Inland Revenue
Te Tari Taake

Industry Guidelines

For general insurance reserving

for income tax purposes

Application

These industry guidelines set out the approach taken by Inland Revenue Corporates, Insurance Sector, to the calculation of reserves for general insurance including non-life riders on life insurance policies and reinsurance activities, but excluding life insurance. The guidelines have effect from the 2002/03 income tax year, and will be updated periodically.

The Insurance Sector's approach is to follow FRS 35 where it is consistent with the income tax legislation.

Legislation

All section references are to the Income Tax Act 1994 ("the Act") unless otherwise stated.

Allowable deductions

Section BD 2(1) states:

An amount is an allowable deduction of a taxpayer

(a) if it is an allowance for depreciation that the taxpayer is entitled to under Part E (Timing of Income and Deductions), or

(b) to the extent that it is an expenditure or loss

- (i) incurred by the taxpayer in deriving the taxpayer's gross income, or
- (ii) necessarily incurred by the taxpayer in the course of carrying on a business for the purpose of deriving the taxpayer's gross income, or
- (iii) allowed as a deduction to the taxpayer under Part C (Income Further Defined), D (Deductions Further Defined), E (Timing of Income and Deductions), F (Apportionment and Recharacterised Transactions), G (Avoidance and Non-Market Transactions), H (Treatment of Net Income of Certain Entities), I (Treatment of Net Losses), L (Credits) or M (Tax Payments).

Allocation of gross income

Section BD 3 states:

BD 3(1) A taxpayer or the Commissioner must allocate each amount of gross income to an income year in accordance with this section.

BD 3(2) If an amount of gross income is subject to a timing regime, the amount must be allocated to an income year in accordance with that regime.

BD 3(3) An amount of gross income that is not subject to a timing regime must be allocated to the income year in which the amount is derived.

BD 3(4) A particular amount of gross income may be allocated only once.

Accrual expenditure

Section EF 1 (1) states:

Where any person has incurred any accrual expenditure –

(a) That expenditure is allowed as a deduction when it is incurred in accordance with this Act; and

(b) The unexpired portion of that expenditure at the end of an income year shall be included in the gross income of the person for that income year and shall be allowed as a deduction in the following year.

Section EF 1(5) states:

The amount of the unexpired portion (if any) of any amount of accrual expenditure of any person to be taken into account in any income year shall be –

(a) Where the expenditure relates to the purchase of goods, the amount of expenditure incurred on goods not used in deriving gross income:

(b) Where the expenditure relates to payment for services, the amount of expenditure incurred on services not performed:

(c) Subject to subsection (8), where the expenditure is incurred by way of monetary remuneration for services that have been performed, the amount of that expenditure that has not been paid in the income year or within such further period as is specified in subsection (6):

(d) Where the expenditure relates to a payment for, or in relation to, a chose in action, the amount that relates to the unexpired part of the period in relation to which the chose is enforceable.

Determination E 10

Determination E 10 states:

Any person who incurs expenditure that is deductible in the income year commencing on the 1st day of April 1994, or that is deductible in any subsequent income year until this determination is cancelled by the Commissioner, shall not be required to comply with section [EF 1 of the Income Tax Act 1994] in respect of that expenditure and that income year where –

(a) The expenditure is of a kind described in column (1) of the schedule hereto; and

(b) The sum of all of the amounts of unexpired portion of the kind of expenditure does not exceed the amount, if any, specified in relation to that expenditure in column (2) of the schedule hereto; and

(c) The length of time between balance date and the subsequent expiry date of the expenditure does not exceed the number of months, if any, specified in relation to that expenditure in column (3) of the schedule hereto; and

(d) In relation to expenditure on goods of any of the kinds specified in categories (d) and (k) of the schedule hereto, the goods are in the possession of the person at balance date:

Provided that this determination shall not apply to any expenditure to the extent that deduction of the expenditure has been deferred to a subsequent income year for financial reporting purposes:

Provided also that, for the purposes of this determination, any expenditure taken into account in calculating the assessable income of a partnership for the purposes of [section 42 of the Tax Administration Act 1994], or that should properly be so taken into account, shall be treated as expenditure incurred by the partnership and by no other person.

Practice

Unearned Premium Reserve

The Unearned Premium Reserve (UPR) is the portion of gross premium that relates to the cover of risks beyond the insurer's balance date, calculated on a daily basis. Alternative calculation methods may be acceptable where the daily basis is not appropriate.

Reinsurance premiums and acquisition costs are not required to be netted off against the premium income in the UPR.

Commentary

The gross written premium for an income year would normally not equate with premium income properly attributable to that year because the insurance cover will extend beyond balance date. These amounts should be recognised as gross income over the remaining life of the insurance policies in subsequent income years or periods.

Insurers should recognise premium income over the period of a policy based on the pattern of risk to which the insurer is exposed or the period of the policy (or period of indemnity for reinsurance) in accordance with FRS 35.

Time apportionment using the "daily" method (or similar actuarial spreading method) is considered appropriate unless there is a marked unevenness in the incidence of risk over the period that leads to a material difference in the recognition of gross income.

An alternative approach to recognising gross premium income on a daily basis (or similar actuarial spreading method) may be acceptable taking into account the following factors:

- It can be shown that the daily method is not practical or possible, and
- The alternative method applied does not produce a result materially different to the daily method, and
- The alternative method applied is used for financial reporting purposes.

Reinsurance Premiums

Reinsurance premiums paid (retrocessions for reinsurers) should be recognised separately as expenditure when applying the deductibility provisions in the Act and are not required to be netted off against premium income or in calculating the UPR.

Any unexpired portion of deductible expenditure on reinsurance at the end of an income year is to be included in gross income as accrual expenditure under section EF 1, subject to any exemptions applicable under Determination E 10.

Commentary

Where reinsurance premiums incurred by an insurer have an unexpired portion of accrual expenditure at the end of an income year, an adjustment is required under section EF 1, subject to any determination of exemption under section EF 1(3) (currently Determination E 10).

The specific exemption to the application of section EF 1 in Determination E 10 that may be relevant to reinsurance is in paragraph (e) of the Schedule to the Determination:

Insurance premiums under an insurance contract where the unexpired portion in respect of the contract does not exceed $12,000 and the expiry date is within 12 months from balance date.

Acquisition Costs

Acquisition costs should be recognised separately as expenditure when applying the deductibility provisions in the Act and are not required to be netted off against premium income or in calculating the UPR.

Acquisition costs are deductible in the income year in which they are incurred. Any unexpired portion of deductible expenditure at the end of an income year is to be included in gross income as accrual expenditure under section EF 1, subject to Determination E 10. This will mainly relate to services not performed at year end.

Commentary

Acquisition costs incurred by a general insurer in obtaining and recording insurance policies are allowable deductions for income tax purposes. The initial costs incurred in acquiring and issuing policies may include:

- Commission or brokerage paid to agents for obtaining the business for the insurer,
- Selling and underwriting costs such as risk assessment and advertising,
- The administration costs of processing insurance proposals, renewals and the cost of collecting premiums,
- Government or local authority charges, levies and contributions which relate directly to policies.

Acquisition costs are incurred to derive premium income which is gross income in accordance with the Act and are deductible under section BD 2(1) in the year incurred. There is sufficient nexus between the expenditure associated with the writing of the policies and the gaining of assessable income to satisfy s BD 2(1).

The test of whether an item has been "incurred" is the time that the taxpayer becomes definitively committed to the expenditure. Acquisition costs generally relate to services that have been performed before the end of the income year. The deductibility of acquisition costs is not contingent upon events which transpire in a future income year. Acquisition costs are not generally incurred over a period of time but rather are incurred in the year of policy commencement when the business is acquired. Acquisition costs should be deducted in year one when the expenditure is incurred. It is not generally necessary to spread the acquisition costs over the life of the policy.

However where acquisition costs are paid in advance, there may be an unexpired portion where the services have not yet been performed. The value of any such unexpired portion will need to be included in gross income under section EF 1, subject to any exemptions applicable under Determination E 10.

Outstanding Claims Reserve

An insurer may deduct a reasonable estimate of its liability for outstanding claims incurred and not paid at the end of an income year. This may include those claims incurred but not reported (IBNR) where the insured event occurred before the end of that income year.

Amounts payable under policies may be satisfied by way of cost reimbursement, cash settlement, goods reinstatement, repairs or alternative make good procedures. Such amounts (policy benefit amounts) and direct claim settlement costs are incurred in the income year in which the insured event occurs.

Indirect claim settlement costs constitute ongoing business expenses that are incurred whether or not any particular claim is received by an insurer. Indirect claim settlement costs should not be included in the estimation of the insurer's outstanding claims reserve or IBNR, but be deducted independently in the income year they are incurred by reference to the contractual arrangements under which they are incurred.

Any unexpired portion of direct claim settlement costs at the end of an income year is to be included in gross income as accrual expenditure under section EF 1, subject to any determination of exemption under section EF 1(3) (currently Determination E 10). Claim settlement costs incurred by an insurer for the benefit of the insured or for the benefit of the reinsurer are not subject to Section EF 1.

Commentary

The outstanding claims reserve calculated in accordance with FRS 35 is deductible under section BD (2)(1) except to the extent indirect claim settlement costs are included. Adjustments may also be required to add back certain amounts of unexpired expenditure under section EF 1.

Claims costs included in the OCR under FRS 35 may include:

- The **policy benefit amount** required to be paid to or on behalf of the insured including all expenditure of the insured required to be indemnified under the policy, and
- **Direct claim settlement costs** that can be directly associated with individual claims such as legal fees, assessor's costs and other professional charges, and
- **Indirect claim settlement costs** that are only indirectly associated with individual claims, such as inhouse claims department costs.

The policy benefit amount and the direct claim settlement costs are incurred for income tax purposes in the income year in which the insured event occurs.

Indirect claim settlement costs that are incurred during the year are deductible under section BD (2)(1) subject to any adjustment required under section EF 1. Indirect claim settlement costs that are not incurred at the end of the income year should not be included in the OCR as these costs cannot be attributed to a particular claim. The insurer incurs these costs regardless of whether a particular claim is actually received. Indirect claim settlement costs involve such general expenses as claims handling, staff salaries, rent and other costs of running and administering an insurer's claims department. These costs are often referred to as "claims administration costs".

Section EF 1 requires that expenditure incurred and unexpired at the end of an income year is to be included in gross income as accrual expenditure, subject to Determination E 10.

Determination E 10 currently provides a general exemption to section EF 1 for services, other than those dealt with specifically in Determination E 10, that do not exceed $12,000 and expire within six months from balance date[1].

In ascertaining whether the threshold in Determination E 10 is exceeded it is necessary to aggregate all expenditure of the kind listed in the exemption.

An issue arises as to how the accrual expenditure provisions in section EF 1 apply to amounts accrued by insurers and reinsurers in the OCR. There are three possible interpretations that could be argued.

- That section EF 1 applies to all expenditure accrued within the OCR.
- That section EF 1 does not apply to expenditure accrued within the OCR.
- That section EF 1 applies to expenditure accrued within the OCR, but only to the extent that the expenditure does not form part of the policy benefit amount in respect of a claim.

Following the Privy Council decision in *Commissioner of Inland Revenue v Mitsubishi Motors New Zealand Limited* (1995) 17 NZTC12,351 Inland Revenue issued an interpretation statement[2] that considers the meaning of "incurred". The statement also considers section EF 1 and its application to warranty expenditure, which provides some guidance on the application of section EF 1 to OCR expenditure.

Consistent with the interpretation statement, Inland Revenue considers that section EF 1 does apply to expenditure accrued with the OCR, but only to the extent that the costs do not form part of the policy benefit amount. Section EF 1 does not require the policy benefit amount of an insurance policy to be adjusted. This is considered analogous to expenditure in discharging the obligation under a warranty.

Accordingly, section EF 1 does not apply to expenditure on goods, services or choses in action in discharging the policy obligation to the insured whether acquired by the insured and reimbursed or acquired directly by the insurer for the benefit of the insured.

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[1] Schedule to Determination E 10, paragraph (i).

[2] IRD Tax Information Bulletin: Vol 10, No.6, Appendix (June 1998).

However, expenditure on services relating to direct claim settlement costs for the benefit of the insurer is required to be adjusted under section EF 1 where the services have not been performed at balance date (and will not be recovered through reinsurance). Such expenditure is by way of payment for services to the insurer, rather than discharging the obligation under a policy.

The following examples illustrate the application of section EF 1.

- Where an insurer arranges for repair services on behalf of the insured to place a vehicle in the condition it was in prior to the insured event section EF 1(5) would not apply. This is the payment of a policy benefit.
- Where an insurer incurs costs under a policy to defend a claim against the insured person by a third party as in a public indemnity claim, section EF 1 (5) would not apply. This is the payment of a policy benefit.
- Where an insurer incurs legal costs to dispute the insured's policy claim or other costs in investigating or settling a claim, and such costs will not be recovered through reinsurance, it is considered the costs are for services for the benefit of the insurer and section EF 1(5) does apply. These costs are direct claim settlement costs and not the payment of a policy benefit.

Section EF 1(5)(b) states that the unexpired portion is the "amount of expenditure incurred on services not performed". To the extent that the services have not been executed, carried out or otherwise rendered in an income year in which the claim occurred, and the services will be for the benefit of the insurer, the unexpired portion is required to be added back as income under section EF 1(1).

In keeping with the *Mitsubishi Motors New Zealand Limited*[3] case a reasonable estimate of the OCR attributable to the unexpired portion can be made in determining the amount to be added back where it is not otherwise possible on a claim by claim basis.

Section DK 5 Outstanding Claims Reserves

Section DK 5 sets out the valuation method to be adopted for outstanding claims in relation to insurance to which the provisions of the Accident Insurance Act 1998 apply.

The following passages are taken from the Tax Information Bulletin Volume 11, No 1 (January 1999).

> "Section DK 5 has been inserted into the Income Tax Act 1994 and applies to the outstanding claims reserve of insurers for insurance business written under the Accident Insurance Act 1998. This section provides for a present value approach to valuing the reserve. If the reserves for financial reporting purposes meet certain requirements, the same basis can be used for tax purposes.
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> The value of the reserve at the end of the income year is to be the amount calculated by an actuary and adopted by the insurer for financial reporting purposes. If the reserve has not been determined on this basis, the Commissioner of Inland Revenue can seek the advice of the Government Actuary or any other actuary to determine the amount of the reserve. The amount of the reserve must have regard to generally accepted accounting practice, generally accepted actuarial practice and the present value of expected future payments.

[3] Commissioner of Inland Revenue v Mitsubishi Motors New Zealand Limited (1995) 17 NZTC 12,351

> The result is that in calculating the outstanding claims reserve, future costs of administering and settling claims incurred and other factors, such as prudential margins, can be taken into account, where this is consistent with accounting and actuarial practice. A present-value approach to valuing the reserve is considered to result in a more accurate measure of an insurer's income in relation to accident insurance. The relevant professional bodies are currently developing accounting and actuarial standards."

Section DK 5 operates as a specific provision that governs the calculation of accident insurance reserves. Accordingly, such reserves are not subject to the accrual expenditure provisions in section EF 1(5).

Salvages and other recoveries

Current industry practice is to credit net recoveries against claims expenses. At year end the OCR is reduced by amount of expected net recoveries attributable to claims included in the OCR.

For tax purposes Inland Revenue considers third party receivables constitute debts subject to the bad debt write off provisions. Salvages are considered to constitute trading stock. However, Inland Revenue accepts that the derivation of any gross income, bad debts written off and the value of any trading stock for salvages are effected through the claim process with adjustments to the OCR.

Section EF 1 does not apply to the costs associated with salvages and recoveries as these costs benefit the insured, not the insurer.