets out the requirements in order to make an election to rely on financial reports. Sub-section 230-270(e) states that in order for an election to be made, there must be no difference after comparing the overall gains or losses on the financial arrangement shown in the financial reports with the overall gains or losses that would arise by applying the provisions of Division 230.

Sub-section 230-270(f) states that the difference would "reasonably be expected not to be substantial".

The Insurance Council submits that it is important to ensure that the requirement is not subject to an unduly tight interpretation where it may be impossible to substantiate and the election cannot be applied. It is suggested that a guideline is provided to define "substantial" in the widest possible terms.

4. The “reasonable and appropriate” requirement under the election to rely on financial reports

Sub-section 230-270(g) states that an election can only be made if it is “reasonable and appropriate”. The EM (at 8.25) provides an example to support the reasonable and appropriate requirement (i.e. whether significant tax deferral will not occur as a result of making of this election).

We suggest that it is important to ensure that the requirement is not subject to an unduly tight interpretation where it may be impossible to substantiate and the election cannot be applied.

5. Priorities among election methods

To the extent the fair value method applies to the financial arrangement, the foreign exchange retranslation method does not apply (sub-section 230-30(4)(a)).

The EM (at 6.8) states that retranslation recognises only gains and losses attributable to movements in foreign currency exchange rates. Fair value recognises gains and losses attributable to changes in other variables such as interest rates and creditworthiness. When considering both this concept and sub-section 230-30(4)(a), it is not clear how gains and losses attributable to movements in foreign currency exchanges rates should be treated for taxation purposes in cases where the fair method overrides the retranslation method?

The Insurance Council suggests that the fair value method and retranslation method work mutually exclusive to each other and there should be no priority setting between these two methods.

6. Treatment of provision for doubtful debts under the fair value method

It is normal accounting practice to write-off bad debts and make a provision for doubtful debts which may be bad. If a fair value method is adopted, the value of debtors will be the gross value less the provision for doubtful debts. This will mean there is an immediate deduction for doubtful debts provisions. We question whether this is the intended consequence and would appreciate Treasury’s clarification of this point.

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

The Insurance Council notes that further issues in relation to character matching hedging will be addressed by the Corporate Taxpayers Association (“CTA”).

8. Australian consolidated financial reports required under the financial reports and fair value methods

Under the financial reports and fair value method, an Australian consolidated financial report is required. However, this may not be readily available because most multi-national companies' consolidated accounts are based on 'world-wide' figures. There will be more administration involved to prepare a separate set of consolidated accounts consisting of only Australian entities.

9. Offshore branch income

The income of an offshore branch of an Australian company is currently exempt under section 23AH. It is not clear whether Division 230 will override this exemption. We submit that the exemption should be maintained.

The Insurance Council welcomes the opportunity to continue dialogue with Treasury regarding TOFA. If you require any further information or wish to discuss any aspect of this submission further please do not hesitate to contact Peter Anderson at panderson@insurancecouncil.com.au or (02) 9253-5135.

Yours sincerely



Alex Sanchez
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Extract from the Insurance Act 1973

3 Interpretation

(1) In this Act, unless the contrary intention appears:

general insurer has the meaning given by section 11.

insurance business means the business of undertaking liability, by way of insurance (including reinsurance), in respect of any loss or damage, including liability to pay damages or compensation, contingent upon the happening of a specified event, and includes any business incidental to insurance business as so defined, but does not include:

- (a) life insurance business;
- (b) accident insurance business undertaken solely in connexion with life insurance business;
- (c) pecuniary loss insurance business carried on solely in the course of carrying on banking business and for the purposes of that business by an ADI;
- (d) business in relation to the benefits provided by a friendly society or trade union for its members or their dependants;
- (e) business in relation to the benefits provided for its members or their dependants by an association of employees or of employees and other persons that is an organisation within the meaning of Schedule 1B to the *Workplace Relations Act 1996*;
- (f) business in relation to a scheme or arrangement under which superannuation benefits, pensions or payments to employees or their dependants (and not to any other persons) on retirement, disability or death are provided by an employer or an employer's employees or by both, wholly through an organization established solely for that purpose by the employer or the employer's employees or by both;
- (g) business in relation to a scheme or arrangement for the provision of benefits consisting of:
 - (i) the supply of funeral, burial or cremation services, with or without the supply of goods connected with any such service; or
 - (ii) the payment of money, upon the death of a person, for the purpose of meeting the whole or a part of the expenses of and incidental to the funeral, burial or cremation of that person;

and no other benefits, except benefits incidental to the scheme or arrangement;

- (h) business undertaken by a person, being a carrier, carrier's agent, forwarding agent, wharfinger, warehouseman or shipping agent, relating only to the person's liability in respect of goods belonging to another person and in the possession, or under the control, of the first-mentioned person for the purpose of the carriage, storage or sale of those goods;
- (i) business undertaken by a person, being an innkeeper or lodging-house keeper, relating only to the person's liability in respect of goods belonging to another person and in the possession or under the control of a guest at the inn or lodging-house of which the first-mentioned person is the innkeeper or lodging-house keeper or deposited with the innkeeper or lodging-house keeper for safe custody;
- (j) the business of insuring the property of a religious organization where the person carrying on the business does not carry on any other insurance business; or
- (k) business as a registered health benefits organization, a registered medical benefits organization or a registered hospital benefits organization carried on by an organization that is a registered organization within the meaning of Part VI of the *National Health Act 1953*.

life insurance business has the same meaning as in the *Life Insurance Act 1995*.