Taxation of the life insurance business: proposed new rules

A government discussion document

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First published in December 2007 by the Policy Advice Division of Inland Revenue, PO Box 2198, Wellington, New Zealand.

Taxation of the life insurance business: proposed new rules; a government discussion document.
ISBN 978-0-478-27160-7

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GLOSSARY

Actuary.* A person employed or contracted by a life insurer to calculate premiums, reserves, dividends, and insurance, pension, and annuity rates, using risk factors obtained from experience tables. For the purposes of certification discussed in this document, the actuary should be as defined in current tax legislation, which broadly is a Fellow of the New Zealand Society of Actuaries or a person who holds an equivalent qualification.

Annual renewable policies. Term life insurance that may be renewed from year to year without evidence of insurability by acceptance of a premium for a new policy term. The premiums under these policies usually increase in cost each year.

Annuity. There are many types of annuities but, basically, they are a contract between the investor and an insurance company under which the investor makes a lump-sum payment or series of payments. In return, the insurer agrees to make periodic payments to the investor beginning immediately or at some future date, with the payments continuing for a set period or until the death of the annuitant. They may include a terminal death benefit that will pay the investor's beneficiary a guaranteed minimum amount, such as total purchase payments.

Claim.* Request for payment from the insurance company by the insured as a result of an insured event occurring. In life insurance, survivors submit a claim when the insured dies. The insurance company investigates the claim and pays the appropriate amount if the claim is found to be legitimate, or denies the claim if it determines the loss was fraudulent or not covered by the policy.

Endowment policy. These policies 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.

Expected death strain (EDS). Expected level of claims against a life insurer as calculated by an actuary.

Fair dividend rate (FDR).* From 1 April 2007 it is the general method for determining foreign investment fund income with respect to less than 10% interests in foreign companies other than some listed Australian companies. It is generally a deemed return of 5% of the market value of the shares held by the taxpayer on the first day of the income year. Natural persons have the option of using the actual return but not a loss.

Group life. A single life insurance policy under which individuals in a group – for example, employees and their dependents – are covered.

Incurred but not reported (IBNR). Losses occurring over a specified period that have not been reported to the insurer.

International Financial Reporting Standard (IFRS) 4. A financial accounting standard that applies to virtually all insurance contracts (including reinsurance contracts) that an entity issues and to reinsurance contracts that it holds.

KiwiSaver.* A work-based voluntary savings initiative set up by the government to help New Zealanders save for their retirement.

Level premium term insurance (sometimes referred to as **level term insurance**). Term insurance that provides consistent coverage over a specified amount of time for a guaranteed level premium cost. The face value of a level term policy usually remains the same for the duration of the period selected. The premium is usually constant over the term of the policy. Level term coverage usually lasts for 10, 15, or 20 years. The product does not usually build cash value.

Life insurance.* A contract 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.

Life office base (LOB). Defined under the current tax rules. It combines underwriting profit (as defined in the legislation) and investment income less expenses. See also "policyholder base".

Margin on services (MoS). The MoS valuation method is used for valuing policy liabilities which, by incorporating profit margins in policy liabilities, seeks to release profit as it is earned through the provisions of services and the receipt of the related income. The New Zealand Society of Actuaries has a professional standard which covers the calculation of policy liabilities under the MoS method.

Mortality. Actuaries use mortality tables that show, for a person at each age, what the probability is that they will die before their next birthday as well as statistics such as the probability of surviving to any particular year of age and remaining life expectancy for people at different ages. The tables usually take into account risk characteristics such as gender, age and smoking status, and can also have regard to occupation and socio-economic status.

Outstanding claims reserve (OCR). A provision made by an insurance company for all claims that have been made and for which the insurer is liable, but which had not been settled at the balance sheet date.

Participating policy (also known as **"with-profits policy")**. A policy that entitles the policyholder to participate in distributions of profit – as most whole of life and endowment policies are.

Policyholder. The owner of an insurance policy, usually, but not always, the insured.

Policyholder base (PHB).* The PHB is part of the two-tier calculation of life insurance income under current tax rules. It attempts to tax the economic income (subject to certain tax adjustments) of policyholders. (Also see "life office base".)

Policyholder income. New taxation rules proposed in this document that aim to tax the economic income (subject to certain tax adjustments) of policyholders.

Portfolio investment entity (PIE). A collective investment vehicle that elects to be a PIE for tax purposes. The difference between PIEs and other investment vehicles is that PIEs are not subject to tax on trading in New Zealand and some listed Australian equities, and most PIEs may attribute income to individual investors and apply tax at their rate (subject to a cap of 30% from 1 April 2008).

Premium.* The periodic payment made on an insurance policy.

Premium loading.* The premium calculated from mortality and interest factors is a net premium, and adjustments, or loadings, will have to be made to arrive at the actual premium chargeable. The major loading is to cover the expenses of the life insurer. There will also be a safety margin to guard against higher than expected mortality and a profit margin. Tax legislation calculates premium loading by formulas for the purposes of the current life insurance rules.

Premium smoothing reserve (PSR). The PSR is a method in the life tax rules proposed in this document to recognise premium income for risk products or risk elements of savings products during the periods when premium rates are contractually guaranteed or in a period when level premiums are payable.

Reinsurance. A contract whereby one party, called the reinsurer, in consideration of a premium paid to it agrees to indemnify another party, called the reinsured, for part or all of the liability assumed by the latter party under a policy or policies of insurance which it has issued.

Reserve. The amount of funds or assets necessary for a life insurer to have at any given time to enable it, with interest and premiums paid as they accrue, to meet all future claims and expenses on the insurance then in force. However, for tax purposes, different calculations are required. It is proposed in this document that the reserves for tax purposes will consist of either a premium smoothing reserve or an unearned premium reserve, and an outstanding claims reserve for claims.

Shareholder.* Any person, company, or other entity that owns at least one share in a company. Shareholders are the owners of a company. They have the potential to profit if the company does well, but that comes with the potential to lose (in terms of the amount invested) if the company does poorly.

Shareholder income. New taxation rules proposed in this document which aim to tax the economic income (subject to certain tax adjustments) of the shareholder.

Surrender value (SV) (also known as "**cash value**", and "**policyholder's equity**"). The sum of money an insurance company will pay to the policyholder or annuity holder in the event his or her policy is voluntarily terminated before its maturity or the insured event occurs. This cash value is the savings component of life insurance policies.

Term insurance. The sum insured is payable only if death occurs during a specified period of time. Premiums usually rise with age (though see level term insurance).This product does not build cash value.

Traditional products. Participating and non-participating whole of life and endowment policies.

Unearned premium reserve (UPR). The sum of all the premiums representing the unexpired portions of the policies which the insurer has on its books as of a certain date. It is usually calculated by a formula of averages of issue dates and the length of term. The reserve is equivalent to the amount of return premium due to policyholders if the insurer terminates the insurance. Under the rules proposed in this document, the UPR will apply for risk products or risk elements of other products where premiums are stepped yearly or where premium rates are not contractually guaranteed.

Unit-linked products. These generally provide a savings vehicle in which the policyholder shares directly in returns of the asset pool, with no guarantee of performance, similar to a unit trust. As such, the investment risk is borne by the policyholder rather than the life insurance company.

Whole of life. The policy guarantees payment of the sum insured, so long as premiums are kept up to date. 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 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.

*** These terms are also defined in section YA (1) of the Income Tax Act 2007. The Glossary definition provides their ordinary meaning unless specifically expressed otherwise.**

CHAPTER 1

New rules for taxing the life insurance business

1.1 Although the provision of life insurance undoubtedly has benefits for those for whom it is intended, there is no compelling reason for giving life insurance companies greater tax benefits than are enjoyed by other producers of goods and services. Tax concessions effectively exist for them, nevertheless.

1.2 Since the tax rules relating to life insurance companies were enacted in 1990, there have been significant changes to life insurance products, to New Zealand's business environment generally, and to the way income in collective investment vehicles is taxed. They all make it timely to review the rules relating to the provision of life insurance and to bring them up to date.

1.3 Individuals who save through life insurance products face a higher tax burden than do other savers who invest directly or through managed funds that become portfolio investment entities (PIEs). To remove this disadvantage, the proposed rules extend PIE tax benefits, where applicable, to investment income earned for the benefit of policyholders.

1.4 On the other hand, term insurance, a major part of life insurance business now but a minor part when the rules were enacted, is significantly under-taxed and, in many cases, profitable business generates artificial tax losses for the insurers. It is this sort of unintended concession for the life insurance industry that the proposed changes seek to remove.

1.5 The changes proposed in this discussion document have emerged from a government review of the taxation of the life insurance business. Most of the life insurers that were consulted in the course of the review agreed with the need for reform of the tax rules, although they did not always agree on the details of the changes that were needed.

1.6 A core objective of the rules proposed here is for life insurance companies to pay no less and no more tax on their profits than would any other business.

1.7 This discussion document looks at problems relating to the taxation of the life insurance business in New Zealand and outlines proposals for changing the rules. Chapters 1 to 3 are intended for a wider, non-specialist audience, while the remaining chapters assume a certain degree of specialist knowledge about the business of life insurance.

Will the changes raise the cost of insurance premiums?

1.8 In the development of the proposed changes, extensive consultation has taken place over the last year with the life insurance industry, actuarial and accounting professionals and their professional associations, representatives of life insurance advisers, the home equity release industry, and other people interested in life insurance taxation. In the course of that consultation, some life insurers argued that if the current rules were changed they would have to increase the cost of life insurance to their customers.

1.9 The government's response is that tax is a business cost, and life insurance companies should not rely on tax benefits to make a profit. They should be able to conduct their business on an equal footing within their industry and with other businesses. Again, there are no compelling arguments for the life insurance industry to be preferred over other sectors of the economy.

1.10 Furthermore, there should be minimal tax-related reasons for prices to increase on policies taken out before 1 April 2009. Profits on those policies will not be subject to the proposed rules for a further five years from the application date (in other words, not until the 2014–15 income year) and, in some cases, will remain taxed under current rules until the policies expire or mature. The proposed rules will apply only to products sold after 31 March 2009.

1.11 Even then, the impact on premium prices is uncertain and will not be the same for all members of the life insurance industry. Not all life insurers or products enjoy the same effective level of tax benefits under the current rules, and, as occurs in any industry, some insurers have cost structures that are more efficient than others and can respond to economic changes better.

1.12 Premium prices are also affected by general market forces as well as factors such as overall health and mortality, and the rate of commissions to advisers who sell life insurance. Commissions are the biggest expense, after death claims, for the majority of term insurance products.[1] On the other hand, other recent tax reforms such as the reduction in the company tax rate to 30% and the application of the PIE rules and fair dividend rate rules to life insurers should tend to reduce the price of life insurance.

Other options investigated

1.13 Chapter 2 discusses the weaknesses of the current tax rules and the reason for replacing them with the proposed rules. The proposals are based on the model discussed in the officials' paper, *Life Insurance tax reform: Suggestions for reform,*[2] and the resulting consultation. During the submission process, two alternative options were put forward, and these were considered but rejected for reasons that are discussed in Appendix 4.

[1] For a recent discussion on the rate of commissions for life insurance products see "Adviser Commissions Dominate Discussion", *Good Returns,* 27 July 2007.

[2] Published by the Policy Advice Division of Inland Revenue, February 2007. This paper followed up *Life insurance tax reform: Officials' paper No 1 – scope of the reform*, published by the Policy Advice Division of Inland Revenue, September 2006. Both papers are available at www.taxpolicy.ird.govt.nz.

1.14 In developing the proposed rules, the tax treatment of life insurers and policyholders in other jurisdictions has been closely examined (see Appendices 1 and 2). New Zealanders' investment income is now taxed under the portfolio investment entity (PIE) tax rules, so in bringing policyholders' investment income under those rules, as is proposed, overseas precedent is limited.

1.15 A number of countries tax claims or benefits received by policyholders either under income tax or through inheritance tax. Although this option was raised in submissions, the government considers that taxing claims is contrary to New Zealand tax law principles (under which the claim is generally a capital item). Furthermore, with the abolition of estate duty in 1992, there is no basis to subject the estate of claimants to an inheritance tax.

1.16 Some countries provide tax deductions (in some cases up to certain limits) to policyholders for premiums paid, as happened in New Zealand up to 17 December 1987. In some countries, the deductibility is for premiums to life savings policies, and in many cases, the claims are taxable, as previously discussed. Tax preferencing of life insurance over and above other taxpayers is not acceptable, for reasons discussed in Chapter 3.

1.17 Life insurers are taxed in a variety of ways internationally. New Zealand is in a small minority by taxing underwriting profits by way of formula (discussed in Chapter 2). Many countries use financial accounts as the starting point, and this has the effect of largely taxing life insurers on their actual profits. The proposed rules favour a general insurance approach to the taxation of risk profits and fee income, similar in concept (though not necessarily in detail) to present Australian tax rules, which aim to tax the insurer fairly on the economic profits derived from that business.

Summary of proposed changes

- The proposed rules separate the taxation of income from a life insurance business into that earned by the equity owners of the company (shareholder income), and the income for policyholders of life insurance savings products (policyholder income).

- Shareholder income will consist of underwriting profits from risk business; traditional business profit attributable to shareholders; fees and charges; and net investment income from shareholder funds. Therefore life insurers will be fairly taxed on all their profits.

- Tax will be payable at the company tax rate, net of any credits related to the income. All other provisions that apply to corporate taxpayers, including imputation credit rules, loss carry forward and grouping, will apply to the life insurer in respect of shareholder income.

- Policyholder income will consist of investment income from policyholder funds (reduced by distributions of with-profits income to shareholders) net of deductible charges and fees, and calculated under ordinary tax principles (as amended by the PIE and fair dividend rate rules). Tax at the top PIE rate will be paid (net of any credits) by the life insurer on policyholders' behalf as a final tax.

- Subject to interest from the industry in developing a suitable methodology, a life insurer may elect for net investment income to be "attributed" to policyholders and so subject to tax at investors' prescribed investor rates (19.5% or 30%).

- Policyholder income cannot be offset with losses or credits from either shareholders' income or any other company in the life insurer's tax group.

- The proposed rules will apply to life insurers on the first day of their income year that begins after 31 March 2009. Term insurance products sold before 1 April 2009 will effectively be taxed under existing rules for a period of up to five income years from application date and for the duration of the policy for some single premium and level term products.

What is not affected by these proposed changes

1.18 Life insurance premiums are not tax-deductible, except for certain income replacement products, and proceeds of claims are not taxable to individuals. That will not change.

1.19 The discussion document does not deal with annuities, which relatively few companies offer today. The government has a clear preference for bringing annuities into the new life rules, but that would raise a number of questions that are outside the scope of this discussion document. Annuities may be dealt with in future considerations.

Submissions

1.20 The government invites submissions on any aspect of the issues raised or the proposals made in this discussion document. Without limiting the range of matters that we want feedback on, we would particularly be interested in comments on:

- What technical problems are there in the proposed rules? Are they fair to all stakeholders in the life insurance business (including the government)?
- Are there feasible ways to correctly attribute investment income to individual policyholders?
- What are the expected initial and continuing costs of complying with the proposed rules (compared with the continuing costs of complying with the current rules)?

1.21 Submissions should be made by 12 February 2008 and be addressed to:

Taxation of Life Insurance
C/- Deputy Commissioner, Policy
Policy Advice Division
Inland Revenue Department
PO Box 2198
Wellington

Or e-mail policy.webmaster@ird.govt.nz with "Taxation of Life Insurance" in the subject line.

1.22 Submissions should include a brief summary of major points and recommendations. They should also indicate whether it would be acceptable for Inland Revenue and Treasury officials to contact those making the submission to discuss the points raised, if required.

1.23 Submissions may be the source of a request under the Official Information Act 1982, which may result in their publication. The withholding of particular submissions on the grounds of privacy, or for any other reason, will be determined in accordance with that Act. Those making a submission that feel there is any part of it that should properly be withheld under the Act should indicate this clearly.

CHAPTER 2

Why the rules need to be changed

2.1 The current rules for taxing life insurers have applied since 1990 and are no longer appropriate for the modern insurance and savings environment. Although a number of submissions on the suggestions set out in the earlier officials' paper[3] agreed that change to the current rules was necessary, a small number of submissions disagreed, arguing that the current rules accurately taxed the economic income of all stakeholders.

2.2 Therefore, before outlining the proposed new rules, this chapter discusses why the current taxation of life insurers requires change in the context of two key principles: that economically equivalent entities, products and services, should be taxed equivalently (often referred to as neutrality), and all taxpayers should contribute their fair share in taxes (equity).

The current rules

2.3 Although the current rules do not contain explicit tax concessions for policyholders, term life insurance products are effectively under-taxed. Individuals generally cannot claim a tax deduction or get a tax credit for life insurance premiums paid (as happens in some countries) but, on the other hand, they are not taxed on insurance proceeds. In its 1989 report, the Consultative Committee considered this to be the correct treatment.[4]

2.4 The current rules tax life insurers on a two-tier basis. The first tier, the life office base (LOB), taxes the income earned for the benefit of both shareholders and policyholders of the life insurer (and a re-insurer) as a whole. It consists of:

- gross income (including realised gains on equities and other property but not premiums from policyholders or life reinsurance claims);[5]
- *less* expenses (with the exception of reinsurance premiums and claims credited to policyholders);
- *plus* underwriting income.

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[3] *Life insurance tax reform: Officials' paper No 2 – suggestions for reform,* published by the Policy Advice Division of Inland Revenue, February 2007.

[4] "4.3.2 Policies covering private risks.
In respect of premiums paid to cover private or non-business risks, a fairly strong case can be made for non-deductibility. This is the current treatment of all policies covering private risks except disablement policies providing replacement income. The Committee considers that such premiums should, in theory, be non-deductible. Claims would of course become non-assessable."
Tax Treatment of Life Insurance and Related Areas: August 1989; Report of the Consultative Committee.

[5] The reinsurance components of the claims and premiums are netted only when the reinsurer is taxed in New Zealand.

2.5 Underwriting income arises from three sources (as laid down by statutory formulas):

- profit on mortality, being the expected death strain (EDS) (in simple terms, the expected claims), less the actual death strain (in simple terms, actual claims);
- profit on termination risks; and
- premium loading, deemed to be 20 percent of the EDS and one percent of reserves released on death in the case of life annuities. The formula is intended to bring in as income the profit and expenses of the life insurer from providing the risk spreading service to the policyholder.

2.6 Income accruing to policyholders is taxed to the life insurer on a proxy basis under the policyholder base (PHB). Income is calculated by a formula equal to the increase in reserves *plus* benefits (such as claims) 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 that can then be used to meet the PHB liability (thus avoiding double taxation) or as tax credits on dividends paid to shareholders.

2.7 There are two fundamental problems with these rules. The first is that they under-tax term insurance profits. The second is that they over-tax savings income.

Term insurance

2.8 At the time the current life insurance tax rules were enacted, the vast majority of life insurance business was the traditional risk protection and savings products such as whole of life and endowment policies. Term insurance, which was small in 1990, however, now comprises the majority of total life insurance premiums written. Term insurance is a pure risk product that pays out only on death (within the term of the policy). There is no savings component.[6]

2.9 The key factor in the taxation of term insurance is the premium loading formula. In practice, 20 percent of EDS bears no relationship to actual profit. Typically, the expenses of many term insurance products are at least, and in many cases considerably more than 20 percent of expected claims, implying that such products will always generate a loss for tax under the formula. The anomalous tax result is illustrated in the following example:

[6] There are varying types of term insurance products with different premiums and benefit characteristics. These include:
- regular premium increasing with age, such as term life and yearly renewable contracts;
- level premium with no reducing sum insured;
- level premium with reducing sum insured, such as home loan repayment insurance; and
- single premium, such as lump sum mortgage repayment insurance.

	Financial accounting	LOB Tax
Premiums	100	
Claims (=Expected claims)	(50)	0
Investment income	10	10
Expenses	(35)	(35)
Premium loading (20% claims)		10
Accounting profit/ tax (loss)	25	(15)

2.10 In this example, where there is a loss ratio (claims ÷ premiums) of 50%, a $25 accounting profit translates into a $15 tax loss. This tax loss may be offset against other profitable business of the company, or with that of another company that is part of the same wholly owned tax group as the life insurer, in which case the after-tax return to the life insurer (at a 30% tax rate) is $29.50.

2.11 Even more incongruously, greater accounting profit on term insurance business may result in a greater tax loss. If another life insurer had the same financial accounting results as in the previous example except that claims were $25 (a loss ratio of 25%), the accounting profit and the LOB tax would be as follows:

	Financial accounting	LOB Tax
Premiums	100	
Claims (=Expected claims)	(25)	0
Investment income	10	10
Expenses	(35)	(35)
Premium loading (20% claims)		5
Accounting profit/ tax (loss)	50	(20)

2.12 The lower expected claims result in a premium loading for tax of $5 and a tax loss of ($20). So, although accounting profit is actually $25 higher than in the first example, the corresponding tax loss is also higher.

2.13 Artificial tax losses such as these demonstrate that the tax system is effectively providing a subsidy to insurers, which was not the intent of the legislation. In effect, life insurers are not being taxed on the profit they make on term risk business and so are treated more favourably than other businesses.

Savings

2.14 Policyholders can save through certain life insurance products, the main examples being participating whole of life and endowment policies, investment bonds, unit-linked products and annuities. The PHB taxes unrealised investment gains. In contrast, investors who hold investments directly or through PIEs are not taxed on realised or unrealised gains on New Zealand and Australian equity investments. They are also taxed at investors' marginal tax rates, not at a proxy rate of tax.

2.15 The PIE rules, which seek tax neutrality between direct investments and investments made through intermediated savings vehicles, currently exclude life insurance,[7] principally because of the technical complexity of life insurance products and life insurance tax rules. PIE benefits should, however, where feasible, be extended to policyholder investment income.

Need for change

2.16 Attempting to deal with these problems by simply amending the current rules in an ad hoc way is not a viable option, in the government's view. For example, increasing the premium loading to a more realistic level would create winners and losers as loss ratios differ between term products and life insurers. What is needed is an approach that better reflects taxing on actual results.

2.17 Incorporating savings products in the PIE rules without addressing the term insurance issue is also inappropriate as it would exacerbate the under-taxation of life insurance income. It would also mean that life insurance tax would develop in an ad hoc and arbitrary fashion and would further add to the complexity of the tax rules.

2.18 The government therefore proposes to replace the current life tax rules with new rules and, in the case of savings products, incorporate them, where relevant and feasible, into the PIE rules. The proposed rules are outlined in the following chapters.

[7] Once enacted, legislation in the Taxation (Annual Rates, Business Taxation, KiwiSaver, and Remedial Matters) Bill will allow policyholders with unit-linked life insurance products to have access to some of the benefits of the new PIE rules with effect from 1 October 2007.

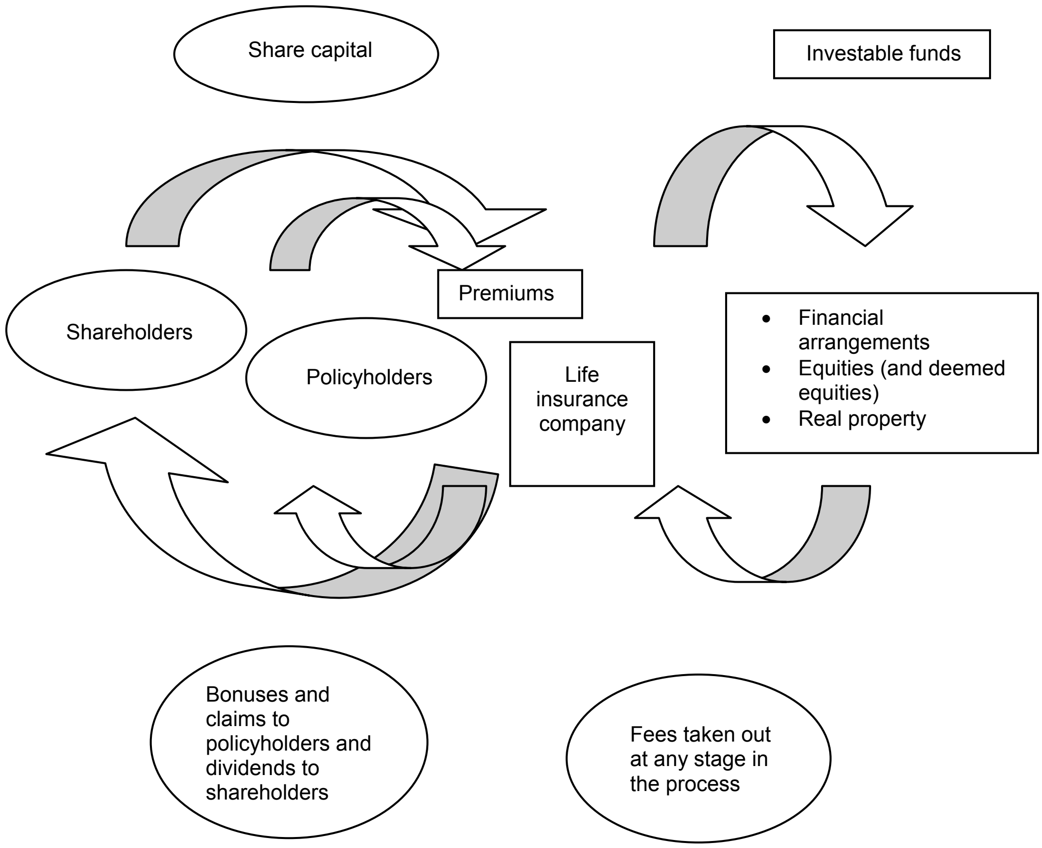
CHAPTER 3

The proposed changes

3.1 When the current rules were enacted, most large insurance companies were mutual companies, and the vast majority of insurance consisted of traditional participating products. Accordingly, someone who bought such a product bought not only a combination of life risk protection and savings, but also an equity interest (usually implying some level of ownership rights) in the company. However, since 1990 all the large life insurers have demutualised, with the result that no large mutual life insurers now operate in New Zealand.

3.2 For this reason, life insurance companies now typically operate through a limited liability corporate structure (though some operate as branches of foreign companies) in which traditional participating policyholders have no ownership rights. The various relationships within a typical life insurance company are shown in figure 1.

FIGURE 1:
STRUCTURE OF A LIFE INSURANCE COMPANY



3.3 A common way of categorising life products is to distinguish between participating and 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.

3.4 Since 1990, term insurance business has increased from being less than 10 percent of total industry premiums to now well over 50 percent. Product development has been 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. This has resulted in several new types of products – for example, combining life protection with income or disability insurance.

3.5 The task in designing a tax on the myriad complexities of a life insurance business is a two-step process. First, the total investment return of a life insurance business must be divided between a return on equity invested in the company and a return on the accumulated savings of the policyholder. Second, a way of taxing these returns must be determined in a way that fulfils as much as possible the concepts of neutrality and equity within existing tax policy settings and structures.

A norm for taxing life insurers

3.6 Life insurance businesses consist of three elements. The first is protection against the improbable event of death during the next succeeding relatively brief period. The insured (or someone else on his or her behalf) pays a premium in return for which a stipulated sum will be paid to his survivors in the event of the insured person's death. The second is the investment element. The third is fee income for managing the other two elements. These components are now analysed.

Pure risk insurance (without savings)

3.7 Pure risk insurance income consists of either or both underwriting gains (if fewer people die than is assumed in setting premiums) and investment income on corporate retained earnings. Therefore, life insurers' profits, measured as the excess of premiums plus interest earnings over outgoings (claims and expenses) are, in principle, no different from the profits of any other business (excess of receipts over cost of goods sold or income from the provision of services less expenses). However, as income for the insurance service is spread over a long period, and liabilities may be incurred but not actually reported in a period, there are differences in the timing of revenue and expense recognition. A number of countries therefore tax on accounting income or, as in Australia, a basis equivalent to general insurance. (See Appendix 1.)

Fees

3.8 A life insurer receives income from fees and charges in respect of investment, administration or risk and these can be deducted from premiums, investment income or account balances. The profits made are therefore no different from any other business that charges fees for services.

Investment income

3.9 A company that sells pure term insurance earns profits on only invested capital, including reinvested income on accumulated company surpluses, but amasses virtually no reserves on behalf of policyholders and earns no investment income for them. It is selling a "risk product". This investment income should be taxed to the life insurer.

3.10 A company that sells *savings* products and *traditional with-profits insurance* accumulates reserves in the name of policyholders, eventually payable to them or their estate. Two types of income are earned by the company: one, ordinary profits, including investment income on invested corporate surplus and equity, and share of traditional participating profits allocated through the gate; and two, investment income. The first type of income flows to be taxed in the company. However, as the second type of income accrues to the owners of the investments, it should be regarded as personal income and treated like other individual income.

Tax preferences

3.11 Whether any aspect of life insurance should enjoy tax concessions to promote uptake of life insurance is an obvious question that must be asked. Some countries provide benefits in the form of deductibility of part or all premiums paid by policyholders, (as was the case in New Zealand up to 17 December 1987) taxing certain life insurance income at concessionary tax rates or deferring taxation of participating policy income until the surrender or maturity of the policy. However, such concessionary features are not universal and some apply for savings policies only. (See Appendix 2.)

3.12 On the other hand, claims proceeds are taxed or subject to an inheritance tax, a form of estate duty, in many countries.

3.13 With the notable exception of incentives to save through KiwiSaver, New Zealand tax policy generally eschews providing tax preferences for particular industries. It is very difficult to establish whether tax concessions would encourage more insurance or simply make it cheaper for those who already have it. In any case, while term life insurance has an important social and economic function, the same can be said of any number of goods and services provided by other sectors.

3.14 Providing tax advantages to saving through life insurance by income deferral or other methods is unjustified as it distorts the savings market and artificially lowers the amount of tax revenue. The PIE system provides a framework for the taxation of investment income which, if possible, should be extended to life insurance savings. To tax investment income earned through life insurers at a lower effective rate than investment income earned in other ways would distort savings behaviour into an inefficiently high level of savings through life insurance.

3.15 There is no compelling case, therefore, for providing any concessionary treatment or tax benefits to producers or consumers of life insurance products over the goods or services of any other industry in New Zealand.

3.16 Likewise, the taxation of claims proceeds is contrary to current law and current policy settings.

3.17 Appendix 4 describes some alternative approaches towards taxing life insurers that were considered but rejected as not being an appropriate method.

The proposed rules

3.18 Taking the foregoing discussion into account, the proposed rules aim to tax life insurance companies on all their profits. This will be achieved by removing tax discrepancies in the treatment between life insurance companies and other entities. Policyholders will also be appropriately taxed on their investment income.

3.19 This means there will be two separate calculations imposing a tax liability on the stakeholders who derive the economic benefit. These are referred to as *shareholder income* and *policyholder income*. In terms of *shareholder income*, the following are included in taxable income:

- premiums (excluding savings amounts) paid to the life insurer, changes in the value of reserves that relate to risk business, risk-related claims and expenses;
- net investment income on shareholder funds calculated under ordinary tax principles;
- fee income; and
- the shareholders' share of traditional profit in respect of with-profits policies.

3.20 Tax will be payable on the shareholder income at the tax rate applying to companies, net of imputation and other credits related to the income. All other provisions that apply to corporate taxpayers, including imputation credit rules, loss carry forward and grouping, will apply to the life insurer in respect of income from those sources.

3.21 *Policyholder income* equals investment income determined in respect of policyholder funds, reduced by distributions of with-profits income to shareholders, net of deductible charges and fees, and calculated under ordinary tax principles (as amended by the PIE rules). This will be paid by the life insurer on the policyholder's behalf at the rate of 30% as a final tax. However, subject to interest from the industry in attribution and the development of a suitable attribution methodology, the life insurer may elect for net investment income to be "attributed" to policyholders and so subject to tax at investors' marginal tax rates (as modified by the PIE rules).

3.22 Policyholder net taxable investment income cannot be offset with losses or credits from either shareholder income or any other company in the life insurer's tax group.

3.23 An algebraic representation of the rules and the underlying methodology is outlined in the next chapter and developed in the subsequent chapters. These chapters are aimed at life insurance professionals (actuaries and accountants), who will implement the rules and work with them on a daily basis. They are therefore more technically focussed than the discussion in chapters 1 to 3.

CHAPTER 4

Taxing structure and methodology of proposed rules

4.1 The formulas for determining taxable income under the proposed rules, discussed in the previous chapter, can be expressed as follows:

- **Shareholder income (Y_{sh})** = $P_r - RP_r - C_r + RC_r + I_r + X + W_s - [E_{total} - E_{wp}]$ +/– Change in (PSR/UPR/OCR)
- **Policyholder income (Y_{ph})** = $I_{wp} - W_s + I_s - EI_{wp} - EI_s$

4.2 The methodology to determine (and define) these formulas is based on dividing life insurance business into three distinct product groups:

- Risk.
- Traditional with-profit (WP).
- Other (mixed risk and savings products).

4.3 Total premiums (P_{total}), and reinsurance premiums (RP_{total}), are split between:

- WP (all premiums in respect of WP): P_{wp} and RP_{wp}
- Risk and the risk portion of Other: P_r and RP_r
- Saving element of Other: P_s and RP_s

4.4 Total claims (C_{total}) and reinsurance claims (RC_{total}) are split between:

- WP (all claims in respect of WP): C_{wp} and RC_{wp}
- Risk and the risk portion of Other: C_r and RC_r
- Savings element of Other: C_s and RC_s

4.5 Total investment income (I_{total})is split between:

- WP: I_{wp}
- Savings: I_s
- Risk: I_r (includes investment income on shareholder funds)

4.6 X refers to other gross income earned by the shareholder not already captured under any of the other headings.

4.7 W_s is the transfer to shareholders from with-profit business through the "gate" (see Chapter 7).

4.8 The relevant component of total expenses (E_{total}):

- WP all expenses: E_{wp}
- WP expenses associated with generating investment income: EI_{wp}
- Savings expenses associated with generating policyholder investment income (which includes the profit component of fees charged to policyholders for providing investment services): EI_s
- Risk and risk portion of other expenses (this includes any shareholder investment-related expenses): E_r

4.9 The risk components of reserves are:

- Premiums: Premium Smoothing Reserve (PSR) for guaranteed premium policies (or the period of level premium) and Unearned Premium Reserve (UPR) for other policies.
- Claims: Outstanding claims reserve (OCR).

4.10 Many of the apportionments are required for accounting and actuarial purposes. A general principle of the proposed rules is that the life insurer should follow its normal accounting and actuarial practices for tax as long as they are consistent with the overall thrust of the rules. Some calculations, such as the calculation of reserves, will be conducted purely for tax, just as occurs with many of the calculations for current tax rules.

4.11 There will obviously be costs for learning and implementing the proposed rules, but it is reasonable to expect that the tax calculation process will eventually be largely systematised, as it is under current rules. Life insurers who already apply similar principles for financial accounting should mitigate the costs of compliance.

4.12 The following chapters explain the components and methodology of the proposed model in more detail. An example of the application of the proposed rules is provided in Appendix 3.

CHAPTER 5

Shareholder income (Y_{sh}) – net risk component of premiums, claims and expenses

5.1 The principal business activity of most life insurers is that of "risk" or underwriting. This chapter proposes rules for including in the calculation of shareholder income net risk premiums (P_r – RP_r), less net risk claims and expenses (C_r + RC_r – E_r).

Splitting premiums between risk and capital

5.2 An amount that is paid as a life insurance premium can have four components:

- a risk component that meets the costs of the life cover;
- premium-based fees such as risk charges, entry fees and exit fees;
- a shareholder margin; and
- an investment and savings component.

5.3 The first three are taxable as shareholder income, but the fourth one is not. The components of a premium are not always readily identifiable. *Bundled policies***,** notably whole of life and endowment insurance policies, have all four components even though they are not separately identified. Such products can be contrasted with *unbundled policies***,** in which all components are separately identified.

5.4 In any year, total premiums (P_{total}) received by a life insurer will be P_{wp} + P_r + P_s. The proposed tax treatment is to make total premiums taxable and then allow as a deduction the savings or capital component of the net premium, or the part of the premium that would be returned to the policyholder when a benefit is paid. Accordingly:

- P_{wp} are excluded entirely from tax and so are deducted from premium revenue.
- P_s (the deposit element of policies that have a savings element) – deductible from the premium.
- P_r (the residual from total premiums less the first two) – entire premium taxable.

5.5 The "net" refers to the taxable amount excluding the amount of the premium that is subject to a reinsurance arrangement that has been offered or entered into in New Zealand.[8] Total reinsurance premiums (RP_{total}) equals RP_{wp} + RP_r + RP_s. Their tax treatment mirrors that of premiums for similar products except that instead of being taxable, they are an expense of the life insurer. The reinsurance premiums will be "premiums" in the hands of the reinsurer.

[8]For discussion of what constitutes "reinsurance" refer to page 41.

5.6 This means that the taxable amount of premiums for a life insurer is calculated as $P_{total} - (P_{wp} + P_s) - RP_{total} + (RP_{wp} + RP_s)$.

5.7 Risk, savings and traditional products need to be tightly defined as discussed next.

Definitions of product types

Traditional participating policies

5.8 "Traditional participating policies" will be comprehensively defined to mean life insurance business that consists of the provision of discretionary participating benefits to policyholders from an identifiable with-profit pool, with an allocation of some element to shareholders (through a mechanism usually referred to as "the gate"). They will be also defined in terms of commonly accepted concepts of whole of life and endowment policies. "Participating benefits" should mean that a specified percentage of profits will go to policyholders as bonuses or similar. Further, these policies should provide a surrender value that gradually increases over the duration of the contract.

Savings

5.9 A policy will generally be deemed to have a savings element if it can acquire a cash value at any stage (other than a return of unexpired premiums).

5.10 A functional definition will be required to determine the savings portion (or element) for premiums for mixed policies. For unbundled products the savings premium will be the amount designated as going towards savings and hence buying units in the designated portfolio. An actuary's certification will be required.

5.11 For bundled and not readily identifiable savings products (such as non-profit endowment insurance and non-profit whole of life) the methodology to determine the risk portion of the premium will need to be prescribed by tax legislation.

5.12 Current financial reporting standards require premiums to be split when feasible. If it is not feasible to split them the deposit element is effectively removed as a result of the change in the insurance or investment liabilities. (Before IFRS 4 these were known as policy liabilities.)

5.13 When the split is not done for financial accounting it should be based on the key assumptions underlying the various services provided by the products. While assumptions will vary between life insurers, general methodologies should be established to ensure that results are consistent between companies and over time.

5.14 A simple method could be to relate the savings component of premiums to the change in surrender values over the year (with appropriate allowance for new policies and discontinuances in the year).

5.15 An actuary's certification will be required.

Risk

5.16 As a general proposition any product line for which there is no cash value at any stage (other than a return of unexpired premium) should be classified as pure risk.

5.17 The "risk component" of a premium or claim can accordingly be defined as:

(a) If:

(i) the policy is not a traditional with-profits policy; and
(ii) the policy does not have a savings element

the total premium; or

(b) if the policy provides for participating benefits or discretionary benefits then nil; or

(c) otherwise the total premium less the savings element of the premium.

Splitting claims

5.18 The same allocation principles used for premiums apply for claims, where a deduction is allowed in the calculation of shareholder income for the net risk component. Total claims (C_{total}) need to be split as follows:

- Pure risk – non-savings element (C_r)
- Traditional – no need to split (C_{wp})
- Savings – savings element (C_s).

5.19 Claims paid on pure risk policies are fully deductible, while claims for traditional participating policies, and the savings element of claims on other policies are not deductible.

5.20 As with premiums, the "net" reference in claims refers to recoveries subject to a reinsurance arrangement that has been offered or entered into in New Zealand. These occur when a life insurer reinsures a policy and a claim is later made on that policy. The life insurer makes a claim under the reinsurance contract and recovers the amount from the reinsurer. If the life insurer is entitled to a deduction of the reinsurance premium, the amount recovered will be taxable. Total reinsurance claims RC_{total} are made up of their equivalents for RP, that is $RC_{total} = RC_{wp} + RC_r + RC_s$.

5.21 This means that the deductible amount of claims for a life insurer is calculated as $C_{total} – (C_{wp} + C_s) – RC_{total} + (RC_{wp} + RC_s)$.

Definitions of claims

5.22 The definitions for the risk component of claims will be similar to the definitions that apply for premiums. However, a functional definition will be required for mixed risk and savings claims. For these mixed risk and savings policies, the amount of the deductible claim is determined by the SV of the policy immediately before the claim less the SV immediately after, with appropriate allowance for reinsurance. This approach caters for partial claims for a rider benefit, partial surrender or a total discontinuance.

Expenses

5.23 Expenses deductible from shareholder taxable profits are total expenses (E_{total}) reduced by expenses attributable to the with-profits pool (E_{wp}).

5.24 Deductible risk-related expenses (E_r) incurred include deferred acquisition costs which will be subject to ordinary deductibility rules. Also included in this category are shareholder investment-related expenses.

Anti-avoidance

5.25 Specific anti-avoidance rules will aim to prevent the artificial structuring of products when policyholder investment income is not being taxed because the claims that contain the investment income allocated to policyholders are deductible.

Timing

5.26 The proposed treatment of the timing when income is earned and when expenses are incurred is discussed in the next chapter.

CHAPTER 6

Risk reserves (PSR/UPR/OCR)

6.1 Chapter 5 discussed the proposed tax treatment of net risk income and claims and expenses. The long-tailed nature of many life insurance contracts means that special rules are required to fairly recognise the timing of income derivation and incurrence of expenses, through movements in reserves.

6.2 The need to set up reserves for risk business can be caused by premiums being level for more than one year, or by premiums being contractually fixed with no right for the insurer to change them (even for all policyholders of a similar class). A positive reserve (even if the policy does not have a surrender value) implies an element of investment return, but does not imply it is being earned on behalf of the policyholder or the shareholder – the only benefit the policyholder gets is implicit in the premium being charged. Pure risk products should not, in practice, produce significant reserves.

6.3 The reserve for premiums will be either the Unearned Premium Reserve (UPR) or a Premium Smoothing Reserve (PSR) and will differ depending on the type of product.

6.4 The reserve for claims will be the Outstanding Claims Reserve (OCR).

6.5 UPR will apply for risk products or risk elements of other products for which premiums are stepped yearly or premium rates that are not contractually guaranteed. The UPR will be the unexpired premium (on a pro rata basis).

6.6 The PSR will apply for risk products or risk elements of savings products during the periods in which premium rate are contractually guaranteed or in a period in which level premiums are payable. It differs from the Margin on Services (MoS) basis in that it does not cover all future cash flows and it does not add back acquisition costs. The PSR would be calculated under the following formula:

PV future expected risk claims (C_r – RC_r)
plus
PV future expected costs of administration and claims management (E_r)
plus
PV of future profit (minimum zero)
less
PV of future risk premiums (P_r – RP_r)

Where:

- PV means present value.
- The future period over which the PVs are measured is the duration for which a level premium is payable or for which the premium rates are contractually guaranteed.
- Best estimates of claims, discontinuance and expenses are used based on the most recent analysis.
- Discounting is at a risk-free rate (gross of tax).
- The profit element is a fixed proportion of the PV of future risk premiums or risk claims, based on estimates for similar policies and such that profit emerges evenly over the term of the fixed or guaranteed premium, and the proportion remains constant at policy level over the future period. This could be the profit margin for that class of policy, as at the start of the reserving period, expressed as a proportion of risk premium. Alternatively it is the margin required for the PSR to be zero at inception, excluding acquisition expenses.
- C_r is the expected claims excluding portions of claims which can properly be regarded as savings elements.
- P_r is the expected premiums payable under the policy less that part of the premium which can properly be regarded as the savings element.

6.7 The Outstanding Claims Reserve (OCR) will be defined as the provision for claims incurred but not reported (IBNR) and claims admitted but not yet paid (including present value of expected future claims payments for income type claims, using best estimate assumptions and appropriate risk margins). The OCR applies to risk and other products, but not to traditional with-profits business.

6.8 Some form of actuary's certification will be required for the reserving calculations.

Applying the reserving principles to specific product groups

Level premium term and other guaranteed premium products

6.9 Level premium term life insurance means a pure risk contract in which the amount of premium is guaranteed and fixed for a number of years.

6.10 Other guaranteed premium products are products with or without a savings element, under which premiums are contractually guaranteed and cannot be changed by the insurer (even for identifiable groups of policies).

6.11 The PSR will apply for these products during the period of level premiums or the period of contractually guaranteed premium rates.

6.12 An example of a methodology for a product which has k years to run (when a level premium is payable or when the premium rates are contractually guaranteed) is as follows:

C(r,t) = expected risk portion of claim in year t (t=1 for the first year), etc
P(r,t) = expected risk portion of premium in year t (t=1 for first year), etc
Prob(t) = probability of the policy being in force in year t
Claim (t) = probability of a claim occurring in year t, given in force
v = discount factor = 1/(1+discount rate)
M = profit margin

PV Claims = Σ (from t=1 to k) [C(r,t)–RC(r,t)]*Prob(t)*Claim(t)*v^(t)
PV Premiums = Σ (from t=1 to k) [P(r,t)–RP(r,t)]*Prob(t)*v^(t)
PV Profit = M*PV premiums
PV Expenses = Σ (from t=1 to k) E(r,t)*Prob(t)*v^(t)

Annual stepped premiums (with ability to review premium rates)

6.13 Annual stepped renewable life insurance means a contract in which the premiums each year are based on the current level of cover. For the purposes of the proposed tax reserving rules, these include contracts in which:

- premiums are level and payable through the term of the contract but the premiums may be changed in certain circumstances described in the contract;
- premiums are level and payable for some term shorter than the term of the contract (other than a single premium policy) and guaranteed in the contract not to change but the premiums may be changed in certain circumstances described in the contract; and
- contracts normally called three-yearly (or five-yearly, or ten-yearly) renewable that are expected to increase after that three, five, ten-year term as the person ages, but the insurer does not guarantee that the rate table will not change during the level premium phase.

6.14 With these products, the UPR is dependent on premium frequency, hence:

UPR = RP% * t * P

- Where RP% = percentage of premium to meet claim cost, administration, commissions, claims, expenses, and profit element (for that remaining period) until next premium payment;
- t = period to next premium payment (as a proportion of a year); and
- P = actual last premium paid.

Single premium

6.15 Single premium life insurance refers to life insurance coverage in which the entire premium is paid at one time at policy inception.

6.16 A life insurer cannot usually require the policyholder to pay for any price increase on these types of policies, so an opening PSR would be the generalised approach set out above. Here the remainder of the term would be the life of the policy.

Without profit whole of life and endowment

6.17 This is a mixed product incorporating both savings and risk elements. On the assumption that premiums for these products are guaranteed, it is reasonable to set PSR as above. Each future premium and claim payment will need to be split between risk and savings, which will require an actuary's certification.

Group life

6.18 These are products provided to groups on an annual renewable terms basis, so the reserving basis should be the same generalised approach as for those products. A UPR will apply for these products.

CHAPTER 7

Shareholder income (Y_s) – other income and investment income

7.1 The previous two chapters discussed the risk income components of shareholder income and claims. We now turn to discussing the other components of the economic returns to shareholders' fees and investment income, less expenses.

Other income (X)

7.2 X represents a residual category for income determined under ordinary taxation principles that is not included under any of the explicit income categories, but is derived for the economic benefit of the shareholder. X is included in shareholder income.

7.3 In particular life insurers should be taxed on their fee income. Fees can be explicit or implicit and can be imposed at the time the policy begins, at the time the policy is terminated, or on a regular basis. An "explicit fee" is one that is specifically deducted from a policyholder's premium or account. Examples of explicit fees include:

- premium-based fees that reduce the amount of a premium invested;
- asset fees specifically debited from a policyholder's account;
- time-based fees debited from a policyholder's account; and
- entry, exit and switching fees.

7.4 Premium-based fees in respect of non-participating business are included in shareholders' taxable income by:

- including all premiums in gross income; and
- allowing a deduction for the savings or deposit element of those premiums,

as described in Chapter 5.

7.5 Explicit fees that are not included in premiums can be relatively easily identified and quantified for tax calculation purposes. These include fees that may be sourced from premiums but separately identified, such as policy fees and investment management fees from unit-linked business.

7.6 An "implicit fee" is one that is implicitly charged to a policyholder rather than explicitly deducted from a policyholder's account. An example of an implicit fee is an asset fee where the investment return credited to a policyholder's account is net of investment management fees. The fee implicitly reduces the value of the policyholder's account. Or, for unit-linked policies, an asset fee is removed from the unitised fund on a daily basis so that the growth in the value of units reflects the investment return after allowing for the asset fee.

7.7 Implicit fees can be determined only by completing an actuarial valuation of the life insurer's liabilities.

7.8 The amount of fees and charges from traditional participating business are only those fees which are paid direct to the shareholder or are deducted from premiums before the net premium is credited to the identifiable with-profit pool.

Shareholder investment and other income (I_r)

7.9 One of the aims of the new rules is to include all investment income derived by shareholders and policyholders and to continue to allow the deduction of all related investment expenses. When life insurers maintain segregated shareholder and policyholder funds the investment income allocation will be as determined by those funds.

7.10 However, in many cases, investment income (I_{total}) will need to be apportioned (or assets segregated) between with-profits (I_{wp}), savings (I_s) and risk (I_r).

Allocating I_{total}

7.11 The new rules will require the deduction of the amount relating to policyholders from the life insurer's total investment income in its annual financial statements (I_{total}). Accordingly, investment income, excluding that relating to segregated funds and participating pools needs to be apportioned between I_r and I_s.. If participating pools are not segregated then they need to be part of an apportionment process – that is, the participating pool's share of investment income (I_{wp}) will need to be determined by apportionment.

7.12 It is proposed that, as much as possible, a life insurer's ordinary accounting and actuarial calculations should be followed. For example, investment income of policyholders may be calculated on the basis of the savings portion of policy liabilities, with the deduction from total investment income thereby being shareholders' investment income.

7.13 If the life insurer is unable to use this basis as a default method, the investment income attributable to policyholders could be calculated using the following methodology:

Let:

I	=	Total investment income to be apportioned
SV(0)	=	Total surrender values of savings products at start of year
SV(1)	=	Total surrender values of savings products at end of year
A(0)	=	Total market value of pooled assets at start of year
A(1)	=	Total market value of pooled assets at end of year

then

$I_s = I * [SV(0) + SV(1)] / [A(0) + A(1)]$

- A similar apportionment can be made for investment income by asset class if needed for PIE calculations and for tax credits.
- The investment income relating to any with-profits pool will need to be separately identified as part of I_{total} as it does not directly enter the tax calculations.
- Deducting I_s and I_{wp} from I_{total} will yield I_r.

7.14 Policyholder investment income so calculated will be taxed separately from shareholder income. Chapter 8 outlines the taxation of policyholder income.

Adjustments to I_r

7.15 The current rule contained in sections CR 1(5), CR 2(5) and EY 46(2) of the Income Tax Act 2007, where investment assets held by a life insurer for the purposes of the life insurance business are on revenue account, will be removed. Life insurers will therefore have to determine whether an investment is on revenue account or capital account under ordinary tax principles. This places them on the same footing as comparable taxpayers. Investment income will be subject to ordinary taxation rules of timing and realisation, as amended by bodies of rules such as the accrual rules, the PIE rules and the fair dividend rate rules.

7.16 Some submissions to the taxation bill currently before Parliament have argued for realised gains on sale of Australasian equities held directly by shareholders funds to be treated as being on capital account. However, there is no reason for life insurers to be taxed differently from other comparable financial institutions that may hold such equities on revenue account.

Shareholder profit on traditional with-profit policies (W_s)

7.17 The deductible component of the premium for policies that provide participating benefits is the whole of the premium paid by the policyholder after any specific fees paid direct to the shareholder. This recognises that under these policies, policyholders are entitled to share in the profits of the business, including underwriting and expense profits.

7.18 Profits from the pools for these types of products are allocated between policyholders and shareholders through a mechanism called the "gate".[9] Profit allocation decisions are based on a variety of factors, including current and expected profitability of the asset portfolio, indications given to policyholders at the time policies were sold, comparable market performance, the interests of the shareholders of the company, and the need to service shareholders' funds. The profits allocated to shareholders form part of the shareholder's retained earnings and can be distributed as dividends.

7.19 Effectively, the profits allocated to shareholders consist of investment returns and other profit sources. As participating premiums are excluded from taxation, the profits and investment returns should be taxed on allocation to shareholders.

7.20 Accordingly, the allocation of shareholders' profit through the "gate" (W_s) from its participating business should be taxed. The amount allocated should be that determined by the life insurer's rules of the particular fund and its normal practice. In the event the actual gate is not specified the default rate will be 20%.

7.21 W_s will be deducted from investment income derived from with-profits products (I_{wp}) to arrive at the amount of policyholder income from those products. This is discussed further in Chapter 8.

[9] Actuarial standards determine the valuation of assets backing the with-profits pool. The payment to shareholders from this pool is determined by the rules of the particular life insurance fund.

CHAPTER 8

Policyholder investment income and expenses ($\mathbf{Y_{ph}}$) = ($\mathbf{I_{wp} – W_s + I_s – EI_{wp} – EI_s}$)

8.1 Under the proposed rules, investment income attributed to policyholders will be taxed separately from shareholders' income. The life insurer will pay the tax on behalf of policyholders. In this way, life insurers act as collective savings vehicles on behalf of their policyholders. The income may be split into its product components.

8.2 Theoretically, policyholders should get the benefits of the PIE rules with the non-taxation of Australasian equity gains and attribution of income to be taxed at individual investor tax rates. However, it may not be possible in practice to attribute income to participating policyholders, and some life insurers may not be able to attribute for policyholders in non-participating savings products.

Calculation of investment income

8.3 Allocation of gross policyholder investment income was discussed in the previous chapter. The investment income allocated to policyholders will be:

- I_{wp} – investment income attributed to the with-profits pool. This will be reduced by the amount of with-profits income that is attributable to shareholders (W_s); and
- I_s – investment income attributable to other policyholder savings.

Adjustments to investment income

8.4 The taxation bill currently before Parliament excludes from taxation under the life office basis realised Australasian equity gains derived by unit-linked products. This exclusion will continue for such products under the new rules. The capital gains exclusion will also be extended to Australasian equities derived in respect of participating business.

Expenses

8.5 Fees and charges applied against policyholder funds are deductible against policyholder income to the extent that they relate directly or indirectly to the derivation of investment income. Generally, the aggregate deductible fees of policyholders should also be included as fee income to shareholders.

8.6 It will be necessary for expenses to be apportioned to the expenses relating to the generation of investment income for the with-profits pool and the savings elements of other policies, that is, EI_{wp} and EI_s. This will require some form of certification.

8.7 Policyholders' taxable income (Y_{PH}) is therefore equal to $I_{wp} - W_s + I_s - EI_{wp} - EI_s$.

Imputation credits

8.8 The allocation of imputation credits and dividend withholding payments on dividends derived by the life insurer between shareholder and policyholder income will follow the allocation of the dividend income using the methodology discussed earlier. Excess imputation credits allocated to the policyholder base will be converted into policyholder losses and carried forward.

Tax rate

8.9 As a default, the policyholder income calculation applies tax at the top PIE rate even though it is intended to tax the income derived on behalf of policyholders, who will be individuals with various tax rates. This is done for practical reasons if there are no ways to apply tax at individual policyholders' tax rates and applies generally in the PIE rules when income cannot be attributed to individual investors.

8.10 Some submissions made in the earlier consultation exercise suggested that life insurers should be able to elect that policyholders in unit-linked products be taxed at their marginal rates (as amended by the PIE rules), and this will be provided for in legislation. If income is attributed, the economic cost of each policyholder's tax must be borne by that policyholder.

8.11 The government is open to attributing participating policyholder income to individual policyholders and allowing them to apply their own tax rate to the income. However, this is subject to life insurers wanting to have the attribution option and development of a practical system for doing that. To date, there appear to be very difficult technical and practical problems in doing so. In this regard, taxing all policyholders at 19.5% is not viable as it would provide a tax benefit to higher marginal rate taxpayers.

8.12 A composite rate between 19.5% and 30% is also unacceptable on similar equity grounds as it would also mean that no-one would be taxed at the appropriate rate. However, ideas are still sought for a practical way of incorporating participating policies into this aspect of the PIE rules, which will achieve the result of policyholders being taxed at their personal tax rate.

CHAPTER 9

Transition to the new rules

9.1 Given the expected timeframe to enactment of the legislation, and the need for life insurers to have certainty of their tax treatment, the government expects the proposed rules to be effective the first day of the life insurer's income year beginning on or after 1 April 2009.

9.2 All new life insurance products sold from 1 April 2009 will be subject to the new rules. There are, however, a number of tax and credit balances that arise from the current rules that will need to be provided for in a manner that is fair to the shareholders and the policyholders.

9.3 Existing policies and those sold up until 31 March 2009 will be subject to the transitional rules.

Existing tax balances

9.4 To be fair to different life insurers, realised tax losses existing before the date of effect of the new rules should be available to be carried forward, since life insurers who are in corporate groups would have been able to benefit from life insurance losses by way of group offset.

9.5 It is important to ensure that allowing losses carried forward to apply under the new rules does not give rise to doubling the benefit (for example, allowing losses that may have been previously used for group loss offsets). Accordingly, the maximum aggregate tax loss that can be carried forward should be the lesser of the LOB loss and the PHB loss existing at year end before the new rules come into effect.

9.6 Because the proposed shareholder income base does not exist in the current rules it will be necessary to consider ways to allocate losses carried forward from the existing bases to the new income calculations (shareholders and policyholders). The government invites submissions on ways to allocate the transitional losses.

9.7 Imputation credits in the life insurer's imputation credit account and policyholder credit accounts (being excess credits after paying the 2008–09 PHB tax liability) can be carried forward into the new system. These credits will be carried forward in the life insurers' imputation credit account, with rules enabling the transfer of credits from the policyholder credit account to the imputation credit account, with the former account then ceasing. Similar rules will apply for dividend withholding payments.

9.8 The credits so carried forward in the imputation credit and dividend withholding payment accounts can be used only by shareholders, for either obtaining refunds of tax, or for attaching to dividends paid. The credits cannot be used for any reason against policyholder income.

9.9 Income tax balances held by the life insurer with Inland Revenue can be carried forward for application against the tax liability on shareholder income.

Transition of pre-application date policies

9.10 Policies are priced on a number of factors, including policyholder-specific matters, general mortality rates, commissions and the tax rules existing at the time the contract was written. They can also take into account future events, in particular, proposed changes to tax rules. A balance therefore needs to be reached between applying the proposed rules, and not creating undue disadvantages in doing so.

9.11 There are a number of policies for which terms and conditions of the contracts cannot be changed, either legally, or, even if technically allowed owing to provisions that allow premiums to change in the event of a tax change, it would be bad commercial practice. Changes in tax rules may also have a negative impact on the financial accounting results for particular products. Any transitional measures, however, must be guided by four general principles.

9.12 The first principle is to be fair to policyholders.

9.13 The second is that the transition rules should not benefit life insurers with late balance dates over earlier balance date insurers. Accordingly, although the new rules will become effective for life insurers on the first day of their income year beginning after 31 March 2009, the grandfathering and transitional rules will apply only to products sold before 1 April 2009, regardless of the insurer's balance date.

9.14 The third principle is that it is undesirable to have long-term transitional arrangements as that would defer the overall benefits without necessarily deferring all the expenses, including accounting and IT costs in maintaining two systems. A period of five years is a reasonable time to meet the duration of a large number of life policies, with minimal commercial impacts (though some exemptions from the limited period for certain policies are proposed.). There is recent international precedent in that the taxation of management fees in Australia was subject to limited 50% taxation for five years in the transition to its new tax life rules. However, more extensive grandfathering is appropriate for policies for which premiums are fixed for a period or for the duration of the policy.

9.15 Finally, to avoid complexity there should not be a multiplicity of rules operating during the transition period. Transitional relief, where appropriate, should incorporate the main taxing driver of the current rules (the premium loading formula) within the context of the proposed rules.

9.16 Accordingly, the proposal is for the calculation of shareholder income to be reduced by a transition adjustment (Z) written on a policy-level basis for policies sold before 1 April 2009:

- Where: Z=P – 1.2 * EDS – (Change in reserves).
- The transition period is the lesser of five income years from the application date of the new rules, and the duration of the policy, *or* as determined for level premium term products and other guaranteed premium policies (discussed below).
- Z would be equal to zero at the policy level if it were negative.
- Change in reserves means change in UPR, OCR and PSR as they apply to the particular products.

9.17 The application of the transition formula would be at the election of the life insurer for particular products, based on its assessment of whether the transitional rules or being fully subject to the proposed life rules give a more appropriate tax result. To provide maximum flexibility and minimise compliance costs, a life insurer can elect not to use the transitional basis at the end of any income year during the transitional period. However, a life insurer cannot switch into the transitional basis once the new rules are used for the particular type of products, even when this occurs during the transitional period.

9.18 Products sold between 1 April 2009 and the life insurer's balance date will be subject to the current rules in the income year before the new rules apply to the insurer. However, on the application date (the beginning of the first income year beginning after 31 March 2009), the product will be fully subject to the proposed rules.

Level premium term products and other guaranteed premium products

9.19 Level term products issued before 1 April 2009, when there is no change in the absolute level of the premium, will be subject to the proposed transition rules for the duration of the policy. Such products sold on or after 1 April 2009 will be subject to the new rules except during the income year before the new rules apply to the insurer. In other words, if a level term policy is sold on 1 April 2009 and the insurer has a 30 June balance date, the policy (and all other policies) will be subject to the current tax rules for the insurer's income year ending 30 June 2009. For the next and all later income years, the policy will be subject to the new rules.

9.20 There is a grey area between level term and "pure" annual renewable policies. For example, there are products for which there is a period of level premiums (for up to ten years) and then the premiums become annually renewable. There are other products for which the premiums are fixed for three or more years at a time. For these types of products, sold before 1 April 2009, the transition period will be the greater of:

- the duration of the guaranteed premium period which straddles that date; or
- five income years from application date.

9.21 Policies sold after 31 March 2009 will be subject to the new rules except during the income year before the new rules apply to the insurer.

Annual renewable term products

9.22 Increases in premiums for annual renewable term products reflect the increased age of the insured but also, typically, take into account other factors, such as improvements in overall mortality, and other economic considerations. The proposed transitional rules therefore will apply for annual renewable term policies that were in force at 1 April 2009 for the five-income year period.

Single premium products

9.23 The transitional rule applies to all risk products. Some single premium products, such as mortgage payment insurance, are typically for 25 to 30 years (or even longer), so the transitional period will be the duration of the particular policy.

Group life

9.24 Typically, the life insurer has the right to review the terms and conditions of these policies at the end of a "guarantee" period (often two or three years). When a guarantee period ends within the five-income year transition period, the transition period will apply for the full five income years. When a guaranteed premium period is longer than five income years after the application date, the transition period may apply until the end of the guaranteed premium period.

Traditional with-profit policies and other products

9.25 There are no features of savings products (both participating and non-participating business) that require any transitional provisions. In the case of mixed products, the transitional rules will apply to the risk portion of the premiums and claims. All policies sold after the application date will be subject in full to the new rules.

Summary of proposed transitional rules

Product	Sold before 1 April 2009	Sold between 1 April 2009 and application date	Sold after application date
Level term	Grandfathering for duration of policy	Current tax rules then subject to proposed rules from application date	Proposed tax rules
Guaranteed premium	Grandfathering for the greater of duration of guaranteed period or five income years	Current tax rules then subject to proposed rules from application date	Proposed tax rules
Annual renewable term	Grandfathering up to five income years from application	Current tax rules then subject to proposed rules from application date	Proposed tax rules
Single premium	Grandfathering for duration of policy	Current tax rules then subject to proposed rules from application date	Proposed tax rules
Group life (guaranteed period less than five income years after application date)	Grandfathering up to five income years from application	Current tax rules then subject to proposed rules from application date	Proposed tax rules
Group life (guaranteed period greater than five income years after application date)	Grandfathering for guaranteed premium period	Current tax rules then subject to proposed rules from application date	Proposed tax rules
Traditional products and savings policies	No grandfathering from application	Current tax rules then subject to proposed rules from application date	Proposed tax rules

Note: Life insurers can elect out of the transitional rules for any product at any time.

Changes to pre-application date policies

9.26 Contracts existing before the application date can have terms subsequently added on to them. For example, a person who has a term insurance policy for \$100,000 cover existing at the beginning of the new rules could later extend the cover under the same policy to \$150,000 (or alternatively, reduce the cover to \$50,000). If these terms were part of the contract as initially issued, the contract as whole would still be subject to the transitional rules.

9.27 However, if the fundamental nature of the original policy is changed (and the previous example is an illustration of such a fundamental change), the old policy will be deemed to come to an end, and a new policy created. This new policy, if the fundamental change occurred after the application date, will be fully subject to tax under the terms of the new rules and not under the transitional rules.

CHAPTER 10

Miscellaneous issues

Definition of "life insurance"

10.1 Earlier consultation sought feedback on whether the current definition of "life insurance" in tax legislation requires amendment, for example, to be consistent with other legislation that deals with life insurance. However, there was no clear impetus for change in the submissions received, though some raised the valid point that the matter should be considered when more details of the new rules were made available.

10.2 The life rules proposed here are based on the current tax definition. In the government's view, there is no policy reason for the income tax definition to be, word for word, the same as definitions for other, non-income tax purposes. However, if anyone thinks there is a good reason to change the definition, that would be taken into consideration.

Non-resident life insurers

10.3 Under the current rules, a non-resident life insurer who issues policies that were offered or entered into in New Zealand is taxed as if the business of the insurer consists of or relates to those policies. The gross income so determined is deemed to be derived from New Zealand. It is not necessary for the life insurer to have a fixed establishment or an agent in New Zealand. Nor is it necessary for the policies to have been issued in New Zealand.

10.4 The new rules should apply to a non-resident life insurer by applying existing provisions applicable to life insurers, including source rules. Any income of the non-resident which is not related to the life insurance business should continue to be calculated as if no life insurance business was carried on in New Zealand. [10]

10.5 The current law provides that a New Zealand branch of a non-resident life insurer is deemed to be a company resident in New Zealand for purposes of applying the life insurance provisions. Submissions are invited on whether the deemed resident company treatment should continue.

[10] On 22 August 2007 the OECD released a revised public discussion draft on *Report on the Attribution Of Profits To Permanent Establishments Part IV Insurance,* which discusses principles of attributing profits of insurance companies to a permanent establishment under Article 7 of the OECD Model Tax Convention on Income and Capital.

Reinsurance premiums

10.6 Reinsurance is a way by which insurers manage risks. These risks include underwriting risk, timing risk (in settling claims), investment risk (low return or asset defaults), expense risk (higher than expected expenses), and credit risk (risk that the reinsurer will default on its payments). The risk is being transferred from one insurer to another. A transfer of premium will also occur, proportionate to the risk being transferred.[11]

10.7 The proposed rules will provide that, generally, reinsurance premiums paid are deductible and reinsurance claims received are taxable when the reinsurance policies are offered or entered into in New Zealand.

10.8 This treatment will be confined to "true" reinsurance, which will obviously need to be carefully defined, particularly as this provision will have an anti-avoidance purpose. A suggested definition is that the reinsurance contract must meet the following conditions:

- There must be a transfer of insurance (underwriting and timing risks).
- The transfer must not include the transfer only of investment risk, expense risk, and credit risk, unless these risks are an incidental component of the contract.
- There must be a business purpose for the reinsurance. This condition will be met if there is an exposure to significant loss (calculated as the PV of cash flows from a worst case scenario).
- The transactions must not be entered into to avoid tax.

10.9 If the "true reinsurance" definition is not met, the contract may be treated as financial reinsurance. In such cases the premiums will be treated as a deposit and non-deductible to the life insurer, and the investment income accruing in respect of the amount deposited will be brought to tax by the life insurer. The accrual rules may need to be amended accordingly or some other method used to determine the income. A New Zealand-resident reinsurer (or one that is subject to New Zealand tax on its reinsurance income) would not include the premiums in income and would be allowed a deduction for the accrued interest.

10.10 Submissions on practical ways of taxing the income are invited. The government is also interested in any other issues related to reinsurance that may require legislative clarification.

10.11 If a life insurer fully reinsures its business, the company will not be subject to the life insurance rules, as is the case under the current rules.

[11] There are two basic types of reinsurance. Under a **reinsurance treaty,** the reinsurer contracts to accept a specified amount of all risks or losses defined in the treaty. The reinsurer does not have the right to examine and select from those risks that meet the defined risks under the contract. With a **facultative reinsurance contract**, the reinsurer assesses each policy before agreeing to assume risks. This type of reinsurance is usually limited to large insurance policies.
Under either type of contract, the reinsurer and insurer will share risks on an agreed basis. Under **proportional reinsurance arrangements**, a constant proportion of each risk is shared. **Non-proportional reinsurance arrangements**, on the other hand, can be used to limit the maximum risk faced by an insurer.

International Financial Reporting Standards (IFRS)

10.12 Financial accounting for life insurance is governed by IFRS 4. However, owing to the complexity of the accounting issues, the International Accounting Standards Board (IASB) issued *Discussion Paper: Preliminary Views on Insurance Contracts,* on 3 May 2007. This document sets out preliminary views on the measurement and recognition of insurance contracts and financial instruments with discretionary participating features.

10.13 The proposed tax rules discussed in this document are based on the current standard. It is not certain when and to what extent the IASB proposals will become part of an amended IFRS 4, though it should be noted that in that event, every country will have to address its life tax legislation in the light of any changes.

APPENDIX 1

Comparison of selected countries: income taxation treatment of life insurers

Country	*Underwriting profits*	*Investment income and realised capital gains*	*Allocation of income between shareholders and policyholders*	*Premium or other life insurance-specific taxes*
Australia	• Risk premiums taxable and risk claims deductible. • Movement in risk-related liabilities also deductible/assessable. • Fees taxable.	Generally taxable in full.	• Taxable income attributed to both shareholders and policyholders taxed at corporate rate. • Superannuation policyholders taxed separately at lower rate and annuity income exempt.	Up to 10% of first year's premium depending on State and type of policy.
Austria	• At least 20% of profit, excluding deduction of premium refunds, subject to tax (minimum tax). • Long-term reserves are taxable. • Policyholder bonuses are tax deductible.	Generally taxable as per accounts.	Provision for premium refunds and profits returned to policyholders are, under special conditions, tax-deductible to the insurer.	11% insurance tax for single premium policy with duration up to 10 years and 4% in all other cases.
Belgium	• Based on statutory account with specific adjustments. • Duly evidenced reserves are deductible. • Special rules for mutual companies.	Generally taxable though dividends and gains on "good" shares may be exempt.	A total income approach including overall profit from subscription and investment income. Policyholders' income (including bonuses in principle – alternatively, a 9.25% annual tax on profit shares is paid by the company) is deducted from taxable profits.	4.4% on group insurance premiums.
Canada	• Based on commercial accounts. • Specific rules for actuarial reserves.	Generally taxable (subject to complex rules).	Only significant for specific calculations involving participating policyholders.	Provincial premium taxes of 2% to 4%. Federal excise tax of 10% on insurance placed directly with unlicensed insurers.
Denmark	Based on accounts. Total income principle including profit from underwriting less actuarial reserves and less provisions appropriated to the benefit of the insured.	Generally taxable, though subject to special rules. Gains on shares owned for more than 3 years are exempt.	See first column.	None.

Country	Underwriting profits	Investment income and realised capital gains	Allocation of income between shareholders and policyholders	Premium or other life insurance-specific taxes
France	Based on accounts subject to certain adjustments.	Generally taxable unless related to long-term gains on certain shares. Special rules for investments supporting unit-linked contracts	Profits allocated to policyholders are tax-deductible.	None.
Germany	Based on accounts subject to adjustments. No discounting of reserves.	Generally taxable, though subject to complex rules.	The reserve for premium refunds is deductible to a certain extent.	None.
Ireland	Based on accounts plus data from regulatory return. Pre-2001 business (old business) taxed on I-E basis, though expenses may be restricted to ensure minimum tax level. Business after 1/1/2001 (new business) gross roll-up applicable to investment return on policyholder funds not taxed. Shareholders' surplus taxed as trading profit.	Generally taxable for old business. Unrealised gains and losses recognised annually but brought to tax over 7 years. New business gross roll-up regime with no tax on investment return within policyholder funds.	See first column.	Inheritance tax and gift duty may apply depending on relationship between policyholder and beneficiary.
Italy	A total income approach, including overall profit from underwriting and investment income. Actuarial reserves deductible in accordance with accounting rules. Policyholder bonuses are tax-deductible. Special rules for mutual companies.	Generally taxable. Unrealised losses may be deductible on certain investments.	See first column.	None.
Netherlands	Tax generally uses commercial accounts as a guideline but a separate concept "good commercial practice" is developed.	Generally taxable. Unrealised losses can be deducted immediately and unrealised gains deferred.	See first column.	None.
South Africa	Income allocated between the Corporate Fund and the Individual Policyholder fund, the Untaxed Policyholder fund and the Company Policyholder fund. Actuarial reserves calculated on best estimates basis (statutory valuation method).	The Tax Act stipulates methods to calculate investment income.	See first column.	None.
Spain	A total income approach, including overall profit from underwriting and investment income. Accounting actuarial reserves are used.	With a few exceptions, follows accounting.	See first column.	None.

Country	*Underwriting profits*	*Investment income and realised capital gains*	*Allocation of income between shareholders and policyholders*	*Premium or other life insurance-specific taxes*
Switzerland	Generally follows accounting.	Follows accounting rules.	Policyholders' income deductible from taxable profits.	Premium tax of 5% for certain cash premiums and 2.5% on single premium life policies.
United Kingdom	I-E basis or by complex methods to determine actuarial surplus. Accounts disregarded except in taxation of loan relationships. There are 5 categories of life business. Permanent health insurance is classified as general insurance.	Recognised under capital gains rules with indexation allowance. Special rules for holdings in unit trusts and business categories.	Income on long-term insurance fund allocated between shareholder and policyholder to determine appropriate rates of tax.	None.
United States	Based on accounts and on overall income with no distinction between investment income and underwriting income. Policyholder dividends are deductible.	Taxable. The company's share of net investment income is computed for purposes of determining availability of tax-exempt interest exclusion and dividend received deduction, and is after reductions for interest added to reserves and policyholder dividends.	See first column.	State premium tax rates ranging from 1% to 3% varying from state to state.

Note: Data in the table is summarised from PricewaterhouseCoopers *International Comparison of Insurance Taxation* (January 2005). Some of the information may be dated, but has been included as indicative of the approaches taken by different countries.

APPENDIX 2

Comparison of selected countries: policyholder taxation

Country	*Premiums*	*Roll-up taxed directly to policyholder*	*Proceeds during lifetime*	*Proceeds on death*
Australia	Not deductible except for certain keyman insurance.	Not taxable.	Generally not taxable except for cash bonuses on certain policies cashed within 10 years or if the person entitled to proceeds is not the beneficial owner.	Not taxable.
Austria	The lower of one-quarter of the premium paid and certain maximum deductions depending on family circumstances, and type of insurance.	Not taxable.	Generally not taxable unless paid as an annuity in certain cases or for some short-term single premium life contracts where proceeds exceed premiums.	Not taxable.
Belgium	Tax breaks available if certain conditions are met.	Not taxable.	When there is no tax break on premiums, the proceeds are taxable as movable property income. Interest in annuities is taxable, and a withholding tax on interest included on certain guaranteed return life policies. For group or individual contracts when a tax break is obtained, proceeds are taxed at earned income at marginal rates and local taxes (reduced if certain conditions are met). Profit shares are tax-exempt.	When there is no tax break on premiums, proceeds are tax-exempt but may be subject to inheritance tax. For group or individual contracts where a tax break was obtained, the proceeds are taxed as earned income at marginal rates plus any local taxes (reduced if certain conditions are met). Profit shares are exempt. Subject to inheritance tax. However, group insurance capital sums may be tax-exempt.

Country	*Premiums*	*Roll-up taxed directly to policyholder*	*Proceeds during lifetime*	*Proceeds on death*
Canada	Not deductible (except for registered retirement savings plans and certain policies required as collateral).	Not taxable except for savings-oriented policies where interest accrues annually to policyholder. In addition, proxy tax of 15% of the investment income accumulating in certain policy reserves is paid by the life insurer.	Excess of proceeds (including policy dividend and loans) over cost basis is taxable.	Not taxable except for when policy is defined as a savings vehicle.
Denmark	Generally tax-deductible if paid to Danish life insurance and (up to a limit) capital pension schemes.	Taxed in the company at 15%.	Current payments taxable. A duty of 40% is payable on lump sum payments.	As for proceeds during lifetime.
France	Very limited relief on qualifying premiums.	Not taxable during contract. Excess of proceeds may be taxable depending on duration of contract. Annuities taxable within certain limits. Social contributions applied to interest build-up.	See second column.	Complex rules relating to when contract written, amount of premiums paid before or after 70th birthday. In some cases, proceeds subject to inheritance tax, income tax, or may be tax exempt.
Germany	Pre-2005 endowment or annuity premiums deductible up to specific limits. Premiums on policies taken out from 1 January 2005 are not deductible except for certain annuity policies up to annual limit.	For pre-2005 policies "one-off" payments are taxable in principle but may be tax-free in certain circumstances. Annuity payments taxable. For policies taken out since 1 January 2005, annuity payments taxable but those annuities with tax-deductible premiums are taxable with phase-in until 2040. Proceeds may be subject to inheritance tax.	See second column.	Not taxable, but proceeds may be subject to inheritance tax.

Country	*Premiums*	*Roll-up taxed directly to policyholder*	*Proceeds during lifetime*	*Proceeds on death*
Ireland	Old business basis: Not deductible. New business basis: Relief for permanent health and retirement annuity contracts subject to certain limits. Life premiums may be deducted in computing a gain.	Old business basis: Tax in fund for life policyholders. New business basis: no tax.	Old business basis: No tax unless owner is a company or the policy is with a foreign insurer. New business basis: Gain on maturity, surrender, or certain assignments, subject to an exit tax paid (accounted for by the life insurer). Pension benefits taxable with certain exemptions.	Old business basis: Not taxable but may be subject to inheritance tax. New business basis: Not taxable but subject to exit tax.
Italy	Not deductible though contracts executed until 31 December 2000 allowed a deduction subject to certain limits.	Taxed on formation for annuity contracts. Otherwise, taxed when paid.	Taxable when paid.	Not taxable.
Netherlands	Certain life annuity payments deductible.	Endowment policy income after an exemption is taxable. Certain annuity policy income.	See second column.	No tax, but the value of the policy is taxable.
South Africa	Some insurance premiums are deductible.	Not taxed.	Not taxable provided the beneficiary is the original beneficial owner.	Not taxable provided the deceased is the original beneficial owner.
Spain	Not deductible.	Generally not taxed until payment.	Proceeds considered financial income (when contracted by individuals) but with reductions at tax base level ranging from 40% to 75%.	Not taxable. Subject to inheritance tax.
Switzerland	Deductible to a limited amount (depending on canton).	Not taxable.	Not taxed if certain conditions met.	Taxable at special rates.

Country	*Premiums*	*Roll-up taxed directly to policyholder*	*Proceeds during lifetime*	*Proceeds on death*
United Kingdom	Not deductible except for pensions (subject to a cap).	Taxed in the company.	See fourth column.	Qualifying policies not taxable but may be subject to inheritance tax. Gains on non-qualifying policies taxable on surrender or maturity and may give rise to inheritance tax.
United States	Not deductible.	Not taxed (provided meets definition of a life insurance policy).	Generally life insurance and endowment contract proceeds are taxed only after full recovery of investment. Annuity payments are taxable.	Not taxed (provided meets definition of a life insurance policy).

Note: Data in the table is summarised from PricewaterhouseCoopers *International Comparison of Insurance Taxation* (January 2005). Some of the information may be dated, but has been included as indicative of the approaches taken by different countries

APPENDIX 3

Life insurance tax calculation under proposed model

ABC Life Insurer – year ended 30 June 20xx

The following example shows the operation of the proposed rules for a life insurer that conducts the following business:

- annual renewable term (YRT) – insurance risk only product;
- investment-linked – savings and risk product, with investment assets held in separately defined pools; and
- fixed interest investments that are held in a separate investment pool for shareholders.

For the purposes of illustration, the annual renewable term product is fully taxable under the proposed rules. No policies have income calculated under the transitional provisions, and policy liabilities have not been separately broken down between Investment Contract Liabilities and Insurance Contract Liabilities, as are required under IFRS 4. No losses or other tax balances have been brought forward.

The overall shareholder income and policyholder income is:

- **shareholder income** is $7,638 (tax at 30% of $2,291**)**
- **policyholder income** is $2,600 (tax of $575)

ABC LIFE INSURER
INCOME STATEMENT & TOTAL TAX CALCULATION (IN $)

INCOME STATEMENT		SHAREHOLDER INCOME				POLICYHOLDER INCOME			
	Accounting net profit	**Shareholder**	**Tax adjustments**	**Taxable profit: shareholder**	**Shareholder income calculation**	**Policyholder**	**Tax adjustments**	**Taxable profit: policyholder**	**Policyholder income calculation**
Premium revenue	14,770	14,770	(42)	14,728	**P_r +/- △ UPR**				
Investment revenue	8,000	3,000		3,000	**I_r**	5,000	(2,000)	3,000	**I_s**
Total revenue	**22,770**	**17,770**	**(42)**	**17,728**		**5,000**	**(2,000)**	**3,000**	
Claims expense	(5,540)	(5,540)		(5,540)	**C_r +/- △ OCR**			0	
Policy acquisition costs	(2,750)	(2,750)		(2,750)	**E_{total}**			0	
Other costs	(1,500)	(1,500)		(1,500)	**E_{total}**			0	
Investment management expenses	(300)	(300)		(300)	**E_{total}**		(400)	(400)	**EI_s**
Transfer to policy liabilities	(4,425)					(4,425)	4,425	0	
Total operating expenses	**(14,515)**	**(10,090)**	**0**	**(10,090)**		**(4,425)**	**4,025**	**(400)**	
Operating surplus (loss) before tax	**8,255**	**7,680**	**(42)**	**7,638**		**575**	**2,025**	**2,600**	
Tax	(2,879)			(2,291)				(575)	
Operating surplus (loss) post tax	**5,376**								

The total calculation is broken down as follows:

YRT	INCOME STATEMENT	SHAREHOLDER INCOME			
	Accounting net profit	Shareholder	Tax adjustments	Taxable profit - shareholder	Shareholder income calculation
Premium revenue	10,000	10,000 [1]	(42)	9,958	P_r +/- $\triangle$ UPR
Investment revenue	**1,000**	**1,000**		1,000	I_r
Total revenue	**11,000**	**11,000**	**(42)**	**10,958**	
Claims expense	(5,040)	(5,040) [2]		(5,040)	C_r +/- $\triangle$ OCR
Policy acquisition costs	(2,000)	(2,000)		(2,000)	E_r
Other costs	(1,000)	(1,000)		(1,000)	E_r
Investment management expenses	0	0		0	
Transfer to policy liabilities	0	0		0	
Total operating expenses	**(8,040)**	**(8,040)**	**0**	**(8,040)**	
Operating surplus (loss) before tax	**2,960**	**2,960**	**(42)**	**2,918**	
Tax at 30% (including timing differences)	(888)	(888)	13	(875)	
Operating surplus (loss) post tax	**2,072**			**2,043**	

NOTES

Unearned premium reserve adjustment for tax		
UPR (monthly premium) closing balance	(417)	
UPR (monthly premium) opening balance	375	
Change in unearned premium reserve (UPR)	(42)	1
Claims expense		
OCR (including IBNR) closing balance	(840)	
OCR (including IBNR) opening balance	800	
Change in outstanding claims reserve (OCR)	(40)	
Claims paid	(5,000)	
Claims expense	(5,040)	2

SHAREHOLDER FIXED INTEREST INVESTMENTS	INCOME STATEMENT	SHAREHOLDER INCOME			
	Accounting net profit	Shareholder	Tax adjustments	Taxable profit - shareholder	Shareholder income calculation
Investment revenue (all interest)	2,000	2,000		2,000	I_r
Operating surplus (loss) before tax	**2,000**	**2,000**		**2,000**	
Tax at 30%	(600)			(600)	
Operating surplus (loss) post tax	**1,400**			**1,400**	

Investment-linked specific assumptions

- Premium components include savings premiums of $20,000 (included in policy liabilities) risk premiums of $3,000 and explicit fee charges of $1,770, comprising a policy fee of $120 and fees to cover other costs of $500, acquisition costs of $750 and investment management expenses of $400 (which includes a profit of $100). Only the investment management fees are directly or indirectly related to earning policyholder investment income.
- Claim components include a maturity claim payment of $5,000 (included in policy liabilities) and a death claim which has been incurred but not reported of $500 (included in claims expense).
- Investment gains are all attributable to the policyholder and include a realised gain of $2,000 on an excluded Australian share.
- Opening policy liabilities equals the savings claim that is paid in the period. The movement in policy liabilities is limited to net policyholder investment income.
- Policyholders' income has been attributed 75% to 19.5% PIE rate policyholders and 25% to 30% PIE rate policyholders.

INVESTMENT-LINKED BUSINESS	INCOME STATEMENT	SHAREHOLDER INCOME				POLICYHOLDER INCOME			
	Accounting net profit	Shareholder	Tax adjustments	Taxable profit - shareholder	Shareholder income calculation	Policyholder	Tax adjustments	Taxable profit - policyholder	Policyholder income calculation
Premium risk & fee revenue (including explicit fees)	4,770	4,770		4,770	P_r				
Investment revenue	5,000					5,000	(2,000)	3,000	I_s
Total revenue	**9,770**	**4,770**		**4,770**		**5,000**	**(2,000)**	**3,000**	
Claims expense	(500)	(500)		(500)	C_r +/- Δ OCR				
Policy acquisition costs	(750)	(750)		(750)	E_{total}				
Other costs	(500)	(500)		(500)	E_{total}				
Investment management expenses	(300)	(300)		(300)	E_{total}		(400)	(400)	EI_s
Transfer to policy liabilities	(4,425)					(4,425)	4,425	0	
Total operating expenses	**(6,475)**	**(2,050)**		**(2,050)**		**(4,425)**	**4,025**	**(400)**	
Operating surplus (loss) before tax	**3,295**	**2,720**		**2,720**		**575**	**2,025**	**2,600**	
Tax at 30%	(1,391)			(816)				(575)	
Operating surplus (loss) post tax	**1,904**								

APPENDIX 4

Alternative methods of taxing life insurance that were considered

1.1 During the process of the review, alternative systems from other jurisdictions, were examined (see Appendices 1 and 2). Two alternative approaches proposed in the earlier consultation process were also examined. The following describes why these two alternatives are not being pursued.

Premium taxation

1.2 Several countries (or at sub-levels such as Provincial Governments in Canada, and some states in the US) levy taxes, stamp duties or other assessments on insurers' premium revenues. Under a typical structure, the tax base is simply the total of the insurer's premium revenue with certain alterations. Usually, but not always, the life insurer is responsible for tax payment.

1.3 While premium taxation is simple to administer and comply with, there are less desirable features:

- It is regressive in that it burdens lower-income purchasers of life insurance more than higher income persons, as unit costs for small policies (which are typically bought by the former) are higher than for larger policies.
- It discriminates unfairly against higher premium forms of life insurance.
- It discriminates against those who must pay higher insurance premiums owing to their age, health, or other difficulties.
- It must be paid irrespective of life insurer profitability.
- It is a direct tax on life savings products that is not applicable to other savings products.

1.4 Therefore, a premium tax is not considered appropriate for the New Zealand environment.

Economic basis

1.5 One life insurer suggested life insurance should be taxed on an "economic" equivalence basis incorporating taxation of the policyholder. This would entail taxing insurance claims paid to policyholders while making premiums paid tax deductible. This is not consistent with New Zealand's tax policy that, except for certain income protection insurance, life insurance claims are not income to the policyholder.

1.6 Further, the insurer suggested that a life insurer would deduct the premiums and recognise the claims as a “proxy” of the policyholders. This would nullify recognition of a life insurer’s underwriting income. This would not be economically equivalent to taxing policyholders on their claims, even if that were desired, because those policyholders who did receive claims in excess of premiums would not be taxed. Instead they would benefit from a global loss of all policyholders.

1.7 Effectively, a life insurer’s tax loss would be greater than that shown in the earlier examples in Chapter 2 as there would be no taxation of underwriting profit. It therefore would perpetuate the anomalous tax treatment of term insurance, and so was also not considered appropriate.