

## English translation

### Tax implications of insurance technical reserves

#### I. Certain insurance terms

Insurance: Insurance is an agreement through which persons and entities transfer their risks in return for a certain premium, in order to protect themselves from the financial impacts of certain events they would encounter under certain circumstances, which would result in loss or loss of income.

Policy: Policy is a contract through which the insurer undertakes to pay compensation in case of any harm to the benefits of the insured that are measurable with money and to pay a certain amount of money in return for a certain premium in life insurances.

Risk: All kinds of losses that may result from actions of the beneficiary of the insurance or the party establishing the insurance, other than unethical actions and actions prohibited by law.

Insurance premium: The amount paid by the insured in return for the risk incurred by the insurer under the insurance agreement.

Guarantee: The assurance that the insurer undertakes to give to the insured in the case of realization of the risk.

Actuary: People who prepare tariffs and technical principles in accordance with legal regulations, by calculating the premiums, reserves and profit shares through the application of the insurance technique and probability and statistical theories in the relevant investment, finance and demographical issues.

Reinsurance (Repeated Insurance): Reinsurance is the repeated insurance of the insured benefits by the insurer, under the conditions they desire. Insurance companies provide repeated insurance in order to avoid getting in difficult situations in claim payments in a possible concurrence of big damages in the risks for which they provide guarantee.

#### II. Insurance sector in Turkey in 2008

According to the 2008 activity report of the Association of the Insurance and Reinsurance Companies of Turkey (AIRCT), there are 59 insurance companies active in the insurance sector as of the end of 2008. In 2008, the insurance premium income generated by these companies increased at 7,76% in current prices compared to the previous year and reached TL 11.779.882.000,00. In dollar basis, the premium income increased at 7,83% compared to the previous year. In the same period, as a result of the global economic crisis, the premium size of the insurance sector in the European Union fell from 1.65 trillion dollars to 1.61 trillion dollars which means a real decrease of 6,7%.

Though the impacts of the global economic crisis were seen in the Turkish insurance sector in 2008, the insurance sector in Turkey is developing and provides the assurance those other sectors in our country need.

As a striking example, the insurance companies in our country provided guarantee of 13.780 billion TL in total, which is approximately 15 folds of the GDP. This figure is an indicator of the importance of the insurance sector and the

guarantee provided by insurance companies to ensure the operation of real economy drivers for the economy of our country.

### **III. What are insurance technical reserves and why should they be set aside**

Insurance technical reserves are the reserves set aside by insurance companies and reinsurance companies over insurance premiums on the basis of certain criteria, in order to be able to fulfill their liabilities resulting from insurance agreements in cases where necessary.

Based on the realization probabilities of the risks, insurance companies should set aside reserves for the amounts they would pay, so that they can fulfill the guarantee pertaining to the risk in cases where a risk assumed by the insurance company is realized, i.e. the loss can be paid to the insured.

Insurance companies may also set aside reserves for economic reasons other than legal regulations (it is obligatory to set aside reserves under the provisions of the Insurance Law).

#### **A. Rules prescribed under the Insurance Law with respect to insurance technical reserves**

The article 16 titled "Technical reserves" of the Insurance Law no.5684 which became effective upon its promulgation in the Official Gazette no. 26552 of 14 June 2007 provides explanations on technical reserves. Under the first clause of the article, insurance and reinsurance companies are obliged to set aside sufficient amount of reserves for their liabilities resulting from insurance agreements, in accordance with the principles specified in the relevant article. Technical reserves are defined in the 2<sup>nd</sup> and 7<sup>th</sup> clauses, the 8<sup>th</sup> clause includes rules on reinsurer's share and the 9<sup>th</sup> clause of the article (last clause) states that the principles and procedures on technical reserves will be set under the regulations.

Technical reserves included in the 2-7<sup>th</sup> clauses of the article 16 are listed below respectively.

##### **1. Unearned premium reserves (UPC)**

Unearned premium reserves consist of the portion extending to the following fiscal period or periods, of the gross premium written with respect to each insurance agreement in effect. In effective annual life insurances and life insurances in which savings premiums with a term exceeding one year are taken into account, the unearned premium reserves consist of the portion extending to the following fiscal period or periods of the amount remaining after deducting the portion set aside for the savings (if any) from the written gross premiums.

According to the Law, in reinsurance and retrocession transactions in which it is impossible to calculate provisions according to day basis, it is possible to set aside unearned premium reserves according to the 1/8 basis.

##### **2. Reserves for continuing risks**

These reserves are set aside in cases where the unearned premiums reserves fail to be sufficient for the risk assumed by the insurance company and the expected cost level, in insurance branches where the level of risk incurred during the insurance agreement term and the time-based distribution of the earned premiums are considered incompatible with each other.

### **3. Equalization reserves**

These reserves are set for the branches determined by the Undersecretariat of Treasury, to balance the possible fluctuations in compensation rates in the following fiscal periods and meet catastrophic risks.

The Insurance Law states that the Undersecretariat of Treasury may decide on setting aside reserves to substitute these reserves, in accordance with the determined principles and procedures.

### **4. Mathematical reserves**

Mathematical reserves are the sum total of the reserves calculated by insurance companies under the statistical and actuarial methods specified in the technical specifications of the agreement, to meet their liabilities against parties who establish the insurance and the beneficiaries of the insurance for life, health, illness and personal accident insurance agreements with a term exceeding one year, and the share reserves set aside for the insured from the income derived as a result of directing these reserves to investment, if undertaken.

### **5. Uncertain compensation reserves**

Uncertain compensation reserves are additional reserves set aside in the framework of the principles determined by the Undersecretariat for compensation amounts which are recorded but not paid and estimated compensation amounts which are realized but not recorded, along with the reserves of expenses incurred for these compensations and for adequacy in the case of insufficiency of these amounts.

### **6. Bonus and discount reserves**

These reserves consist of reserves for the bonus and discount amounts set aside for the insured or the beneficiaries, according to the technical results of the current year, if insurance companies implement bonus or discount applications.

## **B. Regulations of the Undersecretariat of Treasury on insurance technical reserves**

Exercising the authority granted under the article 8 of the Law no. 4632 dated 28.3.2001 on Private Pension Savings and Investment System and the article 16 of the Insurance Law no. 5648, the Undersecretariat of Treasury drew up the "Regulations on the Technical Reserves of Insurance and Reinsurance and Retirement Companies and the Assets in which these Reserves are to be Invested", in order to ensure that insurance and reinsurance companies can set aside technical reserves sufficient to fulfill their current and possible liabilities. The Regulations was promulgated in the Official Gazette dated 07.08.2007.

Some parts of the Regulations were amended with the Regulations promulgated in the Official Gazette dated 18.10.2007. The final version of the Regulations became effective on 1.1.2008.

The regulation provides detailed explanations on the calculation of the following reserves set aside by insurance companies;

- Unearned premiums reserves
- Continuing risks reserves
- Uncertain compensation reserves

- Mathematical reserves
- Equalization reserves
- Bonus and discount reserves.

## **C. Regulations on insurance technical reserves in the Corporate Tax Law and relevant communiqués**

### **1. Regulation in the Corporate Tax Law**

The article 8 titled “Deductible Expenses” of the Corporate Tax Law no. 5520 promulgated in the Official Gazette dated 21.06.2006 came into effect upon its promulgation. Under the clause 1/e of the article, insurance and reinsurance companies may treat the insurance technical reserves pertaining to insurance agreements effective on the balance sheet date as expense in the calculation of corporate tax.

Reserves mentioned in the article are explained below respectively;

#### **a. Uncertain damage and compensation reserves**

Uncertain damage and compensation reserves which may be recorded as expense are defined in the corporate tax law as the amount remaining after deducting the reinsurer’s share from the damage and compensation amounts which were realized over the damage and compensation amounts accrued and determined on account or, if this calculation was not made, over the estimated values of the damage and the compensation and all relevant costs, but which were not reported, along with the relevant costs and uncertain damage reserves sufficiency differences corresponding to the retention share.

#### **b. Unearned premium reserves**

Unearned premium reserves which may be recorded as expense are defined in the corporate tax law. Accordingly, the amount remaining after deducting reinsurer’s share calculated according to day basis from the portion of the amount extending beyond the balance sheet day according to day basis that remains after deducting commissions from the premiums accrued for effective insurance agreements.

The definition states that this amount may not exceed 25% of the amount of the annual premium after the deduction of the commission, which remains in the own retention shares of companies, in transport insurances. According to the clause, the 1/8 method may be applied in the reinsurance and retrocession transactions in which it is impossible to calculate the unearned premium reserves according to day basis.

#### **c. Mathematical reserves in life insurances**

Mathematical reserves in life insurances which may be recorded as expense should be calculated separately over each agreement and the reserves should not be included among the interests and profit shares pertaining to the portion of reserves invested in marketable securities the gains of which are exempt from tax.

#### **d. Equalization reserves**

Equalization reserves which may be recorded as expense are defined in the Corporate Tax Law as the reserves calculated for earthquake guarantees provided only in earthquake and engineering insurance branches in order to

balance the possible fluctuations in compensation rates to emerge in following fiscal periods and meet catastrophic risks.

Furthermore, the fifth line of the relevant clause states that the insurance technical reserves set aside in a balance sheet period will be exactly added to the profit in the following balance sheet period.

## **2. Regulations and explanations in the corporate tax general communiqué no. 1 promulgated in the Official Gazette of 03.04.2007**

As mentioned above, the relevant article provides detailed definitions of insurance technical reserves and the Corporate Tax General Communiqué series no. 1 provides detailed explanations as to how to calculate insurance technical reserves.

Also, under the communiqué no.1, the technical reserves set aside by insurance and reinsurance companies with respect to insurance agreements which are in effect on the balance sheet date may be subjected to deduction from the corporate income, by taking into account the calculations and conditions specified in the Corporate Tax Law and relevant communiqués.

In other words, the Ministry of Finance made its own separate determination on the definition of some insurance technical reserves and how they are to be calculated.

Furthermore, since the regulations of the Undersecretariat of Treasury regarding technical reserves was promulgated on 18.10.2007, the Ministry of Finance provided explanations in the Corporate Tax Communiqués regarding the new reserves or the differences between the rules prescribed by the Treasury and the rules prescribed by the Ministry of Finance.

## **3. Regulations and explanations in the corporate tax general communiqué no 2 promulgated in the Official Gazette of 22.4.2008**

The communiqué states that technical reserves are re-regulated by the Treasury and provides the following statements;

- Calculation of uncertain damage and compensation reserves is explained and it is stated that damage and compensation amounts determined under the insurance legislation which are realized but not yet reported, along with the uncertain damage reserves sufficiency differences corresponding to the retention share may be deducted in the scope of uncertain damage and compensation reserves. However, additional reserves set aside under the actuarial chain ladder method can not be deducted as expense.
- Although there are differences in the insurance legislation regarding the calculation of unearned premium reserves compared to the previous regulation, the unearned premium reserves that should be deducted as expense in the determination of the corporate income shall be calculated under the paragraph 1/e/2 of the article 8 of the Corporate Tax Law and within the framework of the principles specified in the relevant section of the Corporate Tax General Communiqué no.1.
- The section of earthquake damage reserves is removed from the communiqué and it is stated that with the Law no. 5684, insurance companies do not set aside reserves in the name of earthquake damage reserves and the risks reserves, equalization reserves and bonus and discount reserves that should be set aside under the Law can not be deducted as expense by insurance companies in the determination of the corporate income.

#### **4. Regulations in the Corporate Tax Law General Communiqué no. 3 promulgated in the Official Gazette of 20.11.2008**

Since the communiqué ends the earthquake damage reserves practice, the explanations on earthquake damage reserves in the section “8.6.5 Transfer of set-aside insurance technical reserves exactly to the profit in the next balance sheet period” were removed.

Secondly, by reference to the termination of the practice of setting aside reserves in the name of earthquake damage reserves under the Insurance Law, it is stated that insurance and reinsurance companies are allowed to set aside a new type of reserves called “Equalization Reserves” under the Insurance Law.

The communiqué also states that the reserves set aside in the name of equalization reserves may be taken into account in the determination of the corporate income and that insurance and reinsurance companies may treat as expense the equalization reserves calculated for the earthquake guarantees provided in earthquake and engineering insurance branches only, to balance the possible fluctuations in the compensation rates in the following fiscal periods and meet the catastrophic risks. This practice will be applied as of 01.01.2008.

Furthermore, the communiqué states one more time that the continuing risks reserves and bonus and discount reserves among the reserves set aside under the Insurance Law no. 5684 may not be deducted as expense in the determination of the corporate income of insurance companies.

#### **D. Current problems regarding insurance technical reserves**

##### **1. Classification of the technical reserves set aside under the Insurance Law as reserves that may be treated as expense and reserves that may not be treated as expense**

As we have explained above in our article, insurance technical reserves are set aside so that insurance and reinsurance companies may fulfill their liabilities resulting from insurance agreements.

Furthermore, regulations on setting aside these reserves are set out by the Undersecretariat of Treasury which is assigned by the State to make the necessary arrangements regarding the insurance sector. In addition, the reserves set aside by insurance companies and their financial statements are audited by independent audit firms and reported to the Undersecretariat of Treasury.

Within this framework, there is ambiguity regarding the taxation of insurance companies due to the following situations;

- Some of the reserves set aside according to the principles set out by the Undersecretariat of Treasury are not accepted as expense and a separate method of setting aside reserves is determined for these reserves,
- Some parts of reserves which are obligatory to be set aside (equalization reserves other than the equalization reserves calculated for the earthquake guarantees provided in earthquake and engineering insurance branches) are not accepted as expense in the determination of the corporate income,

- Some reserves are not wholly (continuing risks reserves) accepted as expense in the determination of the corporate income.

We are of the opinion that the Treasury and the Ministry of Finance together should regulate insurance technical reserves so that such problems can be prevented and a profit which is not commercially derived is not taxed.

## **2. Deduction of the potential recourse income**

Under the 2<sup>nd</sup> paragraph of the article 7 titled "Uncertain compensation reserves" of the Regulations on the Technical Reserves of Insurance and Reinsurance and Retirement Companies and the Assets in which these Reserves are to be Invested promulgated by the Undersecretariat of Treasury, (briefly) for the uncertain damage files accrued in the last 5 or more years in the determination of the uncertain reserves amount by the insurance companies, an amount should be calculated on the basis of the weighted average detected by dividing the recourse, salvage and similar expenses collected in the periods following the period when these damages arose, by the accrued uncertain compensation reserves pertaining to these years, and this amount should be treated as income in the determination of the uncertain damage reserves. Insurance companies act in parallel to this practice.

The Corporate Tax Law and relevant communiqués do not include any provisions regarding the necessity of recording such an income during the calculation of the uncertain damage reserves. However, there are also not any explanations in the Law and the relevant communiqués, stating that the amount can be deducted.

However, considering that the Ministry of Finance does not accept the provisions that are added by the Undersecretariat of Treasury with the regulations and that create expense, it may be asserted that the amount recorded as income while setting aside provisions should also not be treated as income.

On the other hand, lack of regulations regarding the issue creates hesitations on the deduction of this amount. We are of the opinion that the Ministry of Finance should make an explanation regarding whether the amount can be treated as a deduction item in the calculation of the corporate tax.

## **3. Recording Equalization Reserves as Income**

As we have explained in our article, after the termination of the earthquake damage reserves practice, insurance companies began to set aside reserves in the name of equalization reserves for earthquake guarantees provided in earthquake and engineering insurance branches.

The reason for setting aside these reserves is to create a source for insurance companies to fulfill their financial liabilities in a possible earthquake, just as in the earthquake damage reserves before. Furthermore, under the article 8 of the Corporate Tax Law, equalization reserves calculated for earthquake guarantees provided in earthquake and engineering branches are accepted as expense in the determination of the corporate income.

However, within the framework of the provision of the Corporate Tax Law article 8, which states that technical reserves set aside in a balance sheet period should be added exactly to the profit in the following balance sheet period, equalization provisions that are set aside in the previous year and treated as expense under the corporate tax Law are transferred to the accounts as income in the next period and the amount which is allowed to be recorded as expense in terms of corporate tax is recorded as income in the following year. The right to record the amounts as expense is applied as a one year postponement.

Although there was a similar practice for the earthquake damage reserves that replaced equalization reserves, the practice in its current form conflicts with the purpose of establishing an earthquake fund in insurance companies and the provision that allows recording as expense the reserves set aside for earthquake guarantees provided in earthquake and engineering insurance branches in the name of equalization reserves.

In this respect, rather than considering the reserve practice as a method of imposing taxes, the Ministry of Finance should handle reserves as a practice that creates source for insurance companies in fulfilling their liabilities and should introduce the necessary regulations to clarify the issue.

### **Tax disputes and ways in which taxpayers may resort**

A tax dispute is a legal disagreement about taxes between the tax authority and a taxpayer. A tax dispute can be resolved either during the administrative phase or the legal phase. The subject of this article is the steps which may be followed by taxpayers for resolving tax disputes during the administrative phase without having to resort to litigation.

## **I. Resolving disputes during the administrative phase by requesting correction of a tax error**

Under Article 116 of the Tax Procedures Code, a tax error is described as “requesting or levying excess or insufficient tax unfairly due to errors in tax calculations or in taxation.”

In the Tax Procedures Code, tax errors subject to correction are divided into two sections, calculation errors and taxation errors.

Calculation errors are:

- a) Tax Base Errors
- b) Errors in Tax Amounts
- c) Repeated Tax

Taxation errors are:

- a) Error by the Taxpayer
- b) Error in Tax Liability
- c) Error in the Subject
- d) Error in Taxation or Exemption Period

Taxation errors may emerge in the following ways:

- a. A tax official finds or notices the error
- b. The error is noticed at the end of reviews conducted by senior officers
- c. The error is detected during inspection
- d. The error is detected during tax investigation
- e. The taxpayer applies upon noticing the error

Pursuant to Article 122 of the Tax Procedures Code, taxpayers can request the correction of errors in tax transactions with a letter from the tax authority. On the other hand, clear and absolute tax errors deemed as definite by the authority are corrected arbitrarily.

## **II. Resolving disputes during the administrative phase by paying reduced tax penalties**



Article 371 of the Tax Procedures Code describes “penitence practice”. A penalty due to a tax loss is not imposed on the taxpayers who benefit from this opportunity, yet the original tax and delay interest under the name “penitence surcharge” is imposed.

To benefit from penitence practice:

- A tax loss must have been emerged.
- A request of penitence must have been declared to the related authority with a petition.
- A notice has not been submitted by another person before the application of the taxpayer or an investigation has not been initiated against the taxpayer.
- The declaration must be corrected within 15 days as of the date when the petition is submitted and, in addition, the tax and surcharge must be paid by the same date.

Half the reduction is applied when the tax loss penalty is imposed for the first time, and a third of the reduction is applied when such a penalty is imposed a second time. To apply both reductions, the taxpayer must have applied in person.

### **III. Resolving disputes during the administrative phase through settlement practice**

Settlement is used to ensure that a taxpayer is pacified by solving tax disputes rapidly and thus by removing hesitations a taxpayer may have as soon as possible and to resolve disputes emerging between the taxpayer and the tax authority through negotiations between them.

The settlement practice is applied in two ways:

- a) Settlement before assessment; is maintaining conciliation between the parties at administrative phase before the emergence of any disputes.
- b) Settlement after assessment; is resolution of the tax dispute emerged between tax authority and taxpayer.

For both before assessment and after assessment, agreed taxes and penalties are definite in terms of their implication for both the tax authority and taxpayer and those on whose behalf the penalty is imposed. The parties related to these issues cannot perform any other transactions or make any other requests. The Directorate of Revenue Administration publishes activity reports every year and the number of files in which the application is made, the amount of tax subject to settlement,



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the amount of tax on which a settlement is reached, the amount of penalty subject to settlement, and the amount of penalty imposed at the end of settlement are promulgated in these reports. Activity reports published by the Directorate of Revenue Administration point out that the settlement practice, for both before assessment and after assessment, provide significant opportunities to taxpayers-particularly for avoiding tax penalties.