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News Alert
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Determination of taxable income of a life insurance company in accordance with section 44 of, read with Rule 2 in the First Schedule to, the Act

In brief

In a recent decision dated September 14, 2012, in the case of ICICI Prudential Life Insurance Co. Ltd.[1] (the assessee), the Mumbai bench of Income-tax Appellate Tribunal (Tribunal) held the following

- The assessee's method of combining the results in the Policyholders' Account and the Shareholders' Account without taking into consideration the transfer of funds from the Shareholders' Account to the Policyholders' Account to arrive at actuarial surplus/(deficit) of life insurance business, is in accordance with the provisions section 44 of, read with Rule 2 in the First Schedule to, the Income-tax Act, 1961 (Act).
- Income in the Shareholders' Account is to be treated as part of life insurance business and to be taxed under section 115B of the Act.
- Provisions of section 14A of the Act do not apply to insurance business and accordingly, no disallowance under section 14A is attracted in the assessee' case.

[1]ICICI Prudential Insurance Co. Ltd. *v.* ACIT (ITA No. 6854, 6855, 6856 and 6059 of 2010) ACIT *v.* ICICI Prudential Insurance Co. Ltd. (ITA No. 7765, 7766, 7767 and 7213 of 2010)

- The assessee is entitled to exemption under section 10 and accordingly, the assessee is entitled to exemption under section 10(23AAB) in respect of surplus of participating pension business and also under section 10(34) of the Act in respect of dividend income.
- Adjustment to Form I surplus on account of negative reserves is unjustified.
- Addition of an amount representing 100% depreciation provided on certain assets is unjustified.

The above represents the broad summary of the issues decided by the Tribunal. A detailed summary on these issues is provided in the following part of this News Alert.

Facts

- The assessee is engaged in life insurance business.
- The taxation of profits of life insurance business is governed by the provisions of section 44 of, read with Rule 2 in the First Schedule to, the Act.
- As per the above provisions, the assessee offered taxable income from life insurance business by combining the results in the Policyholders' Account (Form A-RA) and the Shareholders' Account (Form A-PL) and without taking into consideration the transfer of funds from the Shareholders' Account to the Policyholders' Account.

  The assessee claimed exemption under section 10(23AAB) in respect of surplus of pension business and under section 10(34) in respect of dividend income. The assessee also offered an amount for disallowance under section 14A of the Act.
- The AO treated the surplus reflected in Form I (forming part of the Actuarial Report & Abstract) as the income of the assessee from life insurance business.

  The AO separately taxed the income in the Shareholders' Account as 'Income from other sources'.

  While determining the assessed income, the AO made certain adjustments by way of:

  - disallowance under section 14A;
  - denial of exemption claimed as above by the assessee;
  - addition on account of negative reserves;
  - addition of an amount representing 100% depreciation provided on certain assets
- On appeal by the assessee, the Commissioner of Income-tax (Appeals) (CIT(A)) allowed the appeal partly in favour of the assessee.

Key issues before the Tribunal

The key issues before the Tribunal are summarised below in simple terms.

- Is the surplus/(deficit) offered by the assessee, in accordance with the provisions of section 44 of, read with Rule 2 in the First Schedule to, the Act?
- Is income in the Shareholders' Account taxable as 'income from life insurance business' or as 'income from other sources'?
- Is the disallowance under section 14A attracted in the assessee's case?

- Would the deficit* in pension scheme not formpart of total income as the surplus of pension scheme does not form part of total income as per section 10(23AAB)?

- Is the assessee entitled to exemption under section 10(23AAB) in respect of surplus of participating annuities** business and under section 10(34) in respect of dividend income?

- Is the addition on account of negative reserve justified?

- Is the addition of an amount representing 100% depreciation provided on certain assets justified?

[* *The Tribunal has not specifically dealt with this issue in the order.*

*** The Tribunal did not consider the specific issue raised by the Revenue that the surplus in annuities business do not represent the surplus in pension business so as to be exempt under section 10(23AAB).*]

Tribunal's observations and ruling

Taxable profits as per section 44 read with Rule 2

- There is no dispute that the assessee is in the life insurance business and that the taxability of insurance business is governed by the provisions of section 44 read with Rule 2.

- As per Rule 2, actuarial surplus or deficit between two valuation periods can only be taken as income or loss of the period. Before the IRDA Act coming into force, the actuarial valuation was undertaken once in three years. Therefore, the rule provides for only average of the surplus to arrive between two inter-valuation periods.

- With the enactment of the IRDA Act, 1999 (the IRDA Act) and regulations therein, the manner of presentation of accounts and report were modified. Consequent to the same, revised format in Form I was introduced which deviated from the format of Form I prescribed under the Insurance Act, 1938 (the Insurance Act).

- The AO has adopted 'total surplus' stated in Form I under new regulations as the taxable profit of the assessee from life insurance business.

- The AO sought to reopen the earlier assessment years to adopt the above basis of computing the taxable profits. The AO's action was held to be bad in law by the Bombay High Court after examining the entire scheme of presentation of accounts, various applicable regulations and change in formats.

- The dispute in the years under appeal is also similar. The High Court order has consequential effects in later years and there is need to follow uniform methodology.

Actuarial valuation as referred in Rule 2

- Based on the principle[2] of 'legislation by incorporation', the reference in Rule 2 to the wordings "the 'actuarial valuation made in accordance with the Insurance Act, 1938' do mean that the actuarial valuation done in accordance with the Insurance Act, 1938."

- With the introduction of IRDA Act, the relevant provisions of the Insurance Act itself were amended in tune with IRDA Act. In view thereof, Rule 5 dealing with 'taxable profits in case of other insurance business' in the First Schedule

[2] as explained by the Supreme Court in the cases of Mahindra & Mahindra Ltd *v.* UOI [1979] 2 SC 529 and Bharat Cooperative Bank Mumbai Ltd *v.* Cooperative Bank AIR [2007] (SC) 2320

was amended specifically to refer to the IRDA Act or the regulations made there under, but the legislature intended not to amend the Rule 2.

- The legislature consciously omitted incorporating the provisions of IRDA or the regulations made there under in Rule 2 which still refers to the Insurance Act. This indicates the intention of legislature that the actuarial valuation has to be made in accordance with the unamended Insurance Act. The unamended provisions of Insurance Act were only incorporated into the Act as far as life insurance business is concerned.

- Therefore, the AO's action in following the format prescribed under the regulations of IRDA Act is not in accordance with the spirit of Rule 2 and provisions as made applicable under the Act.

Actuarial valuation as per the unamended Insurance Act

- The actuarial report and abstracts under the Insurance Act has to be prepared as per section 13 of that Act in accordance with the regulations contained in Part I of the Fourth schedule and in conformity with the requirement of Part II of that schedule.

- Even though said schedules were omitted from the Insurance Act after incorporation of the relevant schedules in the IRDA Act, as far as Rule 2 is concerned, as per the principle of 'legislation by incorporation', the unamended Insurance Act is applicable.

In view thereof, the actuarial valuation has to be made in accordance with the then existing Part I of the Fourth Schedule and in conformity with the requirements of Part II of that schedule.

Surplus/(deficit) of life insurance business to include the Shareholders' income even after regulatory changes

- After introduction of IRDA Act, number of regulations have been prescribed by the IRDA.

- IRDA (Actuarial Report and Abstract) Regulations, 2000, prescribes the method of preparation of actuaries report and abstracts. *Vide* item no. (iv) of regulation 4(2)(d) of these regulations, Form I was prescribed for the purpose of valuation results and to indicate the surplus or deficit in the life insurance business of a company.

- IRDA also prescribed IRDA (Preparation of Financial Statements and Auditor's Report of Insurance Companies) Regulations, 2002, which specifically require to maintain the Policyholders' Account and the Shareholders' Account separately. The surplus or deficit arrived at by the actuary in his valuation for the inter-valuation period has to be taken into consideration under the regulations in financial accounts as well.

- Just because separate accounts are maintained as required by IRDA regulations, the incomes in Shareholder's account do not become separate from life insurance business. As per Insurance Act, all incomes are part of one business only and these incomes are considered as part of same business.

- Further, IRDA regulations permits transfer of funds from the Shareholders' Account to the Policyholders' Account as and when there is a deficit in the Policyholders' Account. The deficit in the Policyholders' Account is met by infusing capital. Maintaining adequate capital is necessary to comply with IRDA (assets, liabilities and solvency margin of Insurers) Regulations, 2000. Income earned on capital infused in business is integral part of life insurance business.

- The assessee is in life insurance business and it is not permitted to do any other business. Therefore, the incomes in the Shareholders' Account are to be considered as arising out of life insurance business only, as they are part of same business. The incomes in the Shareholders' Account are part of life insurance business and to be taxed under section 115B of the Act.

- The CIT(A) gave the finding that the assessee is in the life insurance business only and incomes are to be treated as income from life insurance business, but surprisingly in subsequent assessment years appeals he accepted AO's contention that surplus in shareholder's account is to be taxed as other sources of income.

- Once assessee is in the life insurance business, the computation has to be made in accordance with section 44 read with Rule 2. Once the provisions of section 44 are invoked anything contained in other heads of income do not come into play and only First Schedule has to be invoked to arrive at the profit.

  Therefore, both the Policyholders' Account and the Shareholders' Account have to be consolidated for the purpose of arriving at the deficit or surplus.

Comparison of Form I under the Insurance Act and IRDA regulations

- Both the AO and the CIT(A) has given credence to Form I without understanding that the old Form I prescribed under the Insurance Act is entirely different from new Form I prescribed under the IRDA Regulations.

- The new Form I was prescribed under regulation 4 of the IRDA (Actuarial Report and Abstract) Regulations. Not only that another format of Form I is prescribed in regulation 8 of these regulations.

- Regulation 8 as shown above has column (a) 'surplus shown under Form I'. In Col. (e) one has to represent sum transferred from shareholder's fund during the inter-valuation period. Item (g) refers to the 'total surplus' after taking into account items (a) to (f). Under Col.(a), surplus shown in Form-I is a deficit as per Form AR-A in the Policyholders' deficit account in this year. This corresponds the 'actuarial valuation surplus or deficit' referred to under the Insurance Act. This amount also tallies with Form I prescribed under Regulation 4.

- Form I under regulation 8 represent the total surplus for the purpose of distribution of bonuses/ dividends to the Policyholders' and does not represent surplus or deficit of actuarial valuation for the purposes of Balance Sheet. This amount is represented in Form I prepared under regulation 4 for the purpose of financial accounts.

- As seen from the orders of the authorities, the 'total surplus' prepared under regulation 8 was taken as basis ignoring the Form I of regulation 4.

- The deficit for the year arrived at by the assessee by considering the deficit disclosed in the old format of Form I tallies with the assessee's computation of income. Further, the reconciliation submitted by the assessee of the IRDA format with that of old insurance Form and of the total surplus (as per new format of Form I) with the return of income is correct. Accordingly, the loss disclosed in the computation of income is according to the actuarial surplus/deficit under the Insurance Act prescribed under Rule 2.

Basis adopted by the AO not correct

- Instead of examining the accounts submitted by the assessee which are in accordance with the Insurance Act, the AO taxed the amount shown in Form I (under Regulation 8) which is after taking into account the transfer of assets by

way of fresh capital from the Shareholders' Account.

This in a way is taxing fresh capital infused into business indirectly which cannot be done as this is not business surplus but infusion of capital directly. Basically, transfers are tax neutral as credit in one account gets cancelled by debit in other account when accounts are consolidated.

- Instead of taking the surplus disclosed at regulation 8(1)(a) which is the actuarial surplus/deficit for the year, the AO took the amount as disclosed at regulation 8(1)(g) (which is total surplus after transfer from the Shareholders' Account), which is not at all correct.

Conclusion

- In view of the above, the computation made by assessee is in accordance with Rule 2. This also corresponds to the way the incomes were assessed in the earlier years i.e. correct method as per Rule 2 and section 44 of the Act.

Disallowance under section 14A

- The AO as well as the CIT(A) did not accept the amount offered by the assessee for disallowance under section 14A.

- The assessee has raised an additional ground before the Tribunal that disallowance under section 14A is not attracted as the provisions of section 14A are not applicable to insurance companies.

- This issue is already decided by the co-ordinate benches in various cases[3].

- Following the decision of the Mumbai Bench of the Tribunal in the case[4] of General Insurance Corporation of India, the provisions of section 14A do not apply to the insurance business.

- Accordingly, the assessee's ground to delete the disallowance under section 14A made by the AO.

Claim for exemption under section 10(23AAB) and 10(34)

- In arriving at the deficit from insurance business, the assessee claimed exemption under section 10(23AAB) in respect of surplus of pension business and under section 10(34) in respect of dividend income.

- The AO did not allow exemption on the ground that these incomes are part of life insurance business and included as income by the actuary. The CIT(A) held in favour of the assessee.

- Following the decisions in the case of General Insurance Corporation of India (above), the Tribunal held that the assessee is entitled to exemption under section 10.

- Accordingly, the Tribunal rejected the Revenue's ground and upheld the CIT(A)'s order allowing the assessee's claim of exemption under section 10(23AAB) in respect of surplus of participating pension business and also under section 10(34) in respect of dividend income.

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[3] Bajaj Alliance General Insurance Co. *v.* ACIT [ITA No. 1447/Mum/2007]
JCIT *v.* Reliance General Insurance Company [ITA No. 3085/ Mum/2008]

[4] General Insurance Corporation of India *v.* ACIT [ITA No. 3554/Mum/2011]

Addition on account of negative reserves

- While completing the assessment, the AO treated negative reserve as income and consequently, made adjustment to the Form I surplus to arrive at income from life insurance business.
- The Tribunal referred to the submissions made by the assessee before the CIT(A) drawing the attention of CIT(A) to the relevant IRDA regulations[5] and thereby, pointing out to CIT(A) that the appointed actuary is mandated to arrive at the surplus after excluding negative reserves.
- The CIT(A) accepted the assessee's contention that the negative reserves disclosed in Form I do not give rise to distributable surplus.
- The mathematical reserve is a part of actuarial valuation and the surplus as disclosed in Form I takes into consideration this mathematical reserve also.
- The AO has no power to modify the amount after actuarial valuation was done, which was the basis for assessment under Rule 2. The principles laid down by the Supreme Court in *LIC's* case, about the powers of the AO also restricts the scope and the adjustments by the AO.
- In view of this, the Tribunal rejected Revenue's ground and upheld the CIT(A)'s order deleting the action of the AO to bring to tax the negative reserves.

[5] Sub-regulation 2 dealing with 'Method of determination of Mathematical Reserves' in Schedule II-A on 'Valuation of Liabilities – Life Insurance' of the IRDA (assets, liabilities and solvency margin of Insurers) Regulations, 2000

Addition of an amount representing 100% depreciation provided on certain assets

- The CIT(A) deleted the action of the AO in making the addition of an amount representing 100% depreciation provided on certain assets.
- The Tribunal noted that the CIT(A) decided the issue in favour of the assessee on the ground that as per the provisions of the law, only those adjustments which are expressly prohibited under section 44 could be made and consequently, depreciation which has been debited in the audited accounts as per the consistently followed and accepted accounting policy need not be disallowed.

  While coming to this conclusion, the CIT(A) had observed that the assessee has to prepare its accounts as per the formats prescribed by IRDA under the Insurance Act, 1938 and accounts so prepared by the assessee have been subject to statutory audit.

- The Tribunal rejected Revenue's ground and upheld the CIT(A)'s order by concluding that the CIT(A)'s action in deleting the addition made by the AO is consistent with the accounting principle followed and the provisions of section 44 read with Rule 2 in the First Schedule to the Act.

Conclusion

- The decision of the Tribunal brings welcome relief for the life insurance industry. The Tribunal decision assumes significance as it seeks to bring much needed clarity in interpretation of section 44 and Rule 2 in the wake of reporting changes brought out by IRADA Act and regulations thereto.

Our Offices

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Ahmedabad	Bangalore	Bhubaneswar	Chennai	Hyderabad
President Plaza, 1st Floor Plot No 36 Opp Muktidham Derasar Thaltej Cross Road, SG Highway Ahmedabad, Gujarat 380054 Phone +91-79 3091 7000	6th Floor, Millenia Tower 'D' 1 & 2, Murphy Road, Ulsoor, Bangalore 560 008 Phone +91-80 4079 7000	IDCOL House, Sardar Patel Bhawan Block III, Ground Floor, Unit 2 Bhubaneswar 751009 Phone +91-674 253 2279 / 2296	8th Floor, Prestige Palladium Bayan 129-140 Greams Road, Chennai 600 006, India	#8-2-293/82/A/113A Road no. 36, Jubilee Hills, Hyderabad 500 034, Andhra Pradesh Phone +91-40 6624 6600
Kolkata 56 & 57, Block DN. Ground Floor, A- Wing Sector - V, Salt Lake. Kolkata - 700 091, West Bengal, India Telephone: +91-033 - 2357 9101/4400 1111 Fax: (91) 033 - 2357 2754	**Mumbai** PwC House, Plot No. 18A, Guru Nanak Road - (Station Road), Bandra (West), Mumbai - 400 050 Phone +91-22 6689 1000	**Gurgaon** Building No. 10, Tower - C 17th & 18th Floor, DLF Cyber City, Gurgaon Haryana -122002 Phone : +91-124 330 6000	**Pune** GF-02, Tower C, Panchshil Tech Park, Don Bosco School Road, Yerwada, Pune - 411 006 Phone +91-20 4100 4444	For more information contact us at, pwctrs.knowledgemanagement@in.pwc.com

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