Taxation (International Taxation, Life Insurance, and Remedial Matters) Bill

Officials' Report to the Finance and Expenditure Committee on Submissions on the Bill

Volume 3

Taxation of life insurance business
General insurance and risk margins

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Taxation of life insurance business

OVERVIEW

Clauses 29, 50(1), 56, 98(2) and (6), 140, 141, 142, 143, 146, 149, 150, 205(1) and (2), 222, 238, 239, 240, 272, 273(1) and (5), 274, 279(1) and (3), 283, 285, 330(2) and (3), 331(1) and (3), 333, 336(1), (2) and (4), 338, 341, 344(2), 372, 408(7) and 408(96)

Significant changes are being made to the taxation of life insurance business in New Zealand. The changes are the result of work that began in July 2006 and in response to submissions and comment received on two officials' issues papers and one government discussion document.

Life insurance companies are companies that carry on a life insurance business and are registered under the Life Insurance Act 1908 to write life insurance policies.

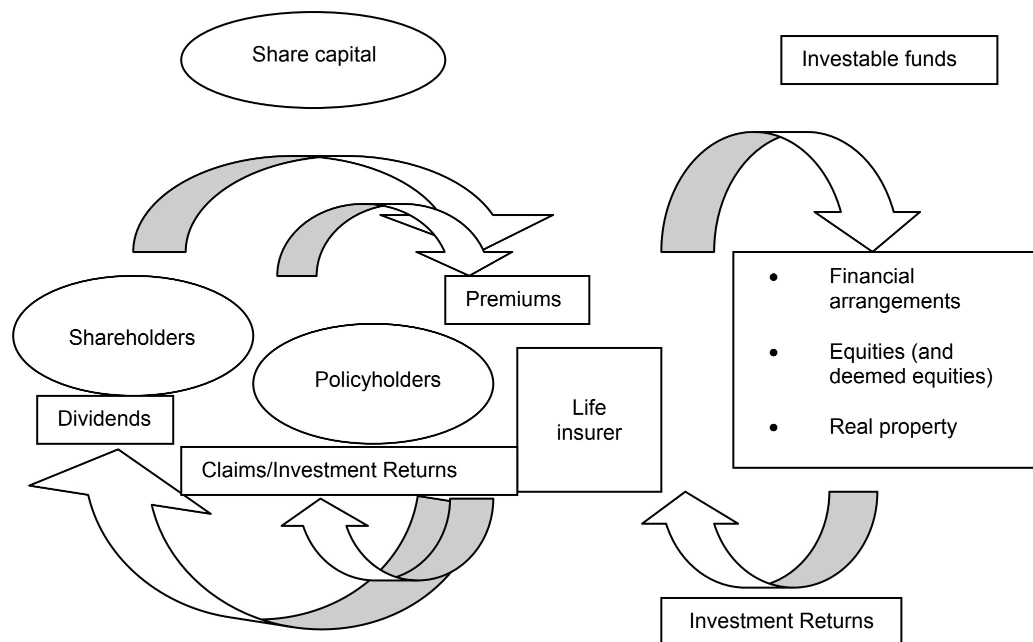
When the current life insurance rules were enacted, most of the large insurers in New Zealand were mutual entities – meaning they were owned by their policyholders, and premium contributions as well as retained investment income built up over the years contributed to the capital base of the life insurer. All of the large insurers are now limited liability companies (though some operate in New Zealand as branches of foreign companies), and most are owned by foreign companies. Many of the large life offices operate within financial services groups of companies that generally provide a wide range of savings products and, in some cases, general insurance. Some subsidiaries of banks are now involved in writing life policies.

Until the 1980s, the products most frequently offered by life insurance companies were the traditional whole of life and endowment products[1]. Since the current life rules have been in operation, term insurance business has increased from being less than 10 percent of total industry premiums to now over 50 percent. Term insurance is a pure risk product that pays out only on death (within the term of the policy). There is no savings component, which means that these policies have more in common with general insurance (such as motor vehicle or home and contents insurance) than traditional savings-related policies.

The nature of modern life insurance companies and their business is illustrated in figure 1. The life insurer, like other businesses, operates to provide an economic return to shareholders who have contributed capital in the company. The life insurer also receives premiums from policyholders which are invested or used to meet expenses and claims. The net returns from the invested funds produce returns for the shareholder, and in the case of savings policies, for the policyholder as well. Certain policies which "participate" in the profits of the life insurer allocate the life insurer's profits to the benefit of the policyholders in those products. Otherwise, the profits from the life insurer are available (subject to corporate law and regulatory requirements) to be returned to shareholders.

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

Figure 1: Structure of modern life insurance business



The net assets of a life insurer are owned by the shareholders. The rights of the policyholder are by way of contract with the life insurer and do not extend to specific assets. The economic policyholder "ownership" rights in the company are generally reflected in "unvested policyholder liabilities".[2]

Current tax rules

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 reinsurer) as a whole. It consists of investment income less expenses, and underwriting income (basically the difference between the premiums earned and the costs of settling claims but which is calculated under the current rules by way of a formula.

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] Nevertheless, many unbundled products give their policyholders rights to a group of assets which are very close to the right of beneficial ownership, and therefore pull back all investment profits.

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.

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

The key factor in the current taxation formula of components of underwriting income is the premium loading formula which brings to tax 20 percent of the "Expected Death Strain" (EDS) which are the expected claims. The 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. This implies that such products will always generate a loss for tax under the formula. The anomalous tax result is illustrated in Example 1.

Example 1

	Financial accounting	**LOB Tax**
Premiums	100	
Claims (=Expected claims)	(45)	0
Investment income	10	10
Expenses	(40)	(40)
Premium loading (20% claims)		9
Accounting profit/ tax (loss)	25	(21)

In this example, where there is a loss ratio (claims ÷ premiums) of 45%, a $25 accounting profit translates into a $21 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 $31.30.

Even more incongruous, a 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 in Example 2.

Example 2

	Financial accounting	LOB Tax
Premiums	100	
Claims (=Expected claims)	(25)	0
Investment income	10	10
Expenses	(40)	(40)
Premium loading (20% claims)		5
Accounting profit/ tax (loss)	45	(25)

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

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

Policyholders saving through certain life insurance products, unlike other investments, are effectively taxed on unrealised investment gains. They are also taxed at investors' marginal tax rates, not at a proxy rate of tax.

Proposed new tax rules

The proposed new rules for the taxation of life insurance business are designed to introduce an integrated framework that:

- taxes life risk business on actual profits in a manner similar to the way that other businesses are taxed; and
- extends the tax benefits of the portfolio investment entity (PIE) rules to all savers in life products.

Under the new rules, life insurers will be taxed on two bases: a shareholder base (representing income derived for the benefit of shareholders) and a policyholder base (representing income derived for the benefit of policyholders). Detailed provisions apply to taxing participating policy income between the shareholder and the policyholder bases. Policyholder base income cannot be offset with losses or credits from either the shareholder base or any other company in the life insurer's tax group.

The amendments in this bill also extend the benefit of the PIE rules to policyholders in all life insurance savings products. Under the new rules, life insurers can also elect to attribute income in investment-linked products to policyholders at their individual PIE rates.

The nature of life insurance gives rise to complexities in applying tax concepts. The long-term nature of most policies makes it difficult to match income and expenses appropriately, and therefore complex legislative provisions are required to equitably bring to tax income and expenses in the correct period.

In addition, complexities in determining the relevant mix of savings return, savings and risk intermediation, and risk pooling inherent in some life policies also requires detailed rules to appropriately allocate the tax burden between shareholders and policyholders.

Moving from the current life tax rules to the proposed rules will affect life insurers' business and accounting processes. To mitigate the impact, detailed transitional rules will apply for term-insurance products sold before the application date. Generally, existing policies will be grandparented under the current rules for up to five years. However, if a policy is a single premium, level premium, or guaranteed premium, it could be grandparented for the life of the policy or for the period for which the premium is guaranteed.

Policies cannot be subject to any fundamental change in their terms during the transition period – otherwise a new policy is created and it is fully subject to the new rules. However, it is proposed that certain minor changes to the amounts of cover would not cause grandparenting to be lost.

The proposed PIE benefits will apply immediately on the application date.

Generally, subject to ordinary shareholder continuity and other specific rules, tax and credit balances, and losses from the LOB can be carried by the life insurer into the new rules.

The life insurance provisions attracted 16 submissions[3] and focused on the following matters:

- opposition to the proposed changes;
- alternative methods of taxation;
- application dates;
- basis of taxation;
- reserves;
- participating policies;
- reinsurance;
- transition;
- miscellaneous technical issues; and
- drafting.

[3] Multiple submissions from the same organisation are treated as one submission.

Officials are recommending a range of technical changes in response to submissions. Of most importance to the life insurance sector is the recommendation that the application date of the changes be deferred to 1 July 2010 (with early application at the election of the life insurer in certain circumstances). Other important changes that we are recommending in response to submissions are as follows:

- changes to the operation of the premium smoothing reserve to ensure the legislation reflects policy intent;
- providing a low compliance alternative to the taxation of existing participating policies;
- providing consistent treatment of reserves for non-life products held by life insurers;
- allowing tax balances carried forward into the new rules to be applied against tax liabilities arising in the shareholder base and the policyholder base; and
- changes to clarify the calculation of taxable income under the new rules.

OPPOSITION TO THE PROPOSED CHANGES

While Minter Ellison Rudd Watts and the life industry generally, and the New Zealand Society of Actuaries (at the oral hearing of the Finance and Expenditure Committee on 11 and 19 March respectively) accept the policy principles underlying the reforms, some submitters do not like the effect of the proposed rules because they remove tax benefits created by the operation of the current rules.

Some submissions have argued that life insurance provides wider benefits to society and therefore the current life insurance tax rules should not be changed, or any alternative rules should include tax incentives.

Issue: Social implications

Submissions
(32 – KPMG, 33A – Investment Savings and Insurance Association of NZ Inc, 52 – Sovereign)

Submissions are of the view that the life insurance tax reforms are unnecessary and should not proceed. The principal arguments are:

- The rationale for the life insurance tax reforms should be considered further. The reason for the reforms appears to be the need to remove perceived tax benefits. The tax benefits are being passed on to policyholders.
- On public policy grounds, life insurance provides a social good that should be supported by the government. In principle, policyholders should be able to claim deductions for premiums. But this would create additional compliance and administration costs. The current rules effectively create a similar result, with the tax benefits accruing to the insurer as a proxy for the policyholder.

Comment

The comprehensive changes to the taxation of life insurance in this bill introduce an integrated framework extending many PIE benefits to all savers in life products.

Under current rules, term insurance profits are taxed on the basis of artificial formulas which were not designed with these products in mind. The formula results in otherwise profitable business generating a tax loss. The aggregate tax benefits to life insurers resulting from these artificial losses amount to an effective $75m (at least) tax subsidy annually. The proposed revised rules tax life insurers on their actual profits from term insurance in the same manner as any other business in New Zealand.

In any case, there is absolutely no reason to provide tax concessions to life insurance. While life insurance provides social benefits, so do numerous other goods and services. For example, fundamental human needs such as food, shelter and comfort are not subsidised by the tax system.

Even if an argument could be made that life insurance requires special tax concessions above all other goods and services, providing tax concessions to the providers of life products rather than directly to the policyholder, as these submissions suggest should continue, has no policy justification and no precedent. The economic benefits of the current tax treatment are basically reflected in a combination of lower premiums, increased profits to insurers, and higher costs, particularly as the industry recognises that it pays a high level of commissions to insurance sales people. There is no certainty therefore that all of the tax benefits that are currently enjoyed by life insurers are being passed to consumers in the form of lower premiums.

Recommendation

That the submissions be declined.

Issue: Impact of proposed rules on affordability

Submission
(32 – KPMG, 33A – Investment Savings and Insurance Association of NZ Inc, 52 – Sovereign, 55 – Asteron)

The proposed rules will require an increase in premium prices of up to 30 percent, making life insurance unaffordable for many, and contributes to New Zealand's under-insurance.

The submission argues against the need for life tax reform (because it would be contrary to social policy) and suggests delaying the application of reforms.

Comment

The pricing of life insurance premiums takes into account a number of factors such as an individual's health and lifestyle, and the costs of selling and administering the policy such as commissions paid to advisers. Taxation is a relatively small component when compared with some of these other factors.

The potential financial impact of the proposed changes on individual policyholders also needs to be objectively considered. For example, the Investment Savings and Insurance Association of NZ Inc considers the benchmark minimum-term life cover to be five times the average annual wage. Assuming this amount to be $250,000 the monthly premium for a 35-year-old male non-smoker for term life cover of this amount, based on an average from several major insurers, would be currently about $20. Even if, as a result of the new rules, products fully subject to the proposed rules are 20 percent more expensive, which officials consider is at the higher end of potential increases, the monthly premium would be $24, a difference of $4 to the premium paid currently.

There is no commonly accepted definition of "under-insurance" just as there is no definition of "over-insurance". Comparisons of insurance levels between countries are not conclusive because of:

- different tax treatments (in some countries insurance benefits are subject to tax or death duties);
- types of insurance (some countries' statistics include investment contracts which are basically savings plans), cost of cover (the same level of cover may cost more than the equivalent contract in another country); and
- availability of insurance equivalents and social welfare network (for example, New Zealand's comprehensive ACC scheme).

However, in a free market, given the level of information available about life insurance, it could be strongly argued that the current insurance levels reflect the consumer preferences to purchase life insurance, in the same way for any goods or services.

The alternative to the proposed reforms is to maintain tax incentives provided to life insurers under the status quo. As discussed earlier, there are considerable policy arguments against this approach.

Recommendation

That the submission be declined.

Issue: Alternative method of taxation

Submission
(52 – Sovereign)

The submission agrees that taxation of insurance needs reform but does not support the proposed measures as it considers they do not take into account social policy issues and the "inevitable worsening of the financial position of New Zealanders through a reduction in life insurance below prudent levels".

The submission suggests an alternative that, in broad terms, is based on the rules contained in the bill with regards to term insurance, with the important difference that claims would be taxable and premiums deductible to individuals. While individuals could take deductions for premiums and pay tax on claims in their individual tax returns, the submission suggests that to reduce compliance costs, this could be done by the life insurer, who would deduct all premiums received and add all claims paid against the insurer's taxable income. As generally premiums exceed claims in a life insurance business, this would result in a tax loss on the risk business. The insurer could offset this loss against other income from the company or corporate group. The tax benefit would be passed through in the form of lower premiums to policyholders.

Comment

The fundamental premise of the suggested alternative, that because life insurance performs a social function, it should receive tax preferences, has been discussed earlier. Additionally, there are a number of other fundamental policy objections to the submission:

- The idea of taxing of claims is foreign to New Zealand and has been adopted only in a small number of countries. If adopted here it would mean that a person insured for say, $100,000 cover would only receive $70,000 after tax, which could cause financial distress to the beneficiaries who might be unaware that the pay-out was taxable.
- Taxing claims would also mean that obtaining the same after-tax level of cover would require the cover to be grossed up by the tax rate. This would mean higher premiums, which would tend to negate the supposed "lower premiums" offered in the first place.

The tax benefit given to the life insurer under the current rules may be reflected in lower premiums but there is no guarantee that some of it may not be reflected in the insurer's profits and/or higher costs (for example, commissions). Providing tax benefits in excess of $135m annually to life insurers (based on current industry figures and assuming full implementation of this alternative) based on no more than an unverifiable hope that the benefits will be passed on, dollar for dollar, in the form of lower premiums, is an inefficient way to transmit targeted tax benefits.

Recommendation

That the submission be declined.

Issue: Tax incentives for non-residents

Submission
(64A – Payroll Giving Limited)

The submission seeks a tax exemption for investment income irrespective of its source, attributable to non-resident policyholders of New Zealand life insurance policies. As an alternative to this exemption, the following amendments are sought:

- restrict the tax exemption to policyholders who are residents of a country that has a double tax treaty with New Zealand;
- a tax exemption for non-source income attributable to non-resident holders of New Zealand life insurance policies;
- non-resident withholding tax rules should apply to interest income attributable to non-resident policyholders and also be eligible for approved issuer levy status.

Comment

Under the proposed rules, all investment income earned by life insurers will be taxed either on the shareholder base or the policyholder base.

The amendments sought by the submission are to enable New Zealand-domiciled insurers to participate in the international insurance market, and to replicate favourable tax treatments given by other countries by providing certain incentives.

The proposed tax rules are intended to remove tax preferences for life insurers under the current rules. They have not extended to providing tax preferences to particular existing or potential policyholders. The potentially wide-reaching ramifications of accepting the alternatives proposed in this submission would need to be discussed with all stakeholders.

Recommendation

That the submission be declined.

DEFERRAL OF APPLICATION DATE

Submissions

(32 – KPMG, 35 – PricewaterhouseCoopers, 33A and 33B – Investment Savings and Insurance Association of NZ Inc, 41 – AXA New Zealand, 52 – Sovereign, 55 – Asteron, 62 – Minter Ellison Rudd Watts, 68A and 68C – Corporate Taxpayers Group)

Submissions suggest a variety of options for deferring the application of the changes to the taxation of life insurance business. Most submissions note that there are significant problems with the rules as currently proposed. Deferring the application date would allow insurers sufficient time to understand the rules and develop robust systems to comply with the new rules.

Other reasons for changing the application date contained in the bill include:

- The need for a "hard" application date that will apply to all insurers. Under the current bill, insurers with a balance date later in the calendar year will have a significant advantage over insurers with an earlier one. While the current "balance date" application contained in the bill is preferred because it reduces complexity and compliance costs, the commercial implications created by the rules need to be addressed by adopting a "hard" application date. *(Investment Savings and Insurance Association of NZ Inc)*
- The global downturn is having a material impact on the balance sheets of most life insurers and the timing of when the proposed changes come into effect needs to be reconsidered. *(Investment Savings and Insurance Association of NZ Inc, Sovereign)*

The options for deferring the application of the changes are:

- The new taxation rules should be deferred until at least one year after the reforms have been enacted. *(PricewaterhouseCoopers, Minter Ellison Rudd Watts)*
- The application date should apply to income years starting on and after 1 April 2010. The grandparenting rules should also apply from 1 April 2010 or not until after six months have past since the bill has been enacted. *(AXA New Zealand)*
- The application date should be deferred to income years starting 1 April 2011 at the earliest. *(KPMG, Sovereign)*
- Insurers should have the choice of application dates – either their first balance date after 1 April 2010 or a "hard" date of 1 January 2011. *(Investment Savings and Insurance Association of NZ Inc, PricewaterhouseCoopers, Asteron, Corporate Taxpayers Group)*

Comment

The bill provides that the change to the taxation of life insurance business starts for insurers with income years beginning on and after 1 April 2009 and in respect of life insurance policies sold on and after 1 April 2009.

As the enactment will occur after 1 April 2009, the Minister of Revenue, on 25 March 2009, asked the committee to give serious consideration to a number of deferrals, in whole or in part, of application dates in the bill, and requested "that the application date of the new rules be deferred until a date to be determined following further discussion with the industry". The Minister's request was especially supported by the Corporate Taxpayers Group.

Officials have discussed the application date options, including the option of creating a "hard" date, with a committee from the Investment Savings and Insurance Association of NZ Inc representing the life insurance industry.

A hard application date would mean that the rules would apply to all life insurers from a specified date. This could mean that when the hard date bisects an insurer's income year, the insurer would be required to complete a separate tax return for the period before the specified date and another for the period after. Both Inland Revenue and life insurers consider that the costs of preparing and auditing two income tax returns in the same calendar year are manageable.

Officials are mindful of the logistical requirements for life insurers to be able to apply the new rules. However, officials are also mindful that delaying the implementation of the new rules may adversely affect policyholders of life insurance savings products.

Following our discussions with the Investment Savings and Insurance Association of NZ Inc, officials recommend that the new rules apply on and after 1 July 2010. This date would apply to the changes to the taxation of life insurance business and the application of the PIE taxation system to policyholder savings policies. This "hard" application date is intended to deal with the equity and competition problems identified by the submissions on the bill. The five-year grandparenting period would also start from that date.

The recommended application date also ensures that all life insurers have sufficient time (10 to 11 months from the likely enactment date of the bill) to develop adequate compliance systems that respond to the new rules.

The industry has also asked for flexibility for insurers who may want to implement the new rules at an earlier date. Officials consider this flexibility is desirable as it would give life insurers an opportunity to provide extended PIE benefits to their policyholders and it may reduce compliance costs for life insurers with balance dates earlier than 30 June 2010. Therefore, officials consider that while the application date for the new life insurance rules should generally be 1 July 2010, that life insurers be given the option to apply the new rules from the beginning of their income year if that year includes 1 July 2010. Officials also consider that if a life insurer elects to apply the new rules from the beginning of their income year, they should be able to make a further election that grandparenting will apply to policies entered into before the beginning of the same income year. If they do not make this election, grandparenting will apply to policies entered into before 1 July 2010.

Recommendation

That the submissions be accepted in part, so that the new rules, and the grandparenting provisions, will apply from 1 July 2010, with an option for life insurers to elect to apply these rules from the beginning of their income year, if the income year includes 1 July 2010. Officials also recommend that life insurers who have elected to apply the new rules from the beginning of their income year be able to make a further election to apply the grandparenting rules from the beginning of the same income year rather than from 1 July 2010.

BASIS OF TAXATION

The proposed tax rules require an allocation of all types of life insurance income and expenditure, and related tax balances to either the new shareholder base or the policyholder base. They provide for a number of ways in which this can be done. A number of submissions requested clarification or suggested improvements on the allocation methods and related issues contained in the bill.

Issue: Apportionment of income

Submission
(67 – New Zealand Institute of Chartered Accountants, 53 – Ernst & Young)

The apportionment basis should be extended to allow a specific identification basis which may also be "equitable and reasonable".

Comment

Section EY 4 provides for an alternative basis (other than the "Default basis") for apportioning income to the policyholder and shareholder bases. The alternative basis is limited to one which is "actuarially determined and is more equitable and reasonable" than the default basis.

Officials consider that the alternative basis is sufficiently broad to allow a "specific identification" basis, if that produces a more "equitable and reasonable" result. Any further extensions of the apportionment basis is therefore unnecessary.

Recommendation

That the submission be declined.

Issue: Non-participating policies – GAAP accounting

Submission
(53 – Ernst & Young, 67 – New Zealand Institute of Chartered Accountants)

The reference to generally accepted accounting principles (GAAP) should be removed and replaced with a definition of "investment income" for life insurers to ensure that only investment income for tax purposes is apportioned to policyholder base income.

Comment

Proposed section EY 15(1)(c) relies on GAAP to allocate investment income relating to non-participating policies to the policyholder base. In recent years, the financial accounting concept for accrual and disclosure of income has changed with the adoption of international financial reporting standards (IFRS) which, in some cases, may be different from the accepted principles for income tax purposes.

Officials consider that the criteria for apportionment (including alternative methods) in the bill are clear and understandable and would not result in any material mis-allocation of income in the life insurer. A reference to investment income determined under tax legislation as proposed in this submission, on the other hand, may have elements of circularity and be complex to legislate and comply with.

However, officials note that if a life insurer does invest the assets of the policyholder into a reinsurance arrangement that earns the investment income of the policyholder by way of a reinsurance claim, then that investment would be life financial reinsurance and a financial arrangement. Proposed section EY 15(1)(c) which requires investment income to be recorded under GAAP would preclude that life financial reinsurance income from being investment income. Therefore that paragraph needs to be amended to include income from life financial reinsurance.

Recommendation

That the submission be declined, however, the words "or income derived from life financial reinsurance" be included in proposed section EY 15(1)(c).

Issue: Non-participating policies – average values

Submission
(53 – Ernst & Young, 67 – New Zealand Institute of Chartered Accountants)

Life insurers should be allowed to select a basis for calculating the average values that are to be used in the formula in proposed section EY 15(2). The basis must be applied consistently when apportioning such investment income.

Comment

Section EY 15(2) provides that in the event investment income may be shareholder gross income in terms of section EY 19, the investment income should be apportioned to the policyholder base income based on the average surrender value relative to the average savings assets. The bill does not prescribe the method to determine average surrender values.

The definition of "average surrender value" officials consider is a clear and understandable concept for life insurers and does not require further precision. If the apportionment was to result in an unfair apportionment of income, the life insurer could instead adopt the "equitable and reasonable" basis prescribed in section EY15 (4).

Recommendation

That the submission be declined.

Issue: Profit participating policies – average values

Submission
(53 – Ernst & Young)

The method to be used to calculate the average value in proposed section EY 17 should either be defined in the legislation, or life insurers should be allowed to select their own basis for calculating such averages, subject to applying their selected method consistently from year to year.

Comment

Proposed section EY 17 provides a formula for determining a life insurer's "policyholder base gross income" by reference to an *"average of policy liabilities over the income year"* and *"an average of the asset base's value over the year"* (paragraph EY 17 (1)(b)) but does not describe how the averages should be calculated.

Officials consider the concept of "average" should be readily understandable to life insurers and does not require prescriptive rules, provided life insurers calculate the "average" consistently.

Recommendation

That the submission be accepted, by allowing life insurers to select their own basis for calculating such averages, provided the method is applied consistently between income years.

Issue: Components of policies

Submission
(10 – New Zealand Society of Actuaries Inc)

It needs to be understood that the components of composite policies, such as the life risk component of premiums, will involve estimations, and the methods of estimation may vary between companies.

Comment

The proposed rules are largely based on calculations performed by life insurers which in turn are largely based on actuarial principles. Officials acknowledge that these calculations require professional judgement, and these judgements may legitimately vary between companies and will bring this understanding to bear when applying the new rules.

Officials note that the estimations have to comply with the definition of "actuarially determined". Conformity with this definition should reduce the estimates of life risk differences between life insurers.

Recommendation

That the submission be noted.

Issue: Shareholder base deductions

Submission
(33A – Investment Savings and Insurance Association of NZ Inc, 52 – Sovereign, 55 – Asteron)

The proposed legislation should ensure that all direct and indirect expenditure incurred by the life insurer is deductible in the shareholder base.

Comment

Proposed section EY 20 requires a direct nexus between the shareholder base gross income derived and the expenditure or losses derived. On this basis it is possible that some general and direct business expenditure incurred by the life insurer but not directly incurred in relation to the income will not be deductible under section EY 20. If so, this is contrary to the policy intent, and therefore needs to be remedied.

Proposed section DR 2(5) overrides the general permission for deduction of expenses and officials agree there is no guidance on the relationship between income. Submissions argue that, for example, some overheads in selling and administering a bond portfolio may have no direct nexus to income but would be deductible under normal principles, and officials agree that this expenditure should be deductible.

Officials therefore accept it is not clear what expenditure or loss in proposed section EY 20 might include and recommend the legislation be clarified.

Recommendation

That the submission be accepted.

Issue: Alternative method for apportionment between shareholder base and policyholder base

Submissions
(53 Ernst & Young, 55 – Asteron, 67 – New Zealand Institute of Chartered Accountants)

The legislation should be amended to allow life insurers to apportion the expenditure or loss between policyholder and shareholder base on a basis that is equitable and reasonable.

The requirement that the expenditure should have a nexus to policyholder base gross income should be removed.

Comment

Income should be split fairly between the shareholder and policyholder base and should be subject to as little manipulation as possible. If not, shareholders may generate imputation credits on true policyholder earnings. Also, some insurers with economically profitable businesses may end up with overstated net income on the policyholder base, and losses on the shareholder base leading to over-taxation, which could make the business unviable. Therefore, a nexus test must still be maintained.

Under proposed section EY 16, policyholder base gross expenditure is restricted to the extent that the expenditure is incurred in deriving policyholder base income as provided for in section EY 15.

As policyholder base gross income is solely investment income, it is arguable that life insurers will be able to deduct from the policyholder base only direct investment-related costs incurred by the insurer on that income (likely to be small). If non-direct investment expenditure and other overheads are not deducted against the policyholder base they will instead be deducted in the shareholder base under proposed subsections EY 20(2)(e) and (f). If this occurs it will lead to most expenses being deducted on the shareholder base generating losses, whereas the policyholder base could have substantial income and little allowable expense.

Officials agree that there should, however, be a trade-off with compliance costs, with one of the aims of the legislation to allow life insurers to use existing actuarial and accounting practices in determining income allocation.

Recommendation

That the submissions accepted in part, by allowing an apportionment basis between the shareholder and policyholder bases which is equitable and reasonable. However, the nexus test for expenditure on the policyholder base must still be maintained.

Issue: Deductibility of fees against policyholder base

Submission
(53 – Ernst & Young, 67 – New Zealand Institute of Chartered Accountants)

Proposed sections EY 16 and EY 18 should be amended to state that all fees and charges, including implicit charges included in premiums by life insurers to recover costs relating to the selling of and administration of policies, other than those relating to life and non-life risk, and claims will be allowed as deductions in the policyholder base.

Comment

In practice, the policyholder base gross expenditure is likely to comprise fees and charges made by the shareholder that are taxable in the shareholder base. Fees and expenses which life insurers charge policyholders relating to the execution and administration of policies are specifically income to the life insurers, but submissions argue it is not clear whether they have a direct nexus to income taxable by policyholders.

The intention of the rules is that the deductibility of fees and expenses to policyholders is consistent with their deductibility if the policyholders incurred the fees and expenses directly. Certain expenses relating to life risk cover which the submission argues should be deductible against the policyholder base would not ordinarily be deductible to policyholders if incurred periodically and so should not be deductible in the policyholder base. Therefore, only expenses related to deriving investment income should be deductible in the policyholder base.

Recommendation

That the submission be declined.

Issue: Fees gross-up

Submission
(52 – Sovereign)

The proposed rules create two separate tax bases between which charges are made, with the result that these charges become subject to tax. So that the life insurer maintains the same level of fee income under the new rules as under the existing rules, it will be necessary to gross up the fee by an amount equal to the tax payable on the income. To avoid the compliance costs and administrative issues if all relevant policies were required to allow fees to be grossed up, the proposed legislation should specifically permit insurers to gross up existing fees for the purposes of proposed sections EY 16 and EY 19.

Comment

Fees are usually determined by way of contract between the life insurer and the policyholder. As a practical matter, most contracts allow changes to their terms in the event of a change in law. It would be outside normal tax policy principles to amend contractual terms.

If tax legislation permitted a "gross up" it might imply that such an event was expected or mandatory, which would not necessarily be the case for each life insurer. Each life insurer will respond differently to the impact of the new rules, particularly as existing contracts will be subject to grandparenting.

Recommendation

That the submission be declined.

Issue: Reinsurance premiums and claims

Submission
(67 – New Zealand Institute of Chartered Accountants, 53 – Ernst & Young, 32 – KPMG)

Clarification on the inclusion of the amount of reinsurance claims received (shareholder base gross income) and reinsurance premiums (shareholder base expenditure) is required.

Comment

Chapter 5 of the discussion document *Taxation of the Life insurance business: proposed new rules*, suggested that only the risk portion of reinsurance premiums and claims must be included, which is consistent with the "introductory" subparagraphs of proposed sections EY 19 and EY 20.

However, officials note that some ambiguity arises because sections EY 19(2)(d) and EY 20(20(d) are silent on whether the full claim or premiums respectively or only the risk portion must be included in the shareholder base gross income and expenditure or loss. Those provisions should be qualified by reference to "the life risk component".

Recommendation

That the submission be accepted, and the legislation be clarified so that only the risk proportion of reinsurance claims paid by the life insurer (reinsurer) and premiums paid to the life insurer (reinsurer) is included in shareholder gross income and expenditure or loss respectively.

Issue: Capital guarantee reserves

Submissions
(10 – New Zealand Society of Actuaries Inc, 33A – Investment Savings and Insurance Association of NZ Inc, 53 – Ernst & Young, 67 – New Zealand Institute of Chartered Accountants)

Where the capital guarantee reserve comprises movements within policyholder funds, no movement should be attributed to the shareholder.

In circumstances where the shareholder is required to inject money, section EY 27(4) proposes a reflex adjustment for "capital guarantee reserving amounts" whereby a positive (taxable) in the shareholder base is expenditure or loss for the policyholder base and vice versa for negative amounts. This will apply to both participating and non-participating guaranteed investment contracts. This reflex adjustment should be amended to give capital treatment to the policyholder base.

Shareholders who transfer funds to support a capital guarantee in a participating capital guaranteed investment contract should be actuarially determined. *(Investment Savings and Insurance Association of NZ Inc)*

Comment

The approach in the draft legislation is to tax non-participating capital guaranteed investment contracts in a manner consistent with non-participating non-capital guaranteed investment contracts and to tax participating capital guaranteed investment contracts in a manner consistent with non-capital guaranteed contracts. This approach is generally supported by submissions.

The capital guarantee reserve (CGR) (or an equalisation or financial smoothing reserve) is a portion of the policyholder return which has been set aside. In times of poor investment performance, the reserve will typically be drawn upon to "top up" the amount credited to policyholders. In times of good investment performance, apportion of the investment return will typically be added to the reserve to support future crediting rates. The proposed legislation provides that movements in the reserve require adjustment for shareholder income or loss. However, there should be

no adjustment where there is simply a transfer between different policyholder funds, both of which are subject to tax.

Shareholder injections to support the capital guarantee, while rare, should have a revenue character for the shareholder base. Such guarantees, however, when paid by the shareholder may have a capital character for individual policyholders. However, CGRs also include a minimum return (investment guarantee) that is in excess of 0 percent on capital invested, and shareholder payments in respect of these are properly treated as revenue amounts.

To be consistent with the capital character of the replenishment of loss to the policyholder capital savings account, the loss that caused the depletion of capital should not be deductible to the policyholder.

These rules should apply to both participating as well as non-participating capital guaranteed investment contracts.

Recommendation

That the submissions be accepted in part, although officials recommend that payments representing a capital amount guaranteed should be deductible on the shareholder base, but not be taxable at the policyholder base. The loss that caused the depletion of capital is not deductible in the policyholder base. However, payments to maintain a minimum return should have revenue treatment on both bases.

Issue: Treatment of tax credits

Submission
(53 – Ernst & Young)

The application of tax credits and calculation of terminal tax between the policyholder and shareholder bases should be clarified.

Comment

Proposed section LA 8B provides for the apportionment of tax credits between the policyholder and shareholder bases. Proposed sections LA 8B(2), LE 2(1) and LE 2B(1) all provide rules for the treatment of excess tax credits.

Officials consider that the rules are clear in their operation and require no further clarification.

Recommendation

That the submission be declined.

RESERVES

The proposed new rules tax risk premiums and allow for deduction of risk expenses, including claims. However, the long-term nature of some life insurance contracts means that premiums derived may cover insurance services provided in the future. Therefore, reserves are required for unexpired risks to ensure equitable taxation.

The nature of claims expenses also require estimation. Movements in the outstanding claims reserve (which includes estimations of claims incurred but not reported) should be incorporated into the new tax rules to ensure a clear and equitable deduction.

The submissions received on reserves have generally not objected to the concept of reserves; rather they have concentrated on technical aspects of the proposed rules.

Issue: Premium smoothing reserve

Submissions

(10 – New Zealand Society of Actuaries Inc, 41 – AXA New Zealand, 53 – Ernst & Young, 67 – New Zealand Institute of Chartered Accountants)

A number of submissions were made on proposed section EY 25, entitled "Premium smoothing reserving amount: non-participation policies not annuities". While submissions generally did not oppose the underlying policy behind the concept of the premium smoothing reserving (PSR), they made a number of technical submissions on its drafting and mechanics:

- Every PSR calculated under subsection (3) has a zero result – for example, using the sub-headings in the definitions in (4) without the brackets.
- It is not clear why there is a reference in section EY 23 (5) to "an individual policy of a class," given the special grouping rule set out in section EY 25. *(New Zealand Society of Accountants Inc)*
- How is the profit margin to be calculated from year to year?
- How is new business to be grouped with existing business for the purposes of calculating the profit margin?
- The definition of "PSR period" requires clarification.
- How should a risk-free rate be determined?

Comment

The PSR is intended to allow life insurers to elect to allocate premium income that is taxable in the current period, and the portion that is taxable in future periods over different income years for any term insurance policies which:

- have a level, or substantially level, premium for more than one year during the PSR period; or

- have a material mismatch between the incidence of risk and the premium payable during the PSR period.

As the purpose of the PSR is to ensure life insurers are not taxed too soon on their premium income and is elective, the PSR can be seen to be taxpayer-friendly.

Unintended tax results occurred because of difficulties in translating actuarial concepts into tax legislative language.

The reason for the reference to an individual policy of a class in proposed section EY 23 (5) is to allow for classes of policies (for example, a yearly renewable term) where only some of the polices in the class may have periods of level premiums (for example, yearly renewable term policies where the premium is level for the first five years).

Otherwise, officials agree with the submissions on the need for greater certainty around the PSR and have addressed issues raised in the submissions. A draft version of the recommended changes to the legislation has been circulated to the New Zealand Society of Actuaries Inc, and Investment Savings and Insurance Association of NZ Inc.

Recommendation

That the submissions be accepted.

Issue: Calculation of reserves generally

Submission
(32 – KPMG)

Proposed sections EY 23 to EY 27 should be amended to define a life insurer's reserves in accordance with its financial reporting treatment.

Comment

The formulas in proposed sections EY 23 to EY 27 define what constitutes a life insurer's reserves. In some cases the financial accounting reserves such as the outstanding claims reserve will be the same for both financial accounting and tax purposes. However, differences arise between accounting and tax for acquisition costs (mainly commission and other expenses paid on a person taking out a life insurance policy generally called deferred acquisition costs (DAC)) which are deducted upfront for tax, whereas for accounting purposes these expenses are spread over the life of the policy. This tax treatment of DAC was very important to the industry, but means that for most reserving requirements in the new rules the financial accounting reserves cannot be used.

Recommendation

That the submission be declined.

Issue: Calculation of outstanding claims reserve (OCR)

Submission
(32 – KPMG, 52 – Sovereign, 33A – Investment Savings and Insurance Association of NZ Inc)

Reserving amounts, particularly the OCR, should be calculated on a gross basis using margin on services principles. Items included in the reserving amounts should not be present-valued.

Comment

An OCR is the provision in the balance sheet of 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. For financial accounting purposes, the OCR is calculated on, amongst other things, a present value basis. This is consistent with general actuarial and accounting principles. Use of the accounting basis permits an accurate deduction of the true economic cost of the outstanding claim. Otherwise a tax deduction could be made for the face value of the claim, notwithstanding that the actual cash in respect of the claim is not paid out until a subsequent tax year. It is also consistent with other changes contained in the bill relating to the OCR of general insurers.

Recommendation

That the submission be declined.

Issue: Opening value of outstanding claims reserve (OCR)

Submission
(32 – KPMG, 52 – Sovereign)

As there are fundamental differences between the current and the new rules, it is important that opening reserves are established so there will be no opportunity for amounts to be double counted or not picked up.

The simplest solution would be for opening reserves to be zero. However, this issue needs to be determined by an industry panel of experts.

Comment

Under the new rules, the opening claim position is an OCR and items within it are effectively excluded for tax. These items should be consistent with the claims that have been brought to account for tax under the old rules.

Because claims are often notified late and further time is needed to determine if a claim is valid, the mechanism of calculating the mortality profit for a year varies between life insurers:

- some may include estimates of claim amounts they expect to pay; and
- others may wait as long as possible before calculating the mortality profit and only include claims definitely settled up to that time.

Furthermore, under the current rules, if in the first year of the start of a policy the life insured party dies, no amount of mortality profit is brought to tax. If any such claims are notified in the future and the date of death was during the period of the current rules, any such claim may end up being taxed under the new rules. Officials agree that this is not intended.

Consistency between the current and new rules is relatively simple for non-participating businesses. The first opening OCR under the new rules needs to comprise claims which were not settled at the end of the last year under the current rules (including those incurred but not reported) but which were included in the calculation of mortality profit for that final year. No other claims should be included. These claims have effectively been deducted for tax and are excluded from a further deduction via the OCR mechanism.

For participating businesses, no claim deductions are allowed under the new rules. Claims therefore cannot be counted twice, although it is recognised that late reported claims will miss out altogether without some adjustments.

Recommendation

That the submission for a zero opening OCR, or a review by a panel of experts, be declined.

However, to ensure a correct opening OCR officials recommend proposed section EY 24(2)(a)(ii) be amended to clarify that the amount of the life insurer's OCR for the first year in which the new rules apply is the sum of the outstanding life risk component of claims not yet paid.

Issue: Outstanding claims reserve (OCR) for non-life policies

Submissions

(32 – KPMG, 52 – Sovereign, matter raised by officials)

Officials consider the movements in the OCR for non-life policies held by life insurers should be treated in a consistent manner as for life insurers holding life insurance policies, and general insurers.

KPMG and Sovereign do not agree.

Comment

The OCR is a reserve of an insurance company to provide for the future liability of claims which have occurred but which have not yet been reported to the insurance company or not yet settled.

The new rules propose that life insurers are able to claim a deduction for movements in the OCR on life insurance policies, and also propose to have similar tax treatment to general insurers who sell general insurance policies.

One aspect of allowing the deduction is that the future claims (that is, claims recognised in the current accounting period that will be paid out in a future period) are discounted to their present value.

Some life insurers hold policies that are not life insurance by definition – for example, disability income protection. These policies are therefore general insurance and not covered under the proposed life insurance rules. However, an unintended lacuna means that such policies do not fall within the general insurance OCR changes. This gap needs to be addressed. KPMG and Sovereign submit that their discounting the OCR to its present value is not consistent with common law concepts. However, officials consider there should be consistency of tax treatment between all life insurance and general insurance policies and so recommend declining KPMG's and Sovereign's submissions.

Recommendation

That the officials' submission be accepted and the other submissions be declined.

Issue: Unearned premium reserve (UPR)

Submission
(10 – New Zealand Society of Actuaries Inc)

The unearned premium reserve should be clarified to confirm that:

- the UPR includes the elements of premiums that relate to expenses, tax and profit, and is not restricted to the pure life risk element; and
- the use of the UPR is not compulsory for any class of policies.

Comment

A UPR is a reserve that contains the portion of the premium that has been paid in advance for insurance that has not yet been provided. The new rules provide life insurers with the alternative of using the UPR or the premium smoothing reserve to spread the recognition of premium income.

The UPR is generally understood for financial accounting purposes. However, to ensure there is no misunderstanding, the UPR can be defined as the submission suggests in terms of the financial accounting treatment.

Given the use of UPR and the PSR is elective under the proposed tax changes, there is no policy reason to be prescriptive in its use.

Recommendation

That the submission be accepted.

Issue: Transfer of business by non-resident and reinsurance

Submissions
(Matters raised by officials)

Section EY 24(2)(ii), "Outstanding claims reserving amount: non-participation policies not annuities", section EY 25(2)(ii), "Premium smoothing reserving amount: non-participation policies not annuities", and section EY 26(2)(ii), "Premium smoothing reserving amount: non-participation policies not annuities" each provide an opening balance adjustment in the current income year where there has been no closing balance returned as income in the previous income year. A number of technical issues arise with these provisions in the context of transferring life insurance business:

- The OCR calculated at the time of the transfer has been incurred for tax purposes and should be deductible to the seller, not the new owner.
- The UPR or premium smoothing reserve (PSR) calculated at the time of the transfer records the premium income due and receivable that is not subject to tax at the time of the transfer. That portion of the premium should be taxable to the new owner.
- When calculating the OCR, PRS or UPR on the date of transfer of a tranche of business reinsurance arrangements that do not qualify as life financial reinsurance, the purchaser's opening transfer OCR, PRS or UPR should be reduced by the equivalent reinsurance closing transfer capital guarantee reserve used for tax by the seller. If the reinsurance is not assigned to the purchaser, there should be no adjustment.
- The reference to closing balance and opening balances for business transfers is inappropriate. These amounts are calculated on the first day and the last day respectively of an income year. When a transfer occurs during an income year for the seller, the closing balance for that tranche of business is zero, and for the purchaser, the opening balance for that tranche of business is zero. The transfer amounts should not be closing or opening balance amounts but instead should be called transfer balances and calculated on the date of transfer.

Comment

There is a real possibility that the reserve tax values calculated by each party to the transfer could be significantly different. In particular, if the purchaser wishes to make its own reinsurance arrangements and the vendor has a reinsurance arrangement that it cancels or reduces after the sale, the reinsurance balance as at the date of sale should not be deductible to the vendor and neither should it be taxable to the purchaser. The vendor should not be able to claim a deduction for the reinsurance value just because the reinsurance was still in force at the time of the sale. It would be unfair to tax a purchaser on the reinsurance reserve when the benefit of the reinsurance was never acquired.

Recommendation

That the submissions be accepted.

PARTICIPATING POLICIES

A participating policy (also known as a "with-profits policy") is a policy where the policyholder is entitled to participate in distributions of profit. Conversely, a non-participating policy (also known as a "without-profits policy") does not enable the policyholder to participate in distributions of profit, examples being term life insurance and most unit-linked policies. Participating policies take the following forms (note they can also be in non-participating forms):

- **Whole of life insurance** – Premiums are level throughout the life of the insured. The policyholder is entitled to bonuses that add to the amount of the benefit and are also received on death or maturity of the policy. The policy guarantees payment of the sum insured, while also providing a share in the life insurer's profits. The policy can be cashed in or surrendered before maturity, although the time when the policy is cashed in will determine what amounts are received (which are generally at the discretion of the insurer).
- **Endowment insurance** – These have features similar to those of a whole of life policy but the sum insured is payable upon the survival of the insured life to a certain age or date, or upon prior death. As with whole of life policies, there is considerable actuarial involvement as a result of the interplay between the insured's mortality and investment return.

Until the 1980s, the most common products offered by life insurance companies were the traditional whole of life and endowment products. Since then traditional policies have declined, with most life insurers ceasing to write new business several years ago. Nevertheless, the products still comprise a material part of many life insurers' business.

The current rules over tax policyholder savings (for reasons discussed in Chapter 2 of the discussion document, *Taxation of the life insurance business: proposed new rules*). Taxation of participating profits is a complex area of life insurance tax, with a variety of approaches adopted internationally. One of the key issues with the taxation of participating policies is in accurately allocating the economic returns to shareholders and policyholders. The scheme of the proposed rules contained in the discussion document was changed for the bill to take into account a number of submissions on the discussion document. The proposed rules on participating profits in concept have received support from Asteron. The New Zealand Society of Actuaries Inc, while noting that the rules contained in the bill were different from that contained in the discussion document, also noted that alternatives were being considered between officials and the industry, and so would not comment further.

Some submissions offered an alternative model of allocating, (I)nvestment income minus (E)xpenses. Officials consider that the approach submitted by Investment Savings and Life Insurance Association of New Zealand Inc and some life insurers, with some modifications is suitable to be adopted for New Zealand purposes, in addition to incorporating the PIE rules for the policyholder base income.

Issue: Allocation of taxable profit

Submissions

(10 – New Zealand Society of Actuaries Inc) 41 – AXA New Zealand, 33A – Investment Savings and Insurance Association of NZ Inc, 55 – Asteron)

The formula allocating taxable profit between the shareholder and policyholder bases should be amended so that the shareholder proportion is included to contain the present value of shareholder transfers that is part of the Margin on Services (MOS) liabilities. The shareholders' interest should be defined as the proportion of the participating assets that are represented by:

Shareholders' retained funds + present value of future shareholder transfers

These amounts are discernable from life insurers' financial accounts.

Defining *r* as (shareholder retained funds / total participating funds) and *s* as (Percent Value of future shareholder transfers / total participating funds) there should be three elements to the taxation of participating business and these should be reflected in the proposed rules:

- Tax on the *(1 – r)* portion of the fund. This should be *(1 – r)* x (tax rate x (I pie – E)).
- Tax on the *r* portion of the fund. This should be *(r x tax rate x (Is – E) + s x tax rate x (Is – I pie))*. That is the tax due on the shareholders' funds plus the additional tax from *(Is – I pie)* on the shareholders' interest contained in the policy liability).
- The imputation credit account should be credited with *(r + s) * tax rate * (Is – E)* as this is the total tax paid by the shareholders.

Comment

The proposed formulas contained in the bill aim to allocate taxable profit between the shareholder and the policyholder, with the policyholders' income being subject to the PIE rules.

The proposed legislation attempts to separately identify shareholder and policyholder components via a number of formulas which use a combination of the "gate" (g) and the proportion of the fund that is attributable to the "liabilities proportion" (p). The "liabilities proportion" is intended to represent policy liabilities as applied in a MOS approach.

Proposed section EY 17 provides the policyholders' share of participating business gross income as *(1+p x g)/(1+g)*.

Proposed section EY 21 provides the shareholders' share as *(1–p) x g / (1+g)*.

While the principles underlying the proposed formulas are generally accepted by some submissions (and subsequent consultation with stakeholders) as theoretically sound, in practical terms, the formulas may not give the correct allocation because the liabilities proportion does not represent exclusively policyholder interests. In particular, assets backing the liabilities proportion include assets generating future transfers to the shareholders. These assets are exclusively shareholder interests. To the extent that the liabilities proportion includes shareholder interests, the formula will incorrectly allocate participating business income to the account of policyholders. On the other hand, ensuring the taxable profit is taxed in line with the split that actually occurs via the "gate" mechanism will better approximate the shareholders' portion of profit.

Officials accept that:

- the calculation of "valuation premiums" (as required in the calculation of "Other Profit" in the draft legislation) would be very difficult in respect of existing business; and
- the item of "premiums – premiums estimate" in the draft legislation seeks to identify the quantum of bonus loadings (and the shareholder profit element contained in the bonus loadings). Because most premiums rates were set at the time these products were popular and expense rates were considerably lower than current levels, the levels of bonus loadings are very small or almost non-existent for existing business. Consequently the element of shareholder profit realistically contained in premiums for existing business is very small or non-existent; and
- because of the very existence of retained shareholder earnings and present value of future shareholder transfers (see above) in the with-profit fund there will be profits distributed to shareholders in the future, although it is almost impossible to identify how much of those distributions have been taxed in the past as they accrue; and
- it is quite possible for shareholder profits to be generated in the future from existing business (for example, by favourable mortality experience of surrender profits).

Recommendation

That the submissions be accepted.

That, for the application for the formulas, both r and s be calculated as the average values of the items at the start and end of the year.

That it be noted that it may be necessary to re-visit the allocation of (I-E) on a change in accounting or actuarial standards.

Issue: Proposed formula – "other profits"

Submission
(41 – AXA New Zealand, 55 – Asteron)

The inclusion of "other profits" should be removed or, alternatively, should apply only to new products.

If "other profits" is included in taxable income for future contracts, the basis for calculating these items of this formula should be consistent with that used for current financial reporting (margin on services (MOS)).

Comment

The basis for taxation of participating policies is comprised of three main components:

I(nvestment income) less E(expenses) Plus O(ther) P(rofit)

For participating savings business, I-E is an appropriate basis and is consistent with that used in some other jurisdictions.

"Other profits" was included in the bill to protect against potential manipulation of the items in taxable income with respect to future participating contracts.

Officials accept that requiring insurers to calculate "other profits" will increase compliance costs in circumstances with existing participating policies, where there is no apparent ability to manipulate I-E.

Accordingly, it is appropriate to find a simpler way of identifying and calculating (albeit approximately) "Other Profit" for existing business.

A suitable method of calculating "Other Profit" for existing business, and one which officials have been advised is relatively simple to perform under current accounting and actuarial standards is to define "Other Profit" as:

> *"Actual"* less *"Expected"* for all cash flows and end-of-year policy liabilities
>
> Where:
>
> *"Actual"* is the actual cash flows and policy liabilities experienced,
>
> *"Expected"* is the expected amounts based on the prior year's valuation assumptions.

This calculation of "Other profit", while not as rigorous as the calculation of "Other Profit" contained in the bill, is acceptable to officials for **existing business** – that is, policies sold prior to a date to be determined. **Existing business** would be defined to include policies taken out after the relevant date as a result of existing conversion rights (such as whole of life policies converting to endowment).

This method was discussed with members of the New Zealand Society of Actuaries and Investment Savings and Insurance Association of NZ Inc and was generally accepted as being fair and workable.

However, it may be possible for an insurer to develop products which could circumvent the intentions of the new tax rules. Therefore, the calculation of "Other Profit" contained in the bill will be retained for **future business**.

Officials therefore recommend that life insurers be provided the option of excluding OP for participating policies sold by 30 June 2009 (being close to the likely date when the current bill is reported back). The legislation will allow this alternative treatment to continue for pre-1 July 2009 policies which are converted into other participating policies, such as when whole of life policies are converted to endowment. The legislation should also confirm that premium increases on pre-1 July 2009 participating policies to meet increases in the CPI will not affect the status of the policy.

In these circumstances the use of MOS reporting will keep compliance costs down.

Recommendation

That for the purposes of existing business, "Other Profit" be replaced with an "Actual less "Expected" formula for policies sold before 1 July 2009.

That existing business be extended to include new policies arising from conversion rights contained in any policies existing on 30 June 2009.

That the draft legislation remains unchanged for new business (other than policies taken out under existing conversion rights).

Issue: Gross or net of tax discount rate

Submission
(Matter raised by officials)

Proposed section EY 28(9) defines policy liabilities using the expression "present value". Present value is defined in section YA 1 and specifies "... discount rate, gross of tax ..." and "... face value, gross of tax ...".

For the purposes of section EY 28(9), the discount rate should be net of tax. A gross of tax is appropriate for the calculations of the premium smoothing reserve (proposed section EY 25); and outstanding claims reserve (proposed section EY 24) but a new definition is needed for proposed section EY 28 and other relevant provisions.

Comment

Present value concepts should reflect whether the income will be subject to tax. Following discussion with the New Zealand Society of Actuaries Inc, officials agree:

- the current definition of “present value” be renamed “present value (gross)” and also be amended by removing the words “gross of tax, “after the words “face value”;
- a new definition be inserted “present value (net)” which is the same as “present value (gross)” except that “”gross”: is replaced with “net”;
- in proposed sections EY 24 and EY 25, all references to “present value” be replaced with “present value (gross)”;
- in proposed sections EY 28, all references to “present value” be replaced with “present value (net)”; and
- in proposed sections EZ 56 and EZ 58, all references to “present value” be replaced with “present value (net)”.

Recommendation

That the submission be accepted, and the bill be amended as described above.

Issue: Shareholder-base gross income – profit participation policies

Submission
(33A – Investment Savings and Insurance Association of NZ Inc)

Proposed section EY 21 should be clarified to ensure that it does not require life insurers to treat the capital gains exclusion applied within wholesale PIE funds in which shareholder assets are invested, to be reversed in the calculation of shareholder tax.

Comment

Proposed section EY 21 defines how shareholder gross income from participating business is to be determined. Paragraph (a) of the formula in that section specifies that section CX 55 should be “ignored” so that gains from the disposal of directly held qualifying New Zealand and listed Australian equities should be included in that calculation. Submissions argue that it is not clear whether the instruction to ignore section CX 55 should be restricted to relevant equities held directly by the life insurer or be extended to include relevant equities held through a PIE.

All shareholders in all New Zealand companies are able to take advantage of the exclusion from taxable income specified in section CX 55 by investing through a PIE. It would therefore be inequitable for a life insurer to be required to take these gains into consideration in the calculation of the profit from participating business.

Therefore, we agree that the legislation needs to make it clearer that this is not the intent.

Recommendation

That the submission be accepted.

Issue: Claims estimates

Submission
(41 – AXA New Zealand)

Surrenders should be included in claims estimates.

Comment

For the calculation of "other profits" in proposed section EY 28(5) surrender profits (or losses) arise when the surrender value paid is less than (or greater than) the policy reserve. As surrenders are already included in claim items, they are technically not required to be included in claims estimates.

Recommendation

That the submission be declined.

Issue: Shareholder transfers

Submission
(2 – Murray Hilder, 41 – AXA New Zealand, 55 – Asteron)

Shareholder transfers to assets supporting participating policies should be deductible in the shareholder base.

Comment

Although the circumstances are considered to be rare it is possible, when market values of assets supporting participating policies dramatically drop, the shareholder will have to make a transfer back to the fund to maintain its solvency. These injections should be deductible to the shareholder as they are part of the life insurance business and relate to the income earning process. Conversely, any transfers to the shareholder should be taxable in the shareholder base.

Recommendation

That the submission be accepted. Transfers back to the shareholder should be taxable in the shareholder base.

REINSURANCE

Reinsurance allows the insurance industry to spread its losses among more companies, lessening the impact of claims on any one company. The life insurer (the reinsured) reduces its possible exposure on either an individual life insurance policy (facultative arrangement) or a large number of life insurance policies (treaty) by giving (ceding) a portion of its liability to another insurance company (the reinsurer). Any reinsurance arrangement the life insurer makes does not affect the insurance policies that it writes for its policyholders and is still liable to pay its policyholders for insured losses regardless of the reinsurance coverage. The policyholder will most likely not even be aware that his or her coverage has been reinsured.

The current and proposed rules treat reinsurance as life insurance by definition. Under the proposed rules a deduction is available to the reinsured for life risk for premiums paid, and life risk claims are taxable on reinsurance arrangements offered or entered into in New Zealand. The proposed new rules also contain an anti-avoidance provision to counter tax advantages for financial reinsurance – that is, financing arrangements more similar to financial arrangements than to financial reinsurance.

Issue: Definitions

Submissions
(32 – KPMG, 56 – Swiss Re, 67 – New Zealand Institute of Chartered Accountants, matter raised by officials)

A definition of "policy" should be inserted into the proposed rules and should apply to "reinsurance" as follows:

1. For transitional rules a "policy" refers to a reinsurance arrangement (whereby no looking through is required). *(KPMG, Swiss Re, New Zealand Institute of Chartered Accountants)*
2. For ongoing life insurance business (outside of the transitional rules), a "policy" should be apportioned in a manner similar that effectively relates to its different life insurance components. *(KPMG, Swiss Re, New Zealand Institute of Chartered Accountants)*
3. General insurance needs to be specifically excluded from the definition of "life reinsurance". *(Matter raised by officials)*
4. Definitions are required for "life reinsurance premiums" and "life reinsurance claims". *(Matter raised by officials)*

Comment

All of the submissions under this heading raise related issues regarding the incorporation of reinsurance into the proposed life insurance rules. The intention of the rules is that the shareholder is taxed on life risk premiums with allowance for life risk reinsurance premiums and life reinsurance claims.

Reinsurance is by definition life insurance. Section EY 12 provides a definition for "life reinsurance" which assumes the only purpose of life reinsurance is to secure against risk, including financial. This definition is so wide that general insurance cover undertaken by a life reinsurer would also fit this definition. This is contrary to the policy intent of the proposed rules which are aimed at the taxation of life insurers. To ensure there is no ambiguity contained in the bill, officials agree general insurance needs to be specifically excluded from the definition as generally insurance reinsurance is subject to its own specific rules.

Proposed sections EY 19 and EY 20 make it clear that only the life risk portion of premiums and claims are included, but allow for the inclusion of "life reinsurance claims" and "life reinsurance premiums". These two items are not defined anywhere and should be. They should be defined so that it is clear that "life reinsurance premiums" means the life risk portion of reinsurance premiums and "life reinsurance claims" means the life risk portion of reinsurance claims.

The transitional provisions refer to life insurance "policies". The use of the term "policies" does not fit with the business of reinsurance as technically, reinsurers do not offer "policies" but rather enter into reinsurance contracts or treaties directly with life insurers.

From the reinsurer's perspective the intention of the grandparenting rules apply to reinsurance as follows:

- Reinsurance treaties should be subject to the five-year grandparenting period but only to the extent they do not cover the reinsurance of any savings part of savings policies.
- Where the reinsurance treaty comprises level term policies, the reinsurer can elect to look through the treaty on a policy-by-policy basis.
- Reinsurance of savings policies are not subject to the grandparenting rules.

Therefore, for transition purposes, the terms applying to the individual reinsured policy, as set out in the treaty, should determine the extent of transition rules applying for that policy.

On an ongoing basis, the reinsurer should be able to elect to look through to the underlying components of the treaty, as it may wish to look through for PSR purposes. It should not be a compulsory requirement, as to do so would place an unreasonable burden on reinsurers and it is not likely that there will be a great disparity between the reinsurer's taxable income and accounting profit. Therefore, the submission is partly accepted.

Investor income that arises from savings policies reinsured should be taxed under the financial arrangement rules. In the reinsurer's case, this should be included in policyholder base income.

Recommendation

That the submissions be accepted in part, with an election for a reinsurer to look through the treaty to the underlying policies.

That appropriate changes be made to give effect to the policy intent discussed.

Issue: Transition – looking through the treaty

Submission
(56 – Swiss Re)

The rules should be clarified so that grandparenting should be available at the election of the reinsurer by treaty, for reinsurance treaties entered into before the application date for the greater of the duration of the treaty or five income years.

Comment

As discussed earlier, reinsurance often groups numbers of individually reinsured policies under one treaty. The transition rules should apply as if the individual policy was reinsured as a single reinsurance arrangement, even though it may be grouped with others under a treaty. Reinsurers who are able to identify the underlying policies can incur the additional compliance costs should they wish and look through the reinsurance treaty to the underlying policies. That is, the terms applying to the individual reinsured policy, as set out in the treaty, should determine the extent of transition rules applying for that policy.

Recommendation

That the submission be declined. The grandparenting rules in section EY 29 will be clarified to apply to the individual reinsured policy, as discussed earlier.

Issue: Reinsurance transition – treaties

Submission
(52 – Sovereign)

The proposed legislation should be amended to clarify that reinsurance agreements entered into before the application date of the proposed legislation are not subject to the new rules.

Comment

Reinsurance involves spreading life insurance risk between other life insurers. Although, as discussed earlier, there are definitional ambiguities which we recommend be clarified, there is no policy reason to treat a reinsurance treaty any differently from the life insurance policies which it reinsures. The transitional rules contained in proposed section EY 29 therefore properly reflect the intention that reinsurance agreements are subject to the grandparenting rules, which, with appropriate qualifications discussed earlier, are consistent with the rules applying to life insurance policies.

Recommendation

That the submission be declined.

Issue: All reinsurance premiums and claims should be respectively taxable and deductible

Submissions
(32 – KPMG, 53 – Ernst & Young, 67 – New Zealand Institute of Chartered Accountants)

All life reinsurance policy claims should be assessable income and all life reinsurance policy premiums should be tax deductible. Accordingly, proposed section DR 2 and the corresponding life reinsurance claims provision should not be passed into legislation.

If this submission is not accepted, the proposed life insurance rules require amendments to ensure that a portion of reinsurance premiums derived by offshore reinsurers are subject to New Zealand tax, by way of a withholding tax. In this situation, all life reinsurance policy claims and premiums must still remain assessable and deductible.

Comment

Proposed section DR 2(3), which disallows a deduction for certain reinsurance premiums and the corresponding life reinsurance claims provision which relate to contracts offered and entered into outside New Zealand, essentially tax New Zealand-sourced life insurance (and reinsurance) on a portion of the profits derived by offshore reinsurance companies. However, submissions argue that offshore reinsurance companies are also subject to tax on the same income in their home country.

Proposed section EY 12, including recommended changes, will provide that life reinsurance premiums will be deductible and reinsurance claims will be taxable to life insurers only when the relevant reinsurance policies are offered or entered into in New Zealand.

The submissions argue that reinsurance premiums are a normal cost incurred by a life insurer in carrying on its business of insurance and should be deductible on that basis, irrespective of whether the reinsurer is onshore or offshore.

Officials consider the reference to policies "offered or entered into in New Zealand" relates to the current rules, under which non-resident life insurers and life reinsurers are taxable in New Zealand on life insurance policies offered or entered into in New Zealand under sections EY 48 and YD 4(17).

The submissions argue that this will not result in the under-taxation of life insurance profits in New Zealand, where life insurance business is reinsured offshore, for the following reasons:

- If the cross-border transaction takes place within the same group of companies, New Zealand (and offshore) transfer pricing rules will ensure that an appropriate profit margin is left in the New Zealand reinsurance company and will therefore be subject to New Zealand income tax.
- If the cross-border transaction occurs between unrelated parties, commercial forces will work to ensure that the transaction occurs at market value and the New Zealand reinsurance company earns an appropriate profit margin which will be subject to New Zealand income tax.

Officials are not convinced by these arguments. Most reinsurance companies which transact with New Zealand life insurers operate from outside of New Zealand. In addition, most life insurers operating in New Zealand are parts of internationally headquartered branches of multinational companies. If full tax treatment of reinsurance contracts is entered into or offered outside of New Zealand, there could be the possibility that a life insurer's business was fully reinsured offshore, with no means (other than withholding tax, which is discussed later) to ensure a level of New Zealand taxation.

The application of current transfer pricing rules in this situation is unclear, and would therefore require significant work to ensure sufficient base maintenance.

The New Zealand reinsurer will be taxable on its reinsurance premiums less claims. In this situation, it is no different from the life insurer. How the foreign reinsurer is taxed, including on its foreign income, should not determine New Zealand tax policy.

The submissions' second suggestion, if the primary one is declined, is that the proposed life insurance rules be amended so that all life reinsurance policy claims and premiums are assessable and deductible but an "as agent" regime is overlayed to ensure that a portion of reinsurance premiums derived by offshore reinsurers is subject to New Zealand tax applying a specific withholding tax. However, withholding taxes are arbitrary in determining taxable profits, costly to administer, and create complexities when dealing with double tax treaties. A withholding tax system is therefore outside the scope of the current life insurance tax reform.

Recommendation

That the submissions be declined.

Issue: Alternative tax treatment of reinsurers

Submission
(32 – KPMG)

The proposed treatment of reinsurers (as opposed to life reinsurance contracts) should be as follows:

- Life reinsurance premiums and claims will be netted off against premiums and claims in the shareholder income calculation.
- Life financial reinsurance will be taxed under the financial arrangement rules (with no deduction for premiums). Legislative confirmation is required to make it clear the FIF rules will not apply to life financial reinsurance (that is, financial reinsurance should not be an interest in a foreign life insurance policy, for the purposes of the FIF rules).
- The new rules will not apply to "existing" reinsurance contracts for a period of the later of five years or the duration of the contract.

Comment

The submission argues that the rules in relation to life reinsurance should be confined to "true" reinsurance (effectively defined as policies that transfer underwriting risk only and where there is a business purpose for the transfer of such risk). If this definition is not met, the contract would be treated as a financial arrangement.

Officials do not see any major difference between this proposal and the proposed rules, and to create a special scheme as suggested would unnecessarily add to the complexity of the legislation.

We are not aware of any case law ruling or generally accepted interpretation that financial reinsurance constitutes a foreign investment fund, and so it would be superfluous to clarify in legislation that it is not.

Recommendation

That the submission be declined.

Issue: Consistency of life reinsurance premiums and claims

Submission
(32 – KPMG, 52 – Sovereign, 56 – Swiss Re)

An equivalent provision to proposed section DR 2(3) (which disallows a deduction for certain life reinsurance premiums) should be included in proposed section CR 2 to ensure that life reinsurance claims received by a life insurer are not assessable income where the premium has been treated as non-deductible.

Comment

Proposed section DR 2(3) states that a life insurer is denied a deduction for life reinsurance policy premiums if the policy was offered or entered into outside New Zealand.

However, there is no corresponding section included in any of the income provisions of the Income Tax Act 2007 or the bill, which states that life reinsurance claims received by a life insurer in relation to policies offered and entered into outside New Zealand are not assessable income.

This is not an intended policy result and is the result of a drafting error.

Recommendation

That the submission be accepted.

TRANSITION

The transition rules recognise that moving from one taxing regime for life insurance products to another affects the pricing of products, and requires new systems and processes. The proposed transition rules cover grandparenting of existing term insurance policies, deemed realisation of policyholder investments before entering the portfolio investment entity (PIE) rules, and the treatment of tax balances (losses, imputation credits, and tax paid) carried into the new rules.

Submissions, including those from KPMG, AXA New Zealand and Sovereign, expressly supported the policy underlying the transition rules. Other submissions related to PIE implications of entry in the new rules, extending the period of grandparenting, seeking grandparenting for specific types of policies, clarifying some aspects of the legislation, and miscellaneous technical matters.

Issue: Deemed sale on entry to new rules

Submission

(33A – Investment Savings and Insurance Association of NZ Inc, 35 – PricewaterhouseCoopers, 41 – AXA New Zealand, 52 – Sovereign, 67 – New Zealand Institute of Chartered Accountants)

The requirement to deem a disposal at market value in proposed section EZ 61 should not apply to assets where a gain would not normally be recognised or where it would be inappropriate, such as foreign shares, interests in PIEs and shares in subsidiaries.

Comment

Proposed section EY 61 provides that a life insurer is deemed to dispose of its assets that support the policyholder income formula on the last day of its income year under the current life insurance tax rules, for market value and immediately reacquire the assets for the same market value. The reason for this adjustment is to align the cost base of assets used in calculating the life office base income with that used to calculate the policyholder base income as policyholder base income has its assets marked-to-market each year in its tax calculation. This is to ensure that double-taxation does not occur under the new rules from recognising gains from historical cost basis when the assets had already been marked-to-market under the current policyholder income calculations.

However, officials agree that it would be unusual for a life insurer to dispose of an interest in a PIE which would trigger taxable income when in other situations a PIE interest could be redeemed without triggering a tax liability. We therefore agree that the deemed disposal should not apply to an interest in a PIE. This should not apply to a PIE that is a portfolio-listed company as there is generally no way to transfer these shares without recognising taxable income.

Because disposals of foreign shares generally do not trigger a tax liability under the fair dividend rate (FDR) rules, officials note that the deemed disposal should be of no consequence. The deemed disposal does not mandate realisation for tax purposes, and the general provision in the FDR rules that a disposal is ignored for the tax calculation still applies.

The deemed disposal is meant to apply only to investment assets held by the life insurer, so there should be no deemed disposal of a subsidiary unless the subsidiary is a vehicle for holding investments. This limited application is meant to be covered by requiring that there be a deemed disposal only of assets supporting the policyholder income formula. Therefore no change to the bill is required with respect to the sale of shares in subsidiaries of the life insurer.

Recommendation

That the submission be accepted in part, by specifying that the deemed disposal on entry will not apply to interests in PIEs, other than portfolio-listed companies.

Issue: The tax on the gain from the deemed sale on transition should be paid over three years

Submission
(52 – Sovereign, 53 – Ernst & Young, 67 – New Zealand Institute of Chartered Accountants)

The tax on the gain arising from the deemed disposal on entry into the new rules should be paid over three years. This was done for entry into the PIE rules and is meant to mitigate the cost arising from a large disposal which was not actually realised.

Comment

The transition rule for the PIE rules provided that all assets held by managed funds which elected to become a PIE were deemed to be sold at market value immediately before entering into the PIE rules. The resulting tax could be paid over the next three years to mitigate tax-flow concerns arising from a large deemed tax disposal which was not actually realised.

Current rules effectively bring to tax (in the policyholder income calculation) realised and unrealised movements in investment assets which are used in the life insurance business. However, the impact on life insurers is likely to be appreciably less than it is for managed funds when they entered the PIE rules in 2007. This is because as discussed earlier, there will be two large categories of investment assets not taxed on realisation under current rules when they were before – PIE interests and foreign shares subject to the FDR rules. Hence the need for relief is much smaller.

Further, taxpayer experience has shown that the three-year payment rule in the PIE transition has been very difficult to comply with as it requires identifying the amount of tax attributable to a particular transaction and overriding usual provisional tax and use-of-money interest rules. Given the lower magnitude of tax at stake on transition into the new life insurance tax rules, officials do not recommend a three-year payment provision.

Recommendation

That the submission be declined.

Issue: Tax balances carried into the new rules

Submission
(Matter raised by officials)

Any overpayment of income tax under the current rules by a life insurer on the life office base, whether or not there is an imputation credit account balance of the same amount, should be carried into the new rules and be used to satisfy both shareholder-base and policyholder-base tax liabilities. An imputation credit will not be generated when applying the overpayment against any tax liability.

Comment

The initial intention of the new rules was that overpayments of tax by a life insurer on the life office base could be carried into the new rules to be used to satisfy shareholder base liabilities. These tax balances arise by overpayments of income tax on the current life office base, including those made to satisfy policyholder base liabilities (in which case, there would not be a sufficient imputation credit account balance to obtain a refund of the overpayment).

However, as the shareholder base plus policyholder base is basically the continuation of I(nvestment income)-E(penses)+ U(nderwriting profit), which in very broad terms are constituents of the current life office base, it is equitable that any past tax overpayments can be used to satisfy liabilities arising from both the new bases. No imputation credits should be generated by the satisfaction of the tax liabilities, as there is no new payment of tax. Nor will any imputation debits arise in the policyholder base when the tax liability is satisfied.

This recommended change is seen as being taxpayer-friendly.

Recommendation

That the submission be accepted.

Issue: Allowances for increases to cover

Submission
(52 – Sovereign, 53 Ernst & Young, 67 – New Zealand Institute of Chartered Accountants)

Proposed section EY 29(1)(b) provides that the grandparenting provisions will not be affected if the amount of the insurance cover in post-application date years does not increase by more than the greater of 10 percent of the previous year's insurance cover or a percentage change in the CPI index for the previous year.

The provision should be clarified in respect of the following:

- date(s) on which the actual measurement must be done;
- date on which the previous year's cover must be determined, and the effect of previous year's increases or decreases in the cover; and
- the position if the insurance cover, for a period in the income year, does not exceed the prescribed limits.

Comment

The purpose behind proposed section EY 29 is to ensure that only existing policies contracted under the current tax rules are subject to grandparenting. Life insurance contracts that have materially changed in nature, such as with increased levels of cover, are in substance new contracts, and so should not enjoy the benefits of the current rules over the grandparenting period. However, officials do recognise that many policies have a built-in increasing cover provision, generally to recognise the impact of increases in the CPI. For example:

- An individual policy might be increased at any time (unconnected with any anniversary).
- There may be no annual anniversary (some policies may have reviews which are not yearly).
- New lives may be added to a policy at any time not connected with anniversary.
- Group policies pose special problems because they may not have anniversaries as such; they may add new lives at any time and the amounts of cover may vary all the time.

The transition rules should have flexibility when allowing life insurers to measure changes in the level of cover, depending on their own procedures. However, to prevent possible manipulation of increase in cover by using different review dates between income years, the life insurer should make a one-off election to determine the review date. The election should be made in the first year of the application of the grandparenting rules for each class of policy.

Recommendation

That the submission be accepted. The test for changes to policies, whether individual or multi-life and group policies should be subject to a one-off election by the life insurer in the first income year of the application of the grandparenting rules on either the anniversary review date of the policy, or annually, for each class of policy.

Issue: Meaning of "first entered into"

Submission
(10 – New Zealand Society of Actuaries Inc, 52 – Sovereign, 53 Ernst & Young, 55 – Asteron, 67 – New Zealand Institute of Chartered Accountants)

Proposed section EY 29 (1) refers to policies "first entered into before 1 April 2009". The discussion document (page 6, para 1.10) refers to "policies taken out" and "product sold". The commentary on the bill does not clarify the matter either and refers to "policies sold".

Comment

The purpose of the provision is to isolate which policies have been sold before being subject to the proposed rules and which are therefore eligible for grandparenting. There is sometimes a lengthy process of the proposal for and issuing of an insurance contract. Often an insurer will cover the person for death by accident while the underwriting process is taking place.

As a large number of policy applications are not accepted by the life insurer, to reduce compliance costs life insurers should be able to elect either that the grandparenting rules apply to a product "issued" (that is, the life insurer accepts the risk on the life of the individual) or when an application for cover is made and a deposit received in respect of that cover from an individual, if either is made before the application date. Note that if an application is made and deposit received and the policy is not accepted it would not be subject to grandparenting in any case.

Recommendation

That section EY 29(1) replace at the option of the life insurer, either when the policy is "issued by the life insurer" or "when the policy is applied for and a deposit is received in respect of the application".

Issue: Grandparenting provision – risk portion

Submission

(53 Ernst & Young, 67 – New Zealand Institute of Chartered Accountants)

Proposed section EY 29(1) applies to life insurance policies (entered into before 1 April 2009) "for which the life insurer has no policyholder gross income or expenditure or loss".

This provides limited relief from the proposed rules for policies sold before the application date that include not only a life risk component but also a savings element.

Comment

The policy intent of grandparenting rules is to maintain the concessionary tax treatment for a certain period in circumstances where policyholders purchased products that were structured on the basis of the prevailing tax rules. However, savings products are not, in officials' view, subject to concessionary tax treatment.

Recommendation

That the submission be declined.

Issue: Negative amounts

Submission

(67 – New Zealand Institute of Chartered Accountants)

Proposed section EY 29(4) appears to conflict with subsection (6) because subsection (4) provides for an adjustment that is calculated for a class of policies, while subsection (6) implies that the calculation (referred to in subsection (4)) must be done on an individual policy basis.

Comment

Section EY 29 details the grandparenting rules for products acquired before the application date. Subsection (4) calculates the exclusion adjustment based on certain classes of policies while subsection (6) (which ignores negative amounts arising from the application of the adjustment formula) applies on a policy by policy basis. The intent of the legislation is that there should be no negative amounts applying to individual policies (which could otherwise be subsumed with positive amounts from other policies if included in a class).There is therefore no conflict between the two subsections.

Recommendation

That the submission be declined.

Issue: Full grandparenting of all risk policies

Submissions

(10 – New Zealand Society of Actuaries Inc, 33A – Investment Savings and Insurance Association of NZ Inc, 35 – PricewaterhouseCoopers, 52 – Sovereign, 55 – Asteron)

Proposed section EY 29 provides for five years' grandparenting of risk policies that are not single, level, or guaranteed premium policies. A number of submissions were made for full grandparenting for all risk policies, based on the following arguments:

- There is little practical difference between an annual renewable term (ART), also known as a yearly renewable term, or rate for age, policies, and a level premium or guaranteed premium products. All products are priced off the same mortality tables and the same assumptions are made with respect to the expected duration that the cover will be maintained.
- Life insurers will be incentivised to write level premiums or guaranteed products, or to transfer existing ART policyholders to level terms. This amounts to an artificial preference based on tax treatment.
- After the five-year period there will be price increases which will affect the affordability of premiums.
- ART policies are long-term arrangements.
- Full grandparenting will allow existing policyholders to maintain a level of premiums that was anticipated at the time the policy was taken out.
- The five-year period is arbitrary and reference to international precedents of life-tax regime change (for example, that of Australia) is not relevant to New Zealand.

Alternatively, if the proposed rules are not changed, the five-year minimum period should be extended to the average period that a life policy is held. In its written submission, Sovereign says this is 10 years, but in its oral presentation to the Committee on 19 March, it said that this was 7 years.

Comment

As with any major industry reforms, the new life rules are intended to apply immediately unless there are reasons, including that of fairness, to delay their effect. For example, existing arrangements may be grandparented and excluded from the scope of the new rules for a particular time. Officials consider such reasons apply in the case of single premium policies and level-term policies because policyholders had acquired policies on a price-certain basis, and this price had been determined by the life insurer based on the prevailing tax rules. Although there may be a legal ability for life insurers to ask for price increases on level term and similar policies, officials accept that for commercial reasons it is unlikely life insurers would request existing policyholders to pay extra premiums. In fairness to life insurers and policyholders, such policies are grandparented for the period of the policy or while there is a level term.

These circumstances are not the same with ART policies. The annual premiums on these policies are affected by a number of factors other than simply the mortality tables. These include tax changes. As ART premium prices may be immediately affected by non-tax factors, it could be questioned why tax should be treated in isolation. However, as a matter of fairness, officials accept that the proposed change should not immediately affect premium prices and therefore policyholder expectations resulting from tax changes.

Officials consider five years is a sufficient transition period for ART policies. The need for tax reform has been discussed with the industry since mid-2006, and the broad changes to the rules have been in the public domain since February 2007. Given the likely enactment date of the legislation and our recommended application date for the new life rules, the period between enactment and the end of the five-year period will be very close to six years. This is not dissimilar to Sovereign's industry's calculation of the average life of a policy of seven years.

With regard to specific arguments raised in submissions:

- Policyholders choose between ART and level term policies based on their individual circumstances (such as age, family responsibilities, and financial commitments) and preferences. ARTs have lower premiums than a level term policy bought for the same level of cover at an equivalent time, and increase with age. Level term policies are higher than ART initially but at some point in time will be lower than the equivalent ART. The different types of policies are therefore not directly comparable.
- Policyholders will have to determine whether they should convert an existing ART for a level term before application, taking into account matters listed earlier.
- Officials have addressed the issue of affordability of premiums earlier.
- Given ART premiums could change for any number of reasons, it is unlikely that policyholders have specific price expectations beyond a short period. In any case, given the average duration of holding a policy, it appears that the vast majority of policies contracted for before the enactment of the new rules will have terminated in any case.
- Consistency with similar jurisdictions is a relevant consideration. It should also be noted as part of the most recent Australian life insurance tax reform, in respect of the taxation of management fees (one of the major changes), 50 percent of the fees were taxable under the new rules during the period. The full grandparenting under the proposed rules is concessionary in comparison.

Recommendation

That the submissions be declined.

Issue: Group life policies

Submissions

(52 – Sovereign, 53 – Ernst & Young, 67 – New Zealand Institute of Chartered Accountants)

Proposed section EY 29 should be amended by including group life policies in force on the application date for a minimum of five years, regardless of whether employees join or leave and without regard to the 10 percent cap on increases in cover.

Where rates are guaranteed before and/or during the grandparenting period, the policy should be grandparented for the life of the guarantee.

Comment

Group life comprises two broad categories – compulsory and voluntary. Voluntary business is broadly similar to individual policies in that employees may elect to take out cover and enter into a separate policy.

The issue here is with compulsory business cover which is sold to employers via one master policy and the employer pays one premium in respect of all employees. Life insurers typically guarantee the underlying rate table for any employer scheme, and the rates vary by age and sex. Each underlying rate table is based on the mix of employee occupation classes at the time the policy is issued.

The initial premium is set on the basis of who is employed at the time, using the underlying rate table agreed with the employer, and is typically guaranteed for a period. Despite any rate guarantee, the master policy's premium changes every year to reflect:

- the employees that have joined or left the employer's company;
- changes to the ages of those still employed; and
- changes to the sums assured of those employed, which are usually based on a multiple of their salary.

The nature of compulsory group life business gives rise to a number of unique considerations in relation to the application of the grandparenting rules, including the following:

- Employees may join and leave a group compulsory scheme throughout the term of the policy. In these circumstances officials consider it appropriate if the relevant policy (being the master policy) is entered into before the application date.
- When rates are guaranteed for a group compulsory scheme, the underlying rate table that the scheme will use in the future is guaranteed, but the insurer has no knowledge of who will be covered as a risk in the future, given the fact that employees come and go. As a result, the premiums could go up or down each year. In our view, the rates guarantee in existence at application date should be considered as being guaranteed for the purposes of the transition rules.

- Group compulsory schemes have only one master policy, and the total sum assured of the master policy is spread across a number of employees. If the number of employees increases in any year so that the total sum assured increases by more than 10 percent, then the 10 percent cap would be breached. Officials, consider that it is inappropriate for grandparenting to be lost in this situation.
- The 10 percent cap could also be breached if employees are provided salary increases of more than 10 percent in any one year (because the sum assured is linked to salary). This does not represent any change in the amount of cover agreed at the inception of the policy – cover continues to be set at the same multiple of salary. Officials consider that breaches of the 10 percent cap as a result of increased salaries only should not result in the loss of grandparenting.
- Schemes may be re-rated (that is go onto a new underlying rate table) within the five-year grandparenting period, thereby extending the guarantee beyond the five-year grandparenting period. Significant practical difficulties in terms of rating will arise if insurers are required to provide separate underlying rate tables for the periods before and after grandparenting applies. The most practical solution would be to extend grandparenting until the expiry of the five-year period of the group life policy provided the original guarantee was made prior to the application date of the proposed life tax rules.

Proposed section EY 29(4) provides an adjustment from the shareholder base for the grandparented amount of the relevant class of policies using the formula:

premium – total reserving amounts –
(1.2 x expected death strain)

"Death strain" is defined in terms of existing lives on the final day of each tax year. New group business does not contribute to the death strain as defined, as the new lives covered do not exist on the first day. But, under the proposed rules every death claim which relates to the new life will produce a loss to the extent of the amount of the claim, but with no associated income.

Therefore, to include group policies as proposed will require an amendment to the adjustment formula to account for the new lives subject to grandparenting. The easiest way to achieve this is by excluding from "claim" the relevant grandparented claim arising from new lives.

Recommendation

That the submissions be accepted for employer-sponsored group life policies only, and that the guarantee period apply only to rates that are guaranteed at the time of application of the proposed life tax rules for a maximum of five years from the application date. Existing lives only can be covered under the grandparenting rules provided increases in individual cover are only for increases in salary or wages of the insured employees on terms applying on or before the application date of the proposed rules. The adjustment formula contained in proposed section EY 29(4), should be amended to exclude grandparented claims on new lives on employer group policies.

Issue: Master policies including credit card repayment insurance

Submissions

(10 – New Zealand Society of Actuaries, 52 – Sovereign)

Master policies (other than group life schemes) with either a fixed level of cover per customer or a variable sum insured should not be subject to the 10 percent increase in cover rule contained in proposed section EY 29(1)(b)(i). *(New Zealand Society of Actuaries)*

Fluctuations in insurance cover under credit card repayment insurance (CCRI) should be disregarded for the purposes of proposed section EY 29(1)(b)(i). *(Sovereign)*

Comment

Section EY 29(1)(b) provides that the transitional provisions contained in section EY 29 will apply to policies existing before the application date of the legislation if:

> "the amount of insurance cover does not increase for the relevant income year by more than the greater of–
>
> (i) 10% of the previous year's insurance cover; and
> (ii) the percentage change in the consumer price index for the previous income year."

A "master policy" is a single contract coverage on a group basis issued to an employer (in the case of group life) or to another entity. Individual policyholders, however, are covered by the terms of the insurance. CCRI is provided by way of master policy and provides cover for the amount of credit card debt outstanding at the time a credit card statement is issued. The premium is also determined at that date. The amount of cover provided by a CCRI policy fluctuates on a regular basis and, from month to month, the amount of cover can increase by substantial amounts on a percentage basis. It is likely that many CCRI policies that would otherwise be subject to the transitional provisions would breach the 10 percent cover increase requirement.

A further complication is that credit card providers may offer credit limit increases to cardholders that could result in insurance cover increases of over 10 percent. The insurer has no control over these credit limit increases.

Master policies have similar considerations to employer-sponsored group life policies discussed earlier. Where the rates of cover are guaranteed at the application date of the proposed rules, and the terms of the master policy are unchanged from those applying at the application date, the master policy should be treated consistently with employer sponsored group life products. The maximum grandparenting period should be five years from the application date.

Given the nature of CCRI policies and similar master policies, officials therefore consider that it is inappropriate to apply the 10 percent cover increase requirement to these policies.

Recommendation

That the submissions be accepted, with the grandparenting period only applying to rates that are guaranteed only on the terms of the master policy at the time of the application of the proposed rules. The maximum grandparenting period will be five years from the application date.

Issue: Meaning of "cannot be changed" and "guarantee"

Submission
(32 – KPMG, 33 – Investment Savings and Insurance Association of NZ Inc, 41 – AXA New Zealand, 55 – Asteron)

The requirement in proposed section EY 29(2) that the rate of premium for a level term insurance policy "cannot be changed" needs to be removed or clarified by applying to a policy for which the rate of premium is always the same amount.

Comment

Proposed section EY 29(1)(b) provides that the transitional provisions contained in section EY 29 will apply to a policy exceeding five years where the premium cannot be changed or during any period of guarantee.

Level term policies do not always strictly guarantee premiums and may, in some instances, allow the premium to be changed at the insurer's discretion. Generally, however, life insurers take into account commercial constraints to raising premiums and so do not intend to change the premium.

Officials consider the policy intent of this provision can be achieved where premium prices are in fact not changed. Provided the rate of premium on the level term policies remained the same and subject to the other considerations included in the rules, officials agree that this transitional provision should continue to apply.

Recommendation

That the submission be accepted, provided the rate of premium does not in fact change.

Issue: Split policies

Submission

(52 – Sovereign)

New policies entered into for the purposes of a division of relationship property should be treated as having been entered into on the same date as the original policy for the purposes of proposed section EY 29. Policies split for other purposes should also be treated as having been entered into on the same date as the original policy where the cover provided remains the same.

Comment

It is not uncommon for two (or more) lives to be assured under one policy – as happens, for example, when spouses are covered by a policy. In the event of a division of relationship property (for example, on dissolution of marriage), Sovereign advises that it "splits" the policy so that separate policies continue for each life assured. The terms of the "split" policies otherwise remain the same as the original policy. Policies may also be split in other circumstances. For example, where there is a desire for life cover provided in respect of a policyholder's children to be split into a separate policy.

As the bill is currently drafted, one of the "split" policies will constitute a new policy. Where the split occurs after the application date of the legislation, the transitional provisions would then not apply to that policy despite the fact that the original policy would continue to enjoy the benefit of the transitional provisions (assuming it was entered into before the application date).

Officials consider the "split" arises from the actions of the policyholder. While the terms of the new policy may be similar to the original, it is a new contract and should therefore not enjoy transitional relief.

Recommendation

That the submission be declined.

Issue: Reinstated policies

Submission

(52 – Sovereign)

To the extent a reinstated policy would give rise to a new contract, the transitional rules should continue to apply if the policy was originally entered into before the application date of the bill despite the fact it lapses and is reinstated after that date.

Comment

It is not uncommon for policies to lapse or be cancelled as a result of policyholders missing premium instalments. Sovereign advises its practice is to revive/reinstate lapsed policies within a minimal period after lapse (typically up to 90 days) if the unpaid premium is met. Its analysis indicates that approximately 4,000 policies are reinstated by Sovereign annually. Of those, approximately 2,400 policies are reinstated within 30 days of lapsing.

As currently drafted, the transitional provisions may not apply to these policies if taken out before the application date despite the fact they are reinstated on the same terms and are treated by Sovereign as never having come to an end.

If the transitional provisions did not apply to reinstated policies, reinstatement could be offered only on the basis of adjusted premiums reflecting the new tax rules.

Officials consider that it is appropriate in these circumstances to treat policies that are entered into before the application date of the bill but reinstated after that date to continue to be subject to the transitional rules, subject to certain limitations.

Recommendation

That the submission be accepted, provided that the reinstatements are made within 90 days of lapsing and that the insurer does not treat the reinstated policy as a new policy.

Issue: Application of transitional provisions where cover increases by more than 10 percent

Submission
(52 – Sovereign, 41 – AXA New Zealand, 33A – Investment Savings and Insurance Association of NZ Inc)

Increases in cover pursuant to "special events" and "future insurability" options should be disregarded for the purposes of proposed section EY 29(1)(b).

Comment

The submissions advise that a number of policies issued by life insurers provide the policyholder with the option to increase insurance cover under the policy on the happening of a "special event" (for example, the birth of a child). In addition, in some cases the policy will provide a "future insurability" option that permits cover to be increased without further underwriting. If cover increases on exercise of these options by more than 10 percent (or CPI if greater), section EY 29(1)(b) will not be satisfied and the policy will cease to be subject to the transitional rules.

The submissions argue that tax considerations would drive policyholder behaviour to not exercise these options. In addition, increases of cover for “special events” or on exercise of a “future insurability” option are specifically contemplated by the policyholder at the time of entry into the policy and an expectation in respect of premium levels for that increased cover is also established at that time.

The 10 percent cap was permitted to allow policyholders some flexibility in extending existing policies. Any relaxation of this concession would allow new policies to be created under “special” circumstances. Officials consider that the exercise of an option implies the creation of a new policy if made after the application date of the proposed new rules. These policies should not be subject to the grandparenting rules.

Recommendation

That the submission be declined.

MISCELLANEOUS TECHNICAL ISSUES

Submissions were received on various sundry technical issues that are not covered under any of the preceding headings.

Issue: Application of PIE rules to life fund PIEs

Submission

(32 – KPMG, 33A – Investment Savings and Insurance Association of NZ Inc, 41 – AXA New Zealand, 52 – Sovereign)

When attributing PIE income for life fund PIEs, the rates to be used should be a 21% flat rate. Some submissions suggested a blended or composite rate which reflected the weighted average of the tax rates of policyholders in the particular fund.

Comment

The bill proposes to allow life insurers to elect into the PIE rules for "life fund PIEs to address concerns about the differing treatment of savings via life insurance products compared with other forms of saving. The bill prescribes that income will be attributed at the current company tax rate (currently 30%) unless the insurer elects to attribute income to policyholders at their individual PIE rates for unit-linked products.

The submissions claim that a significant number of policyholders are on PIE rates of less than 30%. However, Sovereign considers few life insurers would elect into the PIE rules as the costs of implementing the systems required to comply with the PIE rules are expected to be significant. Therefore, Sovereign considers a 21% rate will be an appropriate pragmatic proxy.

Officials consider that life fund PIEs should be treated consistently with other PIEs, which do not attribute income of the investors' tax rates. This would not be achieved by adopting a proxy rate of tax. As the PIE rules are elective, life insurers will each have to make commercial judgements regarding entering the rules.

Recommendation

That the submission be declined.

Issue: Savings products with immaterial risk

Submission

(52 – Sovereign)

Life insurers should have the option to elect to disregard the life risk component of a policy where the life insurer can establish that the life risk component of the premium received is likely to comprise less than one percent of the total premium.

Comment

The proposed legislation requires that for traditional/savings products that are not profit participation policies, life insurers must split premiums received between the life risk component and the savings component. Some products have only a very minimal life risk component, and officials consider that the compliance costs likely to be incurred in determining the split of premiums for these products will greatly outweigh any tax payable in respect of the life risk component.

Officials consider these compliance costs could be removed if life insurers were entitled to elect to treat these policies as not including a life risk component when a life insurer determines on reasonable grounds, that the life risk component of the total premium is likely to be less than one percent. Officials anticipate that this election would only be made when the split of premiums is not required for financial reporting purposes. Therefore, officials recommend that the proposed legislation be amended to allow life insurers to choose to disregard the life risk component of a policy when the life insurer can establish, on reasonable grounds, that the life risk component of the premium received is likely to comprise less than one percent of the total premium.

Recommendation

That the submission be accepted.

Issue: "Actuarially determined"

Submission

(10 – New Zealand Society of Actuaries Inc, 32 – KPMG, 41 – AXA New Zealand, 52 – Sovereign)

The definition of "actuarially determined" contained in section YA 1 should be amended to remove the requirement for the determination to occur by the time of filing the return, and the consistency with general practice requirement should be amended to take into account that the bill requires modifications to general practice.

Comment

The bill defines “actuarially determined” to include a requirement that the actuarial certification be done by the time for filing a return. This requirement presents some practical and technical difficulties.

It would mean that a failure to calculate the required amounts using an actuarial method by the required time either leaves the (current) primary methods to apply inappropriately or leaves no amount of income or expenditure to be brought to account. It also would mean the Commissioner is unable to actuarially determine an amount unless that is done before the return is filed. This is contrary to the self-assessment system and would also make it impossible for the Commissioner to audit a life insurer.

The definition also requires compliance with general practice. The proposed rules themselves mandate approaches to actuarial calculations which change general practice assumptions and approaches. This means that an actuarial determination cannot technically comply with the Act or the definition.

Taking these considerations into account, officials are satisfied from discussions with members of the actuarial profession and Inland Revenue’s operations personnel that it is impractical to ask the life insurer to provide the assumptions, methodologies, bases and working calculations. The information is unlikely to improve the accuracy of the returns and will not provide any material assistance to the investigators when completing their life insurer risk reviews or audits. It is therefore not required.

Paragraph (b) of the definition states that the definition will not be satisfied where the calculation of the amount (by an actuary):

(i) does not accurately reflect the insurer’s business experience;
(ii) is not made according to usual practice; or
(iii) is part of a tax avoidance arrangement.

The requirement to file a return is appropriately dealt with in the Tax Administration Act. Including a penalty for failure to meet deadlines in the substantive rules is inappropriate and against the principles of the recent rewrite of income tax law. That legislation also requires sufficient records to be maintained by the taxpayer to enable the Commissioner to access their tax liability if this is required. Officials consider section 22(7) of the Tax Administration Act 1994 should be amended to make it clear that the Commissioner’s powers extend to request the documents and other materials required for the operation of the life insurance rules.

Finally, there are no current actuarial standards which cover the calculation of tax, but there is a code of conduct for the actuarial profession with standards that could influence how tax calculations are carried out.

However, officials consider that there should still be some objective standard by which the estimate is calculated, and which is consistent with actuarial practice. Subparagraph i) refers to “accurately” which is a higher standard than is usually used in tax law, and which is problematic to assess when dealing with an estimate. Accordingly, officials recommend retaining subparagraph (i) but substituting the word “reasonably” for “accurately”.

Recommendation

That the submission be accepted in part, and the definition of "actuarially determined" in section YA 1 be amended by removing the anti-avoidance proposals except, as discussed earlier, and removing the certification requirements, and that the Tax Administration Act 1994 be amended as discussed above.

Issue: Refunds of unexpired premiums

Submission
(10 – New Zealand Society of Actuaries Inc)

Clarification of the intended tax treatment is sought in the following circumstances:

- single premium policies that provide risk cover but may have some amount returned to policyholders if the policy is cancelled before its natural expiry;
- refunds of premiums after various periods in respect of certain death cover-only policies.

Comment

The definition of "savings product policy" requires a policy to have a "surrender value", and a "surrender value" specifically excludes refunds of unexpired premiums.

A surrender value in ordinary circumstances only arises when there is some savings element in the policy. The two situations described do not refer to savings policies.

Where the premium income has been returned as income in the shareholder base and is subsequently refunded, officials agree there has to be a mechanism to allow the life insurer a deduction in the shareholder base for the amount refunded.

For premium payback products there may be a mis-match between the amount of risk premium returned as income and premium payback deducted as a claim. For example, a premium received before the commencement of the proposed new rules or under the new rules but subject to transitional relief, should not be the subject of a shareholder deduction when repaid.

Recommendation

That the submission be accepted, and section EY 20(2), which outlines a life insurer's shareholder base expenditure or loss for non-participation policies be amended to include "unexpired premiums" and "premium payback amounts", but should only cover premium paybacks at the end of the contracted policy term to the extent those premiums have been returned as income under section EY 19(1), except where a transitional adjustment has been made under section EY 29. Both these terms will be appropriately defined in section YA (1) to encapsulate the types of policies noted in this submission.

Issue: Meaning of "class of insurance policy"

Submissions
(53 – Ernst & Young, 32 – KPMG, 67 – New Zealand Institute of Chartered Accountants)

The meaning of the phrase "class of policies" must be clarified. *(Ernst & Young, New Zealand Institute of Chartered Accountants)*

Officials should confirm that leaving "class" of life insurance policies undefined is intended and accepted so that disputes are minimised. If this is not intended, then what constitutes a "class" of life insurance policies should be defined. *(KPMG)*

Comment

The phrase "class of policies" is frequently used in the provisions relating to the reserves (see, for example, sections EY 23 to EY 27, and EY 30). Ideally, a life insurer should be able to apply the new rules in the most compliance-effective manner. Therefore classes of policies can be not only in terms of the broad types of risk policies (for example, annual renewable, level term and so on), but specific products, or even in terms of the dates issued (for example, those subject to grandparenting).

While officials consider that the intention underlying "class of policies" is clear, a definition would ensure there is no ambiguity in interpretation. The Actuarial Standard PS 3 definition of "related policy group" provides guidance by referring to "substantially the same contractual terms and conditions and prices on a basis of substantially the same occupations".

Recommendation

That the submissions be accepted, and that "class of policies" be defined to be "substantially the same contractual terms and conditions and priced on a basis of substantially the same assumptions". This follows the definition of "related policy group" in the Actuarial Standard PS3.

Issue: Capital revenue boundary

Submissions
(32 – KPMG)

- Inland Revenue practice needs to support the ability to apply the capital/revenue distinction effectively (and without dispute).
- Consideration could also be given to providing the tax exemption on Australasian share trading gains, under the PIE rules, to shareholders.

Comment

In a change from the current rules, where life insurers have been required to treat all their investments as being held on revenue account, ordinary principles will determine whether an asset held by a life insurer is held on capital or revenue account.

Most of these principles were developed as a result of a long line of case law often referred to as the "banking and insurance" cases and which apply to life and general insurers and banks.

In accordance with these cases, investments held for the purposes of a life insurance business are generally held on revenue account. Whether an item is on capital or revenue account has, however, always been a mixed question of fact and law.

Application of these principles has been modified in certain cases by the PIE rules, including the tax exemption on Australasian share trading and FDR rules. However, to ensure consistency between life insurers and similar financial institutions, and with the earlier established principles, there are no policy reasons to extend further tax exemptions on trading gains to the shareholders of the life insurer.

Recommendation

That the first submission be noted.

That the second submission be declined.

Issue: Late elections

Submission
(32 – KPMG)

Section EZ 62 should be amended to allow the Commissioner to accept an election at his/her discretion to treat an amount as policyholder base gross expenditure or loss after the time the relevant income tax return is required to be filed with Inland Revenue.

Comment

Consistent with the general loss offset provisions included in subpart IC of the Income Tax Act 2007, the Commissioner should be able to use his/her discretion in accepting late elections (that is, after the date in which a return is required to be filed) to allow an amount to be treated as policyholder base gross expenditure or loss, provided the other requirements of section EZ 62 are met.

Recommendation

That the submission be accepted.

Issue: Remove references to schedular policyholder base

Submission
(32 – KPMG)

All references to the "schedular policyholder base" should be changed to "life fund PIE base" and the taxation of each base should be made explicit and clear.

Comment

The submission argues that the description of a life fund PIE as the "schedular policyholder base" of a life insurer is confusing and misleading. This is compounded by the reference to two bases of taxation when there are in effect three: shareholder base, policyholder base and life fund PIE base.

Officials consider the drafting is consistent with the core design principles of income tax legislation. The reference to "schedular policyholder base" is consistent with those core principles. Subject to the minor drafting clarifications discussed in this report, officials consider that the taxation of the various components of shareholders and policyholders income is clear, and do not require further clarification.

Recommendation

That the submission be declined.

Issue: Treatment of annuities

Submission
(32 – KPMG)

The tax treatment of annuities should be considered alongside any changes to the taxation of life insurance.

Comment

The bill proposes to approximate the current taxation of annuities by taxing the net income of annuity products in the shareholder base. However, subject to Ministers' approval, an issues paper suggesting a basis for annuity taxation and inviting discussion, is planned for release in the near future.

Recommendation

That the submission be declined.

Issue: Definition of "surrender value"

Submission
(Matter raised by officials)

The definition of "surrender value" in Section YA 1 should be clarified to include a gross-up for unpaid premiums, and loans advanced against the surrender value or interest charged on these amounts.

Comment

The proposed definition of "surrender value" is contained in section YA 1, and is also relevant, amongst other things, in the definition of "savings product policy".

The definition of "surrender value" is used in the calculation of policyholder base income in proposed section EY 15. "Surrender value" is also included in the definition of "savings product policy" which is also involved in section EY 15 when determining the apportionment of income under the formula in section EY 15(2).

The unpaid premiums, loans advanced against the surrender value or/and interest are debts against the value of the policy and so should not reduce the surrender value of the policy for the purposes of investment income attribution. However, lapsed policies, where the gross surrender value is less than the policyholder debt, should be excluded from the savings policies as they have been legally terminated as a result of a breach in their contractual terms.

Also, a loan on the policy and interest accrued on the loan is a liability of the policyholder and should not be netted off against the surrender value when apportioning with total assets that do not include those liabilities. Until such time as the policy lapses, the interest expense accrued on overdue premiums should be deductible to the policyholder base as a cost of investment earnings and deductible under section EY 16. Such a deduction should not be available for interest on a loan secured against the policy surrender value as the purpose of the borrowing is not connected to the policy and the policyholder base investment earnings.

Recommendation

That the submission be accepted.

Issue: Definitions of "premium" and "claim" and sale of a life insurance business

Submission
(Matter raised by officials)

The definitions for life insurance claims and premiums should expressly exclude any amount paid on the transfer or sale of a life insurance business; otherwise such a capital payment could be inadvertently taxed under section EY19(2)(b) or deducted under section EY 20(2)(b).

Comment

Proposed section EY 19(2)(b), entitled "Shareholder base gross income: non-participation policies", includes as income "the life risk component of the premiums they derive". This would potentially include the payment received by a seller on sale and transfer of a tranche of life insurance business.

The components of such a payment will include all the components of the balance sheet (including any relating to non-life business), being assets less liabilities (including goodwill and reserves). For instance it may include:

- general insurance business, including reserves (unearned premium reserve and outstanding claims reserve), other policy reserves, general expense provisions and goodwill on that business;
- investments – assets and liabilities; and
- life business reserves, including policy reserves.

Under the new life rules, any gains or losses on sale or transfer will be subject to tax under the general tax rules; common law will prevail to determine whether profits or losses on sale of the investment assets will be subject to tax. Only gains on those investment assets held on revenue account will be subject to tax under the new rules. However, other assets net of liabilities, could perhaps be expected to be related to the long-term business of insurance and be held on capital account.

Such net assets could be held by the life insurer on revenue account if, for example, that life insurer was in the business of buying and selling insurance businesses. Any such gain should be taxable to the shareholder under section EY 19(2)(e) as investment income derived.

Thus, no special rules are required to deal with the sale except to ensure the same tax reserves are applied for the buyer and the seller.

However, the definition of a life insurance "claim" under section EY 7(1)(b) "includes a payment made by a life insurer on the transfer of some or all of its life insurance business". This is no longer appropriate because the common law distinction will apply to that transfer. On the other hand, the definition of "premium" under section YA 1 is very wide and potentially includes an amount received by a purchaser. It should therefore exclude a payment received by a life insurer on the transfer of all or part of a life insurance business.

In the definition of “claim”, officials recommend deleting the word “includes” and replacing it with the word “excludes”.

Recommendation

That the submission be accepted.

DRAFTING MATTERS

Issue: Complexity

Submission
(10 – New Zealand Society of Actuaries Inc)

Concerns are raised about the complexity of the drafting of the proposed legislation.

Comment

Concerns about the drafting have specifically been raised about deficiencies in the operation of the premium smoothing reserve and the difficulty for taxpayers in having to discern the meaning of the definition "policyholder base gross expenditure and loss" across an extensive number of cross-references.

Life insurance presents drafting challenges in translating complex actuarial concepts (such as the "premium smoothing reserve", which spreads the derivation of premium income in a manner fair to taxpayers) into appropriate legislative language. Life insurance is an inherently complex business, and any tax legislation will inevitably have an element of comparative complexity to adequately deal with the subject matter.

Officials accept the comments raised about the operation of the premium smoothing reserve and have made specific recommendations in this report under the heading "premium smoothing reserve" to deal with the problems identified. Officials have also recommended a number of changes addressed in this report that help clarify some complex issues.

Recommendation

That the submission be noted.

Issue: Technical review

Submissions
(10 – New Zealand Society of Actuaries Inc, 32 – KPMG, 33A and 33B – Investment Savings and Insurance Association of NZ Inc, 43 – Ascendant Consulting Limited)

A range of concerns have been raised about the technical quality of the legislation and that a technical review by a panel of experts is required for the following reasons:

- The quality of the legislation is questionable. *(New Zealand Society of Actuaries Inc)*

- The bill contains a number of drafting errors both substantive and remedial. The presence of these errors requires an increased level of scrutiny by taxpayers and makes it more difficult to discern the policy intent. A consultative approach to the legislation should have been adopted. *(KPMG)*
- The highly technical and specialised nature of life insurance and life insurance taxation means that the legislation would benefit from further consultation by a recognised panel of experts. *(Investment Savings and Insurance Association of NZ Inc)*
- The errors in the legislation make it unworkable. It is not enduring or robust. *(Ascendant Consultation Ltd)*

The Investment Savings and Insurance Association of NZ Inc submitted that the life insurance provision be excluded from the current bill and included in a later tax bill.

Comment

Officials have received (and continue to receive) expert actuarial advice from senior actuaries from PricewaterhouseCoopers, about the technical accuracy and commercial practicality of the policy design and drafting of the legislative changes to the taxation of life business. Therefore, we consider that an expert review panel is not required. Also, as this officials' report recommends a number of amendments that should address other concerns, there is no reason for delaying the reform of life insurance taxation by inclusion of the legislation in a later bill.

Recommendation

That the submissions be declined.

Issue: Officials to be flexible

Submission
(35 – PricewaterhouseCoopers)

Officials should be flexible in dealing with drafting and technical issues as they arise over time.

Comment

Drafting and technical issues will arise over time as life insurers implement new systems and processes to cater for the new rules and in the transition period. Many issues are not yet known at this time.

Recommendation

That the submission be noted.

Issue: Consistency

Submissions

(10 – New Zealand Society of Actuaries Inc, 32 – KPMG, 33A – Investment Savings and Insurance Association of NZ Inc)

A number of comments have been made about the consistent use of terms or the use of imprecise terms.

Examples of what appear to be different words used for the same concepts are:

- "Reserve" is used for business other than participating, and "policy liabilities" for participating business.
- Claims are said to be "received" in section EY 28(6)(d) and to have "occurred" in section EY 24(4)(a).
- Premiums are described as "always the same amount and cannot be changed" in section EY 29(2)(a), and "guaranteed" in section EY 29(2)(b). *(New Zealand Society of Actuaries Inc)*
- Section EY 23(1) uses the phrase "risk component". This term is not used elsewhere in the life insurance changes and should be changed to "life risk component".

Comment

Submissions have made a number of useful suggestions and, where appropriate, these have been incorporated into the proposed legislation arising from the changes recommended in this report.

Recommendation

That the submissions be noted.

CROSS-REFERENCES AND OTHER ITEMS OF A MINOR NATURE

Submission
(32 – KPMG, 53 – Ernst & Young, 67 – New Zealand Institute of Chartered Accountants, matters raised by officials)

A number of omitted cross-references, misleading section headings and other items of a minor drafting nature have been identified. All section references are to those proposed in the bill:

- In section CR 1, "schedular income" is not listed as a defined term.
- In section CR 2, there is an incorrect cross-reference to "policyholder gross income".
- In section DR 1, "business" is not listed as a defined term.
- In section DB 23(2), the defined terms "portfolio investment entity", "life fund PIE", "life insurer" or "PIE" no longer feature in section DB 23. The references are no longer relevant and should be removed.
- The title of section DR 1 should be amended to "Policyholder base gross expenditure or loss of life insurer and exclusions".
- The title of section DR 2 should be amended to "Shareholder base gross expenditure or loss of the life insurer and exclusions".
- In section EY 1, "policyholder base" and "shareholder" base are listed as defined terms.
- In section EY 2, "amount" and "profit participation policy" are not listed as defined terms.
- In section EY 3, "life risk" is not listed as a defined term.
- In section EY 4, "income" and "policyholder base gross income" are not listed as defined terms.
- In section EY 12, the definition of "life financial reinsurance" has a double negative that requires re-wording to avoid ambiguity.
- In section EY 15, "actuarially determined", "income" and "life risk" are not listed as defined terms.
- In section EY 15, "Gross" was omitted from the heading. It should refer to "policyholder base gross income…".
- In section EY 16, "income year" and "life insurer" are not listed as defined terms.
- In section EY 17, "profit participation policy" is incorrectly listed as "profit participation".
- The heading above section EY 19 should be amended to "Shareholder base excluding profit participation policies".
- The title of section EY 19 should be amended to "Shareholder base gross income: all income excluding profit participation policies".

- The title of section EY 19 should be amended to “Shareholder base gross expenditure or loss: all income excluding profit participation policies”.
- In section EY 20, “life insurer” and “life risk” are not listed as defined terms.
- In section EY 24, the income year before the current year is not defined as the “prior year” as it is in section EY 25.
- In section EY 24(2)(a)(ii), there is a typographical error and the section should be updated to refer to the “prior year”.
- In section EY 25, “actuary”, “income year” and “life insurer” are not listed as defined terms.
- In section EY 28, “actuary”, “asset base”, “shareholder base gross expenditure or loss” and “shareholder base gross income” are not listed as defined terms.
- In section EY 29, “life insurance policy”, “policyholder base gross expenditure or loss” and “policyholder base gross income” are not listed as defined terms.
- Section EY 29 should also specifically refer to reinsurance treaties.
- The heading above section EY 29 should be amended to “Transitional adjustments – life risk and annuities”.
- The title of section EY 30 should be amended to “Transitional adjustments – annuities”.
- In section EY 30, “life insurance policy”, “shareholder base gross expenditure or loss” and “shareholder base gross income” are not listed as defined terms.
- In section EZ 53, “amount” is not listed as a defined term.
- Section EZ 59(1) includes an incorrect section reference. Replace the section references as follows: “For the purposes of sections EY 54 to EZ 57 actuarial reserves…”
- In section EZ 59, “income year” is not listed as a defined term.
- In section EZ 60, “actuarially determined” is not listed as a defined term.
- In section EZ 62, “policyholder base” is not listed as a defined term.
- In section IT 1, “amount” is not listed as a defined term.
- In section IT 2, “amount” and “policyholder base gross expenditure or loss” are not listed as defined terms.
- In section LA 5(4), a cross-reference needs to be made to section LE 2B.
- In section LA 8B, “life insurer”, “policyholder base”, “schedular policyholder base income” and “shareholder base” are not listed as defined terms.
- In section LE 2B, “policyholder base gross expenditure or loss” and “policyholder base gross income” are not listed as defined terms.
- In section YA 1, the definition of “schedular income” needs to be updated.
- In section YA 1, the definition of “profit participation policy” requires amendment to reflect policy changes arising from various recommendations in this report.

- Replace in the definition of “shareholder base gross income” under section YA 1, the word “policyholder” with the word “shareholder”.

Comment

As part of the recommended amendments to the bill, the changes to the taxation of life business in the bill would be restructured to make them clearer and ensure that they achieve their intended effect. Officials consider that the missing cross-references and other minor items listed above should be taken into account as part of this work.

Recommendation

That the proposed minor remedial amendments be taken into account in amending the legislation.

OFFICIALS' LIST OF DRAFTING CORRECTIONS

Officials have noted the following minor drafting corrections to ensure the correct policy intent is reflected in the proposed legislation.

Issue: Financial arrangement rules – exclusion of life financial arrangement from excepted financial arrangements needs correcting

Submission

Insert after the words "financial arrangement" in section EW 5(2) the words "to the extent it is not life financial reinsurance".

Replace the word "that" in proposed section EW 5(8) with the words "to the extent that it".

Comment

Under current law, section EW 5 (2) excludes all annuities as excepted financial arrangements. Proposed subsection (8) excludes "life financial reinsurance" from the exclusion of "insurance contracts".

This is inconsistent because the annuities are also likely, at least in part, to qualify as "life financial reinsurance" but do not have an exclusion.

The definition in proposed section EW 5(8) is also incomplete as life financial reinsurance may be only part of an "insurance contract" but is only excluded from the "excepted financial arrangement" definition where the whole contract qualifies as a "life financial reinsurance".

Life financial reinsurance arising on an annuity contract will not be subject to the financial arrangement rules. If a "life financial reinsurance" arrangement is a part of an "insurance contract" it will continue to be an "excepted financial arrangement".

Recommendation

That the submission be accepted.

Issue: Reinsurance premium expenses incurred by a life insurer not offered

Submission

Replace proposed section DR 2(3) with:

> "A life insurer is denied a deduction for life insurance policy premiums if the policy was not offered or entered into in New Zealand".

Comment

Proposed subsection DR 2(3)(a) denies a deduction for reinsurance premiums where the policies are not offered in New Zealand by a life insurer. However, a life insurer enters into a life reinsurance policy issued by a reinsurer who has offered that life reinsurance policy to the life insurer. The life insurer does not offer the reinsurance policy to anyone.

Recommendation

That the submission be accepted.

Issue: Shareholder income for non-participating policies

Submission

Insert at the end of proposed section EY 19(1) the words "or policyholder base gross income".

Replace the words "equal to" in section EY 19(2) with "includes".

Insert an extra section (3), "The shareholder gross income in section (2) is not intended to capture any savings portion of a premium that is notional capital of the policyholder".

Comment

In proposed section EY 19(2) the words "equal to" should be "includes" so that it does not limit the income captured and to make it clear the policyholder gross income and the savings portion of income is excluded.

Recommendation

That the submission be accepted.

Issue: Life risk claims incurred – ensure reserves not double counted

Submission

Insert at the end of proposed section EY 20(2)(b) the words "excluding life risk claims in the reserves referred to in section EY 23".

Comment

Proposed section EY 20(2)(b) includes "the life risk component of the claims they incur" which would include by definition any reserving claims amounts also referred to under section EY 23. This may lead to double counting of the reserves in the calculation of shareholder base income.

It was not intended to include the reserves in proposed section EY 20 so to prevent double counting they should be expressly excluded.

Recommendation

That the submission be accepted.

Issue: Wording changes

Submissions

Replace:

- The word "to" in section EY 1(1) with the word "between".
- The word "apportioned" in section EY 1(2) with the words "allocated by apportionment".
- All the words after and including the words "actuarially determined" in sections EY 4(2) and EY 15(4) with the words "results in an actuarially determined amount that is more equitable and reasonable than the amount calculated using the basis described in subsections (…)".
- Section EY 24(4)(a) should be amended to insert after "…risk component of claims" the words "where the underlying event that gives rise to the claim has occurred prior to the end of the income year…".

Comment

- Proposed section EY 1 uses the words "apportionment" and "apportioned" incorrectly. It is not correct to "apportion" something to either A or B. One would either apportion between A or B, or allocate to either A or B.
- Proposed section EY 4 uses the words "basis" and "actuarially determined" incorrectly. "Actuarially determined" refers to an amount and the calculation thereof, it does not refer to a "basis".

- In proposed section EY 6 the use of the word "matter" should be to "amount".
- In proposed section EY 15 the words "basis" and "actuarially determined" are incorrectly used.
- Proposed section EY 24(4)(a) refers to "claims that have occurred". A claim cannot occur; the event which results in a claim entitlement occurs.

Recommendation

That the submissions be accepted.

Issue: Use of the defined terms "year" and "income year"

Submission

In proposed section EY 20(2)(f), insert the word "income" before the word "year".

Comment

Proposed section EY 20(2)(f) refers to expenditure or loss "for the year", whereas proposed section EY 19(2)(f) entitled "Shareholder base income: non-participation policies" refers to income "for the income year".

Recommendation

That the submission be accepted.

Issue: Outstanding claims reserve (OCR)

Submission

The calculation of the OCR contained in proposed section EY 24(4)(c) requires some minor refining.

Comment

Proposed section EY 24(4)(c) requires refining to more accurately describe the "best estimate" methodology. This can be achieved by replacing the words "reflects the inherent uncertainty in the relevant best estimate assumptions," with "reflects the uncertainty of the estimates that arise from the use of the relevant best estimate assumptions".

Recommendation

That the submission be accepted.

Issue: Unearned premium reserve (UPR) and formula definitions

Submission

The calculation of the UPR in proposed section EY 26 requires refining.

Comment

In proposed section EY 26 (1), a calculation is required without reference to the timing of the calculation and in subsection (3) the formula definition requires refining.

Recommendation

That the submission be accepted.

Issue: Capital guarantee reserve (CGR) words and timing

Submission

The calculation of the CGR in proposed section EY 27(1) requires refining.

Comment

Proposed section EY 27 (1) CGR is referred to as being a circumstance and a calculation is required without reference to the timing of the calculation.

Recommendation

That the submission be accepted.

Issue: Definition of “asset base” under a profit participation policy

Submission

Replace the words in the definition of “asset base” with:

> “asset base”, being a separately identifiable group of assets or proportion attributable to the profit participation policies, including any life financial reinsurance assets.

Comment

In proposed section YA (1), the definition of “profit participation policy” involves the words “asset base”. However, “asset base” is not clearly defined but should be amended as suggested.

Recommendation

That the submission be accepted.

General insurance and risk margins

OVERVIEW

Clauses 79 and 408

An amendment to the Income Tax Act 2007 is proposed to clarify that general insurers can claim a tax deduction for movements in the outstanding claims reserves (OCR) calculated under new New Zealand International Financial Reporting Standard (IFRS) 4. The issue was brought to the attention of officials by the Insurance Council.

Under IFRS 4 and actuarial practice, the OCR has two components. The first, the "central estimate", is the mean value in the range of possible values for outstanding claims. The second is a risk margin, which is a prudential addition to reflect the inherent uncertainty of the central estimate. Most insurers already claim a tax deduction for the entire annual movement in the OCR. While it is clear that the movement in the central estimate is tax deductible, the law is unclear on the deductibility of the movement in the risk margin, though it is likely determined on the facts of each insurer. The proposed amendments remove the uncertainty and confirm deductibility for financial accounts prepared under New Zealand IFRS 4.

The proposed amendment will have application from the income year that the insurer adopts New Zealand IFRS 4. As the standard was adopted by some companies for their 2009 income year, it will therefore have retrospective effect, but as it is taxpayer-friendly this should not cause any major problems.

Three submissions were received which generally confirmed support from the general insurance industry for the amendments, and included submissions on some technical aspects of the rules.

APPLICATION DATE

Submission
(32 – KPMG)

The provisions applying to movements in a general insurer's outstanding claims reserve should apply retrospectively back to the first year a person adopts IFRS, unless insurers "opt out" of a retrospective application.

Comment

The retrospective application date before the 2009–10 income year (which applies if the person has adopted New Zealand IFRS 4) is intended to be taxpayer-friendly by clarifying the law that the movement in reserves calculated for IFRS 4 purposes can be deducted for tax purposes.

However, this provision may not be taxpayer-friendly when a general insurer has filed income tax returns adopting a different approach for tax purposes than for accounting purposes.

The provisions applying to movements in a general insurer's outstanding claims reserve should apply retrospectively unless insurers "opt out" of retrospective application if they wish (that is, the provisions should apply unless a return is filed to the contrary).

Recommendation

That the submission be accepted.

SOURCE DOCUMENT

Submission
(10 – New Zealand Society of Actuaries Inc)

That legislation should refer explicitly to IFRS 4 as the source document rather than New Zealand IFRS 4.

Comment

A source document can be used as the primary source for technical interpretation and definitions. IFRS 4 (which is the international standard) and New Zealand IFRS 4 are parallel accounting standards. However, the definition of "outstanding claims reserve" contained in the bill refers specifically to paragraphs of New Zealand IFRS 4. There is no need therefore to refer to IFRS 4 as a source document.

Recommendation

That the submission be declined.

DEFINITION OF OUTSTANDING CLAIMS RESERVE

Submission
(10 – New Zealand Society of Actuaries Inc)

The definition of "outstanding claims reserve" should include reference to the wider range of paragraphs 5.1 to 6.1.3 of New Zealand IFRS 4, Appendix D.

Comment

The definition of "outstanding claims reserve" specifies the value to be that as measured under Appendix D, paragraphs 5.1 to 5.1.12 of New Zealand IFRS 4. These paragraphs explicitly refer to the concept of discounting liabilities to obtain a present value, but do not provide any guidance on what interest rates should be used for discounting. As such guidance is set out in paragraphs 6.1 to 6.1.3 these paragraphs should be incorporated into the definition.

Recommendation

That the submission be accepted.

OPENING BALANCES

Submission
(32 – KPMG)

The definition of "opening outstanding claims reserve" in sections CR 4 and DW 4 should be amended to ensure that, in the year a general insurer transitions to the new tax rules, the opening outstanding claims reserve (OCR) is the prior year's closing OCR used for tax purposes rather than financial reporting purposes.

Comment

In proposed sections CR 4 and DW 4, a general insurer's "opening OCR" is defined to be the insurer's closing outstanding claims reserve for the income year before the current year. "Outstanding claims reserve" is proposed to be defined in section YA 1 to mean the insurer's reserve used for IFRS purposes.

The proposed legislation will only deal with financial accounting treatment arising from the insurer's adoption of New Zealand IFRS 4. In tax returns relating to periods before the insurer adopting IFRS, the insurer may have claimed a deduction for the movement in the OCR that was not based on the financial accounting treatment in which case the closing tax reserve will be different from the closing financial reserve.

The opening reserves in the first year when applying the new rules must be those used in the previous year's tax return. This is because the use of the new New Zealand IFRS 4 opening balance, if different from that used in the previous year for tax, would result over time in either a portion of the claim payment becoming non-deductible or the deduction being in excess of the actual claim as a consequence of the tax rule change.

Recommendation

That the submission be accepted.

CALCULATION OF OUTSTANDING CLAIMS RESERVE

Submission
(32 – KPMG)

The prescribed method for calculating the amount of assessable income or allowable deduction resulting from the movement in a general insurer's outstanding claims reserve (OCR) does not accurately reflect payments made to settle insurance claims. This should be addressed by either:

- amending the income and deductions formulas in sections CR 4 and DW 4 to take the amount actually paid to settle a claim into account (opening OCR – closing OCR – claims paid); or
- alternatively, a "narrative approach" could be taken to provide that the tax treatment of outstanding claims and claims paid must follow IFRS. This could be further supported and explained by an Inland Revenue policy statement.

Comment

The intention of the bill is to align the tax rules with those of financial reporting. Previously, general insurers were allowed deductions for amounts incurred and included in their closing OCR and also for the amount of claims when eventually paid out, to the extent this differs from the amount reserved in earlier years. This is because, under the normal principles of deductibility, the expense incurred in settling claims was deductible whenever it was incurred, provided it satisfied the general principles of deductibility. The submission argues that the use of the formula will lead to unintended results, denying a deduction previously allowed.

In the example provided by the submission:

> We have assumed that an insurer experiences and reserves only one claim. In this example, the general insurer initially creates a reserve of $100. However, the insurer actually ends up paying $120 to settle the claim the following year.
>
> **Year 1**
> The general insurer creates an OCR provision for $100 (the opening provision is nil in this example). Under the ordinary rules of deductibility, a deduction of $100 would be allowed in Year 1, as this amount has been incurred for tax purposes. A deduction of $100 would also be provided by section DW 4 in this case under the new rules but only a single deduction of $100 would be allowed in Year 1.
>
> **Year 2**
> In Year 2, the amount expended to settle the claim is actually $120. Under the old rules, a further deduction of $20 is allowed at this point as this additional amount has been incurred for tax purposes. The total allowable deduction between the two years is therefore $120 – this is the correct tax deductible amount.

> Under the new rules, the bill has introduced a formula which has codified the method for calculating income and deductions for movements in a general insurer's OCR. Under sections CR 4 (income) and DW 4 (deductions) the formula is as follows:
>
> Opening outstanding claims reserve – closing outstanding claims reserve
>
> Because the OCR of $100 was settled in Year 2, the closing OCR is now $0, giving the insurer income of $100 under the above formula. In addition to this, the insurer will obtain a deduction of $20 under ordinary principles, as this additional amount has been incurred for tax purposes.
>
> Accordingly, the new rules produce a net deduction over Year 1 and Year 2 of only $20, rather than the amount incurred of $120.

Officials disagree with the conclusions. A claim expense is ordinarily deductible under general principles. The proposed legislation only deals with that portion of the claim that relates to a movement in the OCR. Officials accept however, that it is desirable to clarify that a general insurance company can deduct amounts paid during the year in respect of claims under general insurance policies as well as movements in the OCR. A provision of this nature is included in the equivalent Australian legislation.

Recommendation

That the submission be declined, but that there be legislative clarification of the deductibility of both claims paid and movements in the OCR.

INLAND REVENUE GUIDELINES

Submission
(10 – New Zealand Society of Actuaries Inc)

Inland Revenue's *General Insurance Reserving Industry Guidelines* should be updated when the proposed amendments are enacted.

Comment

The definition of "outstanding claims reserve" specifies the value as that measured under Appendix D, paragraphs 5.1 to 5.1.12 of New Zealand IFRS 4 and includes in paragraphs 5.2(d) and 5.2.3 indirect claims handling costs. This is at variance with Inland Revenue's *General Insurance Reserving Industry Guidelines* published on Inland Revenue's website.

Recommendation

That the submission is noted. The need for guidelines will be discussed with interested parties.

"ACTUARIALLY DETERMINED"

Submission
(7 – PricewaterhouseCoopers on behalf of the Insurance Council of New Zealand)

The proposed definition of "actuarially determined" contained in section YA 1 should be amended by removal of:

- subparagraph (a)(iii); and
- subparagraph(b).

Comment

The definition of "actuarially determined" is also relevant for the life insurance reforms and is separately commented on in that part of the report. The comments that follow are relevant for both general insurance and life insurance.

Subparagraph (a)(iii) of the definition of "actuarially determined" requires, among other things, that the actuary has "provided to the Commissioner in writing, in the form prescribed by the Commissioner, if any, all assumptions, methodologies, bases and working calculations necessary to support the calculation of the amount".

The submission argues that detailed prescription of information is unusual and unnecessary as there are sufficient powers already given to the Commissioner to request all information in the Tax Administration Act. If this provision was enforced, the submission argued it would impose unnecessary compliance costs.

Officials note that it was never the intention that the Commissioner would request all the information noted in the subparagraph (hence use of the words "if any"). Officials agree that, with a few minor clarifications to the relevant provisions in the Tax Administration Act 1994 which would make it clear that the Commissioner's powers extend to the documents referred to in this proposed provision, this provision is unnecessary.

Paragraph (b) states that the definition will not be satisfied where the calculation of the amount (by an actuary):

(i) does not accurately reflect the insurer's business experience;

(ii) is not made according to usual practice; or

(iii) is part of a tax avoidance arrangement.

Officials accept that actuarial standards require actuarially determined amounts must reflect the insurer's business practice, and so in applying these standards the "usual practice" requirement is met. So, subparagraph (ii) is superfluous. Subparagraph (iii) duplicates the general anti-avoidance provision and is also superfluous, as any tax avoidance can be determined under that provision.

However, officials consider that there should still be some objective standard by which the estimate is calculated, and which is consistent with actuarial practice. Subparagraph i) refers to "accurately" which is a higher standard than is usually used in tax law, and which is problematic to assess when dealing with an estimate. Accordingly, officials recommend retaining subparagraph (i) but substituting the word "reasonably" for "accurately".

Recommendation

That the submission be accepted in part, and the definition of "actuarially determined" in section YA 1 be amended by removing the anti-avoidance proposals except, as discussed earlier, and removing the certification requirements. The Tax Administration Act 1994 to also be amended as discussed above.

EXTENSION TO GENERAL INSURANCE PRODUCTS HELD BY LIFE INSURERS

Submission
(32 – KPMG)

The provisions applying to movements in a general insurer's outstanding claims reserve should not apply to the general insurance business of a life insurer (that is, accident, disability and health business).

Comment

As defined currently in the bill, the provisions which provide tax deductibility for movements in a general insurer's outstanding claims reserve to be determined under IFRS 4 do not apply to non-life products held by a life insurer.

This result is not correct from a policy perspective. While life insurers are not required by New Zealand IFRS 4 to apply prudential margins in calculating reserves, actuarial practice is to apply discounting. For this reason, the proposed life insurance provisions dealing with reserves require discounting. This appears to be generally accepted by the industry. If a deduction is allowed for a future claim, it is logical and fair that only the present value of that claim be deducted.

However, a drafting error did not extend the risk margin and discounting criteria to general insurance products held by life insurers. Officials propose a new provision applying the tenor of the reserve calculations provisions contained in proposed section EY 24, that applies to non-life products held by life insurers.

Recommendation

That the submission be declined.

MINOR DRAFTING CORRECTIONS

Submissions
(Matter raised by officials)

The following amendments should be made for the purposes of consistency:

- In section CR 4 (1)(b), add after "..CR 3" – "(Income of non-resident general insurer)". This would make it consistent with CR 4(2).
- In section DW 3(2), add after "…year" – "(the **current year**)". This would make it consistent with CR 3(2).

Comment

These amendments are minor, to ensure consistency in the headings.

Recommendation

That the submissions be accepted.