CONSULTATIVE DOCUMENT ON SUPERANNUATION AND LIFE INSURANCE

Volume 2

MARCH 1988

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CHAPTER 1 - INTRODUCTION

1.1 Issues Covered

Volume 1 of this Consultative Document focussed on life insurance and superannuation as vehicles for saving and outlined tax reforms designed to achieve neutrality of treatment between savings conducted in these and other forms. It also provided further details on the tax changes for life insurance and superannuation that were announced in the Government's Economic Statement of 17 December 1987 (Annex 3).

The 17 December statement also announced that the present tax treatment of life offices would be reviewed with consideration being given to taxing them in a manner more consistent with that of other corporate taxpayers. In addition, changes to the tax treatment of some related areas of business activity were announced. These included annuities, health insurance and friendly societies. All of these related areas are discussed in this volume.

With the exception of changes already announced (and any specific measures considered necessary to support the international regime), the tax changes discussed in this volume will not come into effect until the beginning of the 1989/90 income year at the earliest.

Chapter 2 reviews the present tax treatment of life offices and considers the feasibility of taxing the insurance as well as the savings income of a life office. It also discusses the question of whether life office taxation can be made to integrate more easily into the imputation system for companies in general. Should the changes discussed in Chapter 2 not be considered feasible or desirable, the

existing regime will be retained. However, some changes will be made to improve this regime and these are outlined in Chapter 3.

Chapter 4 reviews the tax treatment of annuities with the aim of putting them onto a regime consistent with that developed in Volume 1 for superannuation and life insurance.

The tax treatment of health insurance is discussed in Chapter 5 and the taxation of friendly societies, which conduct a large proportion of health insurance business, is discussed in Chapter 6. Since friendly societies and credit unions are closely related by their common tax treatment and similar regulatory environments, credit unions have been included in this review and are also discussed in Chapter 6. This chapter focusses on the mutual nature of these organisations and discusses the problems that arise when these organisations are taxed under the same rules as non-mutual companies.

Issues relating to the taxation of mutual organisations also arise in the context of the life office taxation review of Chapter 2. Since the issues for mutual life offices are essentially the same as those discussed in Chapter 6 for friendly societies and credit unions, the discussion of mutual life offices has been left until Chapter 7.

Annex 1, included at the back of this volume, contains a list of errors in Volume 1. A change to one of the measures in Volume 1 - relating to the timing of valuations of assets of superannuation funds for tax purposes - was announced in a recent press statement from the Minister of Finance. This press statement is reproduced in Annex 2. A summary of the tax rate changes proposed in this Consultative Document (some of which have now been passed into law) is given in Annex 3.

1.2 Submissions

In Volume 1, interested parties were invited to make submissions to a consultative committee by 8 April 1988. The date for submissions on the material contained in this second volume is Friday 29 April. The Committee is to report to the Minister of Finance on the issues discussed in this volume by 27 May 1988. As for Volume 1, submissions should be on A4-size paper, typed in double space on one side of the page only and should contain a brief summary of their main points and recommendations. Please send a total of 8 copies to:

The Chairman,
Consultative Committee on Superannuation,
Life Insurance and Related Areas,
c/- The Treasury,
PO Box 3724,
WELLINGTON

All submissions received by the due date will be acknowledged.

CHAPTER 2 - THE TAXATION OF LIFE OFFICES

2.1 Introduction

The method of taxing life offices outlined in Chapter 6 of Volume 1 of this Document carried over the existing taxation regime for such entities for 1988/89. It is nevertheless recognised that this taxation regime, introduced in 1982, has not proved to be entirely satisfactory from either the Government's point of view or from the perspective of taxpayers - life offices and their policyholders. As part of the general review of this area, the method by which life offices are to be taxed in the future is being reconsidered. The ambit of the review of life insurance in general is wider than the taxation of savings through a life office considered in Volume 1. The focus is widened to consider the taxation of life offices in their business activity as insurance underwriter and financial intermediary whereas previously the focus was on the taxation of the investment income of the policyholder.

This chapter therefore considers the feasibility of taxing the insurance as well as the savings income of a life office and how life office taxation can be made to integrate more easily into the imputation system for companies in general. It seems desirable to have superannuation funds taxed in a similar manner to life offices. Consideration will therefore be given to amending the base for taxing superannuation funds along the same lines as any changes to the taxation base for life offices. In this chapter, defects in the basis of the existing taxation regime are identified. An alternative method for taxing life offices is outlined. Should a change in tax regime not be considered feasible or desirable, the next chapter considers some aspects of the existing regime which could be improved upon.

As explained in Chapter 4 of Volume 1, under the present taxation regime life office taxation is limited to the net investment income derived by that company. This is unsatisfactory from the Government's point of view since it means that part of a life office's possible income earning process is not subject to taxation. It has proved equally unsatisfactory from the point of view of taxpayers since deductible expenses are limited to those which are incurred in deriving net investment income. Other expenses (such as those incurred in advertising products or in managing insurance aspects of the business) are non-deductible. It would appear to meet the concerns of both the taxpayer and the Government if life offices were taxed on a basis which replicated that of other taxpayers.

The Government is committed to the objective of a non-distortionary tax system. However, it recognises the complexities involved in life office taxation and considers that any changes to the taxation regime should be developed in close consultation with industry participants and other interested parties.

This chapter canvasses the issues involved in the taxation of life offices, details the Government's objectives and suggests a taxation regime which would meet those objectives. The suggested taxation regime has a number of practical problems. This could lead to the regime being modified or the problems of instituting a tax system better than the existing one might prove to be insurmountable. If such problems are insurmountable, the existing regime may be the nearest we can get to meeting the Government's obectives. In that case alterations to the details of the existing regime seem desirable in order to improve the workability, effectiveness and fairness of the regime. Alterations along these lines are suggested in Chapter 3.

2.2 Objectives

It would be inconsistent with the Government's general reforms of the taxation of superannuation and life insurance to tax life offices in a manner which provided them with special taxation concessions. It would be equally inconsistent with those reforms to tax life insurance in a penal manner so as to encourage consumers to use substitute financial organisations. The ideal tax system for life offices would be one which taxed such entities in a manner consistent with income tax principles which apply to other business taxpayers. Just as the taxation system should not discriminate between life offices and substitute intermediaries, so it should not discriminate between mutual life companies (those companies which are owned by policyholders) and proprietary companies (those companies which are owned by independent shareholders). Mutual and proprietary companies should, as far as possible, be taxed in the same way.

Modifications will need to be made to normal income tax rules so that those rules can be applied to life insurance. Such modifications should not be made because life insurance may involve long-term investments and liabilities (other long-term investments do not necessarily receive special tax treatment). Normal income tax rules will, however, need to be amended to take into account any special operating characteristics of life insurance. One such characteristic is that life insurance generally involves a mixture of insurance and savings elements. This does create some difficulties in applying normal business income tax rules. Where necessary, therefore, the life office taxation regime may need to depart from general rules so as to operate efficiently and fairly.

2.3 The Nature of Life Insurance

In the case of a life office offering only insurance policies the claims on which are paid out at the same time as premiums are paid in, the insurance company is acting as a pure insurer - an intermediary in a risk pooling process. The life office enables unrelated individuals to join together in pooling risks so that those who bear a loss receive an insured sum. This is a service which people value and are prepared to pay for. The company is thus able to charge a management fee which is normally incorporated into the premium. In addition, it can make a profit (**mortality profit**) if losses suffered are below that expected when premiums are set. The total income of an insurance company operating only such policies is the difference between premiums received and payments made (including claims).

In the normal case a life office will act as a savings intermediary as well as a pure insurer. It will take the premium which is not required to meet immediate claims and invest this sum. Premiums plus the investment income forms a savings fund for the benefit of the policyholder. This savings fund can be used to subsidise future premium payments (when actual premiums paid are insufficient to meet the level of risk covered) and to provide the policyholder with an endowment benefit or to increase the amount paid out on claims.

A life company will derive income from both the insurance and the savings element of a policy. In the former case, it can charge a management fee for acting as a risk-pooling intermediary, and make a profit (loss) if deaths of those insured are below (above) expectations. On the savings side, it can charge a fee for managing the savings fund built up by each policyholder. In addition, it may make a profit from favourable investment performance. When setting the premium

so as to create an investment fund sufficient to meet future risks plus any endowment element of the policy, the life office has to estimate what return the savings fund will produce. If the company underestimates this return, the savings fund will be more than is required to cover future liabilities. The resulting 'excess savings' can be used (in the case of a participating policy) to pay bonuses to policyholders. With non-participating policies, or policies which do not participate fully in investment returns, some of the excess may be retained for distribution to company owners or to build up the "capital" of the life office.

The profit of a life insurance company can, therefore, consist of the following:

- management fee profit derived from its savings and risk-pooling functions;

- mortality profit which results from deaths of those insured being below expectations (and similarly for disablement insurance); and

- savings profit which results from a favourable investment performance.

Net management fees from the risk-pooling function together with mortality profit is <u>underwriting profit</u>, being derived from the life office's role as an insurer. Net management fees from the savings function together with savings profit is <u>financial intermediation profit</u>, being derived from the life office's role as a financial intermediary or savings institution.

Similarly the premiums paid by policyholders normally consist of:

- a pure insurance aspect, the payment necessary to cover immediate risk;

- a savings aspect, a payment which is invested by the life office and then drawn upon both to cover shortfalls in future pure insurance premium payments and to provide for future endowment payments; and

- a fee aspect, which covers the life office's fee for undertaking both the underwriting and the financial intermediation functions.

2.4 Existing Taxation Regime

To meet the Government's objective of a fair taxation regime under which life offices are taxed on normal income tax principles, the life office should be taxed on all its underwriting profit plus all its financial intermediation profit. That should be in addition to the tax levied on the share of net investment income attributable to policyholders and paid by the life office on their behalf.

The existing taxation regime for life offices does not achieve this objective. Taxable income is limited to investment income. On the other hand, allowable deductions are limited to investment expenses. By limiting the tax base of life offices to net investment income, no tax is levied on underwriting profit and no tax is levied on that part of financial intermediation profit which consists of net management fees from the savings function.

Depending on the circumstances of each life office, the existing regime may be concessionary or penal. It is concessionary where the life office is deriving net savings, management fees and an underwriting profit. This can be

illustrated with a simplified example. Assume a life office collects $100 in premiums for a group of pure insurance contracts. Claims under the policies total $90 at which point the policies expire. (Alternatively, the risk under the policies may have been immediately re-insured for a premium payment of $90). Expenses total $5. Assume no investment income since the policies are pure insurance with no savings element. The underwriting profit on these policies is $5 - the $100 in premiums less the $5 in expenses less the $90 in claims. Existing law allows this profit to be tax-free.

Although the existing taxation regime may be concessionary in some cases, in other cases it may be penal. As noted above, the life office is taxed on that part of its financial intermediation profit which is not derived from fees - ie its share of net investment income. Unlike a bank or other financial intermediary, however, it is not allowed a deduction for the costs of attracting the deposits (by way of premiums) from which its share of net investment income is derived. In addition, a life office may incur a net loss from its underwriting activities. Such a loss cannot at present be offset against other life office assessable income, but again it may be incurred as part of the life office's costs of obtaining funds from which it will (as well as providing a return to the policyholder) make a profit as a financial intermediary.

2.5 An Appropriate Taxation Regime for Life Offices

If life offices are to be taxed on a basis more closely approximating other financial entities, they should be taxed on their full underwriting and financial intermediation profit. In that case, the range of deductible expenses should be widened to include all expenses of a revenue nature necessarily incurred in carrying out the full range of life

insurance business activities.

Any new life insurance taxation regime cannot exactly duplicate the taxation regime applied to banks and similar financial intermediaries. This is because, as stated in Volume 1 of this Document, life offices will continue to pay tax on net investment income as a proxy for the interest which policyholders have in this income. Life office net investment income attributable to policyholders is the return policyholders receive for the savings element of their premium payments. Taxing policyholders directly on their share of this income may be a purer way of determining an individual policyholder's tax liability, but there are practical problems in apportioning income between policyholders and in taxing returns not yet received by policyholders. To overcome such problems, tax is levied at the life office level as a form of final withholding tax on policyholder income.

For life offices, therefore, the taxation regime needs to be modified to ensure that this withholding tax is properly collected in addition to any separate tax liability the life office itself should incur. This requires tax to be levied at the level of both the policyholder and the proprietor (ie shareholders or, in the case of a mutual life office, policyholders in their role as owners).

For policyholders, the appropriate tax base is:

	investment income
less	investment expenses
less	any financial intermediation fee charged by the life office
less	any net investment income transferred to proprietors or retained as capital (savings profit).

This policyholder income should be taxed at a rate appropriate to policyholders - ie a rate based on personal tax rates. Since the withholding tax levied on the life office is a final tax and a complete substitute for tax which otherwise should be levied on policyholders, no further tax liability should arise when the income is distributed to policyholders in the form of benefits.

For proprietors, the appropriate tax base is:

	underwriting profit
plus	financial intermediation fees
less	total revenue expenses
plus	investment expenses
plus	any net investment income transferred to proprietors or retained as capital (savings profit).

On the basis that this proprietor income is derived via a company, it should be taxed at the company rate. As with income derived by other companies, tax should be levied at the tax rate of shareholders when the income is distributed to them, with an imputation credit for the tax levied at the company level.

2.6 Taxing Underwriting Profit

In simple terms, underwriting profit is the difference between insurance premiums received and insurance claims paid out. On that basis, the life office should be assessed on premiums received or receivable and claims should be deductible.

As previously noted, however, premiums (and claims) include both an insurance and a savings element. Conceptually it is inappropriate to tax the life office on the savings deposits

it receives from policyholders. This is a capital receipt. Thus, the premium should in principle be differentiated into its savings component and its pure insurance component. The life office should be taxed only on the latter.

Such a differentiation, however, would require complex actuarial calculations. The pure insurance component of each policy written by a life office would need to be determined. This would be dependent in each case on:

- the type of policy being considered (its terms and conditions);
- the period the policy has been in force;
- the age of the life insured;
- the sex of the life insured;
- whether the policy has been altered in the past;
- whether the policy has been loaded for extra risks;
- whether the policy has a contingent debt; and
- the underlying mortality rates, future net earnings rates and future expenses.

As well as determining the insurance aspect of the policy premium, it would be necessary to determine the insurance and savings components of policy claims and benefits. Since the savings component of the premium would not be included in the life office's assessable income, the savings component of claims/benefits should be non-deductible.

Differentiating savings and insurance components of premiums and claims/benefits should be possible. Indeed, with many policies it is already done. Modern "unbundled" or "universal" policies do, to a large extent, differentiate between the insurance and savings components of premiums so as to allow the policyholder to determine the extent to which his or her premium is to be used to provide insurance cover and the extent to which it will be accumulated in a savings

fund. Nevertheless, for many other policies, such as whole-of-life and endowment policies, differentiation of premium components would be a difficult task. High compliance and administration costs would be likely. The necessary law would be complex, and the tax liability of a life office would be dependent on the actuarial assumptions made.

These problems could be mitigated to some extent by differentiating savings and insurance components at an aggregate rather than at an individual policy level. Underwriting profit can be determined as U where:

$$
\begin{aligned}
U &= (P - L^{+}) - (C - L^{-}) \\
&= P - (L^{+} - L^{-}) - C
\end{aligned}
$$

where

- P is gross premium income of the life office;
- L^{+} is increases in the office's liabilities;
- L^{-} is decreases in the office's liabilities; and
- C is life office claims and benefits.

A life office's liabilities are recognised in the policy or actuarial reserve. This is the provision which the life office makes for future policy claims. In estimating the required reserve, the amount of policy claims and benefits that are expected to be paid in future years based on the expected mortality of the life office's policyholders, and the premiums yet to be received from those policyholders less future expenses, are discounted to the present year using the expected after-tax rate of return on investments. This reserve, plus future net premiums, plus the investment income on these funds should accumulate to an amount sufficient to meet the expected claims and benefits.

In determining underwriting profit, the subtraction from gross premium income of increases in liabilities would remove

the savings component of premium income (ie the sum set aside to cover future risks and endowments). The balance consists of an amount which covers the the company's cost of covering the current year's risk, together with a loading for expenses (if any).

The subtraction from gross claims of reductions in liabilities would remove the savings element of claims and benefits. Since the savings component would be deducted at the time it is set aside by being added to the life office's liabilities, it should not be deducted a second time when the savings are drawn down. The amount of premium which is assessable to the life office should not be reduced by any expense loading. This is because all revenue expenses would be deductible at the appropriate time when they are incurred.

There would, of course, be no need to separately identify increases and decreases in a life office's liabilities. Instead, a deduction would be provided for any net increase in liabilities over the year, and any net decrease would be added to assessable income.

The problem with this method of calculating underwriting profit is that it requires a calculation of life office liabilities based on the actuarial reserve. This in turn would require estimates to be made of mortality risk, future expenses and future investment yields. A number of countries operate life insurance taxation regimes which are reliant on such estimates being made. Examples are Canada and the United States of America. However, because the estimates are necessarily based on judgements as to future events, there is a considerable margin for disagreement about the appropriate provision for actuarial reserve. It is very difficult to operate a tax system critically dependent on valuations arrived at within such judgemental parameters.

Countries which do operate a tax system based on changes in actuarial reserve have adopted a number of approaches. The estimating parameters can be set by the Government. However, mortality, investment and expense experience can vary significantly between life offices. The application of standard estimates is likely to penalise some offices and favour others.

Alternatively, parameters for each life office can be agreed upon. For example, the Government Actuary may be required to agree to the valuation of each life office's liabilities. However, such an approach would be likely to involve high compliance and administrative costs and still leave tax liabilities to be determined by a number of judgemental issues. In this regard, it is to be noted that the Canadian 1966 (Carter) Royal Commission on Taxation considered that any system which allowed different life offices to use different assumptions in valuing actuarial reserves would be inequitable and administratively complex.

It thus seems highly desirable to use a taxation system which avoids the need to value life office actuarial reserves. Limiting the taxation base to net investment income is one such option. However, as previously noted, this can result in either concessionary or penal taxation.

Another option is to make all premiums as well as investment income taxable and all claims/benefits as well as expenses deductible. This would mean that the savings component of premiums would be taxed. However, all claims/benefits (including the savings component) would be deductible. Tax on the savings component would be payable at the time the premium is paid with the offsetting deduction being deferred until claims/benefits are paid out. As a result, there would be a high tax liability for expanding offices with an increasing premium income but few claim/benefit payouts.

However, in present value terms, the amount of tax paid should be approximately right. While the income is taxed earlier than the matching deduction, deductible benefits would be comprised of both the initial (post-tax) premium and the (post-tax) return derived from investing that premium. Apart from mortality gains and losses, the higher level of benefits would be adequate compensation for the deferral in the deduction. While the expanding life office would face a high tax liability, it would be accruing an offsetting high level of deductions. The point is illustrated by the following simple example.

<u>Example</u>
Assume a premium with a savings component of $100 is received by a life office. Assume a rate of return on the life office's investments of 10% after tax (paid on behalf of the policyholder), and a life office tax rate of 28%.

If the life office pays out the entire benefits to policyholders, it would derive no profit and should thus not be subject to tax in its own right (tax should of course be levied on the net investment income on behalf of policyholders). After two years the policyholder would receive $121 in benefits.

If the life office tax regime taxes premiums but allows a deduction for actuarial reserves, the life office would be taxable on the $100 premium, but would receive an offsetting deduction of $100 (the value of $121 in benefit payouts in two years time discounted at 10% per annum).

If instead tax were payable on the premium but a deduction allowed for benefits at the time they are paid out, the life office could still offer a benefit of $121.

> It would pay tax on the $100 premium, reducing the post-tax premium to $72. After two years that would accumulate to $87.12. It could pay out $121, and so receive a tax deduction of $33.88 (28% of $121). When added to the $87.12, this would fund the $121 benefit payout. When the premium is received the life office would have a net premium of $72 plus a present value of future tax deductions of $28 ($33.88/1.1^2). The total premium value would therefore be the desired $100.

The advantage of this approach over use of the actuarial reserve isthat it removes the need for the tax system to be reliant on actuarial estimates of mortality, future investment yields and future expenses. It is a relatively simple approach which achieves the right result as long as the life office is able to utilise the tax deduction resulting from deductible benefits. Provision would thus need to be made to allow the office to carry any loss back into past income years.

This right result is also dependent on no change in tax rates. If tax rates are increased, too little tax would be collected at the time premiums are paid. Conversely, if tax rates are reduced, too much tax would have been collected. Small variations in tax rates would not produce major distortions. However, if tax rates were changed to a significant extent, the tax liability of the life office would need to be adjusted in order to minimise any advantage or penalty.

Given the distortions caused by limiting life office taxation to net investment income, and given the problems of implementing a regime based on actuarial assumptions, the preferred approach would seem to be to tax life offices on premium income as that income is derived, while allowing a deduction for benefits/claims when they are paid or become

payable.

2.7 Taxing Net Investment Income

Net investment income would continue to be taxed along the present lines with any necessary modifications considered in the next chapter. It should be noted again that tax on net investment income is for the most part a tax on policyholders paid by the life office as a final withholding tax. It should therefore be separate from, and should not be able to be offset against, any tax liability incurred by the life office itself.

2.8 Expenses

Investment expenses would continue to be deductible against gross investment income. Other revenue expenses incurred by the life office would be deductible. In general, normal income tax laws should be applied to determine whether expenses are of a revenue nature and the timing of deductibility. However, life offices do tend to incur some expenses (such as agent commission fees) which have capital characteristics in that they are incurred early in order to establish an income-generating process (the life policy). Such expenses should be deductible since they are incurred in deriving assessable income, but consideration should be given to identifying such costs with a view to having their deduction spread over the average term of a company's life policy.

2.9 Transfers of Net Investment Income to Proprietors

The final item in the income of a life office is transfers of net investment income to proprietors. Such transfers should be deductible from the net investment income of policyholders, and assessable as income of the life office.

2.10 Summary of Suggested Tax Regime

Under the suggested taxation regime, the existing tax on the net investment income of life offices would be replaced by two levels of taxation.

First, taxation would continue to be levied on net investment income as a withholding tax on income which is effectively being accrued for the benefit of policyholders. In general, tax rules for personal income would apply. The tax rate would be based on personal tax rates and would reflect the tax rates of policyholders. There would be no ability to offset net investment losses against other life office income, nor to offset life office losses against such net investment income. However, transfers of net investment income to the proprietors of the life office would be deductible.

Secondly, a separate tax would be levied on the life office itself. The life office would be taxed on all premium income as the premiums are received or become receivable. It would also be taxed on any other business income (such as fees) which the life office derives, as well as transfers of net investment income. All non-investment revenue expenses would be deductible as they are incurred with consideration being given to spreading rules for such expenses as agent commission fees. Claims and benefits paid to policyholders would be deductible when those payments are made.

The assessable income so derived would be taxed as the corporate income of the life office and be subject to normal corporate tax rules. Thus the tax rate would be the corporate tax rate and income and losses would be able to be offset against other corporate income subject to the normal rules in section 191 of the Income Tax Act. Losses would be able to be carried forward in accordance with section 188 of the Act. As noted above, special rules would allow losses to also be carried backwards.

2.11 Timing of Tax Payments

Tax payments on net investment income would be payable under the normal provisional and terminal tax rules. The balance date of the life office would be used for the purpose of determining the applicable income year.

For other life office income, special tax payment timing rules would need to apply. Since, under the suggested regime, claims/benefits would be deductible, a proper tax treatment of life insurance would not be achieved if the life office were able to invest and obtain a return on pre-tax rather than post-tax premiums. In the extreme case where tax is not collected until claims are met, the ability to invest pre-tax premiums would allow the life office to avoid any tax impost on the investment income which the life office derives on behalf of policyholders. That is because the life office is able to deduct all claims and benefits paid, which will implicitly include the initial premium plus the investment return on that premium. Under the method proposed, it is the post-tax premium rather than the pre-tax premium which should be invested. The point can best be illustrated by an example.

Example

Assume that the life office is subject to the suggested taxation regime but that all tax payments are on the normal provisional and terminal basis. Further assume that a premium of $100 is paid at the beginning of the year, on which the pre-tax annual investment return is 10%.

The claim at the end of the year is $110, so that the policyholder receives the full investment return tax-free. The $100 premium would be assessable, the $10 investment return would be assessable, but the $110 claim would be deductible. In calculating its taxation liability (provisional and terminal) the life office would have no assessable income. The end result would be that the policyholder would be able to receive a totally tax-free return on his or her savings.

This potential problem would be partially relieved by the separate tax treatment of net investment income and life office income. However, the underlying problem would still remain and would need to be mitigated by taxing gross premiums on a withholding tax basis with payments due on the 20th of the month following the month when the premium was received or became receivable. This withholding tax payment would be credited against provisional and terminal life office tax liabilities with, where appropriate, tax refunds being made.

Example

Assume a premium of $100, a pre-tax rate of return on investment of 10%, tax on net investment income at the rate of 33%, and a life office corporate tax rate of 28%.

When the premium is received the life office would pay withholding tax of $28. The net premium invested would

be $72. The pre-tax investment return on this $72 would be $7.20, on which tax at 33% would be $2.38. The benefit which the policyholder would require after personal tax is $106.70. The life office would have cash of $76.82 (the $72 premium plus the $4.82 post-personal tax investment return). The office would pay out a tax-free benefit of $106.70 which it would be able to deduct. The deduction would have a value to the life office of $29.88 ($106.70 x .28). The life office would thus be able to fund the required benefit of $106.70 out of cash of $76.82 plus the value of the tax deduction ($29.88).

2.12 Imputation

The Consultative Document on Full Imputation stated (in section 4.8) that tax payable by a life insurance company will be excluded from the Imputation Credit Account (ICA) and will not be available as an imputation credit to its shareholders. The rationale is that a life office pays tax as a proxy for policyholders, not for shareholders. A life office will receive imputation credits with its dividend income. The aim is to allow it to offset its tax liability on dividend (and other) income, but not to pass credits on to its own shareholders in the same manner as non-life companies. Nor could a life office pass imputation credits resulting from its other tax liabilities down to its shareholders.

This special treatment of life offices recognises their role as policyholder proxies. However, as a result, shareholders of a life company could be placed at a disadvantage relative to shareholders in other companies. This would be ameliorated by the taxation regime suggested in sections 2.6 to 2.10 above, which would enable life offices to be treated under imputation more like other companies.

As previously stated, proprietor income would be taxed as company income at the company tax rate. When distributed, such income would be taxed in the hands of shareholders as a dividend. Since proprietor income would be taxable separately from the tax levied on behalf of policyholders, this would enable an ICA to be established and would enable a life company to make imputation credits available to its shareholders under normal imputation rules.

Dividends received by the life office as part of its net investment income would remain taxable and the life office would continue to be able to offset its investment income tax liability with any imputation credits received. This should ensure that the life office pays tax at the appropriate rate on the underlying corporate income which the dividends represent. Should the life office wish to transfer that dividend to proprietors, it will be able to do so. It will simply transfer to proprietors an amount equal to the grossed-up dividend. That amount will be deducted from net investment income and be taxed as proprietor income. Tax paid on proprietor income would then be included in the proprietary ICA, and be available for distribution to life office shareholders. The correct amount of tax should then be paid at the life office shareholder level.

Example

Assume that a company in which a life office holds shares derives $100 of income and pays tax on this income of $28. The net $72 is distributed to the life office as a shareholder in the company together with an imputation credit of $28. The net investment income of the life office consists of a grossed-up income of $100. At a tax rate of 33%, the life office would have a tax liability on the dividend of $33 against which it would be able to utilise the $28 imputation credit. Its net tax liability would therefore be $5, leaving the life office with the

net sum of $67.

It could then transfer $100 (the grossed-up dividend) to its proprietors. It would not, however, transfer the associated credits of $28. These credits would continue to be held on behalf of policyholders, and would be available to offset tax on other investment income. The tax on proprietor income would be $28 and this amount would be credited to the life office's ICA. Should the life office pay the net sum of $72 as a dividend to its shareholders, they would receive a grossed-up dividend of $100, with an offsetting imputation credit of $28. The result would be the same as if the dividend had passed from the initial dividend-paying company directly to the life office shareholders, or indirectly via a non-life company.

2.13 Mutual Life Offices

It has been implicitly assumed so far that the life office is a proprietary company, ie a company owned by shareholders who are separate from policyholders. Many life offices are mutual companies which are, in effect, owned by the policyholders. An objective of the life insurance taxation reforms is to tax mutual and proprietary companies, as far as possible, in the same way.

However, a mutual company might effectively distribute income to its policyholders/shareholders by way of reduced premiums. This would erode the tax base and give mutual life offices a competitive advantage over non-mutual offices. This problem also arises in respect of friendly societies and credit unions. Since these organisations are discussed in Chapter 6, the subject of the taxation of mutual life offices is deferred to Chapter 7.

2.14 Transition

A major difficulty in bringing into place a new taxation regime for life offices along the lines suggested above would be the problem of transition from the existing regime.

The suggested regime should not result in any significant increase in life office taxation - it could result in a decrease. Thus, existing life contracts should not be disrupted. However, the Government would not be prepared to allow all future claims/benefits to be deducted from life office income when past premiums funding those claims/ benefits were not initially taxed. One option would be to exclude from deductibility a proportion of claims/benefits on the basis of an actuarial valuation of liabilities at the date any new regime came into place.

2.15 Life Reinsurance

The income tax provisions presently governing life insurance business also govern life reinsurance. There does not appear to be any reason why any new life insurance taxation regime should not similarly apply to life reinsurance.

2.16 Non-Resident Life Offices and Life Offices Operating Offshore

The current life insurance and reinsurance income tax provisions also apply to any non-resident life office with respect to its New Zealand business. The same would apply to the suggested new taxation regime.

A distinction will, however, be drawn between resident and non-resident life offices with respect to:

a tax-free life benefits - as proposed in Volume 1 of this Document, the benefits of non-resident life offices may be subject to income tax. This is an anti-avoidance measure. Further anti-avoidance measures may be considered necessary in the light of decisions on the international taxation regime; and

b imputation credits - non-resident life offices would, along with other non-resident entities, not be entitled to imputation credits.

If applied strictly, these measures would be unduly harsh on some life offices, especially some non-resident mutual companies whose structure would make the establishment of a resident subsidiary difficult. Consideration should therefore be given to deeming life funds of non-resident entities to be New Zealand resident companies. The life fund would need to be approved by the Commissioner of Inland Revenue and any offshore transfer of funds by that life fund would need to be deemed to be a dividend payment.

The position of New Zealand resident life offices operating offshore will need to be considered in the light of decisions made on the international taxation regime.

2.17 Superannuation Funds

Because many superannuation funds constitute an undifferentiated part of life office funds, there would be some administrative advantages in putting superannuation funds onto the same taxation regime. This would also allow superannuation funds to have the benefit of being able to deduct non-investment expenses.

A superannuation scheme can also make an underwriting profit

and should, ideally, be subject to tax on this. For example, with a pension superannuation scheme, members pool the risk of living a long life. In return for the benefit of the certainty of receiving an income for as long as they live, members obtain a relatively small benefit if they die soon after retirement. Just as a life office makes a mortality profit on term insurance policies if people live longer than expected, so a pension superannuation scheme will make a mortality profit if people live for a shorter period than expected. This, together with any net fee charged for acting as risk-pooling intermediary, is the superannuation scheme's underwriting profit. Frequently, a superannuation scheme will engage a life office to carry out its underwriting function by purchasing annuities. Any underwriting profit will then be made by the life office.

Any changes to the announced tax base for superannuation funds should be dependent on this not disrupting the transition of existing superannuation schemes to becoming taxpayers.

2.18 Implementation Date

Any changes to the taxation regime for life offices (except for those measures already announced and any specific measures considered necessary to support the international taxation regime) will not come into effect until the beginning of the 1989/90 income year at the earliest.

CHAPTER 3 - AMENDMENTS TO THE EXISTING TAXATION RULES FOR LIFE OFFICES

3.1 Introduction

The previous chapter concluded that there was a case for changing the basis under which life offices are taxed. Options for a new tax base were considered and an alternative regime for taxing life offices outlined. Should a satisfactory alternative taxation regime not prove possible, as a second-best option, the existing taxation regime under which the life office tax base is limited to net investment income would continue. However, there are areas of that taxation system which should be amended or clarified in order to ensure that the objectives of the legislation are properly met. Such amendments are considered in this chapter. Since life offices and superannuation schemes are to be taxed on the same basis, amendments to the existing taxation regime for life insurance would also carry across to superannuation schemes.

3.2 Principles on Which Amendments Should be Made

If the existing tax base for life offices were to be retained, the principle that a life office is then largely a payer of a withholding tax levied on the life office as a proxy for its shareholders should be reinforced. The justification for possible amendments to the law should be judged on whether that principle is advanced by the amendment in question.

3.3 Relationship of Special Life Office Tax Provisions to Other Provisions in the Income Tax Act

The special tax rules for life offices are currently contained in section 204 of the Income Tax Act. Some clarification may be desirable as to the relationship between this section and other provisions in the Act.

Section 204 sets out rules for determining the assessable income of companies of life insurance and reinsurance with respect to their business of life insurance. Presumably, it has always meant to apply also to a life office's business of life reinsurance. The section would need to be amended to make this clearer.

There is some obscurity as to the relationship between section 204 and the rest of the Income Tax Act. Section 204(8) states that the profits of a life office from its life insurance business shall be deemed to be its:

gross revenue derived from life insurance and reinsurance;

less life insurance/reinsurance premiums and annuity considerations which are received or receivable;

less direct and indirect investment revenue costs.

Gross revenue is not exhaustively defined. Specific items are deemed to be included in gross revenue. These are:

- premiums from life insurance and reinsurance and annuity considerations which are received or receivable;

- received or receivable revenue from investments;

- realised capital gains/losses from investments;

- commissions and fees (except those that are in respect of insurance, reinsurance and annuities).

Section 204(5) purports to establish the relationship between section 204 and the rest of the Income Tax Act. It states that, subject to section 204, life offices are assessed as if they were normal corporate taxpayers. It appears that the best interpretation is that life offices are subject to normal income tax rules unless those rules are in conflict with the special rules in section 204, in which case section 204 overrides the normal rules.

As it is presently drafted, the section can be difficult to interpret and apply. This is because it can be difficult to determine the breadth of the section and/or whether there is a conflict between the section and other provisions which should be overriden.

Turning first to the breadth of the section. The business of life insurance is not exhaustively defined by the Income Tax Act. An integral aspect of a life insurance business is the investment of premiums and the management of that investment. There can, however, be uncertainties as to what constitutes investment. Holdings of debt instruments are clearly investments, as are holdings of equities. Similarly, life offices invest in real estate even though this may also involve them in the additional business of being a rentier. The issue can become somewhat less clear where the life office uses its funds directly in other businesses such as running farms, resource extraction and so on.

There seem to be two approaches to this issue. The first would involve defining the business of life insurance more precisely. This may involve restrictions on the use to which life office funds can be put. The second option would impose no such restrictions but would clarify the law so that a life

office would be taxed under the life office taxation regime on any other business activities it may carry out subsidiary to its life office business. Since direct investment in other businesses may be the best use of life office funds, it would seem desirable not to restrict the use to which life office funds can be put and to tax any other business activity of the life office under the life office tax regime. This emphasises the desirability of taxing life offices on a more normal basis and the need to ensure that any life office taxation regime is robust and fair.

Another difficulty with the legislation as it is presently drafted is that it can sometimes be unclear whether section 204 is in conflict with other provisions of the Income Tax Act in such a way that section 204 and not the other provisions should prevail.

Since section 204(8) deems life insurance assessable profits to be gross revenue less certain specified cost categories, it can be arguable whether certain income is included within the income base of a life office and whether some costs are properly deductible. On the income side, gross revenue is defined to include a number of items on a received/receivable basis. An example is income accrued under a debt instrument which is taxable under sections 64B to 64M of the Act. It may be at least arguable that such income, not being received/receivable, is not assessable income of a life office. On the cost or expenditure side, it seems to be the clear intent of the legislation to allow life offices depreciation allowances under the normal rules set out in section 108 of the Act. However, this can be difficult to justify under a literal interpretation of section 204. Similarly, it can be unclear whether a life office is free to take a deduction for unrealised losses on investments which under general law would be considered to be trading stock.

The law in this area should therefore be clarified. The appropriate principle to adopt is that income derived by a life office for the benefit of its policyholders should be taxed on the same basis as if that income were derived directly by the policyholder.

3.4 Identifying Investment Revenue

Many of the possible problems of identifying what constitutes investment revenue were considered in the previous section. There are, however, at least two other potential problem areas.

First, it may sometimes be unclear when a capital gain on an investment has been realised so as to give rise to an income tax liability. An example is a share swap associated with, say, a takeover of the company in which the life office has shares. The question presently revolves around whether, in the particular circumstances of the case, there has been a profit or gain from the sale or disposal of the investment. The same question arises with respect to a profit or gain which would be assessable under other provisions of the Act, such as section 65(2)(e). Since this issue also arises outside the life insurance area, it should be considered in a more general context.

Similarly, there does not appear to be a case for constructing special life office rules for determining the cost price of investments which constitute an undifferentiated part of a wider investment portfolio, such as shares in a company or Government stock. Under existing law the life office is free to adopt a reasonable basis for determining the cost price of such an investment.

A second area which may give rise to some difficulties is in determining whether a particular asset, such as a building, is

an investment of the life office or whether it is acquired for the business use of the company. This issue currently tends to be determined by rulings of the Commissioner of Inland Revenue. It would seem desirable, where practical, for such distinctions to be embodied in the legislation.

3.5 Deductibility of Life Office Expenses

Ever since the present taxation regime for life offices was enacted in 1982, industry participants have consistently argued that the range of deductible expenses should be widened to include non-investment expenses such as advertising costs and the costs of agent commissions.

The arguments presented by the industry in favour of full expense deductibility can be summarised along the following lines.

If the tax regime is viewed as taxing life offices as financial intermediaries, then these institutions should be able to deduct the same expenses as other financial intermediaries. A trading bank can deduct its fundraising expenses such as the costs of employing tellers and the costs of advertising. It is argued that a life office should similarly be able to deduct such costs, including the costs of agent commissions.

If, on the other hand, the tax regime is viewed as a tax on the net investment income of policyholders, it has been asserted that life offices should be able to deduct all expenses from gross investment income. The policyholder deposits a capital sum with the life office (the premium). The tax regime should be structured so as to allow the policyholder to receive back this deposit in full together with the after-tax return the life office derives from

investing the premium.

These arguments were considered and rejected when the present legislation was enacted in 1982. The arguments were also rejected when Australia's similar system of life office taxation was examined by the 1981 (Campbell) Committee of Inquiry into the Australian Financial System. The reasons for not allowing non-investment expenses to be deductible are outlined below.

First, the life office taxation regime does not impose taxation on the life office as a financial intermediary. A finance company derives income on the margin between its borrowing costs and its lending costs. All its expenses must be met out of this gross margin. Thus its profit is its gross margin less all expenses. It is this profit which is taxed. The interest return to depositors is then taxed when that interest is derived by the depositors.

For a life office, on the other hand, this is not the case. To a large extent, it is not taxed on its insurance activities. The only tax it pays is a withholding tax on behalf of policyholders. It is appropriate that expenses incurred on behalf of policyholders should be deductible. These are investment expenses. Other expenses, however, are incurred as part of the life office's underwriting and other business. They are not expenses incurred on behalf of policyholders. They are expenses incurred in carrying out a tax-exempt activity. Thus related expenses should remain non-deductible.

The second argument advanced for full deductibility of expenses - that the company should be taxed like its policyholders - has more force in that it appears to be more in line with the principles of the current taxation regime. However, the argument has in the past been rejected. The

argument presumes that the premium is equivalent to a savings deposit. In fact it is partly a savings deposit and partly a fee in return for which the life office provides insurance. It is not correct that policyholders can expect to receive back their premium payments plus after-tax interest thereon and that the tax law should make this possible. For instance, with a term insurance policy a policyholder will not receive any premium back unless the insured event occurs. More generally, the expected return to the policyholder is less than the expected return on savings because part of the premium is the underwriting fee paid to the company.

The conclusion reached is that, as a first preference, life offices should be taxed on all their income under rules as close as possible to normal income tax rules. As a second preference, deductible expenses should be limited to investment expenses.

3.6 Apportionment of Expenses

If deductible expenses are to continue to be restricted to investment expenses, these expenses need to be identified and general expenses need to be apportioned between investment and other activities. This would also be necessary under the wider taxation regime suggested in the previous chapter, although in that case, the apportioned expenses would be deductible to the life office either in its role as underwriter or in its role as proxy for the policyholder.

Investment expenses are defined by existing law as the sum of "direct investment revenue costs" and "indirect investment revenue costs". "Direct investment revenue costs" are defined as costs incurred in carrying on the business of life insurance in the income year exclusively in deriving investment revenue and/or assessable fees and commissions which are not

recoverable, directly or indirectly, from any person. "Indirect investment revenue costs" are defined to be, in effect, a proportion of those costs which are not directly attributed to investment activities or to deriving premiums.

It was noted in section 6.6 of Volume 1 of this Document (page 96) that the non-deductibility of expenses incurred by a Class B superannuation fund where those expenses are recoverable, directly or indirectly, from any contributor, has caused interpretive problems and is difficult to justify under a non-concessionary taxation regime. The same comments apply with respect to life office expenses. Where otherwise deductible expenses are met by premiums, no tax problems should arise since the expenses, if met directly by the policyholder, should be deductible to that policyholder. Where expenses are recoverable from other parties, that recovery should be included within the life office's investment income either explicitly or by general provisions such as section 78 of the Income Tax Act.

One of the difficulties of administering this part of the life office taxation regime has been determining what is a "direct investment revenue cost". Given the statutory definition of this term, for an expense to be a direct investment revenue cost, it must be exclusively incurred in deriving investment revenue. The Inland Revenue Department appears to interpret this requirement restrictively. Thus, where a life office employee is not 100 per cent employed in investment activities, his or her salary and other costs are generally not considered to be direct costs. Similarly, where a building is not entirely used for pursuing an office's investment activities, it has been argued that even those costs associated with that building which can be apportioned to investment activities are not direct costs and thus not fully deductible.

Costs which, because they are not exclusively incurred in deriving investment revenue are not fully deductible, are included in general revenue costs. Such costs are apportioned between deductible investment expenses and non-deductible premium expenses on the basis of the proportion of the life office's revenue which consists of premiums and the proportion which consists of investment income.

These rules for determining the deductiblity of expenses have not proved to be satisfactory. Life offices are encouraged to restructure their affairs so as to maximise the extent to which their expenses satisfy the requirements for full deductibility as a direct investment expense. For example, the tax system can advantage the life office which reduces the extent to which individual staff members divide their time between investment and non-investment related activities. This can be advantageous from a tax viewpoint, however, it may not result in the most efficient use of the life office's resources.

Apportionment on the basis of the percentage of total life office revenue which consists of premium income is arbitrary and unlikely to reflect the true position of each firm. It assumes that one dollar of premium and one dollar of investment revenue both incur the same amount of general costs. In fact this would seem to be unlikely. Furthermore, it results in a high tax impost for expanding life offices deriving a high level of premium income, and a high tax impost in those years in which a life office derives low investment income because, for example, it realises substantial losses on investments. Conversely, contracting life offices and those deriving high investment income are advantaged.

It would be desirable to construct an apportionment system which reduced the extent to which life offices are advantaged

or disadvantaged according to how they employ their staff and other resources, and which was not dependent on their relative level of premium income. While no basis for apportionment is likely to be ideal, it should be possible to apportion most expenses on the basis of their use in the investment income-generating process. For example, accommodation costs should be able to be apportioned on the basis of floor area used for investment activities. Staff costs should similarly be able to be apportioned on the basis of work studies. Those costs which could not be so apportioned may be able to apportioned using the percentage of other costs which are attributed to investment activities.

3.7 Apportionment of Income

Before the recent policy change (which takes effect from 1 April 1988), the income of most superannuation funds was tax-free. A significant proportion of life office business has been from tax-exempt superannuation funds placed with life offices by trustees of superannuation schemes. Those funds are included in the life funds of life insurance companies. If the income of the life funds were to be subject to taxation in full, life offices would have been placed at a disadvantage in that tax-exempt superannuation scheme assets invested through a life office would be subject to taxation.

To enable life offices to compete for superannuation business free of tax disadvantages, the legislation has attempted to adjust the net assessable income of a life office so as to leave income attributable to tax-exempt superannuation (as well as income attributable to annuities and certain mortgage repayment insurance policies) tax-free.

This has been done by attributing to tax-exempt activities a

proportion of overall life office income on the basis of the percentage of total life office liabilities which consist of assets attributable to tax-exempt activities. The assessable income of the life office has been reduced by the income attributed to tax-exempt activities in this way.

While the tax exemption for superannuation funds and annuities is being removed, there will still be a requirement to adjust life office income in a similar manner. The tax exemption for income attributable to certain mortgage repayment insurance policies is to be retained, and, more importantly, while superannuation and annuity funds are becoming taxable, for such funds in existence on 17 December 1987, a reduced rate of tax is to be applied.

The present method of adjusting life office income described above is not satisfactory. First, it requires actuarial calculations of life office liabilities. Difficulties of operating a tax system which uses such calculations led to the rejection of an actuarial-based tax system in Chapter 2. Secondly, the present method is only accurate if the proportion of non-taxable/low-taxable liabilities to all liabilities is the same as the proportion of non-taxable/low-taxable income to all income. This seems to be an unrealistic assumption.

The reduction in the margin between the tax rate of superannuation funds and other life office business will significantly mitigate any problems in this area. However, the establishment of separate funds for low-taxed superannuation and annuity business would still appear to be justified in the interests of a fairer and simpler tax system. Such a move was suggested in the 1983 Budget but deferred because of the decision announced in the 1984 Budget to undertake a wider review of superannuation and life insurance taxation.

3.8 Grouping Provisions

The Income Tax Act contains provisions which, to a greater or lesser extent, permit separate companies to be taxed as the one entity. This allows the loss of one company within a group to be set off against the income of another company in the group. A related issue is the provision which restricts the ability of a company to carry forward to future income years losses incurred in prior income years.

If a life office is to continue to be taxed only as a proxy for its policyholders, the validity of applying these provisions to life offices needs to be reconsidered.

Section 191 of the Income Tax Act allows companies with a sufficient degree of common share ownership to offset losses of one company within the group against the income of another company within the group. This has also applied with respect to life offices. However, under the proxy taxation regime, it is policyholders who are, in effect, being taxed, not shareholders. In those circumstances, application of a grouping provision allows losses incurred by one group of individuals to be offset against income derived by other individuals. This is contrary to the intent of the present legislation. It is therefore proposed that section 191 not apply to life offices so long as the tax base of such entities remains restricted.

Section 188 of the Income Tax Act allows a company to carry forward losses to future income years if certain requirements as to continuity of share ownership are maintained. Again, for a life office taxed under a proxy system, share ownership does not seem to be a relevant consideration. It is proposed that life offices be able to carry forward losses derived from the business of life insurance irrespective of any change in share ownership.

3.9 Imputation

If the proxy system for life offices were to be retained, a life office should be taxed as if it were its individual policyholders. Individual New Zealand resident policyholders would be able to receive imputation credits and utilise them to offset their tax liability on the dividend and/or their other tax liabilties. The same rules should also apply to life offices taxed under the proxy system.

3.10 International Considerations

As outlined in the previous chapter, consideration will be given to deeming approved life office funds of non-resident life offices to be New Zealand residents.

The offshore activities of New Zealand resident life offices will be considered in the light of decisions made with respect to the international taxation regime.

Even if the existing taxation system for life offices were retained, amendments in the law would be necessary to deal with life offices reinsuring life risks offshore. Present law provides an avoidance opportunity. A life office can reinsure its risks offshore. This could be structured so that the offshore reinsurer is not subject to New Zealand tax on the investment income derived from the reinsurance premium. The policy proceeds could then be channelled back to New Zealand tax-free. To close this opportunity, it seems desirable to levy a withholding tax on offshore reinsurance premiums.

CHAPTER 4 - ANNUITIES

4.1 Introduction

This chapter considers the taxation of annuities. To date most annuities have been provided under superannuation schemes. Changes to the tax treatment of annuities therefore flow from the changes to the taxation of superannuation. However, in other countries, especially North America, a significant volume of annuities are written outside of superannuation arrangements. One possible explanation for the low volume of annuity business in New Zealand is that such contracts are at present, in general, penally taxed. The Government's objective is to move all annuities onto a taxation system which is consistent with the new superannuation taxation regime. That will in turn place them in the same position as other forms of saving.

4.2 Definitions

An annuity consists of a series of payments made at regular intervals for a stipulated period of time. The stipulated period may be a specific number of years (an **annuity certain**) or payments may continue until the happening of some event, most commonly the death of the annuitant or a dependent (a **life annuity**). Either way, the annuity is usually purchased by the payment of a lump sum, although this payment may be made some time before annuity payments begin (a **deferred annuity**).

The provider of the annuity will invest the lump sum received from the annuitant. Payments to the annuitant will then be a mixture of a portion of the original capital sum and the return earned on the investment of that sum.

4.3 Existing Tax Law

This section briefly summarises the existing taxation law applying to annuities.

- **Financial Arrangements**

An annuity is prima facie a financial arrangement and taxed under the accrual rule provisions in sections 64B to 64M of the Income Tax Act. However, where the annuitant is a natural person, the annuity is an "excepted financial arrangement" and should thus, in general, be outside the ambit of the accrual rules. The following discussion is in terms of annuities which are "excepted financial arrangements".

- **Contributions**

These consist of the capital sums or lump sum payments which are used to purchase the income stream which the annuity represents. The purchase of an annuity is not generally deductible from the purchaser's assessable income. It is common for pension superannuation schemes to provide a pension by purchasing an annuity from a life office (a **retirement annuity**). Since the funds in such a scheme have in the past generally been contributed out of pre-tax income, and earnings have accumulated on a tax-exempt basis, such annuities can be said to be purchased out of pre-tax income. On the other hand, an annuity which is not associated with a pension superannuation scheme (**purchased life annuities**) may be viewed as being purchased out of after-tax income.

- **Investment Earnings**

The capital sum used to purchase the annuity will generally be invested and managed by a life office. Under section

204(9) of the Income Tax Act, the assessable net investment income of a life office is adjusted so as to effectively exempt from tax income derived from annuity deposits.

- **Benefits**

The benefits under an annuity consist of those payments which are made to the annuitant. By section 65(2)(j) of the Income Tax Act, annuity payments are taxable in the hands of the annuitant. The courts have, however, attempted to distinguish between a taxable annuity, which is the purchase of an annual income stream in return for the surrender of capital, and an annual repayment of capital with or without interest. In the latter case, the capital portion is tax-free and only the interest portion is taxable. This line between a taxable annuity and a capital repayment has proven difficult to draw in practice.

In New Zealand, a distinction has been drawn between life annuities and annuities certain. The former have been considered to be taxable in full whereas the latter are treated as the repayment of a capital sum with interest. The capital portion is then exempt and only the interest portion is taxable. There is no statutory basis for this distinction between life annuities and annuities certain and the case law is at best equivocal.

4.4 Proposed Changes to the Law

It can be seen from the above that the taxation treatment of annuities can vary considerably under existing law. Contributions may or may not be effectively tax-free, investment earnings on the capital sum from which the annuity is paid may or may not be tax-free, and the annuity benefits may be fully or only partially taxed. Taxing all annuities

on the same basis as superannuation will produce a more consistent treatment.

As with superannuation schemes, there will be no deduction for annuity contributions. Similarly, there will be no exemption for the investment earnings on capital sums backing annuities. Where such income is presently exempt (such as annuities provided through a life office) annuity contracts in existence on or before 17 December 1987 will receive the same transitional measures as are being provided to previously exempt superannuation funds (including the low 25 per cent tax rate). An annuity fund which is subject to New Zealand tax on the basis of residency will be able to register as a superannuation scheme with the Government Actuary or the Inland Revenue Department. Benefits from such a fund will be taxed in the same manner as superannuation scheme pensions, ie tax-free from 1 April 1989 with the national superannuitant surcharge levied on one half of the annuity from that date.

CHAPTER 5 - HEALTH INSURANCE

5.1 Introduction

There are a number of inter-relationships between life insurance, superannuation and health insurance which make it appropriate to consider all of these at the same time. For example, accident and sickness insurance premiums have been exempt from tax under the same sections of the Act that have applied to various types of superannuation and life insurance. In addition, some institutions that have been taxed on a concessionary basis may offer life insurance and superannuation as well as health insurance. It is therefore important to ensure that reform of the tax treatment of these types of business, and the institutions offering them, is coordinated.

Since friendly societies conduct a large proportion of health insurance business, there will be some overlap between this chapter and the next which considers the tax treatment of friendly societies and credit unions.

5.2 Background

While some general insurance companies and industrial and provident societies offer health insurance, this type of cover is primarily provided by friendly societies. The largest insurer is the Southern Cross Medical Care Society. Southern Cross was established in 1961 and has a current membership (including spouses and children) of over 1 million. Approximately 60% of Southern Cross members are covered under commercial group schemes while another 20% belong to non-commercial group schemes and the remaining 20% have individual cover. In 1986, member contributions to Southern Cross

totalled $62 million. Based on Southern Cross's revenue and estimated market share, total expenditure on health insurance in 1986 is estimated to have been around $75 million.

Other organisations offering medical insurance include New Zealand Medicare Society, Aetna Health Society Ltd, Medic Aid Fund Society, Healthcare Fund of the Druids Friendly Society, and Union Medical Benefits Society Ltd.

Health insurance offers partial (typically 80-90%) or full cover for private hospital and practitioner expenses in return for an annual premium. Benefits may also be provided in the form of income support payments, funeral benefits or through the waiving of premiums. In addition to the major insurers, many other friendly societies provide health insurance on a smaller scale.

5.3 The Present Tax Treatment

a Premiums/Contributions Paid by the Individual

Under section 59 of the Income Tax Act, taxpayers have been able to claim an exemption for premiums or contributions to funds providing benefits in the event of sickness, accident or death. Payments that have been claimable under the exemption include:

- premiums on personal accident or sickness insurance;
- payments to any insurance fund of a friendly society of which the taxpayer was a member on or before 8 November 1984;
- payments to any insurance fund of a friendly society that provides benefits solely in respect of accident, disease, sickness or expenses consequent on death;
- payments to any fund which provides benefits solely in respect of accident, disease, sickness or expenses

consequent on death and which is approved by the Commissioner of Inland Revenue.

The section 59 exemption, which also covered various life insurance premiums and superannuation contributions, provided a maximum annual deduction of $1,200 for those contributing to subsidised superannuation schemes and $1,400 for other taxpayers.

b Premiums/Contributions Paid by the Employer

An exemption from Fringe Benefit Tax (FBT) has been provided under section 336N where an employer paid premiums or made contributions on behalf of employees to funds providing benefits in the event of sickness, accident or death. Qualifying payments have been the same as those listed in (a) above for individuals (except that payments to an insurance fund of a friendly society have been exempt FBT irrespective of when the employee joined the society).

c Treatment of Fund Income

Income earned by the trustees of any sickness, accident or death benefit fund approved by the Commissioner of Inland Revenue has been exempt from tax under section 61(41) of the Act. Further, income earned by a friendly society on business conducted within its circle of membership is exempt under section 61(23).

d Treatment of Benefits

Section 61(39) of the Income Tax Act exempts income derived, in respect of any incapacity for work, from a friendly society or from a sick, accident or death benefit fund to which the person was a contributor at the start of the period of incapacity. Similar benefits paid under a policy of

sickness or accident insurance are exempt by virtue of section 61(40), unless the payments are calculated according to loss of profits or earnings.

5.4 Who Benefits from the Concessions?

Information compiled by the Health Benefits Review Committee showed that somewhere between 1.1 and 1.3 million New Zealanders held private medical insurance in 1986. A social indicators survey held in 1980/81 by the Department of Statistics provided information on the pattern of use of private medical insurance. This information provides a good indication of which groups have been gaining most benefit from the tax concessions.

The survey showed that around 35% of the population aged 15 or over held full private medical insurance. However, coverage was found to vary markedly depending on factors such as age and income. Coverage was found to be most common amongst the 36-50 age group - 47% of this group held medical insurance. Despite the fact that the elderly are proportionately the heaviest users of health services, the survey found that only 13% of those in the 65+ age group were insured.

Coverage for those employed in the paid labour force was estimated at 42% compared with only 24% for the rest of the adult population. The survey results also showed that coverage was below average amongst individuals experiencing recent or chronic ill-health.

The distribution of private medical insurance by household income was also uneven. The survey found that coverage amongst those in the higher household income brackets (41% of adults) was 47%, while only 27% of those in the lower

household income brackets held private medical insurance. However, the associated distribution of tax concessions for health insurance will be more heavily weighted toward higher income households than these statistics suggest. This is because tax concessions given in the form of exemptions of income (or deductions from assessable income) are of greater value to those on higher marginal rates of tax.

These results suggest that, in general, the major beneficiaries of the tax concessions have been those who are less likely to need medical insurance and those who are best able to pay for it themselves.

5.5 The Role of Health Insurance and the Effect of the Concessions

Tax concessions for health insurance lower the cost of such insurance to the individual and thereby encourage its purchase. Thus, both the extent of coverage and levels of cover will be greater than otherwise. The cost of this increased cover is reflected in tax concessions for those covered and this cost must be met by taxpayers generally. In considering the arguments for these concessions, the question is not whether private health insurance is desirable, but whether its subsidisation at the expense of other taxpayers can be justified.

Are Tax Concessions for Health Insurance Justified?

One argument commonly advanced in favour of tax preferences for health insurance is that, by encouraging use of the private health sector, the demand for public services and thus public expenditure on health are reduced.

However, health insurance covers a variety of services and the use of these will not always reduce public expenditure. For example, where a visit to a doctor is covered by private health insurance, there is no reduction in the Government's contribution to the doctor's charge (ie the General Medical Services or GMS benefit). Other services covered by private insurance may not be available in the public sector. In these cases, the use of private hospitals is additional to, rather than a substitute for, the use of public health services and, therefore, there will not be any reduction in public expenditure. Furthermore, from the perspective of national welfare, it is the total level of resources devoted to health services and the effective use of those resources that are relevant. The fact that some health care costs are borne privately does not necessarily reduce the total cost of providing a given level of care.

Alternatively, it may be argued that the reduction in demand for public services improves the quality of care that can be provided to those remaining in the public system. The problem with this argument is that increases in demand for private care mean that resources, especially health care personnel, are attracted away from the public sector. Thus, at least in the short term, greater use of the private health sector is not likely to reduce pressures on public services.

A third argument is that use of the private health sector should be encouraged because it is considered more efficient than the public sector. However, if the private sector is indeed more efficient, this does not imply that tax concessions for private health insurance are in order. A more appropriate response would be for Government to purchase services from the private sector directly, by contracting for the provision of services to the public for example.

Effect on the Allocation of Resources

Compared with a system where medical costs are met in full by the individual, the use of private medical insurance is likely to lead to inefficiency in the use of resources. The problem arises from the sharing of the costs of services covered by insurance between different funders. First, the individual will probably be required to meet part of the direct charge for services used, though this proportion may be quite small. Secondly, a large part of the cost of services covered by insurance will be met by the insurer. Thirdly, the Government may meet a proportion of the direct costs of insured services in the form of health benefits. When costs are shared by these three different parties, no one funder has a strong incentive to control expenditure on the services being supplied. As a result, insured individuals may use services beyond the point where the cost equals the benefit at the margin, and the level of resources allocated to the private health sector will be excessive.

Effect on Access to Health Services

In terms of its effect on access to health services, the 1986 Health Benefits Review Committee suggested that the growth in private health insurance has tended to increase existing inequities. Certainly health insurance improves access to a range of health services for those covered. However, as noted above, health insurance is more common amongst those less likely to need care and those less likely to experience financial difficulty in gaining access to care. It may also lead to over-use of services by this group at the expense of those who are not covered.

Effect of the Tax Concessions

By reducing the cost of insurance to the individual, the tax concessions encourage individuals to purchase more cover than they would otherwise. This may take the form of cover for a higher proportion of costs, or cover for a wider range of services. In either case, the incentive for the individual to minimise the costs of services used will be further reduced. Inefficient use of services covered by private insurance may of course lead to higher premiums being charged and the insurer may run the risk of losing business. However, since extra premium costs are, to some extent, shared with the Government, individuals will be less sensitive than otherwise to such increases and insurers will be able to pass on extra costs more readily.

Further, by encouraging private insurance, the present tax exemptions tend to exacerbate inequities between those better and less well off financially and between those with good rather than poor health.

5.6 Reform of the Tax Treatment of Health Insurance

In light of the equity and efficiency arguments discussed above, the Government has decided to remove existing tax concessions for health insurance (broadly defined). Details of the measures being taken to give effect to this decision are set out below. Further measures, relating to the tax treatment of friendly societies involved in the provision of health insurance, are discussed in the next chapter.

a   Premiums/Contributions Paid by the Individual

As announced in the Government Economic Statement of 17 December 1987, the section 59 personal exemption has been removed for all payments made on or after that date. This deduction was withdrawn on the passage of the Taxation Reform Act (No 3) 1988. Thus, payments on personal accident or sickness insurance and payments into sickness, accident and death benefit funds made on or after 17 December 1987 will not now qualify for a tax exemption.

b   Premiums/Contributions Paid by the Employer

The Fringe Benefit Tax (FBT) exemption provided under section 336N has also been removed in respect of employer-paid premiums/contributions paid on or after 17 December 1987. The rate of FBT on previously-exempt payments to approved sick, accident and death benefit funds existing on 17 December 1987 is to be 24% non-deductible. This rate is concessional and has been adopted as a transitional measure in recognition of the fact that income earned by such funds has been exempt. The reduced FBT rate will apply to amounts paid in the remainder of 1987/88 and during 1988/89. From 1 April 1989, the rate will be increased to the standard FBT rate.

Other payments that were previously exempt will be subject to FBT at the rate of 35% from 17 December 1987. This includes payments to approved sick, accident or death benefit funds, insurance funds of friendly societies, and payments in respect of policies of sickness or accident insurance that do not qualify for the reduced rate of 24%.

FBT on premiums and contributions paid between 17 December 1987 and 31 March 1988 will not be due until 20 July 1988.

c Taxation of Fund Income

The section 61(41) exemption for the income of trustees of sickness, accident and death benefit funds will be phased out from 1 April 1988. To allow time for these funds to adjust premium levels, the income of approved funds existing on 17 December 1987 will be subject to tax at the concessional rate of 25% from 1 April 1988. As a further transitional measure, these funds will not be required to pay provisional tax in 1988/89. Tax for the 1988/89 year will be payable in two instalments: 50% due on the normal date for terminal tax for the 1988/89 year and 50% on the terminal tax date for 1989/90.

Funds established on or after 17 December 1987 will be taxed at the rate of 33% from 1 April 1988. Since the top personal rate of tax will be 40.5 percent in 1988/89, the 33 percent rate will be concessionary in that year for many fund members. The tax base for all approved sickness, accident and death benefit funds will be investment income net of investment expenses, including net income from realised investments (eg profits from the sale of shares or property).

This treatment will be reviewed for 1989/90 once the tax regime for friendly societies has been determined.

d Treatment of Benefits

All proceeds of policies of sickness or accident insurance and benefits paid from sick, accident or death benefit funds will be tax-free from 1 April 1989.

CHAPTER 6 - FRIENDLY SOCIETIES AND CREDIT UNIONS

6.1 Introduction

Friendly societies and credit unions are closely related in three respects. First, both are classified as "friendly societies" under the Income Tax Act and are therefore subject to the same tax treatment. Secondly, both types of organisation are registered under the Friendly Societies and Credit Unions (FSCU) Act and are subject to very similar regulatory controls. Finally, membership of a friendly society sometimes constitutes the common bond required for membership of a credit union and, until 1982 when the FSCU Act made statutory provision for credit unions, some of these funds were held within friendly societies.

Volume 1 of this document focussed on achieving a consistent tax treatment for alternative forms of saving - in particular, savings by way of life insurance and superannuation. Since friendly societies may offer life insurance and pension plans, it is important to consider their tax treatment as part of this reform exercise. In view of the close links between credit unions and friendly societies and the fact that credit unions offer an alternative means of saving, it is also appropriate to include credit unions within the present review.

It is important to note that this review of the tax treatment of friendly societies and credit unions is closely associated with the concurrent review of the regulatory environment within which these organisations operate. The relationship between the two reform exercises is discussed in section 6.5 below.

6.2 Objectives and Scope of Tax Reform

Tax reform undertaken in recent years has been aimed at achieving a consistent treatment across sectors of the economy and between different organisational forms used for conducting business. In this way, the potential for the tax system to distort business decisions and the allocation of resources within the economy can be minimised.

Volume 1 of this document concluded that savings conducted through life insurance and superannuation should be subject to a normal income tax regime equivalent to that applying to savings made through bank deposits. For similar reasons, savings conducted through a friendly society, or through a credit union, should be taxed on the same non-concessionary basis.

The preceding chapter discussed the equity and efficiency arguments for removing tax concessions for health insurance, and detailed measures to move health insurance onto a non-concessionary regime. Since friendly societies are the major providers of such insurance, their tax treatment needs to be reviewed in this context.

The objective of tax reform of friendly societies and credit unions is therefore to tax them, as far as possible, on a non-concessionary basis and, in particular, to achieve neutrality of tax treatment between these organisations and their competitors.

To this end, the Government announced in its statement of 17 December 1987 that the section 61(23) exemption for income derived by a friendly society within its circle of membership would be removed from the beginning of the 1990 income year. The present section 61(23) exemption applies to all societies registered or incorporated in New Zealand under any Act

relating to friendly societies, credit unions, industrial unions, industrial associations, or trade unions. The Government intends to review the tax treatment of all these organisations.

Registered friendly societies and credit unions will have their present tax exemption removed and be subject to a new regime from 1 April 1989. In view of their similar nature, benevolent societies and specially authorised societies registered under Part II of the FSCU Act will be treated in the same way as friendly societies and be taxed from 1 April 1989.

This chapter discusses how these organisations should be taxed from 1 April 1989. Issues relating to the tax treatment of life insurance and superannuation were addressed in Volume 1 and in earlier chapters of this volume. Those discussions also apply to friendly societies in respect of their life insurance and superannuation business. However, the taxation of friendly societies and credit unions is complicated by the mutual nature of these organisations. This chapter discusses the problems arising from the organisational form of friendly societies and credit unions and presents taxation options designed to alleviate these concerns.

Once satisfactory tax regimes have been developed for these organisations, consideration will be given to extending these treatments to other bodies covered by the present section 61(23) exemption. Thus, all organisations covered by section 61(23) of the Income Tax Act are invited to consider the tax options outlined in this chapter and make submissions on the applicability of these options to their own activities.

6.3 Friendly Societies: Nature and Activities

Friendly societies are mutual societies funded by voluntary subscriptions of members to provide benefits to members or relatives of members during sickness or in other distressed circumstances, as well as to meet surgical and medical expenses and provide insurance cover. They include traditional orders, medical care societies and friendly society dispensaries. Societies established for charitable or for recreational purposes may also be registered under the friendly societies' legislation.

The traditional orders have operated in New Zealand since the mid-nineteenth century and were effectively the forerunners of the modern welfare state. Since the introduction of social security in the 1930s, the membership of traditional orders has declined though the funds of societies have continued to grow. The largest of these orders is the Manchester Unity Friendly Society with a current membership of 23,000 and funds totalling $60 million. The Society also operates a credit union with accumulated funds of approximately $22 million. Manchester Unity offers services to members including life insurance, pensions, mercantile insurance, medical insurance and mortgage finance.

While the membership of traditional orders has declined, that of modern medical care friendly societies has increased rapidly in recent years. As noted in Chapter 5, the largest of these is the Southern Cross Medical Care Society with a membership (including children and spouses) of around 1 million and member contributions of $62 million in 1986.

United Friendly Society (UFS) Dispensaries are pharmacies owned by groups of friendly societies whose members receive discounted goods and services. Because their registration as friendly societies was found to be inappropriate (and illegal

under the FSCU Act), the Government announced in 1986 that an amendment to the Pharmacy Act would be prepared to enable UFS dispensaries to register under that Act. Certain restrictions on trading are to be removed at the same time.

As at 31 December 1987, there were 591 separate registrations of friendly societies although this includes separate registrations for the districts and lodges of the traditional orders. In addition, there were two registered benevolent societies (providing benefits similar to friendly societies), 26 working men's clubs and two specially authorised societies (providing fidelity insurance for officers of friendly societies). These are the various types of registration available under Part II of the FSCU Act 1982. Membership and funds of these organisations in 1986 were as follows:

Table 6.1 Membership and Funds of Organisations Registered Under Friendly Societies' Legislation, 1986

	Members	Funds ($m)
Friendly societies		
-Medical care	1,034,000	76.1
-Other	60,000	99.3
Benevolent societies	600	0.2
Working men's clubs	40,000	21.3
Specially authorised societies	700	0.5
Total	**1,135,300**	**197.4**

6.4 Credit Unions: Nature and Activities

Credit unions are co-operative bodies which use and control members' savings for their mutual benefit. The members of a credit union must share some common bond such as a common occupation or employer, residence in a particular locality, or membership of a particular organisation (eg a friendly society).

There were 268 registered credit unions at the end of 1987. Total assets at their respective balance dates in 1986 amounted to nearly $118 million, with a total membership of 142,000. The New Zealand Credit Union League, formed in 1961, had 203 affiliated credit unions with a combined membership of 106,000 and total savings of $88 million in 1987.

6.5 Regulatory Environment

The activities of these organisations are governed by the FSCU Act 1982. This Act imposes constraints on the activities that can be undertaken, limits the amounts that can be insured or saved, and sets out rules governing the investment of funds. It also makes demands on the officers of societies with respect to providing security and specifies various information requirements.

The Act is currently under review as part of the Government's programme of regulatory reform of the financial sector. The main objective of this reform programme has been to ensure competitive neutrality between financial institutions. In the case of friendly societies and credit unions, the desirable direction of reform is to relax restrictions so that friendly societies and credit unions have greater freedom with respect to services offered and are not subject

to unnecessary financial controls.

However, the extent to which existing regulations can be relaxed hinges, to a large extent, on the development a satisfactory basis of taxation for these bodies. Clearly, the objective of competitive neutrality cannot be met unless both the tax treatment and the regulatory regime applying to these bodies is aligned with that applying to other institutions offering similar services.

6.6 Present Tax Treatment of Friendly Societies and Credit Unions

Under section 59 of the Income Tax Act, payments by a taxpayer to any insurance fund of a friendly society have qualified for a personal exemption (up to specified limits) where the taxpayer was a member on or before 8 November 1984. Payments to insurance funds of friendly societies that provide benefits solely in respect of accident, disease, sickness or expenses consequent on death, have qualified for a personal exemption irrespective of the date of joining the society. In addition, employer contributions to insurance funds of friendly societies have been exempt from Fringe Benefit Tax. These exemptions have now been removed in respect of payments made on or after 17 December 1987.

Under section 61(23) of the Income Tax Act, the income of friendly societies and credit unions is exempt from income tax except for income derived from business carried on beyond its circle of membership. In practice, investment income derived from non-members has not generally been regarded as "income from business" and has therefore not been subject to tax. Where such income has been judged to be business income, it has been taxable unless covered by the section 61(41) exemption for the income of a sick, accident or death

benefit fund approved by the Commissioner of Inland Revenue.

Trading profits of UFS Dispensaries have been taxable to the extent that trade has been with the public, ie non-members. On amendment of the Pharmacy Act, UFS Dispensaries will (on registration under that Act) be liable to tax as for any pharmacy.

As noted above, the tax treatment applying to friendly societies and credit unions also applies to societies registered or incorporated in New Zealand under any Act relating to industrial unions, industrial associations, or trade unions.

Judged according to normal income tax principles, this treatment is concessionary in three respects. The first concessionary element is the exclusion from the tax base of all income generated by business conducted with members. The second concession is the exclusion of most investment income derived from non-members, and the third is the exemption relating to income received by sick, accident and death benefit funds.

The Government Economic Statement of 17 December 1987 announced that the section 61(41) exemption for the income of approved sick, accident and death benefit funds would be removed from 1 April 1988. In addition, the section 61(23) exemption will be removed from 1 April 1989 for registered friendly societies, benevolent societies, specially authorised societies, and credit unions.

Issues relating to the taxation of friendly societies and credit unions are discussed in the following sections.

6.7 The Mutual Nature of Friendly Societies and Credit Unions

The mutual or co-operative nature of friendly societies and credit unions means that the development of a satisfactory tax regime is not straightforward. Friendly societies are not formed as companies. Thus, they do not have shareholders per se nor do they distribute profits by way of dividends. However, under the co-operative basis of such societies, all members can be regarded as shareholders who receive "profits" in the form of increased benefits or reduced charges.

While the members of credit unions are called "shareholders", their "shareholdings" reflect the extent to which they are using the services of the credit union, as well as their share in the ownership of the business. The dividends they may receive are, to a large extent, simply interest on savings deposited with the credit union. A portion of such dividends may constitute a return on equity investment in the union. However, businesses organised on a mutual basis can distribute profits in a number of ways. For friendly societies and credit unions, these include providing increased insurance cover, reduced premiums, increased interest on savings deposits, or reduced interest charges on loans.

A difficulty arises in taxing businesses operated in this way because it is not possible to differentiate between the customers and the owners of the business. Ordinarily, companies aim to maximise profits for the benefit of their owners or shareholders. However, the incentive to maximise profit, as normally defined, is lacking for co-operatives. This is because while increasing revenue and/or reducing expenditure will increase "profits", it will not necessarily benefit members (or shareholders). For example, increases in premiums (for a given level of cover) do not increase the

wealth of members. Yet increases in investment earnings, through improved investment management for example, will add to members' wealth. Thus, if tax were to be levied on profit as normally defined, the incentive would be for co-operatives to minimise this by distributing profits in kind. As a result, the income taxed would be only a fraction of the amount that would be taxed if the business was organised in a non-mutual form.

It may be argued that, because of their non-profit nature, it is quite proper for these organisations to pay little or no tax. Such arguments rely on the "mutuality principle" which asserts that a person cannot make a profit from trading with him or herself and is sometimes argued to extend to groups of individuals trading within the group.

The counter argument to the "mutuality principle" is that the form of organisation of a business activity does not affect its basic income-generating nature. Like other businesses, co-operatives produce goods and services using capital provided by shareholders (members) and thereby generate income which is properly subject to income tax. The problem inherent in applying the mutuality principle can be seen by supposing that a public company instituted a policy of trading only with its shareholders. Clearly, this would not detract from the income-generating nature of the business activity undertaken, nor should it result in the elimination of the company's tax base.

While co-operatives should generally be subject to tax, the practicality of taxing the income of any particular co-operative depends, to some extent, on the size of the business undertaking. Exempting from taxation a small neighbourhood co-operative (formed to purchase groceries, for example), may be justified where the activities are on a scale and level of sophistication such that the income of

competing businesses is not markedly affected, and where the administrative and compliance costs of levying tax would be prohibitive. However, it will not be appropriate to exclude larger organisations where the competitive advantage derived from a concessionary tax treatment may have a more significant impact on the form or purpose for which economic resources are used. Thus the argument for exempting some co-operatives from tax is a pragmatic one - that the administrative and compliance costs of enforcement outweigh the distortion to investment activity - rather than one of principle.

6.8 Present Tax Treatment of Mutual Associations

Mutual associations which are currently taxable are subject to a special tax regime set out in section 199 of the Income Tax Act. This regime effectively apportions income and expenditure between business conducted with members and business conducted outside the circle of membership. Undistributed profits derived from business with members, and profits derived outside the circle of membership, are subject to tax in the hands of the co-operative. This includes any investment income derived from non-members. Profits distributed in respect of member transactions (called rebates) are not assessable to the co-operative. Rebates are assessable in the hands of the members only insofar as the rebates relate to members' business activities. Rebates in respect of private or non-business transactions with members are presently excluded from the tax base.

A change to this regime is proposed in the Consultative Document on Full Imputation released on 17 December 1987. The proposed change would bring rebates in respect of non-business transactions with members into the taxable income of the co-operative.

The tax treatment of mutual associations is analysed further below.

a <u>Transactions Related to the Business Activities of Members</u>

In the case of transactions conducted by business co-operatives (eg a co-operative established to buy trading stock for sale to members of a profession or trade), the present tax system does not distort commercial decisions, nor does it allow the tax base to be eroded. This is because reductions in the assessable income of the co-operative, resulting from, say, charging less for items sold to members, are reflected in increased assessable incomes for members. Thus, under the present tax system for co-operatives, the activities of the co-operative are regarded as an extension of the business activities of members. Profits earned by the co-operative are reflected in members' assessable incomes, either as rebates or as reduced expenditure on inputs purchased from the co-operative. Accordingly, there is no tax incentive for co-operatives to reduce prices charged to members in respect of the members' business activities.

The new regime proposed under the company/shareholder imputation system would also leave commercial decisions in respect of these transactions largely unaffected by tax considerations. The tax base would therefore continue to be protected.

b <u>Other Transactions with Members</u>

The situation is somewhat different when the transactions are not related to the business activities of members. This is because, under the present tax system for co-operatives, distributed profits in respect of non-business transactions with members are not assessable to either members or the co-

operative.

Under the proposed new regime non-business rebates will be assessable to the co-operative. However, the co-operative will still have some ability to effectively distribute these profits tax-free by reducing prices charged to members.

6.9 Application to Friendly Societies and Credit Unions

The co-operative nature of friendly societies and credit unions means that, in the absence of the section 61(23) exemption, and assuming no other special provisions are introduced, they would be taxed under section 199 for co-operatives. Changes to that regime made as part of the company/shareholder imputation system would also apply. As noted above, under the proposed changes all rebates would become taxable irrespective of their source. However, the ability for co-operatives to reduce taxable profits on non-business transactions (by reducing prices of services provided) and thereby erode the tax base would remain. The regime would therefore still be concessionary.

Clearly this problem arises for all co-operatives undertaking non-business transactions with members. However, until now, the scale of activities conducted under this concessionary regime has been relatively small. The possible inclusion of friendly societies and credit unions under this regime means that this problem could become much more significant. This is especially so in light of the proposals to relax existing controls on the activities of these organisations. The relaxation of these controls would allow friendly societies and credit unions to operate on a larger scale and undertake a greater variety of activities in competition with other non-mutual organisations. This raises concerns about the competitive advantage conferred by a concessionary tax

regime, and the erosion of the tax base. Accordingly, it is necessary to consider alternative means of taxing friendly societies and credit unions.

The tax regime for friendly societies and credit unions will be developed in conjunction with the Consultative Committee on Full Imputation which is considering the tax treatment of co-operatives in general. Some options are considered in the following sections.

6.10 Tax Treatment of Friendly Societies

- The Life Insurance and Superannuation Business of Friendly Societies

In respect of their life insurance and pension business, friendly societies should be subject to the regime detailed in Volume 1 of this document. Included under this heading will be policies for the "endowment of members or nominees of members at any age or on marriage" provided for in the First Schedule to the FSCU Act 1982. The tax treatment for these types of business will therefore be as follows:

a contributions/premia paid by the member on or after 17 December 1987 will be paid from after-tax income and not qualify for a personal tax deduction;

b contributions/premia paid by the member's employer on or after 17 December 1987 will be subject to Fringe Benefit Tax at the non-deductible rate of 35 percent;

c fund earnings will be taxable in the hands of the friendly society from 1 April 1989 (when the section 61(23) exemption is removed); and

d <u>emerging benefits</u> will be tax-free.

The assessable fund earnings will include profits/losses from the realisation of investments, and expenditure incurred in earning assessable income will be deductible.

If the present taxation regime for life offices is subsequently changed along the lines suggested in Chapter 2, the new regime could also apply to the life insurance business conducted by friendly societies. However, the applicability of the Chapter 2 regime to friendly societies would depend on the tax regime adopted for the other activities of these organisations, as discussed below.

- <u>Other Business Conducted by Friendly Societies</u>

The provision of sickness and accident insurance is similar to the business of a fire and general insurer. Under the present system, fire and general insurance is taxed under standard income tax rules. The basis of taxation is profit, defined as income earned less expenditure incurred in the process of earning that income. In the case of insurance business this means that:

- premiums are assessable;
- income earned from the investment of premiums is assessable;
- claims are deductible;
- expenditure incurred in gaining premiums is deductible;
- expenditure incurred in gaining investment income is deductible.

Profits of insurance companies (other than life insurance companies) will be taxed at the company rate under the new imputation system for companies. Tax will be levied at the company rate of 28% and then imputed to shareholders so that

profits can be effectively taxed at the shareholders' marginal tax rates.

As far as possible, friendly societies should be taxed on their non-life insurance business in the same way as other general insurers.

As part of their investment activities, friendly societies may provide mortgage finance for members, or lend money to a credit union for which membership of the friendly society is the common bond. In respect of this business, it will be important to ensure that the tax treatment of friendly societies is compatible with that for credit unions.

Options for taxing the insurance and investment activities of friendly societies are discussed below.

Option 1 - Tax as Non-Mutuals

This approach would apply the same regime to friendly societies as applies to fire and general insurers. Because of the non-business character of the transactions involved, this treatment would have two drawbacks. First, the tax system would create an incentive for friendly societies to set premiums/contributions and interest rates on loans to members in a way that minimised taxable profit. Thus, commercial decisions would be distorted by the tax system. Secondly, because of the ability to minimise tax in this way, such organisations would have a competitive advantage over other non-mutual organisations.

For these reasons, it would seem desirable to maintain at least some of the existing regulatory controls on friendly societies if this option were adopted.

Option 2 - Market-Related Income Tax Treatment

This option is motivated by the assumption that, under the regime applying to non-mutuals, friendly societies would return profits in the form of reduced premiums for given levels of benefits or by charging reduced rates of interest on loans to members, thereby escaping tax. The option would involve applying an objective benchmark market price for services offered against which the effective discount being offered by the friendly society would be calculated. The discount would then be added to the assessable income of the friendly society. With this exception, assessable income would be as under the treatment for non-mutuals outlined above. Naturally, this treatment would not preclude friendly societies from offering reduced premiums or charging low rates of interest to members. It would, however, prevent them gaining a tax advantage from doing so.

Alternatively, the Commissioner of Inland Revenue could have the discretion to deem any discount on premiums to be a dividend. This could be done along the lines of section 4(1)(b) of the Income Tax Act.

The difficulty with option 2 is that, given the dominance of friendly societies in the health insurance business for example, the information available to assess a "market price" for services offered is likely to be thin. Further, prices charged by non-mutual companies will vary, making it difficult to determine an objective benchmark. However, if it were possible to overcome these difficulties, the resulting regime would be non-concessionary and thus allow for the relaxation of regulatory controls.

Option 3 - Taxation of Net Investment Income

Another approach is to tax friendly societies on investment income net of investment expenses. Thus friendly societies would be treated as investment or savings vehicles in the same way as life insurance and superannuation funds are currently treated. This approach capitalises on the incentive for friendly societies to maximise returns from the investment of surpluses. However, to the extent that friendly societies are able to lend surpluses to members, or associated credit unions, this incentive will be undermined. To counter this, friendly societies could be required to invest a certain proportion of surplus funds with non-members. Alternatively, consideration could be given to including the discount on interest charged to members in the assessable income of the friendly society (as under the market-related option).

Provided one of these measures was included, this option would have the advantage that the tax base would be less open to manipulation than under the non-mutual tax treatment (option 1). Thus the distortion of commercial decisions and the competitive advantage obtained from tax minimisation would be less. On the other hand, because this tax treatment would still be concessionary, misallocation of resources would still result. As for option 1, it would seem desirable to maintain at least some of the existing regulatory controls on friendly societies if this option were adopted and, as noted above, it may be necessary to introduce additional controls on investment activities with members.

6.11 Tax Treatment of Credit Unions

The business activities of credit unions are essentially the same as those of banks. Banks are taxed on their profit as follows:

- interest derived from borrowers is assessable;
- income from other sources (eg bank fees and other investment income) is assessable;
- interest costs incurred are deductible;
- expenditure incurred in gaining deposits and making loans and other investments is deductible;
- expenditure incurred in gaining other investment income is deductible.

Deposits made by an individual are paid out of after-tax income, interest received by depositors is assessable income and withdrawals are tax-free. Interest paid to a bank by a borrower will generally only be deductible to the borrower if the loan is of a business nature.

As far as possible, credit unions should be taxed on the same basis as banks. Options for taxing credit unions are discussed below.

Option 1 - Tax as Non-Mutuals

There are three problems with applying the tax treatment for non-mutual businesses to credit unions. The first two are the same as those for friendly societies under the non-mutual tax option discussed above. First, this treatment would create an incentive for credit unions to minimise taxable profit by charging reduced rates of interest to borrowers. Thus commercial decisions may be distorted and minimal tax would be collected at the expense of other taxpayers. Secondly, because of the ability to minimise taxable profit

without disadvantaging members, credit unions would have a competitive advantage over other institutions such as banks.

The third problem is that, when credit unions charge and pay interest at below market rates, amounts of interest received by and assessable to members are lower than otherwise. Thus the tax base is further eroded, again at the expense of other taxpayers. It should be noted that the latter argument applies only where interest paid by members is non-deductible, as will often be the case for loans from credit unions.

For these reasons, it would seem desirable to maintain some controls on the amount of business that can be conducted by credit unions if this option were adopted.

<u>Option 2 - Market-Related Income Tax Treatment</u>

The foregoing discussion suggests that the tax base for credit unions needs to differ from that applying to banks. The following possible tax base for credit unions is designed to solve the problems inherent in taxing credit unions as non-mutuals. The derivation is provided in Appendix 6.1. Under the market-related option:

- interest charged to members would be assessable to the credit union;
- discount on interest charged to members (based on <u>market rates of interest</u>) that is non-deductible to members would be assessable to the credit union;
- interest paid by the credit union would be deductible to it;
- net income from other investments/borrowings would be assessable;
- all expenses would be deductible.

Under this approach, if credit unions endeavoured to distribute

"profits" by way of reduced interest charges, then these would reduce the deduction that can be claimed by members if the interest is deductible, or increase the discount which would be assessable to the union. There would therefore be no tax advantage in charging lower than market interest rates. Since increased interest payments to members would be assessable to them, a credit union's interest rate policies should not be influenced by the tax system.

An alternative would be to include the discount on all interest charged by the credit union in its assessable income and use an imputation system to avoid any double taxation. Under this approach, tax paid on the discount would be imputed to members and be deductible to them only where the associated interest payments are deductible. Imputed tax on discounts in respect of non-deductible interest payments would simply be disregarded by members. This would avoid the need for credit unions to differentiate between interest that is deductible and non-deductible to members.

Under a further alternative, the Commissioner of Inland Revenue could have the discretion to deem any discount on non-deductible interest charged to be a dividend. This could be done along the lines of section 4(1)(b) of the Income Tax Act.

The difficulty with a market-related approach is the need to determine market interest rates against which to measure the discount provided to borrowers. Such an approach would, however, result in a non-concessionary regime and therefore facilitate the relaxation of controls on credit unions.

Option 3 - Taxation of Net Income Earned from Non-Members

Another approach is to tax credit unions on net income earned from third parties. This would amount to maintaining the

present tax treatment for these organisations. To the extent that this income is passed on to members as taxable interest, some double taxation would result. However, credit unions could avoid this by passing this income on to members in the form of reduced (non-deductible) interest charges. Alternatively, a limited form of imputation system could be adopted.

As for friendly societies, life insurance and superannuation, this approach capitalises on the incentive for credit unions to maximise returns from the investment of surpluses. As a result, the credit union's tax base would be less open to manipulation than under the non-mutual tax option. However, credit unions would still have a tax incentive to charge and pay lower than market rates of interest. Thus the problems inherent in option 1 will also arise under this option.

Since credit unions compete with financial institutions taxed on a non-concessionary basis, the tax advantage would continue to attract business to credit unions at the expense of banks. As for option 1, it would seem desirable to maintain at least some of the existing regulatory controls on credit unions if this option were adopted.

6.12 Conclusion

As noted in 6.2 above, the section 61(23) exemption for income derived within the circle of membership of registered friendly societies, benevolent societies, specially authorised societies and credit unions will be removed from 1 April 1989. In line with other tax and regulatory reform exercises undertaken in recent years, the Government's preferred outcome is a non-concessionary tax regime coupled with the relaxation of regulatory controls. However, achieving this outcome for friendly societies and credit

unions is not straightforward and no decisions have yet been taken by the Government as to the tax regime that will apply to these organisations from 1 April 1989. The regime to apply from that date will be developed during the consultative process with the benefit of submissions received from interested parties.

As well as the options outlined above, consideration will be given to other options suggested in submissions. However, in making such suggestions, friendly societies, credit unions and other organisations covered by the present section 61(23) exemption, should bear in mind that the development of a non-concessionary tax regime is both the Government's objective and a prerequisite to the relaxation of existing regulatory controls.

APPENDIX A6.1

DERIVATION OF MARKET-RELATED TAX BASE FOR CREDIT UNIONS

The market-related tax base is derived by first considering how a credit union would be taxed if it operated on the same basis as a trading bank, ie charging and paying market interest rates with the aim of earning profits for shareholders. In this case, the standard income tax base would be as follows:

Let

IC_M_D = interest charged by credit union at market rates and deductible to borrowers
IC_M_ND = interest charged by credit union at market rates and not deductible to borrowers
IP_M = interest paid by credit union at market rates (assessable to lenders)
OI = net income from other investments/borrowings received by the credit union
E = expenses incurred by the credit union.

Then the credit union's taxable profit would be:

$$\text{Credit Union Profit} = IC_M_D + IC_M_ND + OI - IP_M - E$$

and borrowers/lenders would be taxed on:

$$\text{Members' assessable income} = IP_M - IC_M_D$$

In total (disregarding the effect of differences in tax rates), the tax base would be:

$$\text{Total Tax Base} = IC_M_ND + OI - E$$

This can now be compared with the position for a credit union operating on a mutual basis and setting interest rates at levels that differ from market rates.

Let

IC_D = actual interest charged by credit union and deductible to borrowing members

IC_{ND} = actual interest charged by credit union and not deductible to borrowing members

IP = actual interest paid to members (assessable to lending members)

In this case, the credit union's taxable profit would be:

$$\text{Credit Union Profit} = IC_D + IC_{ND} + OI - IP - E$$

and borrowers/lenders would be taxed on:

$$\text{Members' assessable income} = IP - IC_D$$

In total (disregarding the effect of differences in tax rates), the tax base would be:

$$\text{Total Tax Base} = IC_{ND} + OI - E$$

The difference between this tax base and that derived above for a credit union charging market interest rates is given by:

$$\text{Difference between market-related and mutual tax base} = IC_{M_ND} - IC_{ND}$$

This is the discount (compared with market interest rates) on interest charged by the credit union that is not deductible

to members. The discount is a benefit which results from membership of the credit union and should be taxed as profit in the hands of the credit union. The discount is therefore added to the tax base of the credit union to achieve the non-concessionary tax base as set out in 6.11 above. Using the variables defined in this appendix, the market-related tax base for credit unions is given by:

$$Profit = (IC_D + IC_ND) + (IC_M_ND - IC_ND) - IP + OI - E$$

CHAPTER 7 - MUTUAL LIFE OFFICES

7.1 Introduction

In Chapter 2 it is implicitly assumed that the life office is a proprietary company, ie a company owned by shareholders who are separate from policyholders. Many life offices are mutual companies which are, in effect, owned by the policyholders. An objective of the life insurance taxation reforms is to tax mutual and proprietary companies, as far as possible, in the same way.

However, under the regime suggested in Chapter 2, a mutual company might effectively distribute income to its policyholders/shareholders by reducing premiums instead of paying dividends. In this way, the profits that would normally be taxable in the hands of the life office, could be distributed free of tax. To avoid this possibility, the Chapter 2 regime may require modification before it could be applied to mutual life offices.

The ability of organisations formed on a mutual basis to distribute profits free of tax, and the problems arising from this ability, are discussed in some detail in Chapter 6. Accordingly, these issues are covered only briefly in this chapter.

7.2 Problems Taxing Mutual Life Offices

Under the present taxation regime for life offices, there is no need to differentiate between mutual and non-mutual companies. This is because both types of company have an incentive to maximise net investment income, ie the tax base, for the benefit of policyholders and shareholders. Since premiums are not included in the tax base, mutual companies

would not derive a tax advantage by reducing them. However, under the regime suggested in Chapter 2, this would no longer hold. Mutual companies would be able gain a tax advantage over non-mutual companies by charging lower premiums for the same levels of cover. Consequently, the commercial decisions of mutual companies could be influenced by the tax system and mutual companies could achieve a competitive advantage over non-mutual life companies. At the same time, the tax base would be eroded at the expense of taxpayers generally.

As noted above, issues relating to the taxation of mutual or co-operative organisations were discussed in the previous chapter on friendly societies and credit unions. If the life office regime outlined in Chapter 2 is adopted, then the principles underlying the discussion in Chapter 6 will also apply to mutual life offices. Thus, consideration could be given to applying the options outlined for friendly societies and credit unions to mutual life offices. These options are discussed briefly in the next section.

7.3 Options for Taxing Mutual Life Offices

Option 1 - Tax as Non-Mutuals

This option involves applying the same tax rules to mutual life offices that apply to non-mutual companies. In the context of a tax regime for non-mutual life offices along the lines suggested in Chapter 2, this would involve deeming policyholders of a mutual company to be shareholders. Should they so wish, mutual companies would be able to establish a proprietors' account. Transfers of net investment income to that account would be deductible from policyholder net investment income and assessable as proprietor income. Distributions from that account to policyholders would be deemed to be dividends and would be assessable as such, with

any available imputation credits.

However, instead of distributing taxed income as deemed dividends, mutual life offices could distribute profits by way of reduced premiums, and these distributions would not be taxed. Option 1 would then fail to address the problems outlined above (and considered in more detail in Chapter 6). Unless there are compelling reasons why a mutual life office would not wish to distribute profits by way of reduced premiums, option 1 would not be satisfactory.

Option 2 - Market-Related Income Tax Treatment

This option would be similar to option 1 except that any discount on premiums paid to a mutual life office would be included in the assessable proprietor income of the office. Tax paid on these discounts would then be imputed to policyholders/shareholders in the usual way. Thus, policyholders would include in their assessable income the value of discounts received (as notified by the life office), and use any attached imputation credits to offset the tax liability on this (or other) income.

Alternatively, the Commissioner of Inland Revenue could have the discretion to deem any discount on premiums to be a dividend. This could be done along the lines of section 4(1)(b) of the Income Tax Act.

The difficulty with the market-related option is the need to determine a benchmark premium level (or set of premium levels) against which to measure the discount being offered (if any). However, if it were possible to resolve this problem, the resulting regime would be equitable as between mutual and non-mutual life offices as well as addressing the efficiency and tax base concerns discussed above.

Option 3 - Retain Present Investment Income Tax Base

Under this option mutual life offices would remain under the present tax regime but with the modifications proposed in Chapter 3. The advantage of this option is that the tax base would not be open to manipulation in the way that would be possible under option 1 above. It would also avoid the need to measure discounts as required under option 2. The disadvantages of this option are all those discussed in Chapter 2 in respect of the present regime, except in so far as these are resolved by the changes to that regime proposed in Chapter 3.

7.4 Conclusion

Among other things, the feasibility of the tax regime suggested in Chapter 2 is dependent on establishing a satisfactory companion regime for mutual life companies. Life offices and other interested parties are invited to consider the three possible approaches set out above and discuss their relative merits in submissions. Other suggestions put forward in submissions will also be considered by the consultative committee.

ANNEX 1

ERRORS IN VOLUME 1

1 In the Table of Contents, Chapter 6, section 6.5 should read:

6.5 Taxation of Employer Contributions to Superannuation Schemes

2 On page 103, the first paragraph should read (change underlined):

Subject to the comprehensive review of the taxation of life offices covered in Volume 2 of this Document, existing rules on the deductibility of life office <u>expenditure</u> will be retained.

3 On page 109, the last sentence of the last (complete) paragraph should read (change underlined):

The removal of the exemption for the remainder of <u>1987/88</u> will be taken into account by way of reduced end of year tax refunds or increased terminal tax.

4 On page 121, the third (complete) paragraph should read (change underlined):

Employer-paid premiums for the benefit of the employer will all become non-deductible from the beginning of the 1988/89 income year. All benefits under such policies will become <u>non-</u>assessable from the same date.

ANNEX 2

TIMING OF VALUATIONS FOR THE ASSETS OF SUPERANNUATION FUNDS

On 25 March 1988, the Minister of Finance issued the following press statement:

"Finance Minister Roger Douglas announced today that the date for valuations of the assets of superannuation funds for the new tax regime would be 1 April 1988, irrespective of balance date.

Mr Douglas said that life offices, fire and general insurance companies, banks and superannuation funds already subject to tax, were taxed based on profits and losses realised on the sale of investments.

The same treatment had now been proposed for previously exempt superannuation funds, in the Consultative Document on Superannuation and Life Insurance.

For this purpose, the consultative document proposed valuation of the assets of previously exempt funds as at 1 April 1988 or the first day of the income year in which that date fell.

Profits and losses calculated by reference to the initial value would have been pro-rated so that only the proportion accruing after 1 April was assessable.

Mr Douglas said the Consultative Committee on Superannuation and Life Insurance had since advised him that the original proposal could create anomalies between companies with balance dates of 30 September, before the sharemarket crash, and others with balance dates of 1 January, after the crash.

The consultative committee members were agreed that equitable treatment required the use of a common date for all funds, for the initial valuation of assets.

They had recommended that the common date be 1 April 1988. Its use would allow income from the sale of investments to be pro-rated on the same basis as other income. The Government had accepted the Consultative Committee's recommendation.

All large funds routinely valued assets on a monthly basis, and most smaller funds balanced on 31 March. They would not need any additional valuations for 1 April.

Smaller funds with balance dates other than 31 march should not have any difficulty in doing such a valuation on a one-off basis.

Valuations for 1 April 1988 were required to be completed only by the time the assets of the fund were realised, Mr Douglas said."

SUMMARY OF TAX RATES

The rates of tax to apply to the income of superannuation funds, life office funds, and sick, accident and death benefit funds, as detailed in the two volumes of this Consultative Document, are summarised below. The rates of FBT to apply to payments to these funds by employers (for the benefit of employees) are also given.

a Rate of tax on fund income from 1 April 1988: 25%
FBT rate (non-deductible) from 17 December 1987: 24%

- Category 1 superannuation schemes existing on 17 December 1987; and
- Approved[1] sick, accident and death benefit funds existing on 17 December 1987.

b Rate of tax on fund income from 1 April 1988: 33%
FBT rate (non-deductible) from 17 December 1987: 35%

- New registered superannuation schemes;
- Category 2 superannuation schemes[2];
- Approved[1] sick, accident and death benefit funds established after 17 December 1987; and
- Life insurance[2,3].

c Rate of tax on fund income from 1 April 1988: 40.5%
FBT rate (non-deductible) from 17 December 1987: 48%

- Category 3 superannuation schemes.

d FBT rate (non-deductible) from 17 December 1987: 35%

- Payment to an insurance fund of a friendly society; and
- Premium on a policy of personal accident or sickness insurance[4].

Notes

1. Approved for the purposes of section 61(41) of the Income Tax Act.
2. The 33% rate on fund income is the existing rate.
3. The FBT rate of 35% applies to premiums previously exempt FBT.
4. Unless the insurance fund is an approved sick, accident and death benefit fund existing on 17 December 1987.