Amount allocated as bonus to policyholders and amount appropriated as funds for future appropriation do not form part of actuarial surplus that is chargeable to tax

January 17, 2018

In brief

In a recent decision[1] the Delhi bench of the Income-tax Appellate Tribunal (Tribunal) held that the amount allocated as bonus to policyholders and the amount appropriated as funds for future appropriation do not form part of the actuarial surplus that was chargeable to tax under section 44 read with rule 2 in the First Schedule to the Income-tax Act, 1961 (Act).

The Tribunal held *inter alia* that the profit disclosed in the shareholder's account was taxable as profit of the business, and further held that disallowance of provision for doubtful debts and share issue expenses was not attracted, in view of special provision applicable to a life insurance company.

The Tribunal has also made passing comments that royalty paid could not be regarded as an expense relating to the life insurance business.

In detail

Facts

- The taxpayer was engaged in the business of life insurance. The taxpayer offered its income to tax applying the provisions of section 44 read with rule 2 in the First Schedule to the Act.
- The taxpayer computed its total income by aggregating the surplus/ deficit disclosed in the revenue account (i.e. policyholder's account) and the profit and loss account (i.e. shareholder's account).
- While assessing the income chargeable to tax, the Tax Officer (TO) disallowed, *inter alia,* the amount paid as donation and share issue expenses.
- In appeal, the Commissioner of Income-tax (Appeals) [CIT(A)] upheld the above disallowances made by the TO. Further, the CIT(A) changed the basis of computation and enhanced the income of the taxpayer by treating–

a) The profit disclosed in the shareholder's account as the profit from other than life insurance business, to which section 44 read with rule 2 in the First Schedule to the Act does not apply;

b) The amount declared and allocated as bonus to policyholders as part of the actuarial surplus chargeable to tax under

[1] ITA No. 142/Del/2017 dated 5 January 2018

section 44 read with rule 2;

c) The amount appropriated as funds for future appropriation (FFA) as part of the actuarial surplus chargeable to tax under section 44 read with rule 2;

d) The provision for doubtful debts debited to the shareholder's account as a non-deductible expense; and

e) Dividend income as not exempt under section 10(34) of the Act.

In addition, while allowing the set-off of brought forward losses against the income for the year under appeal, the CIT(A) directed the TO to re-compute the losses of earlier years.

- The taxpayer filed an appeal with the Tribunal.

Tribunal's decision

Bonus to policyholders

- The basis of taxation for a life insurance company is the actuarial surplus. The term "actuarial" is defined neither in the Act nor in the Insurance Act, 1938 (Insurance Act)/ Insurance Regulatory and Development Authority Act, 1999. Therefore, its meaning must be understood from the ordinary commercial principles governing the life insurance business and relevant rules, guidelines and norms governing actuarial valuation of life insurance contracts.
- Actuarial surplus represents the amount available for shareholders after providing for all the expenses and ascertained liabilities of the life insurance business. The policyholders were not the shareholders but the customers.
- The liability or the amount set aside for future distribution to the policyholders, which in law, was not available to the shareholders could not form part of the actuarial surplus. The amount set aside for the policyholders was in the nature of liability/ charge on the income.
- The premium received by the taxpayer was embedded with the obligation to declare bonus to participating policyholders (i.e. customers), therefore, it had to be set-off against the premium received. Once the bonus was declared, the taxpayer could not reverse the same and once bonus was declared it became an ascertained liability towards customers.
- The appropriation of income under the Act has a definite import of application of income, i.e., after income has been earned/ accrued; the "appropriation" of surplus under insurance laws means the act of declaring a particular amount as being kept aside for the benefit of the policyholder/ shareholder. The amount that was kept aside or transferred to the shareholder's account was taxable as income, whereas the amount kept aside or distributed to policyholders was a liability/ charge on the life insurance business, to be discharged in present or in future, and was ascertained liability.
- Any amount ascertained by the actuary as a charge/ bonus for future appropriation could not form part of actuarial surplus.
- Unlike erstwhile rule 3 in the Act which limited the allowability of the deduction pertaining to the amount set aside for the benefit of policyholders to 80%, there is no provision under the Act which states that while arriving at the actuarial surplus, the liability ascertained by the actuary as bonus payable in future would not be deductible. The actuarial surplus is the amount computed after providing for liabilities, which includes the amount of future bonus set aside for the benefit of the policyholders both by way of bonus allocation and funds for future appropriation. The Old Form G, H and I prescribed under the Insurance Act clearly provide the same.
- Even on the grounds of consistency, the Revenue could not discard the consistent and regular method followed for determining the taxable income without there being any change or otherwise. The bonus declared had been allowed as a deduction by the Revenue.
- The bonus declared by the taxpayer therefore, did not form part of the actuarial surplus that was chargeable to tax.

Funds for future appropriation

- In view of the contract of life insurance and the regulations by the Insurance Regulatory and Development Authority of India, the shareholders were entitled only to 10% of the surplus or deficit out of the participating policyholders account. The remaining amount belonged to the policyholders and the company could not allocate the funds to shareholders. Therefore, participating policyholders had a charge over this amount. These funds were generally kept aside as participating funds for declaring or smoothening bonuses in future. It represented the reasonable expectation of future bonus on account of the performance of participating funds over the years.

- FFA was earmarked for participating policyholders and represented providing for expectation of further bonuses based on terms and conditions laid down in the insurance policies. It would represent ascertained liabilities towards policyholders as it could not be used by the insurance company for allocating it to the shareholders although it had not been due to the policyholders.
- The premiums earned by the taxpayer had been embedded obligation to make available the benefits provided under the insurance contract, in future. The premiums earned had to be set off by estimated liability to make available future benefit as the actuary declared such provision in form of FFA.
- Even on the grounds of consistency, the Revenue had consistently excluded the amount appropriated for FFA out of the available surplus for ascertaining actuarial surplus while computing profits and gains of life insurance business of the taxpayer.
- As the amount was earmarked for policyholders, it could not form part of the actuarial surplus rather it had to be reduced while working out the actuarial surplus under rule 2 in the First Schedule to the Act.

Profits in the shareholder's account

- A life insurer such as the taxpayer, was not permitted to carry on any other business other than that of life insurance; the manner of investment was strictly regulated by the IRDAI, implying that investments made out of shareholder's funds was an integral and inextricable part of the life insurance business and not an independent business.
- The argument advanced by the Revenue that the provisions of section 115B(1)(ii) will become redundant in case the income in the shareholder's account is taken to be the income derived from life insurance, is not acceptable.
- Following the ICICI Prudential's[2] case where it was held that the income in the shareholder's account was taxable as income from life insurance business, and based on the principle of consistency the profit disclosed in the shareholder's account was to be treated as forming part of the income from the life insurance business.

Provision for doubtful debts and share issue expense

- Income in the shareholder's account also formed part of the profit and gains from the life insurance business of the taxpayer, which was taxable as per section 44 read with rule 2 in the First Schedule to the Act.
- Section 44 debars the Revenue from applying provisions of sections 28 to 43B of the Act.
- Therefore, the provision for doubtful debts debited to the shareholder's account could not be disallowed. The enhancement made by the CIT(A) for this was deleted. Further, the disallowance for share issue expenses was also deleted on this basis.

Royalty expense

While addition towards royalty income was not an issue in the appeal, the Tribunal has made passing comments that royalty paid cannot be regarded as an expense relating to the life insurance business, as it is not towards liability incurred for the life insurance business.

The takeaways

The decision of the Tribunal regarding the bonus allocated to policyholders, and FFA not forming part of actuarial surplus (which is chargeable to tax), sets a precedent for the industry. In addition, the Tribunal's comment that royalty paid cannot be regarded as an expense relating to life insurance business, is noteworthy.

The Tribunal also dealt with some of the issues which were common to earlier cases decided at Tribunal level in the case of ICICI Prudential[2] and certain other taxpayers. The Tribunal has largely followed the decision in the case of ICICI Prudential[2] to decide these issues in favour of the taxpayer.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact your local PwC advisor

[2] ICICI Prudential Life Insurance Company Limited *v.* ACIT [2013] 140 ITD 41 (Mumbai)

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