Life insurance tax reform

Officials' paper No. 1 – scope of the review

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LIFE INSURANCE TAX REFORM
SCOPE OF THE REVIEW

INTRODUCTION

Objective of the life insurance tax review

1. The business of life insurance is the assumption or transfer of risk from the policyholder to the life office. It is also financial intermediation, which is the management of someone else's money with the goal of increasing its value. Both of these activities have significant implications for the New Zealand economy and, as with any business, the tax rules under which the life insurance industry operates is a key determinant in its efficient operation – both for the taxpayer concerned and for the wider economy.

2. The ideal life tax system:

   - is transparent;
   - integrates as much as possible with actuarial and accounting principles;
   - is robust while being flexible enough to incorporate new ways of doing business;
   - minimises costs of compliance;
   - simplifies administration and collection of tax;
   - imposes tax in the same way as comparable activities – the "neutrality principle";
   - is equitable between shareholders in life offices, policyholders, and the government; and
   - reflects commercial reality.

3. The commercial, regulatory, accounting and savings environments have changed markedly since the current life tax rules were enacted in 1990. New products and ways of doing business have emerged and a number of apparent anomalies and inequities in the rules have been identified. The current rules are considered complex and expensive to comply with and administer. Furthermore, the proposed Portfolio Investment Entity (PIE) rules currently exclude life insurance and so, without some legislative action, those taxpayers who save via life insurance will be taxed in a way that is disadvantageous relative to other savings vehicles.

4. For these reasons, it is timely to review the principles governing life insurance taxation, with a view to designing tax rules that are closer to the "ideal" than the present rules are. Accordingly, on 17 August 2006, the Minister of Finance and the Minister of Revenue announced that such a review was to take place.

5. **The review will focus on amending the "life insurance rules" contained in Subparts CR and EY of the Income Tax Act 2004 and the related provisions dealing with imputation credit accounts and policyholder credit accounts. This paper outlines the various issues involved in designing rules for the taxation of shareholders and policyholders in life offices and then sets out design alternatives as bases for discussion.**

6. While there are a number of corporate compliance issues that relate to the taxation of life insurance companies – such as thin capitalisation, the conduit tax rules and applicability of the consolidation rules, given the tight time frames involved, these matters will not be dealt with in the current review. The ultimate life tax rules that result from the review may have flow-on effects on other tax provisions, but they will be considered as they arise.

Timing

7. Ensuring that life insurance is included in the PIE rules at the time of their proposed implementation date (1 October 2007) will require the relevant draft legislation to be included in the taxation bill planned for introduction in the first half of 2007. However, even if appropriate rules are included in that bill and have an effective date of 1 October 2007, because the legislation is unlikely to be enacted before 1 October 2007, life offices would have to take the commercial risk of changing products, IT and accounting systems and pricing on the basis of draft legislation.

8. Inclusion of changes in the early 2007 taxation bill is a "best endeavours" target, the achievement of which will largely rest on officials and the life industry agreeing with the policy and content of the rules by January 2007. Consequences of not meeting this deadline include delays in integrating life insurance with the PIE rules.

Purpose of this paper

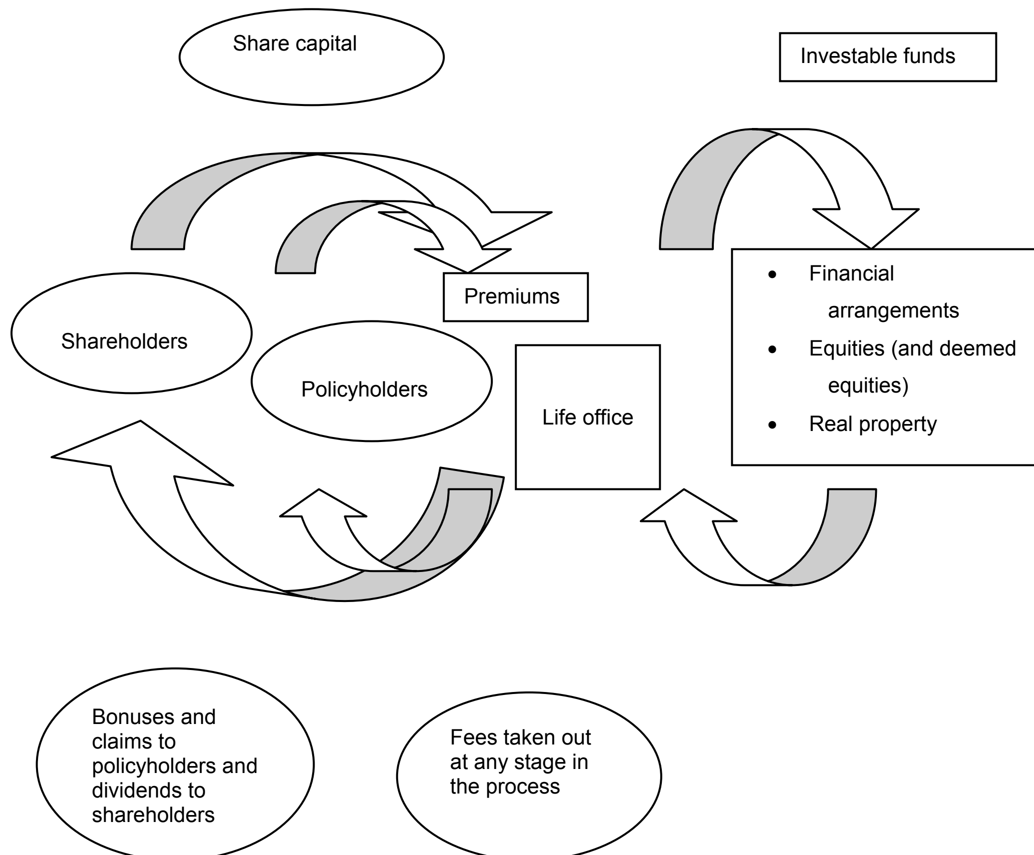
9. This paper presents a high-level discussion, written by policy officials, of the underlying issues facing life insurance tax and suggests some broad design options. It is designed to facilitate the consultation process, which is expected to be a dynamic and continuing one. Accordingly, officials welcome feedback on the paper, though formal written submissions are not required. It is expected that as discussion between officials and industry stakeholders develops, there will be further papers on specific issues.

10. Life insurance is a complex and arcane business in which, life insurers excepted, relatively few professionals and commentators specialise. As there are very tight time frames to meet legislative deadlines, the paper is focussed towards those with a specific interest in life insurance. Readers without a reasonably sound knowledge of life insurance tax and accounting may find some parts of this paper challenging.

OPERATION OF A LIFE INSURANCE COMPANY

Introduction

11. The taxation of life insurance covers a number of activities by (and also among) a variety of stakeholders. The modern life industry differs significantly from that existing in 1990, when the current tax rules were enacted. By way of background, therefore, it is useful to outline the various entities whose activities and relationships should be considered in the life tax review:[1]



Life offices

12. Life insurance companies are companies that carry on a life insurance business and are registered under the Life Insurance Act 1908 to write life insurance policies. As at 1 July 2006, 44 entities had lodged deposits with the Public Trustee to be life insurers, though not all of them write life insurance policies for the public, while a small number are re-insurance companies.

[1] The diagram is adapted from “Taxation of Life Insurance Companies” Module 1; ATO PDP(2003).

13. A life insurance policy is a policy on the life of a person. A classic definition is:

> *The contract of life [insurance] may be further defined to be that in which one party agrees to pay a given sum upon the happening of a particular event contingent upon the duration of human life in consideration of a smaller sum or certain equivalent periodical payment by another.*[2]

14. A life insurer is distinguishable from a general insurer in that:

- A general insurer will write a policy for a limited term, often one year.
- At the end of the term the policy becomes due for renewal.
- The insurer is not bound to renew, and if the risk is found to be unacceptable, the insurer can decline to renew.
- On renewal, the insurer can alter the premium and terms of cover.

Life insurance tax rules have developed differently from those applying to general insurance. However, as discussed later, there is a degree of cross-over with general insurance in terms of products offered by life insurers.

15. A life office applies the money it receives from premiums:

- to ensure it has sufficient amounts invested to meet future life policy liabilities (including income and disability claims);
- to pay administrative expenses, including commissions to agents;
- to pay bonuses to policyholders (though life offices often retain reserves from earnings in positive years in order to cover periods of negative earnings); and
- to make a profit.

16. Fees and charges in a life office can take many forms and structures. They can be implicit (meaning they cannot be separately identified) or explicit. Premium-based fees such as entry fees are deducted on payment.

Shareholders

17. When the current life insurance rules were enacted, most of the large insurers in New Zealand were mutual entities – meaning they were owned by their policyholders, and premium contributions as well as retained investment income built up over the years contributed to the capital base of the life insurer. All of the large insurers are now limited liability companies (though some operate in New Zealand as branches of foreign companies), predominantly ultimately owned by foreign companies. Equity in the life insurer comprises shareholder equity, though IFRS 4 (at paragraph 4.1.2) notes that a life insurer will have policyholder equity if it has life insurance operations in a jurisdiction which permits retained profits to be unallocated between policyholders and

[2] Bunyon C J (1914), *Law of Life Assurance* (5th Edition).

shareholders, and the policyholder's portion is yet to be determined. Many of the large life offices operate within financial services groups of companies that generally provide a wide range of savings products and, in some cases, general insurance. Some subsidiaries of banks are now involved in writing life policies. New Zealand and overseas trends indicate further consolidation of financial services providers.

Policyholders

18. The policyholder (insured) accepts a proposal by the life office by purchasing a policy. Depending on the terms of the policy, a policyholder may have the right to:

- terminate the policy (or simply stop paying the premiums);
- transfer the ownership of the policy to another party; and
- receive benefits within the scope of the policy terms and conditions

19. The net assets of a life insurer are owned by the insurer, not the policyholder. The rights of the policyholder are by way of contract with the life insurer and do not extend to specific assets. The economic policyholder "ownership" rights in a non-mutual are generally reflected in "unvested policyholder liabilities". Nevertheless, many unbundled products give their policyholders rights to a group of assets which are very close to the right of beneficial ownership, and therefore pull back all investment profits

20. There are no accurate statistics for the number of policyholders in New Zealand.[3]

Products sold by life insurance companies

21. Life policies can be single premium contracts or regular premium contracts. Single premium contracts require one lump sum payment which is made at the beginning of the contract, whereas the regular premium contract requires consistent payment throughout the life of the policy. The regularity of the payment may vary from fortnightly to yearly premium payments.

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[3] For completeness, the other stakeholders in the life insurance relationship are as follows and, at this stage, are unlikely to be affected by the review:

- *Insurance agents*: Arrange policies between customer and the life insurance companies and receive a payment on commission for their services from the life insurance company. Common overseas are brokers who advise on and arrange insurance cover for clients and are paid commission by their clients.
- *Regulatory bodies*: These are a number of bodies used to regulate life insurers including:
  - Insurers carrying on insurance in New Zealand are required to lodge a monetary deposit with the Public Trustee.
  - The primary supervisory role is the Government Actuary, who is part of the Insurance and Superannuation Unit of the Ministry of Economic Development.

The industry is represented by the Investment Savings and insurance Association of New Zealand (ISI).

22. In discussing the common types of products sold by life insurance companies it is important to keep in mind that:

- Not every life insurance company will offer every product described here.
- With competition, the industry is continually evolving with regards to the development of products.
- While the following descriptions seem to distinguish clearly between different product types, in reality, the boundary lines are often blurred. Hybrids of two or more products are common.

23. The following is a list of some of the different types of products sold by life insurers. They can be broken down into pure risk products and those that include a savings element:

Risk with savings element

- **Whole of life insurance** – The policy guarantees payment of the sum insured, while also providing a share in the life office's profits. The policy can be cashed in or surrendered before maturity, although the time when the policy is cashed in will determine what amounts are received (which are generally at the discretion of the insurer). Premiums are level throughout the life of the insured. When the policy is a participating policy (see paragraph 24), the holder is entitled to bonuses that add to the amount of the benefit and are also received on death or maturity of the policy.
- **Endowment insurance** – These have features similar to those of a whole of life policy but the sum insured is payable upon the survival of the insured life to a certain age or date, or upon prior death. As with whole of life policies, there is considerable actuarial involvement as a result of the interplay between the insured's mortality and investment return.
- **Investment bonds** – These provide a savings vehicle in an accumulation-style product, either with capital guarantees for both the accrued balance and the declared interest, or backed by equity assets.
- **Unit-linked policies** – These generally provide a savings vehicle in which the policyholder shares directly in returns of the asset pool, with no guarantee of performance. As such, the investment risk is borne by the policyholder rather than the life insurance company. The appeal to the policyholder is that he or she can benefit in a transparent way from the investment returns while having life cover. The appeal to the insurer is that it ties up less equity and resources than traditional policies do. In some countries whole of life policies are unit-linked.
- **Annuities –** These allow policyholders to draw down on their retirement savings by paying a large sum to the life office upfront and then receiving regular payments until they die. In many ways, they are the opposite of a policy offering life cover.

Risk (generally no savings element)

- **Term-life insurance** – The sum insured is payable only if death occurs during a specified period of time. Premiums rise with age.
- **Trauma insurance policies** – This is a product that provides cover in the event of a certain trauma (such as a severe accident or a specified medical condition).
- **Disability insurance** – This is an income or lump sum benefit based on insured's normal income in the event of a defined permanent or temporary disability

24. A common way of describing life products is whether they are participating or non-participating policies. A participating policy (also known as a "with profits policy") is a policy entitled to participate in distributions of profit – as most whole of life and endowment policies are. Conversely, a non-participating policy (also known as a "without-profits policy") does not participate in distributions of profit, examples being term life insurance and most unit-linked policies.

25. Until the 1980s, the most common products offered by life insurance companies were the traditional whole of life and endowment products,. Since the current life rules have been in operation, term insurance business has increased from being less than 10 percent of total industry premiums to now over 50 percent.

26. This relative decrease of traditional policies and increase in risk insurance arises for several reasons. Traditional policies are in "sunset mode" with little (and for some companies, no) new business being written. Generally, New Zealanders' debt levels have increased, and term insurance covers this increase (though, it has to be said, not to the levels of other countries). Product development driven by consumer demand for greater clarity in life insurance products and a desire to unbundle, or split out, the various risk, savings and expenses components of a contract have resulted in several new types of products – for example, combining life protection with income or disability insurance.

27. Financial services companies also "cross-sell" products to achieve similar or (because of a more competitive commission structure) more efficient savings packages. For example, a customer could purchase term insurance and also contribute to a unit trust or superannuation scheme as an alternative to saving via a traditional life policy.

Implications for life tax review

28. If life insurance was to be taxed in the same way as other New Zealand businesses, premiums would be taxable income, net investment earnings taxable income and claims deductible expenses. Under such rules a deduction is not usually allowed for reserves and provisions unless they meet strict conditions that have been set out in case law. Tax would be applied at the corporate rate against the net result.

29. This simple relationship cannot be applied to life insurance, however. The long-term nature of most policies makes it difficult to match income and expenses appropriately. In addition, tax needs to be paid not only on income generated by the life office on behalf of shareholders, but also in respect of income attributable to policyholders. There are difficulties in determining the relevant mix of savings return, savings and risk intermediation, and risk pooling (all of which can give rise to income) that is inherent in a life policy. And when taxing policyholders, consideration has to be given as to the appropriate rate. For example, traditional product policyholders tend to be overly represented in the age group of those retired or approaching retirement, and hence are typically at the 21% effective marginal tax rate.

30. How New Zealand currently deals with the tax issues is discussed in the next section.

CURRENT TAX RULES

Introduction

31. The current life insurance tax rules are based on the company tax model and aim to tax the shareholder income and policyholder income in a life office on a consistent basis. The "life office base" (LOB) is directed at the income of the life insurer (and also a re-insurer) as a whole (that is, both shareholder and policyholder). It consists of gross income (including realised gains on equities and other property but not premiums from policyholders or life reinsurance claims) *less* expenses (with the exception of reinsurance premiums and claims credited to policyholders) *plus* underwriting income. Underwriting income arises from three sources:

- profit on mortality;
- profit on termination risks; and
- premium loading (to reflect underwriting expenses and profit) deemed to be 20 percent of the net cost of pure risk insurance and 1 percent of reserves released on death in the case of life annuities.

32. Formulas for these three items are laid down in legislation, and although there is scope for actuarial judgement, Inland Revenue and members of the life industry agreed to a common reserving basis in 2002, in respect of the elements of the formulas related to the reserve.

33. Income accruing to policyholders is taxed to the life insurer on a proxy basis under the policyholder base (PHB) and is calculated by a formula equal to the increase in Reserves *plus* Benefits paid *plus* Underwriting income *less* Premiums. The tax base is grossed-up by (1- the LOB tax rate) to arrive at the before-tax amount necessary to provide the after-tax benefit implicit in the policy. Tax paid on the LOB generates imputation credits which can then be used to meet the PHB liability (thus avoiding double taxation) or as tax credits on dividends paid to shareholders.

34. The current rules have some theoretical appeal as they tax underwriting income and savings income on an accruals basis and are arguably more efficient, for example, than taxing on a payments (claims) basis, as occurs in the United States. However, the system is actuarially complex and involves high compliance and administrative costs. There is not a full transparency with the insurer's financial accounts, and a number of technical weaknesses with the rules have been identified over the years. The life insurer as proxy for the taxation of investment income on behalf of policyholders is also not wholly consistent with current policy settings.

Technical problems with current rules

Definition of "life insurance"

35. "Life insurance" is defined in section EY 8 of the Income Tax Act 2004. The general inclusion provisions that benefits provided be contingent upon the death or survival of one or more human beings are derived from case law on the meaning of "life insurance". Excluded are some forms of sickness or accident insurance relating to death from specific causes.

36. The trend in life insurance products is to combine many features, such as income protection, accident insurance and disability insurance; it is therefore difficult to determine whether the products are life insurance or general insurance or a financial arrangement, or a combination of all three. It is not sound policy to have different tax treatments for similar products based on artificial and arbitrary legislative distinctions. The life insurance rules should provide the appropriate tax environment for current and potential "mixed" products.

Underwriting income

37. This problem arises as a result of the premium loading content of underwriting income. Premium loading is intended to bring to tax the profit (net of expenses), being the amount of the premium not expected to be paid out as a claim. Because of the difficultly in identifying the "risk" premium, the premium loading was calculated on a proxy basis of 20 percent (other than for life annuities) of the expected claims, regardless of the risk and savings components of the particular policy. The 20 percent rate represents a "loss ratio" (claims ÷ premiums) of 83.3 percent, and so 16.7 percent of the premium is accrued to cover expenses and life office profit. This was generally appropriate at the time when the rules were enacted but may not reflect current reality when for a pure risk product (term insurance) the average industry loss ratio is possibly much lower.

38. The current premium loading has resulted in tax losses bring generated in both the LOB and PHB for profitable business. In fact, under the relevant formula, greater profitability (through lower than the expected level of claims implicit in the premium loading formula) results in greater tax losses.

Annuities

39. The annuity market, while well developed overseas, is very small in New Zealand. A major impediment is that the majority of potential annuitants are on a 21% effective tax rate rather than 33%. Therefore the product is not perceived to offer value for clients.

Home equity release

40. Home equity release products (also known as reverse annuity mortgages) are annuities for life, with the premium being due at the end of the term. The PHB tax calculation effectively treats annuity payments as taxable income on derivation, and the full premium payment, when made, is a tax deductible expense. The wait for the premium following the eventual sale of the house is likely to be 10 to 20 or more years, and the deduction is therefore likely to create a taxable loss that cannot be carried back.

41. Some commentators have argued for a diverse home equity release market to provide financial choices that are readily available in comparable countries. Removing the tax disadvantages of such products may encourage the private sector to offer them.

Imputation credits

42. The policyholder credit account (PCA) does not have any shareholder continuity requirements, whereas the imputation credit account (ICA) does. A life insurer who is about to undergo loss of credits because of a continuity breach, such as purchase of the shares in the company, can survive the breach by transferring credits from the ICA to the PCA. This also applies to any consolidated or group ICA credits transferred to a consolidated PCA.

43. There does not appear to be a policy problem to the extent the credits represent tax paid on policyholder funds, as the tax paid is effectively a proxy for tax paid by the policyholders, who themselves are not associated with each other or the company (provided it is not a mutual). However, there are arguments going either way whether life insurers should be able to shelter credits arising from tax on shareholders income from continuity breaches.

TAXATION OF SAVINGS

Introduction

44. The PHB taxes unrealised gains on the basis that because all investments are held on revenue account, the LOB and PHB should, over time, equate when gains are eventually realised (after allowing for the timing effects of bonuses, and allocation of profit to shareholders). However, direct investors are not taxed on unrealised gains on directly held non-foreign investment fund equity investments, and are taxed at their marginal tax rate, not at a proxy rate of tax.

45. The proposed PIE rules, which seek tax neutrality for investors between direct investments and intermediated savings vehicles, currently exclude life insurance. The life industry is concerned that if life insurance products are not put on the same taxation footing as other savings vehicles, policyholders will surrender life insurance savings-type policies and not necessarily invest the proceeds in other savings products.

Investment return

46. The investment return credited to policyholders that results from the payment of premiums in excess of claims and other costs can be referred to as "inside build-up".[4] The life insurer invests cash from premiums to match the nature and duration of the liability – for example, long-term liabilities are matched with long-term assets.

47. The savings component in participating policies earns an "implicit" return. Inside build-up is substantial in whole of life policies and endowment plans, and some term life insurance can also have inside build-up as a result of pre-funding of benefits. Inside build-up is less of an issue for policyholders who receive an "explicit" return, such as returns from certain non-participating policies.

48. The current rules levy tax on investment income in the hands of the insurer for predominantly practical reasons. However, taxing the policyholder on income as it accrues is the theoretically correct approach.

49. The issue is how to integrate life office investment income into the PIE rules when the income arises from unit-linked and non-unit-linked policies. From a tax policy perspective, these types of products should not have different tax outcomes in the hands of the investor, even though from a practical perspective, there are many difficulties.

Unit-linked policies

50. About 20 percent of total policyholder assets in New Zealand life offices are held in unit-linked policies. Although there are many variations, in practice, unit-linked policies are generally pooled in a manner similar to that of unit trusts. The premium purchases units in an unfixed fund, the unit price of which is recalculated each business day to reflect the investment performance of the assets in the fund. Accordingly, the value of the units can rise and fall, and the investment performance is not guaranteed. The life company is remunerated by a fee which is commonly included in the unit price calculation or, in some cases, by cancelling units.

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[4] An algebraic formulation of inside build-up is described in *Taxing Insurance Companies* OECD Tax Policies Studies No.3 at page 83.

51. In previous meetings with officials, industry representatives have argued that there is effectively a transparency between the actual performance in the unitised fund and tax paid, and that the investment income can be traced to individual policyholders. The ISI and some life offices have suggested to officials that unit-linked funds can therefore be relatively easily integrated into the PIE rules.

Non-unit-linked policies

52. Traditional life policies have no direct mechanical relationship between the benefits paid to any policyholder and the income and gains accruing to the life office over the duration of the policy. While it is possible eventually to identify the total investment return attributed to a particular policyholder, it is not possible to know how it is made up, or in which particular years it accrued. A life insurer may distribute retained profits to policyholders by means of a reversionary bonus. This bonus is a guaranteed addition to the policyholder sum insured. In addition, terminal bonuses may be received on death or maturity of the policy. In practice, though, earnings on an investment fluctuate widely. Accordingly, if all earnings were to be distributed as a bonus in the year they were earned, the life insurer would find itself losing heavily in times of negative returns. As a result, life insurers "smooth" returns to policyholders by retaining revenue from earnings in positive years in order to cover periods of negative earnings.

53. Also, in the early years of the policy, the premium in excess of the cost of pure insurance can cover only a part of the expenses, mainly commissions, of the policy. Accordingly, the insurer must use some of its surplus to pay the agent. The insurer borrows funds from the policyholder and its shareholders/ participating policyholders so that it can pay for the commission. It expects to recover that surplus with interest through future premium receipts and then to begin to build up capital with respect to the policy.

54. These timing issues create difficulties for the computation of the life insurer's policy reserve. This is a measure of the life insurer's future liability with respect to its life insurance policies, determined at the end of the current accounting year and requiring a comparison of the present valuation of future liabilities with the present value of future premium receipts. In terms of the benefit and premium components, the life insurer must use mortality rates to estimate the probability of death each year under the policy. It is more difficult to estimate the future income to pay future benefits.

55. Annual quantification of a policyholder's investment income therefore effectively requires knowledge of the benefit held on behalf of the policyholder, and the invested portion of premiums received for each policy, whether unbundled or not. This may prove to be a difficult and expensive task.

DESIGN OPTIONS

Introduction

56. In making a case for tax reform of life insurance, this paper has highlighted the following:

    - Life insurance products are becoming more, rather than less complex.
    - The current rules overtax some aspects of life insurance business and undertax others.
    - The taxation treatment of the savings component of life insurance is inconsistent with the policy underlying the taxation treatment of other entities that carry on similar business.

57. The major reforms therefore have to:

    - ensure that risk business is taxed on a basis that is not inconsistent with similar businesses – for example, general insurers; and
    - integrate savings income into the PIE rules.

58. The key to achieving the policy intent is to effectively segregate various types of insurance business within the life company, to ensure taxation of those different businesses at the appropriate (or most practically appropriate) rate and to the account of the appropriate person. Note that this is a function for tax purposes only. It does not and should not impinge on the commercial operation of the life business, and hence on its non-tax regulation.

59. If we consider the life tax rules of other OECD countries, while there are obviously many permutations, there are two broad design options that we can draw on.[5] The first taxes a life office on its full underwriting income and as a proxy for policyholders on their investment income. The current New Zealand LOB/PHB methodology is an example and is therefore the starting point for discussion. The other option leverages off the new life insurance financial accounting standards. Both options assume that the current tax treatment of recipients of life insurance benefits (including exclusion from gross income where applicable) will continue to apply.

60. **The options discussed here are high-level approaches to possible ways of taxing life insurance business and are provided to form the basis for discussion and debate. The options should not be considered as viable tax legislation at this stage, and they require considerable refinement before they can be subject to the ordinary tax policy review process. Neither option at this stage is preferred or endorsed by Inland Revenue and the Treasury. Other options that may emerge from the discussion will also be considered.**

[5] A third broad option, which involves concessionary treatment of particular aspects of life office and/or policyholder taxation, is outside current policy settings and so is not considered.

Option 1

Proxy basis

61. Under this option, the current LOB/PHB rules will be maintained but amended to deal with the issues discussed earlier, including:

    - Determining if the definition of "life insurance" is still appropriate. One alternative is to make the definition of "life insurance business", "insurance contract" and "life insurance contract" (with related definitions) consistent with the accounting definitions under IFRS.[6]
    - Establishing premium loading at a realistic level.
    - Possibly to resolve the home equity release problem, the actuarial reserves in respect of any policy at any time will never be less than any surrender or discontinuance value.
    - Integrate unit-linked savings products and investment bonds into the PIE rules (although this will be on an elective basis), whereby realised Australasian equities gains, together with any relevant adjustments to other investment income, will be excluded from tax under the LOB. Adjustments to the PHB will ensure no claw-back of the tax benefits. The shareholder portion of investment income is excluded from these adjustments. Tax on the attributed income will be paid by the life office on behalf of individuals at their marginal rate (as with PIEs, to a maximum of 33%).
    - Non-unit-linked products need to be integrated into the PIE rules. The way to achieve this however, appears problematic.

[6] A "life insurance business" is defined in IFRS 4 as "all life insurance contract and life investment contract business conducted by a life insurer" A "life insurance contract" means as an insurance contract or a financial instrument with a "discretionary participation feature" issued by a life insurer. A "discretionary participation feature" is a contractual right to receive, as a supplement to guaranteed benefits (benefits to an investor or policyholder that are not at the discretion of the life insurer), additional benefits:

– that are likely to be a significant portion of the total contractual benefits;
– whose amount or timing is at the discretion of the issuer;
– that are based on either performance of a pool or type of contract; or realised/unrealised investment returns; or the financial performance of the life office, fund, or other entity that issues the contract.

An insurance contract is defined as "a contract under which one party (the insurer) accepts a significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder". The insurance risk has to pre-exist the contract and not be financial in nature. In IFRS 4, financial risk is defined as "the risk of a possible future change in one or more of a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract."

A contract must involve significant risk transfer in order to be classified as an insurance contract. Therefore, for instance, there is an insurance risk when the benefits payable on death (insured event) are significantly higher than the benefit payable on surrender or maturity in a life insurance contract.

A "life investment contract" means any contract issued by a life insurer that is not an insurance contract and with a few other exemptions (contained in paragraph 4 of IFRS 4).

62. The advantage of maintaining the LOB/PHB methodology is that it is reasonably well understood by life companies and practitioners. Furthermore, maintaining its framework should minimise transitional requirements relative to other more radical reforms. The actuarial reserving calculations (supported by a uniform methodology such as the 2002 Agreement), with the proposed adjustments, may result in a more accurate reflex of taxable income than, arguably does reliance on pure accounting standards.

63. Disadvantages are that it entrenches a tax system which is not directly related to the actuarial and accounting output of the life company and so lacks transparency. The actuarial complexity may be increased by the PIE inclusion (including the income allocation between shareholders and policyholders). A method has to be determined to attribute non-unit-linked investment income equitably to individual policyholders. Also, the taxation of risk products can be seen as ad hoc "band-aid" solutions and may leave the door open for anomalies to arise in the future.

64. Without in any way wanting to limit discussion, we are interested in receiving feedback on the following questions:

1. What features of unit-linked policies might complicate inclusion in the PIE rules and how can these complications be dealt with? For example, how would switching and early termination fees be accommodated in calculating a policyholder's attributed income?

2. For non-unit-linked savings policies, is it feasible – both technically and practically – under current actuarial and accounting principles to attribute income to an individual policyholder? Consider factors such as:

   – allocation between shareholders and policyholders; and
   – how to allocate "smoothed" income to individual policyholders.

   If the answer is "No", then are there any pragmatic alternatives, which, although not fully attributing income, give policyholders similar tax benefits to what they would receive under the PIE rules (or different tax consequences to that which they would receive under the current rules)?

3. What are the implications for the industry if non-unit-linked policies cannot integrate with the PIE rules?

Option 2

Integrate with financial accounting rules

65. This option replaces the LOB/PHB dichotomy and uses as a starting point the new financial accounting rules for life insurance, IFRS 4,[7] which applies from 2007, (though owing to their international connections, many New Zealand life insurers would probably be "early adopters"). It adopts IFRS 4's definition of life insurance business[8] (see paragraph 61) and uses the accounting information to ensure that underwriting profits and management fees are taxed appropriately to the life insurer.

66. Premiums paid, claims, underwriting profits and changes in the value of liabilities which relate to risk business would be taken into account in determining taxable income of the life insurer. In general, this means that for risk business the life insurer would be taxed in a manner similar to that of a general insurer.

67. Realised Australasian equity gains and other taxable investment income relating to policyholders would be taxed under the PIE rules to individual policyholders in the same fashion as discussed in paragraph 61, provided solutions regarding the same problems raised earlier with respect to unit-linked and non-unit-linked products can be resolved.

68. The advantages of the financial accounting based approach are:

- IFRS 4's definition of life insurance is a functional one that will clarify the tax treatment of hybrid products. It will also treat products that have no significant life insurance risk, such as some investment-linked products, correctly as deposits in savings vehicles.

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[7] IFRS 4 reflects "Phase One" of the project by the International Accounting Standards Board to develop the life insurance accounting standard. Phase two is in progress.

[8] Adopting IFRS's definition would result in the financial accounting treatment of the following selected products:

	Insurance Contract Significant insurance risk	*Investment Contract Insignificant insurance risk*
Term life, disability and critical illness	X	
Pure endowment	X	
Whole of life	X	
Life contingent annuities and pensions	X	
Guaranteed investment contract		X
Unit-linked without significant mortality risk		X
Savings contract with lapse or expense risk only		X
Disability and medical	X	
Traditional life and non-life reinsurance	X	
Reinsurance catastrophe bonds with triggers related to the issuer's losses	X	

Arrangements that do not meet the definition of an insurance contract in IFRS 4 must be accounted for as financial instruments.

Embedded derivatives must be accounted for at fair value, with changes in fair value being recorded in the income statement. IFRS 4 exempts derivatives from measurement at fair value if the derivative itself is regarded as an insurance contract.

Some insurance contracts contain both insurance and deposit components which, in certain cases, life insurers will be required or permitted to unbundled. However, few products are expected to be affected by the unbundling requirement.

The treatment of financial assets is addressed by IAS 39.

The recently released officials' Issues paper "The Tax Consequences of Adopting International Financial Reporting Standards" (September 2006) discusses the taxation policy implications of the changes of accounting for financial arrangements.

- Disclosure requirements may lead to consistency of financial accounting and actuarial assumptions within the industry.
- Policyholders are taxed at the correct rate on savings products.
- Life offices are taxed appropriately.

69. The major disadvantages are that:

- Adopting a financial accounting approach requires detailed analysis as to whether the financial accounting rules provide sufficient information to provide a taxation result that meets the policy objectives set out at the beginning of this paper. There is also uncertainty about the full accounting implication of the rules, given their novelty and the unknown impact of Phase Two of their development.
- Complex transitional rules will be required.

70. As with the first option, without wanting to limit debate, feedback would be useful on the following issues:

1. The description of the financial accounting based system has been left as general as possible so as not to restrict areas for discussion. Clearly, there are theoretical and practical issues involved in making the information produced by life insurance companies under IFRS consistent with tax policy objectives. For example, to what extent should the accounting treatment take precedence over ordinary tax principles? What are the practical implications, for example, of splitting out the risk component of premiums? Does the accounting standard provide sufficient information? Can we find useful assistance from other jurisdictions (for example, Australia)?

2. In terms of potential transitional issues, how should non-shareholder income related imputation credit balances arising as a result of the LOB being in excess of the PHB be treated? What should happen to LOB and PHB losses carried forward? What other transitional matters need to be considered?

3. The same questions regarding unit-linked and non-unit-linked products and the PIE rules asked under Option 1 are also relevant here.

Next steps

71. The desired outcome of discussion on the design options is to arrive at a broad schematic (or schematics) for the new life tax rules. Officials intend a robust discussion of the options, using this paper as the basis for thrashing out issues and arising at workable solutions. It is hoped that from discussions with stakeholders on a regular and intensive basis over a month to six weeks of the release of this paper, broad policy will be developed. From there, a more detailed blue-print of the possible reform will be released for comment.