

# Life insurance tax reform

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*Officials' paper No. 2 – suggestions for reform*

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*Prepared by the Policy Advice Division of the Inland Revenue Department  
and by the New Zealand Treasury*

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# LIFE INSURANCE TAX REFORM

## SUGGESTIONS FOR REFORM

### INTRODUCTION

#### Overview

Life insurance companies provide valuable long-term risk insurance cover against financial uncertainty, are a means for regular savings for a large number of New Zealanders and are major financial intermediaries. Accordingly, their tax treatment has wide-ranging implications for the New Zealand economy. Officials' paper No. 1 – *Scope of the review* (26 September 2006) discussed how the commercial and accounting environment has changed from the time the current life insurance tax rules were enacted and suggested two broad alternatives for a tax structure that is more equitable and commercially robust. Option 1 – *Proxy basis* is based on updating the current taxing methodology and Option 2 – *Integrate with financial accounting rules* is based on taxing life insurers on the same principles as general insurers.

The purpose of this paper is to set out a possible new structure for life insurance taxation which expands on Option 2 of the earlier paper. In the process, it addresses weaknesses in the current tax rules that can result in under-taxation of some products and over-taxation of others. The aim is also to develop tax rules that suit current life products and reflect the contemporary commercial environment.

Feedback is sought so that a proposal along the lines contained in the paper can be developed for consideration by Ministers.

The myriad of life insurance tax systems adopted in different foreign jurisdictions is testament to the multi-faceted nature and inherent intricacies of this area. The approach adopted in this review is to try to tax life insurance in a manner that is consistent with similar businesses and in a manner that, as much as is practical, leverages off existing tax, actuarial and accounting principles.

Officials favour a general insurance approach to the taxation of life-risk products, similar in concept (though not necessarily in detail) to the present Australian tax rules. We also favour the view that some aspects of life insurance savings should be subject to the Portfolio Investment Entity (PIE) rules. The taxation of annuities presents unique problems, and the methodology discussed in this paper does not at this stage extend to these products.

Any tax changes resulting from consultation on this issues paper are intended to be included in the second tax bill of 2007. They would not come into effect until a date to be determined. Transitional issues are also discussed later in this paper. Some changes to the PIE rules under the existing life insurance rules are being considered for the first tax bill of 2007.

Chapter 1, entitled “A model of life insurance taxation”, outlines the model officials seek feedback on. The component parts of the model are developed in the subsequent three chapters. Chapter 2, “Shareholders’ income”, discusses the taxation of pure-risk products and fee income in the hands of the life insurance company, and Chapter 3, “Savings”, deals with assessable income attributed to the policyholders and shareholders.

Officials are mindful that any changes to the current law must be introduced in such a way that commercial disruption is minimised. Chapter 4, “Other matters”, discusses the issues involved in changing from the current tax rules to the model discussed in this paper.

The “Appendix” provides a simple example using the suggested methodology.

## **Feedback**

Feedback on the questions specifically raised in the paper or on any other aspect of the life insurance review are invited by 5 April 2007, and can be sent to:

Life Insurance Review  
Deputy Commissioner of Inland Revenue  
PO Box 2198  
Wellington

Attention: Anthony Merritt

or via e-mail to: [anthony.merritt@ird.govt.nz](mailto:anthony.merritt@ird.govt.nz)

All submissions received by the due date will be acknowledged.

Feedback and 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 who feel there is any part of it that should properly be withheld under the Act should indicate this clearly.

In addition to seeking written submissions, Inland Revenue and Treasury officials intend to discuss the issues raised in this paper, including detailed design issues, with key interested parties.

# CHAPTER 1

## A MODEL OF LIFE INSURANCE TAXATION

### Current life tax rules

- 1.1 The current life insurance tax rules aim to tax both the investment activity and underwriting activity of life insurers. Since the publication of the first officials' paper on life insurance tax reform, which included consulting with a number of parties interested in the taxation of life insurance, the current taxation methodology has been analysed according to the "ideal" life tax system outlined in paragraph 2 of that paper.
- 1.2 The current rules lack a degree of transparency as they are based on complex formulae for determining underwriting income that exist only for tax purposes and do not easily reconcile with actual financial results. There are no obvious ways to remedy this problem except to make the rules even more complex than they are at present.
- 1.3 They were formulated in part to reduce the potential for manipulation of actuarial reserves by life insurers.<sup>1</sup> International accounting standards now specify rules for the financial accounting of life insurance companies and leverage off codified actuarial standards. All life insurers publish audited accounts, and as most of the large New Zealand life insurers listed on the New Zealand Stock Exchange or subsidiaries of overseas-listed parents are subject to strict disclosure rules they now are subject to a greater degree of transparency compared with when the current regime was enacted.
- 1.4 Furthermore, the rules were designed at a time when nearly all life insurance business was of a conventional participating (whole of life and endowment) type. Today, very few new conventional products are sold and underwriting income from the predominant type of policies (term insurance) is generally under-taxed by the current rules. In addition, participating policyholders are taxed on their savings on unrealised gains and, for 19.5% taxpayers, at a level above their marginal tax rate. The current rules, which combine the two components of a life insurance business – risk and savings – in one methodology therefore over-tax some aspects of the business and under-tax others.
- 1.5 Finally, the current rules are costly for some life insurers to comply with, as they require separate actuarial calculations, and are complex for Inland Revenue to audit and administer. Officials are not aware of any other country which has adopted the current New Zealand approach.

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<sup>1</sup> *Tax treatment of life insurance and related areas—report of the consultative committee* (August 1989) p19-20.

1.6 The overall conclusion is that the current tax rules have a number of negative features and modifying them (as suggested in Option 1 in the first paper, *Scope of the review*) does not provide an optimum solution for both taxpayers and the tax base. In reviewing possible alternatives (and many different models are used by OECD jurisdictions), officials rejected, on grounds of equity and compliance simplicity, changing the taxation of recipients of life insurance benefits.<sup>2</sup> The approach favoured by officials is to tax shareholders<sup>3</sup> on their life insurance risk income in the same way as general insurance (this approach was adopted by Australia in 2000–01). Investment income should, where appropriate and practical, be taxed under the PIE rules, with the policyholders' share of that income being treated as separate from the shareholders' portion.

### **Officials' model**

1.7 The officials' model segregates the various cashflows in a life insurance company between shareholders and policyholders and applies what is considered to be an appropriate taxing basis to each group. The model abandons the present two-tier Life Office Base (LOB)/Policyholder Base (PHB) structure. Instead, the model splits the taxable income calculation into shareholders' income (reflecting the return on assets owned by the equity owners of the life insurer) and policyholders' income (reflecting the return on assets that are attributed to policyholders in the life insurer).

1.8 The main principle underlying the model is that all aspects of a life insurers' business are appropriately taxed. This is obviously important from a fiscal point of view, but it also should enable life insurers to design and market economically efficient products which do not rely on tax benefits for their profitability. Other features which the model aims to reflect are:

- consistency with domestic and international precedents;
- consistency of taxation with similar types of income, particularly with regards to income recognition and timing;
- flexibility for future-proofing;
- self-balancing to minimise tax deferral and avoidance opportunities;
- and
- practicality.

1.9 Two distinct tax calculations will be required:

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<sup>2</sup> Under current law, life insurance benefits paid in a lump sum on the death of the insured are generally free of tax. In some cases, insurance proceeds are subject to tax – for example, insurance payments under a “key person” policy are generally taxable under ordinary principles. However in these cases premiums are tax deductible.

<sup>3</sup> This paper will refer to “Shareholders” as a shorthand description of the annual operating profits of the life insurer that belong to shareholders and reflect the return on capital which they have invested and put at risk through their equity stake. Shareholders' income will be taxed as a corporate entity – that is to say, the shareholders will not be individually taxed. “Policyholders” refers to income from policyholder assets that are ring-fenced from those belonging to shareholders.

### ***Shareholders' income***

- 1.10 Shareholders' income would consist of:
- risk premiums, investment income less claims and expenses adjusted for movements in reserves; *plus*
  - conventional participating business profit attributable to shareholders; *plus*
  - fees and charges in respect of unit-linked business less expenses attributed to these products; *plus*
  - investment income (net of deductible expenses and exclusions from income determined under the PIE rules) relating to shareholder funds (as determined later in this paper); *plus*
  - income not covered by other categories.
- 1.11 Tax would be payable on the taxable 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, should apply to the life insurer in respect of income from those sources.

### ***Policyholders' income***

- 1.12 Investment income would be segregated into that generated by policyholder funds (defined as the liabilities assumed by the life insurer in respect of policyholder-supplied funds) and income generated by shareholder funds (defined as the funds contributed by the shareholders plus shareholders' retained profits from participating policies plus funds arising from the life insurer's non-participating risk business). Tax on policyholder investment income, net of deductible charges and fees, and calculated under ordinary tax principles (as amended by the PIE rules) would be paid by the life insurer on policyholders' behalf as a final tax. However, the life insurer would be able to elect for net investment income from unit-linked products to be "attributed" to policyholders and so subject to tax at investors' marginal tax rates (as modified by the PIE rules).
- 1.13 Policyholders' net taxable investment income cannot be offset with losses or credits from either shareholders' income or any other company in the life insurer's tax group.
- 1.14 The suggested model is compared to the current rules in the table on page 6. The detail of the model, including underlying principles and issues, is discussed in the following chapters.

## COMPARISON OF CURRENT AND SUGGESTED TAX MODELS

<b>CURRENT TWO-TIER APPROACH</b>			
<b>Life office income</b>	<b>Policyholders' income</b>	<b>Imputation</b>	<b>Features</b>
Life base taxes life insurance business – risk and savings – as a whole  $I + U - E$	Policyholder base taxes net investment income attributable to policyholders  $\frac{C + (v1 - v0) - (P - U)}{1 - t}$ Tax paid by life insurer as proxy for policyholder	Tax paid on life base credited to policyholder base	No split required between risk and savings component of premiums/claims  Underwriting income (relates to risk component) determined by prescribed formulae
<b>Key</b>			
I	Income excluding net premiums		
U	Underwriting income		
E	Expenses excluding net claims		
P	Premiums net of reinsurance		
C	Claims net of reinsurance		
(v1 - v0)	Movement in reserves		
t	Tax rate		

<b>OFFICIALS' SUGGESTED MODEL</b>			
<b>Shareholders' income</b>	<b>Policyholders' income</b>	<b>Imputation</b>	<b>Features</b>
Taxes shareholder items only – from risk and shareholder investments:  $Is - Es + [Pr + Ir - Cr - Er - (v1 - v0)r] + [FCul - Eul] + Ws + X$	Taxes net investment income attributable to policyholders:  $Iul - FCul + Ic - Ec$ Tax is paid by life insurer as proxy for policyholder	Tax paid on life insurer income available to shareholders' income only  Tax paid on policyholders' behalf not available to shareholder	Split required of: <ul style="list-style-type: none"> <li>• Risk and fees (taxable) and deposit (non-taxable) component of premiums and claims</li> <li>• Investment income between shareholder and policyholder</li> <li>• Expenses between shareholder and policyholder</li> </ul> Tax rate of policyholder dependant on whether income is attributed. Otherwise default rate applies
<b>Key</b>			
Pr	Risk component of net premiums		
Cr	Risk component of net claims		
Er	Risk component of expenses		
Ir	Risk component of investment income		
(v1 - v0)r	Risk component of movement in reserves		
Is	Shareholders' share of investment income		
Es	Shareholders' share of investment expenses		
Iul	Policyholders' share of income-related to unit-linked business		
Eul	Expenses related to unit-linked business		
FCul	Policyholders' share of fees and charges related to unit-linked business		
Ic	Policyholders' share of income related to conventional business		
Ec	Policyholders' share of expenses related to conventional business		
Ws	Conventional participating business profit attributed to shareholder		
X	Income not covered under any other categories		

## CHAPTER 2

### SHAREHOLDERS' INCOME

#### What should be taxed?

- 2.1 A challenge faced by officials in designing a new tax system for life insurance is to split the return which originates from the receipt of a premium between that which is earned by the shareholder and that which is attributed to the policyholder. The premium may pay the life insurer for the insurance of risk, may primarily have a savings component, or may be a combination of both. There may be a substantial period of time between the receipt of the premium and the payment of any claim on the policy, and so funds are invested by the life insurer to earn a return. Life insurers also receive fees for managing policies and share profits from certain groups of policies.
- 2.2 Taxing life insurers on their risk or underwriting income does not fit easily into orthodox tax theory as the actual profit on a pure non-participating life insurance policy cannot be ultimately determined until its termination. Underwriting income on conventional participating policies is difficult (both in theory and practice) to isolate and categorise.
- 2.3 Of the alternatives officials have analysed or discussed with stakeholders, we consider that risk income is most appropriately taxed on a basis that is consistent with the taxation of general insurance. Admittedly, there are differences between life and general insurance. For example, unlike life contracts most non-life policies are contracts of indemnity where, in very broad terms, insurance paid compensates for the loss incurred by the policyholder. Also, many general insurance policies are for shorter terms than life policies, though the differences are not so marked with annual renewable term life premiums and with some general insurance products such as certain disability products which are long-term. On balance, however, officials consider the differences are outweighed by the conceptual similarities.
- 2.4 Australia adopted a general insurance methodology for taxing risk insurance in 2000. The different regulatory environment across the Tasman aside, the similarities in the products offered in the two countries and the similar accounting practice and commercial environment make an appealing case for New Zealand having a similar tax treatment.

#### Calculation of shareholders' income

- 2.5 When completing tax calculations for an entity, the normal starting point is the accounting net profit before tax, with tax adjustments then made to arrive at taxable income. However, for the purposes of discussion this paper takes a "top-down" approach to illustrate the following taxable components:
  - premium (net of reinsurance) net of amount attributed to savings; *plus*
  - investment income; *plus*

- profit attributed to shareholder from conventional participating business; *plus*
- other income including fees and charges; *less*
- net outlays; *plus/less*
- movement in risk reserves.

2.6 The information used to perform the tax calculations should, as much as practicable, be contained or used as a component in the life insurer's financial statements.

2.7 These items are explained below.

### *Net risk premiums*

2.8 Life insurance premiums are made up of three components:

- an investment or savings component;
- a risk component which is the death cover; and
- a fee component which the life insurer charges to cover the costs of administering the policy (including the funds invested in respect of the policy).

2.9 The investment component is in the nature of a deposit and therefore should not be subject to tax, although the other two components should be taxable. In other words, the amount of the premium that is taxable should be the total premium less the deposit component. Reinsurance paid is deducted to arrive at the "net" taxable amount. As discussed in paragraph 2.12, premiums relating to conventional participating business are wholly excluded.

2.10 Although the amount relating to each component may not be separately disclosed to the policyholder, this model is based on the components being able to be identified. Determining the risk and any embedded fee components of a premium should not be, we understand, particularly onerous for "pure risk" products such as:

- term insurance with either a flat premium (which may increase after a period of several years) or annual renewable premiums (which increase with age) where the only entitlement is a benefit upon death;
- non-participating whole of life policies which have flat premiums, no surrender value, and with payment only upon death; and
- group life.

2.11 Officials also understand it should not be difficult to determine the deposit element of policies that are substantially savings (that is, having no significant insurance component) and so not included as taxable, such as:

- single-premium life insurance bonds;

- short-term fixed return bonds (similar to a bank deposit);
- capital-guaranteed regular savings with insignificant life cover;
- policies where the amount payable upon death is the same as the amount payable on termination or maturity; and
- pure endowment (where the death benefit is usually the return of the premiums paid).

2.12 Difficulties arise when trying to identify a split for mixed or bundled products. The most significant of these are premiums for conventional participating whole of life and endowment policies. Australia completely omits premiums for these policies from the taxation of ordinary business. Officials favour this approach, so long as the shareholders' profit arising from these products, together with the investment component, as discussed later in this paper, is also subject to tax (see paragraph 2.17).

2.13 Some mixed policies have a separately identifiable risk component (for example, some group superannuation policies) or have sufficient information to enable the risk component to be identified (for example, some capital guaranteed products). For mixed products that cannot be easily split (and which officials understand currently constitute a relatively small number of products) the risk proportion of the premium would need to be prescribed by tax legislation. The underlying principle of any rules would need to ensure:

- Similar products are taxed on an economically equivalent basis.
- The rules are flexible to accommodate future product developments.
- The rules reflect the substance of the products so that they are both fair and do not encourage tax deferral by artificial contrivances.
- They are simple to implement and keep systems changes to a minimum.

2.14 There are a number of approaches to resolving boundary issues for such products:

- **Actuarial** – A formula could be prescribed either for the categories in general – for example, an amount required to purchase death benefits in excess of the termination value, or be product-specific. The formula would need to include a component for profit and expenses. The main disadvantage of this approach is that it could lead to the same complex and arbitrary type of formulae contained in the current tax rules for life insurance.
- **Defined percentage** – The law could set a percentage of the amount of premium that is taxable – for example, Australian rules prescribe 10% of non-participating endowment policy premiums and 30% for non-participating whole of life premiums. Although this is a simple procedure, there is obviously an arbitrary nature to determining the percentage.

- **Financial accounting** – Tax could follow the accounting treatment of premiums. IFRS 4 requires that premiums are split into certain components, but this is subject to practicality, materiality and reliability.
- **Compliance cost** – The rules could simply consider products as either pure risk (and so the premium is fully included), and other products as wholly savings (with premiums fully excluded). Such lists would tend to be detailed and there may be winners and losers in terms of the amount of risk income taxed or not taxed.

2.15 The approaches need not be mutually exclusive, and could be implemented by way of a hierarchy. This could be achieved by adopting the financial accounting approach and, to the extent that it did not provide a complete answer, then one of the other approaches could be used.

### *Investment income*

2.16 Investment income from risk and from shareholders' funds is discussed in Chapter 3.

### *Shareholders' profit from conventional participating business*

2.17 This term refers to the shareholders' allocation (through the "gate") of profits from its participating business. Officials consider that the amount allocated should be that determined by the life insurer's rules of the particular fund and its normal practice.

### *Other income*

2.18 This is a catch-all category to include any income (including fees) that may be separately identified from the financial accounts relating to the life insurance business. Note that "non-life" income would still be taxed as it is now, although it may no longer be necessary to separate it into a different income tax return.

### *Net outlays (expenses and claims)*

2.19 A deduction from taxable income would be available for expenses incurred relating to risk products in addition to the risk component of claims. This latter amount would need to be defined in a manner consistent with the taxable component of the premium. For most pure risk products such as term insurance, it would be the whole of the claim. To the extent that particular premiums are excluded, claims from such policies would be excluded in similar proportion. For other "mixed" products it could be the difference between the benefit payable on death and the current termination value, the policy reserve, or simply the amount paid on death where appropriate. Claims relating to conventional participating business would be wholly excluded.

### *Movement in risk reserves*

- 2.20 Officials consider that it would be fair for movements in risk reserves to be included as an adjustment to the shareholders' income calculation. The timing of profit release for financial reporting purposes in life insurance is affected by movements in reserves. In mature life insurance businesses the movement in the reserves may not be large as new policies are written to replace those discontinued and so produce only minor timing effects. In periods of rapid growth, however, the movement could be more pronounced.
- 2.21 Officials reviewed a number of reserving methodologies and their suitability for tax. The first approach that officials considered was the policy liabilities movement from the life insurer's financial accounts. Policy liabilities under IFRS 4 have two components: the best estimate liability (the present value of the expected future payments and receipts under a life policy) and the present value of future margins. Though the accounting approach has the advantage of simplicity, as it considers future years' experience rather than just the current year, officials are concerned that the assumptions used by various life insurers may not be uniform and there remains the possibility of deferral of income.
- 2.22 Alternatively, a general insurance reserving approach could be adopted for life insurance. These reserves include the **unearned premium reserve (UPR)** which is the portion of gross premium that relates to the cover of risks beyond the life insurer's balance date, and the **outstanding claims reserve (OCR)** which relates to claims incurred but not paid at the end of the income year and may include claims incurred but not reported (**IBNR**) if the insured event occurred before the end of that income year.
- 2.23 Reserves for **deferred acquisition costs** raise a number of issues. On the one hand, it could be considered that policy acquisition expenses are incurred for tax purposes and so should be wholly deductible when paid. On the other hand, amortisation of expenses for accounting purposes suggests that they should be matched with the period over which the services are provided.
- 2.24 Officials favour the general insurance reserving approach for risk products, and to ensure appropriate matching between income and expenses, deferred acquisition costs should be spread over the life of the policy. However detailed feedback on this matter is sought.
- 2.25 Officials consider that the reserving basis should be prescribed in legislation, to avoid any possibility of misunderstanding.

### **Corporate tax treatment of shareholders' income**

- 2.26 Shareholders' income should be treated in the same way as that of a corporate taxpayer but solely in respect of the taxable income determined above (to make it clear that the policyholder's investment income is not part of the corporate income calculation) with tax payable at the corporate rate. Officials suggest (subject to stakeholders' feedback) that the shareholders' income would, like any other corporate income, be subject to the provisional tax rules, be able to maintain an imputation credit account, with tax paid on

shareholder income only being eligible to be credited. Officials consider that shareholder tax losses, including LOB losses available for carry-forward from the current rules, should generally be able to be carried-forward for offset against future shareholder income, provided ordinary continuity rules are followed. Shareholders' income should be able to utilise a loss from a company in the same tax group.

#### **Questions for feedback**

1. How should premiums from mixed products be split between taxable and non-taxable components?
2. What is the most practical approach to the calculation of risk reserves? In particular, what are the conceptual and compliance difficulties with the officials' favoured approach? How should deferred acquisition costs be treated for tax? How should the reserves be defined?
3. What alternatives are there to taxing profits from conventional participating business from that outlined?
4. What general corporate tax issues are raised by this model that require consideration?

## CHAPTER 3

### SAVINGS

#### Taxing investment income

- 3.1 In designing a basis for taxing life insurance investment income there should be two guiding principles. The first is the “neutrality” principle underlying the PIE rules, which requires savers to have as close as possible the same tax outcome whether investing via a collective investment vehicle or directly in financial assets. The second principle is that shareholder income should be treated in the same way as income earned by shareholders in similar financial intermediaries.
- 3.2 These principles have the following implications:
- Separate tax calculations for policyholders and shareholders should be performed.
  - Shareholders invest in New Zealand and Australian equities on revenue account.
  - Policyholders invest in New Zealand and Australian equities on capital account.
  - The tax rate for policyholders is theoretically distinct from the corporate tax rate.
  - To the extent possible, policyholders should have the benefit of the PIE rules.
- 3.3 The PIE rules attempt to achieve neutrality in investment decision-making in two ways. The first relates to the investment income base, by excluding from tax realised gains from the disposal of New Zealand and certain listed Australian equities and Australian unit trusts (referred to here as “excluded income”). The second relates to the attribution of taxable investment income to the individual investor, so that tax is paid at the investor’s marginal rate (up to 33%).
- 3.4 The difficult task for attributing income to policyholders is to design rules that will encompass the myriad products and the unique policyholder/shareholder relationship. One alternative would be to tax investment income as it is allocated to policyholders – for example, by taxing increases in surrender value or policyholder claims (sometimes referred to as the “US model”).
- 3.5 The other alternative would be to tax the life insurer as it derives the income. The life insurer would therefore be taxed as the “proxy” for the policyholder.
- 3.6 The advantages of the US model are two-fold. The first is that it ensures that policyholders are taxed at their marginal tax rates. The second is that, it

simplifies the practical issues of distinguishing between shareholders and policyholder income. However, the US model provides strong incentives to defer the taxation of income. The approach can also be complex – requiring, for example, non-taxable distributions of claims paid out of capital to be distinguished from taxable claims paid out of investment earnings. It would also be difficult to isolate out non-taxable investment earnings such as excluded income.

- 3.7 The proxy approach is simple and avoids tax deferral, but it does not allow different rates to be applied to policyholders. However, with the exception of income derived from certain unit-linked products, officials are not aware of any practical ways to adopt the US model to New Zealand conditions.
- 3.8 Taxing investment income from a conventional participating business pool provides unique challenges as shareholders share in the allocation of “profits” from the pool, including those relating to investment, usually by means of a set ratio – traditionally 80% (policyholders): 20% (shareholders). The lack of any direct annual correlation between both the amount and nature of investment income earned by the life insurer, and the bonus credited to the policyholder appears to make attribution conceptually and practically very difficult.
- 3.9 There are also some theoretical difficulties with excluding capital gains from conventional products from tax. For example, extending the PIE base benefits to the entire pool would mean that shareholders would indirectly benefit from the realised capital gains exclusions. Officials seek detailed feedback on whether capital gains on participating non-unit-linked products should be excluded from tax, consistent as much as possible, with the principles set out in paragraph 3.1.
- 3.10 Where a pool is “non-participating” (or “without profits”) business, all investment income belongs to shareholders.
- 3.11 Shareholder investment income from risk businesses and other investment income from shareholders’ funds would form part of the shareholders’ tax return.

### **Officials’ model for taxing life insurance savings**

- 3.12 The starting point for the tax calculation would be to carve investment income (**I**) from the life insurer’s financial accounts and/or the income attributed to the life insurer under the PIE rules (which would be zero-rated for PIE purposes and hence will be gross to the life insurer). All ongoing administration, management and acquisition expenses (**E**) related to the investment component of the policy would be allocated against the taxable portion of the income. The net income would then be allocated between:
- Policyholders’ funds
    1. Participating and other non-unit-linked funds
    2. Unit-linked
  - Shareholders’ funds.

## ***Policyholders' funds***

### *Participating policies and other*

- 3.13 Policyholders would be taxed on investment income derived in respect of conventional participating policies and the deposit component of mixed policies, which would be calculated subject to ordinary tax principles. The tax would be paid by the life insurer on behalf of the policyholders as a final tax at a rate linked to the top PIE tax rate (currently 33%).
- 3.14 Imputation and other credits attached to income would be used as a credit against the tax liability. Policyholders would not maintain an imputation credit account, and officials consider that imputation credits that are not utilised in the annual tax calculation should be grossed up at the tax rate and carried forward as a loss for offset against future tax liability. Other non-refundable tax credits not utilised would be treated under ordinary rules.

### *Unit-linked products*

- 3.15 Income from these products could be taxed at the default rate by the same proxy method as applies to participating policies, described above, and, realised Australasian capital gains could be excluded from tax. However, officials suggest that life insurers should be able to elect, on a product by product basis, to attribute taxable income to policyholders based on their unit holding.
- 3.16 In a typical unit-linked policy the unit purchased by the policyholder is linked to a specific asset class, or to a specified investment portfolio and the unit price recalculated daily to reflect the investment performance of the assets in the fund. The policyholder has no entitlement to the change in value of the policy until it is surrendered or reaches maturity though the policy could be sold. The risk cover on many such products is sometimes minimal but transparent.
- 3.17 These products have much in common with unit trusts, and so the attribution process already contained in legislation for those vehicles could, with suitable modifications, be adopted for unit-linked products. Therefore, the investment income, net of expenses and excluded income could be attributed to the individual policyholder. Tax on the income would be paid as a final tax at the policyholder's PIE marginal rate. Officials seek feedback on whether this is feasible and what legislative and systems mechanics are required.

## ***General***

- 3.18 The policyholders' net income is separate from the shareholders' income, and so cannot be reduced by losses incurred by the life insurer from its other business or by other group companies. Policyholder losses would not be subject to any continuity rules.

## ***Shareholders' funds***

- 3.19 Other than their share from the participating profits pool (included as part of shareholders' income, as discussed in paragraph 2.17, shareholders earn

income from non-participating (Ir on the table on page 6), and retained shareholder profit pools (Is on the table on page 6).

- 3.20 The shareholders' proportion of investment income (net of deductible expenses) from these latter two pools should be included as part of the shareholders' taxable income calculation. Excluded income attributed from PIEs would, consistent with other taxpayers, not be taxable. However, all investments that form part of the shareholders' life insurance business would continue to be held on revenue account.

#### **Questions for feedback**

1. Feedback is sought on all aspects of the officials' suggested tax treatment of savings, in particular regarding:
  - practical compliance difficulties (and costs of compliance);
  - extending a realised capital gains exclusion for Australasian equities to participating non-unit-linked products;
  - information technology systems capabilities;
  - particular products that may require specific treatment – for example, annuities: and
  - issues (if any) relating to income and expense allocation between shareholders and policyholders.
2. Instead of a 33% tax rate on policyholder income there have been suggestions that the life insurer could segment its business into categories and apply an average policyholder proxy tax rate against the net investment income within each. Officials do not favour this as it still over-taxes policyholders on the lowest tax rate, and gives a comparative benefit to middle and higher marginal rate taxpayers. Feedback is invited on this suggestion.
3. Would the elective attribution solution for unit-linked products discussed above, if included in legislation, actually be used by any life insurers?

## CHAPTER 4

### OTHER MATTERS

#### Definition of “life insurance”

- 4.1 The discussion in this paper is based on the current Income Tax Act 2004 definition of “life insurance”. The definition has existed in largely unchanged form since the current life tax rules were implemented. This paper does not address whether the definition is sufficiently robust to reflect not only the current commercial environment but also future developments in life products. There are also issues as to whether there should be consistency in definition between income tax, GST, financial reporting, and regulatory provisions.
- 4.2 Feedback is requested on whether the current tax definition requires change.

#### Transitional issues

- 4.3 The suggested tax structure discussed in this paper does not purport to subject hitherto untaxed components of life insurance to tax. Rather it aims to tax income more appropriately. Officials recognise that any new life insurance tax rules require time to develop new systems to administer policies, develop new accounting systems, and review the structure and pricing of particular product lines. However adverse impacts can be mitigated by clear timing of the application of the new rules and careful legislative transitional measures.
- 4.4 Any transitional measures must be guided by two general principles. The first is that it is undesirable to have long-term transitional arrangements as this would defer the overall benefits without necessarily deferring all of the costs. Secondly, to avoid cost and complexity there should not be a multiplicity of rules operating during the transition period. Transitional relief, where appropriate, should be afforded in some other pragmatic way.
- 4.5 Feedback is also sought on the extent to which tax and credit balances arising from the current regime should be able to be carried forward.

#### Questions for feedback

1. Does the current income tax definition of “life insurance” need to be changed, and in what way?
2. Life insurers in New Zealand have a wide variety of balance dates and officials consider that starting any new rules on an income year basis would create competitive advantages and disadvantages. A specific commencement date is preferred. Officials seek feedback on why any new rules should not apply from a specific date.

3. What is the nature of existing contracts for products that may be adversely affected (based on the model put forward by this paper) and the transitional rules required to deal with them?
4. If the PHB is discontinued (as a consequence of the segregated approach), should PHB tax losses carried into the new rules be forfeited by the life insurer?
5. Should credit balances in the imputation credit account and/or policyholder credit account arising from payments of tax on the LOB in excess of the PHB liability be fully or partially retained?

## APPENDIX

### LIFE INSURANCE TAX CALCULATION UNDER OFFICIALS' MODEL ABC Life Insurer – year ended 31 March 200X

**Background:**

- Two policy types issued
  - Annual renewable term insurance (YRT) – risk-only product
  - Investment-linked – savings-only product (insignificant risk). No attribution to policyholders.
- Policy liability movement for YRT is nil due to steady premium income
- For illustration purposes the deposit and withdrawal components of savings products have been included as premiums and claims (IFRS 4 requires these to be shown as deposits)
- Claims experience matches expected due claims to realistic assumptions. No lapses
- No reinsurance
- Investment-linked investment revenue of \$5,000 includes New Zealand equity gains of \$1,000 (which are assumed to be not subject to tax)
- Implicit management fee charged on investment-linked product of \$400
- \$50 non-deductible legal fees incurred for YRT product
- No accounting deferral of policy acquisition costs

ACCOUNTING CALCULATION	Financial statements	YRT	Investment linked
Premium revenue	30,000	10,000	20,000
Investment revenue	6,000	1,000	5,000
<b>Total revenue</b>	<b>36,000</b>	<b>11,000</b>	<b>25,000</b>
Claims expense	(10,000)	(5,000)	(5,000)
Policy acquisition cost	(2,750)	(2,000)	(750)
Other expenses	(1,500)	(1,000)	(500)
Investment management expenses	(300)		(300)
Increase in policyholder liabilities	(17,575)		(17,575)
<b>Total operating expenses</b>	<b>(32,125)</b>	<b>(8,000)</b>	<b>(24,125)</b>
<b>Operating surplus (loss) before tax</b>	<b>3,875</b>	<b>3,000</b>	<b>875</b>
Tax expense	(1,814)	(1,006)	(808)
<b>Operating surplus (loss) post tax</b>	<b>2,061</b>	<b>1,994</b>	<b>67</b>

<b>TAX CALCULATION</b>	<b>Shareholder</b>	<b>Policyholder</b>
Premium revenue (risk)	10,000	
Investment revenue (net of excluded income)	1,000	4,000
Fees, charges and management fees (implicit)	1,650	
<b>Total revenue</b>	<b>12,650</b>	<b>4,000</b>
Claims expense (risk)	(5,000)	
Policy acquisition cost	(2,000)	(750)
Other expenses	(1,000)	(500)
Expenses related to savings product	1,250	
Investment management expenses	(300)	(400)
Tax adjustment – legal fees	50	
<b>Total deductions</b>	<b>(9,500)</b>	<b>(1,650)</b>
<b>Taxable income</b>	<b>3,150</b>	<b>2,350</b>
Tax on taxable income	1,039*	775

\* \$1,039 cr to Imputation Credit Account

The tax calculation can also be expressed in terms of the formulae contained in the Table on page 6 as follows:

**Shareholder income:**

$$\begin{aligned}
 & I_s - E_s + [Pr + Ir - Cr - Er - (v_1 - v_0)r] + [FCul - Eul] + W_s + X \\
 & = 0 - 0 + [10,000 + 1,000 - 5,000 - (2,000 + 1,000 - 50) + 0] + [(400 + 750 + 500) - \\
 & (300 + 750 + 500)] + 0 + 0 \\
 & = 3,150
 \end{aligned}$$

**Policyholder income:**

$$\begin{aligned}
 & I_{ul} - F_{cul} + I_c - E_c \\
 & = 4,000 - (400 + 750 + 500) + 0 - 0 \\
 & = 2,350
 \end{aligned}$$