



Life Insurance Review
Deputy Commissioner of Inland Revenue
P O Box 2198
WELLINGTON

Attention: Anthony Merritt

3 May 2007

Dear Sir

Life insurance tax reform

The Investment Savings and Insurance Association (ISI) appreciates the opportunity to comment on the second Officials' paper, "*Life insurance tax reform – suggestions for reform*" ("OP2"), released on 27 February 2007. We enclose a copy of our paper providing our general comments on OP2 and specific responses to questions raised by Officials.

The ISI has 20 investment and life insurance members and 19 associate members.¹ The association does not just represent the interests of its member companies, but works to ensure that all New Zealanders are provided with the best options to secure their own future through savings, investment and the protection they receive from insurance. Our consideration and representation of members on matters associated with tax reform are made having regard to this primary objective of securing the future of all New Zealanders.

Whilst we appreciate the efforts of Officials from the Inland Revenue Department and Treasury in presenting OP2, we have a number of concerns regarding the current timetable for reform and in particular the fact that changes resulting from consultation on OP2 "are intended to be included in the second tax bill of 2007". It is ISI's view that it is not possible to achieve a successful robust reform of the magnitude suggested within the intended timeframe.

As you would expect our submission reflects the reservations and concerns we have with aspects of OP2 and the proposed timetable. It is however important to state ISI's willingness to work constructively with Officials if Government is committed to change the taxation basis for life insurance.

Based on our own enquiries and research to date our key concerns (which are elaborated on in our paper) are:

¹ Refer Appendix B of attached paper for a complete listing of ISI's members.

- The ability of the industry to cope with the Officials' suggested reform timetable. Industry resources are currently stretched to capacity in dealing with an unprecedented level of major regulatory changes including KiwiSaver, PIE and offshore investment taxation changes, and the Ministry of Economic Development's Review of Financial Products and Providers. It is these same scarce resources that need to be brought to bear in assisting with the development and implementation of any major tax reform affecting insurance.
- There is an insufficient level of detail and analysis currently provided in OP2 having regard to the extraordinarily complex nature of issues confronted in respect of the Officials' proposals. This is of particular concern given the intended timeframe of implementing the reform.
- The scope of the current review and work undertaken to date does not extend to cover wider New Zealand social policy issues impacted upon by life insurance taxation reform.
- The apparent lack of depth of investigation undertaken to date by both Officials and the industry in respect of transitional issues. Transitional issues will be critical to any successful reform and will have a major impact on both the industry and policyholders (irrespective of the nature of any changes made to the current regime).
- The expectation of IFRS changes in the near future and the inherent difficulties associated with formulating a new tax regime which is dependent on elements of unsettled financial reporting information.
- The scope of the review not covering annuities given the expected growth in savings in coming years.

In light of these fundamental concerns and outstanding matters we presently have no choice but to reserve our judgement on endorsing the Officials' suggested model at this time and to express our strong concerns at the achievability of successful reform in the intended timeframe.

Identifying and developing the most appropriate long-term life taxation reform direction for New Zealand will take time. ISI is of the firm opinion that any changes to the current regime should only be made after extensive consideration and consultation is undertaken in a manner consistent with New Zealand's Generic Tax Policy Process. This will ensure any changes to the current regime are workable, practical, robust, and equitable for the long-term benefit of all New Zealanders.

In order to identify and develop the best model for all New Zealanders we recommend that the review is undertaken in totality after wide public consultation as the benefits of doing so, including a more considered set of rules, are more important than urgency. This will require:

- More expansive consultative documents to be provided to the public, including a detailed outline of the proposals and an analysis of their expected impact, including social policy issues;² and
- The provision of further information and analysis of models adopted in other OECD countries. This will allow the industry and other stakeholders to leverage off the research which we understand has been undertaken by Officials and assist the wider consultative process. We

² A benchmark for this in our view are the Consultative Documents released the last time the life insurance regime was overhauled 20 years ago.

have also commenced our own analysis of other OECD model alternatives but would appreciate access to this information to avoid duplication of effort; and

- The establishment of focussed working groups comprising Government Officials, representatives from the industry, and other stakeholders to collectively work through some of the inherently complex issues associated with any regime change and transitional matters.

We are confident that the attached paper carries a very high degree of consensus of the majority of ISI members, particularly in respect of the broad thrust of the paper.

We are aware that individual companies will be making submissions, some of which will reflect differences largely at a detail level. BNZ Insurances has indicated that they have a difference, particularly in the treatment of deferred acquisition costs. As we cannot imply that BNZ agrees with all the views expressed by the ISI, and as time pressure for completing the submission has not allowed us to agree suitable wording with BNZ that reflects their view, we advise that BNZ Insurances do not support the ISI submission in its current form. The balance of the industry has expressed strong support for the industry paper.

We request a time to discuss the contents of this letter and attached paper with Officials at a mutually convenient time.

Yours faithfully

Vance Arkininstall
Chief Executive



Life Insurance Review
Deputy Commissioner of Inland Revenue
P O Box 2198
WELLINGTON

Attention: Anthony Merritt

3 May 2007

Dear Sir

Response to “Life insurance tax reform – suggestions for reform”

The Investment Savings and Insurance Association (ISI) appreciates the opportunity to comment on the second Officials’ paper, “*Life insurance tax reform – suggestions for reform*” (“OP2”), released on 27 February 2007. The ISI is cognisant of the significance and importance of life insurance taxation reform for its members and the wider New Zealand economy. In preparing this paper we have conducted a series of meetings with our members within the timeframe provided to consult on key issues associated with life insurance taxation reform and our response to feedback specifically requested by Officials.

Based on our enquiries and research to date it is ISI’s view that the Officials’ suggested timetable for tax changes resulting from consultation on OP2 to be included in the second Tax Bill of 2007 is simply not achievable if the reform is to be successful and robust. We recommend that any changes to the current tax regime should only be made once further time is afforded for additional thought and broader consultation in a manner consistent with the approach advocated in this paper. This will assist in ensuring the right ultimate reform option is selected which is best suited to all New Zealanders’ long-term needs.

Our general comments on OP2 issues are outlined below. Feedback on specific questions raised by Officials is included in Appendix A.

Treatment of investment linked life insurance products

Following the release of OP2 the Ministers of Finance and Revenue announced on 27 March 2007 that investment-linked life insurance products would be incorporated into the PIE regime with effect from 1 October 2007. While ISI would have preferred the extension of PIE principles to all life insurance policies that have a savings component, we remain supportive of this initiative and welcome the opportunity to work constructively with Officials’ to ensure robust legislation is included in the May Bill.

Approach to reform

Our general comments in relation to the Officials' proposed approach to reform in OP2 are encapsulated below under the following headings:

- The proposed legislative timeframe;
- The consultative process;
- Social policy issues;
- Transitional issues;
- The scope of the review.

The proposed legislative timeframe

Unfortunately, we are unable to support the Officials' suggestion that wider tax changes resulting from consultation on OP2 "are intended to be included in the second Tax Bill of 2007". Based on our enquiries and research to date this suggested timetable is simply not achievable due to:

- The welcomed but unprecedented level of regulatory changes which are currently stretching industry resources to their capacity. In particular, management, tax, actuarial, and system resources presently utilised in implementing Kiwisaver, PIE, and offshore investment taxation initiatives are the same scarce resources that will also be required for life taxation reform initiatives.³
- The number of extraordinarily complex issues identified but not resolved by Officials in OP2 and amount of further work anticipated in order to resolve them.
- The expectation of IFRS changes in the near future and the inherent difficulties associated with formulating a new tax regime which will inevitably be dependent on elements of unsettled financial reporting information.

The International Accounting Standards Board (IASB) is set to release a Discussion paper in relation to Phase II of the development of an International Financial Reporting Standard for insurance contracts later this month.⁴ This paper will analyse and potentially impose changes to a number of key areas which could have a material impact on the tax framework for a model with accounting elements. Areas noted by the IASB for inclusion in the Discussion paper include:

- Measurement of insurance liabilities.
- Unbundling of deposit and service components of insurance contracts.
- Changes in insurance liabilities and estimating margins.
- The treatment of acquisition costs.
- Reinsurance assets.
- Policyholder participation (with profits) contracts.

Although IFRS may never be able to be used as a core basis for the taxation of life insurance business, to enhance efficiency of the tax system and minimise compliance costs the extent to which accounting and tax principles could be aligned should be considered in more detail. At a minimum we recommend the direction of Phase II of the IASB's project should be factored into any tax review process before any changes to the current tax regime are settled.

³ An ISI survey of members in April 2007 which was conducted to gauge the extent of resources committed to Kiwisaver and PIE reforms revealed industry costs expected to be incurred in implementing these reforms are in excess of \$100m.

⁴ Source: www.iasb.org

- The apparent lack of depth of investigation undertaken to date by Officials and the industry in respect of transitional issues. Transition will be a critical issue and will have a major impact on both the industry and policyholders (irrespective of the nature of any changes made to the current regime).
- The additional work still required by Officials and the industry in understanding the wider social policy issues associated with any life insurance taxation reform (refer below).

In our view the timing of any changes to the current regime cannot be determined at this stage. The consultative process should progress in a timely manner which is consistent with the operation of the Generic Tax Policy Process (refer below). This will require further work to be undertaken by Officials, industry members, and other stakeholders to address unresolved issues and agree on a fundamental design framework. This work should then be followed by the release of a timetable for detailed design work, the introduction of legislation, and an agreed transition period for implementation.

The consultative process

When the Minister of Finance and Minister of Revenue announced on 17 August 2006 that the Government was to “carry out a comprehensive review of the life insurance tax rules“ they also stated that the review would be conducted in “full consultation with the industry”. Since that time Officials have released two papers, the first dealing with the scope of the review (OP1), and the second (OP2) containing a suggested Officials’ model and notification that “any tax changes resulting from consultation on this issues paper are intended to be included in the second tax bill of 2007.”⁵

Although we met with Officials and formally responded to OP1, it was difficult for us to make meaningful comments due to the lack of detail contained in the paper. Unfortunately, we have struggled to respond to certain aspects of OP2 for the same reasons. Whilst we acknowledge the efforts of Officials from the Inland Revenue Department and Treasury to date in preparing OP1 and OP2, we are of the view that the proposed approach and suggested timeframe for legislating such major reform will not allow the level of consultation expected under the terms of the Generic Tax Policy Process (GTPP).⁶

In our view the consultation timeframe for OP2 of only 9 weeks (increased from the initial period of 5 weeks) is too tight given the significant complexities associated with any changes to the current regime and transitional issues that will need to be resolved before implementation. There has been neither sufficient time nor detail provided to the industry and other affected stakeholders, to enable them to participate effectively thus far in the reform process. Without an extension to the proposed timetable, the expeditious approach to this reform has the potential to compromise a number of key GTPP objectives, including:

- Encouraging earlier, explicit consideration of key policy elements and trade-offs;
- Providing opportunities for substantial external input into the policy formulation process;
- Increasing transparency and providing for greater contestability and quality of advice at all stages;

⁵ OP2, page 1.

⁶ The GTPP comprises five steps: Strategic, Tactical, Operational, Legislative, Implementation and Review.

- Clarifying the responsibilities and accountabilities of participants in the process.

If major life insurance taxation changes are rushed without full public consultation, this will substantially increase the risk of unsound and ineffective tax legislation being introduced which will potentially cause harm to the life industry and the New Zealand economy in the long-term. By adopting a measured approach under GTPP in relation to life insurance tax reform, and allowing more time for public scrutiny and consultation, Officials should be able to develop the most effective workable options for sustainable reform in this complex area. Although this may result in a longer legislative process, the end result will be better, more robust policy proposals and more effective legislation. Neither the industry nor Officials will want to undertake another major reform of life taxation in a few years time because of dissatisfaction with the outcome of this process.

We note by way of comparison that the United Kingdom (UK) is currently in the midst of its own reform of life insurance taxation. In May 2006, HM Revenue & Customs (HMRC) published "Life Assurance Company Taxation: A Technical Consultative Document" to solicit views on how to simplify certain aspects of the tax law relating to life insurance companies. After allowing a period of approximately 5 months for responses to the Consultative Document the consultation was then divided into five strands, and for each of them a working group was established consisting of HMRC officials and representatives from the insurance industry and its advisers. Further measures resulting from products of this work were recently outlined in the UK Budget announcement of 21 March 2007. It was also noted in the UK Budget announcement that consultation continues on the detail of current reform measures and on other issues identified during the consultation process.⁷

The measured approach adopted in relation to life insurance taxation reform in the UK contrasts with that being proposed here and we request that additional time for meaningful consultation is provided for. The benefits of doing so are in ISI's view more important than urgency. This will require:

- More expansive consultative documents to be provided to the public, including a detailed outline of the proposals and an analysis of their impact, including social policy issues (refer below),⁸ and
- The provision of further information and analysis of models adopted in other OECD countries. This will allow the industry and other stakeholders to leverage off the research which we understand has been undertaken by Officials to date and assist the wider consultative GTPP process. We are also commencing our own analysis of other OECD model alternatives but would appreciate access to this information to avoid duplication of effort; and
- The establishment of focus working groups comprising Government Officials, representatives from the industry, and other stakeholders to collectively work through some of the inherently complex issues associated with any regime change and transitional matters.

Social policy issues

Social policy issues associated with any life insurance taxation reform will be important for all New Zealanders, not just the Government and insurers.

Life insurance has two important roles in New Zealand:⁹

⁷ The Chancellors Budget 2007; Budget Note 32.

⁸ For example, refer to the Consultative Documents released the last time the life insurance regime was overhauled in the late 1980's.

- To enable citizens and businesses to manage the financial implications of death. In this way, it promotes individual financial stability and facilitates commerce. For example:
 - protecting a family against the financial effects of the death of an income earner or a caregiver;
 - protecting businesses (generally small-to-medium size) against the financial effects of the death of a key person;
 - preserving the value of an estate;
 - protecting against the financial effects of a homeowner's death; and
- To provide a convenient vehicle for savings and investment. This assists individuals to save for their retirement and other needs, and benefits economic development in New Zealand.

Officials have noted in OP2 that Australia adopted a general insurance methodology for taxing risk insurance in 2000 and that "the similarities in the products offered in the two countries and the similar accounting practice and commercial environment make an appealing case for New Zealand having a similar tax treatment."¹⁰ The Official's review of the Australian model for taxing term risk insurance in OP2 focuses on the taxation of life companies and their shareholders, rather than policyholders. What also needs to be recognised when considering the merits of the Australian regime is that a considerable amount of term risk insurance is accessed by Australians through superannuation schemes. This allows Australian term life risk policyholders to access the associated benefit of taxation advantages that exist for superannuation savings in Australia. The provisions of a tax efficient means for policyholders to access term risk cover is consistent with the Australian Government's wider policy objective of making superannuation an attractive vehicle for retaining assets to minimise tax.¹¹ Any review concerning the suitability of adopting the Australian model in New Zealand should therefore also take into account these wider policyholder related pricing and taxation aspects.

Last year the industry paid out over \$500m of death and disablement benefits which enabled surviving family members to remain financially strong and reduce reliance on the State.

In its recent OECD Economic Survey of New Zealand released in April 2007, the OECD recommended that careful attention should be paid to financial market regulation and the tax regime to ensure that policies in those areas are consistent with government objectives to encourage the accumulation of financial assets for retirement purposes and provide a neutral treatment between housing and financial assets.¹² The reform of life insurance taxation must be considered in the context of these wider social policy objectives.

It is also logical that those likely to be either directly or indirectly affected by the life insurance taxation review should also be consulted on the effect of the proposed reforms. We are concerned that in its existing form, the Officials' proposed model for taxing term risk business may lead to substantial increases in premium rates. It is not possible to precisely predict how the market will react, however initial estimates from a survey of our members are that the increase will be in the range of 20-30%. As a consequence, life insurance will become less affordable, in particular to those from lower socio-economic backgrounds and small-to-medium sized businesses. This will impact negatively on the important roles life insurance currently has in New

⁹ Chapter 1 of *Life Insurance* (NZLC PP53, Law Commission, Wellington, 2003).

¹⁰ OP1, page 7.

¹¹ Explanatory Memorandum to Tax Laws Amendment (Simplified Superannuation) Bill 2006

¹² OECD Economic Surveys – New Zealand, April 2007, page 75.

Zealand as explained above and will exacerbate the current levels of underinsurance within the economy¹³.

Other policy initiatives could be considered in order to ameliorate such detrimental effects, and these can be canvassed as part of the broadened scope review.

As noted above, we recommend that more expansive consultative documents are provided that not only include more detail in respect of technical aspects of the Officials' proposals, but also provide an analysis of their potential social policy and economic impact.

Transitional issues

Transition will be a critical issue for the industry and policyholders. Whilst we welcome the Officials' offer for the industry to suggest transitional options, it would be a helpful starting point if more detailed analysis of the Officials' thinking on transitional options was provided for in OP2. In addition, although transitional issues will be material for both the industry and policyholders irrespective of the nature of changes made to the current regime, they can only be decided once specifics on the nature of such changes are determined.

At paragraph 4.3 of OP2 it is stated:

“Any transitional measures must be guided by two general principles. The first is that it is undesirable to have long-term transitional arrangements as this would defer the overall benefits without necessarily deferring all the costs.¹⁴ Secondly, to avoid cost and complexity there should not be a multiplicity of rules operating during the transition period. Transitional relief, where appropriate, should be afforded in some other pragmatic way.”

We are of the view that this represents somewhat of an oversimplified framework. In our view the guiding principles should be that all transitional measures must:

- Be formulated in line with the GTPP and policyholders are also consulted on their impact.
- Cater for complex issues and prevent double taxation. In particular, the treatment of memorandum account balances and policyholder and life base tax losses.
- Not risk companies becoming insolvent upon transition. If not handled with caution, there is the potential for some products to generate significant financial losses for the life company, which may also impact on the financial security of all policyholders. The transitional treatment of opening reserves may also give rise to solvency issues under the Officials' suggested approach and will need to be considered in more detail.
- Provide for realistic introduction dates which:
 - Allow sufficient time for insurers to change systems and comply; and
 - Have regard for the long term characteristics of life insurance contracts; and
 - Spread the financial impact of any regime changes progressively over time.¹⁵

¹³ Refer ISI media release of 2 March 2006. www.isi.org.nz

¹⁴ The meaning of this first principle is not apparent to us. In particular, who is obtaining the benefits and who is suffering the costs?

¹⁵ We understand such an approach was adopted when Australia changed its regime.

- Cater for current premium and reinsurance contractual arrangements which have been priced based on the existing regime and in many cases cannot be altered.
- Cater for branches of non-resident life insurers that have previously elected to treat themselves as companies for the purposes of the life insurance rules.

Scope of the review

It is noted in OP2 that “the taxation of annuities presents unique problems, and the methodology discussed in this paper does not at this stage extend to these products”. New Zealand’s annuity market is very underdeveloped by world standards. In light of the recent Kiwisaver reforms and prospect for the future development of New Zealand’s annuity market we are of the view that any review of New Zealand’s life insurance taxation regime must appropriately deal with the tax treatment of annuities. Similarly reverse annuity mortgage products should also be addressed due to the increasing demand for these products. The review for these products should also encompass the wider social policy issues in taxing these forms of savings products appropriately.

Our preliminary thinking of other issues that should be addressed within the scope of any life insurance tax review includes the following:

- For some years the ISI has been asking for clarification on the tax treatment of income protection insurance. The fact that this issue has not been able to be progressed or resolved by the Department is disappointing but it must now be dealt with as part of any life insurance taxation review¹⁶.
- Non-resident life insurers are currently subject to the New Zealand life taxation regime to the extent policies of life insurance are *offered or entered into in New Zealand*. This applies regardless of whether the policies have been executed in New Zealand or if the life insurer has a fixed establishment or agent in New Zealand. The wide scope of these current source provisions should be considered in conjunction with any review of the regime.
- Issues associated with reinsurance are not covered in detail in OP2. The treatment of premiums (in particular reinsurance premiums) paid to non-resident insurers will need to be addressed in more detail. This will include thought as to whether the scope of the as-agent for foreign insurers regime will be extended.
- The impact of any new regime and transitional measures will need to cater for non-resident life insurance branches who have elected to be treated as companies under section EY 48 of the Income Tax Act 2004.
- Another aspect of any life insurance review that will need to be covered is ensuring that any change to the current regime is able to cater for all possible types of life insurance corporate structures (including mutuals) and life products.

We would welcome the opportunity to meet with Officials to discuss the contents of our response to OP2 at a mutually convenient time. If you have any questions in relation to our comments please contact the undersigned.

Yours faithfully

¹⁶ The tax treatment of MRI policies should also be confirmed.

Vance Arkininstall
Chief Executive

Appendix A : Feedback on questions specifically raised by Officials in paper No.2

Chapter 2 – Shareholders’ Income

1. “How should premiums from mixed products be split between taxable and non-taxable components?”

ISI feedback:

Premiums will not only need to be split between taxable and non taxable components (i.e risk and savings) but for some products premiums may also need to be split into initial, renewal, and investment expenses.

The composition of premiums for each insurer’s product will vary by insurer and by product type so a rigid legislative process of splitting premiums will not be appropriate.

A principles-based approach should be considered which specifies the principles to be adopted by each office in making its premiums splits. The principles based approach could specify the items that the office may wish to take into account when making the split (such as expected future expenses, expected future claims rates, relative contributions to profit) and should be consistent with the reserving principles. Legislation could also specify that regard must be had to, for example, recent expense analyses and claims analyses.

The principles would also need to recognise that for some products explicit risk charges may be unrelated to premiums but may be more of a contractual nature.

At an early stage comprehensive administration guidelines would also need to be agreed between the industry and Officials.

Appendix A : Feedback on questions specifically raised by Officials in paper No.2

Chapter 2 – Shareholders’ Income (continued)

2. **“What is the most practical approach to the calculation of risk reserves? In particular what are the conceptual and compliance difficulties with the Officials’ favoured approach? How should deferred acquisition costs be treated for tax? How should the reserves be defined?”**

ISI feedback:

Risk reserves

We agree in principle that the transfers to risk reserves should be deductible from the risk component of premiums and transfers from risk reserves should fall into the tax calculations for the year transfers are made. This is consistent with the current general insurance model.

Within life insurance companies there will be a need to set up reserves (unearned premium liabilities) where there is some element of pre-payment of premiums to cover future years’ risks. These particularly arise for level premium term insurances, single premium policies, and level premium non-profit whole of life and endowment insurances. Transfers to those reserves to ensure that premiums will be available to meet the risks in future years should be deductible (on the basis the gross premium income will be taxable upon receipt). When reserves are subsequently released, to meet the premium requirements in the year of the risk, then that release can then enter the tax calculation as income for that year.

Outstanding claims reserves will also need to be established within life insurance companies. Again, transfers to claims reserves should be a deductible item and transfers from claims reserves, to meet claims as and when they are payable in future years, should be treated as income (or netted off against claim payments) in the year that the transfer is made.

The levels of reserves will vary between companies and will depend on each individual company’s particular circumstances. Reserves will depend on expected future levels of mortality, morbidity, claims incidence, expected expenses, etc. Each of these items will be different for particular companies. It is therefore necessary to allow reserves to be set up which best reflect the expectations of the individual companies. Prescribing levels of reserves (however framed) will undoubtedly result in too-high or too-low levels of reserves being set aside by particular companies. A principles-based approach is the best way of allowing companies to set aside risk reserves appropriate for their own operations whilst minimising the risk of inappropriate transfers to and from reserves being made.

There is no evidence that reserves have in the past been manipulated to provide tax advantages. In any case a principles-based approach, suitably worded, would minimise differences in interpretations or variations in approach. The ISI would be happy to work with officials to help formulate appropriate legislative wording. The New Zealand Society of Actuaries should also be asked to help with the wordings of appropriate principled legislation.

The reserving principles should also recognise the need for the risk margin element of solvency reserves (as required by international financial reporting standards and actuarial standards).

The treatment of opening reserves in the transitional period will be an important and material issue that will need to be considered.

Deferred acquisition costs (DAC)

Acquisition costs are currently fully deductible at the time of expenditure for both life insurance and general insurance companies. We see no reason for a change in this approach as it is a well established tax principle for all taxpayers that a deduction for expenditure is allowable when the expenditure has been incurred. To the extent that acquisition costs are deferred for the purposes of financial reporting (as in the current Margin on Services system) those portions of reserves which represent the release of deferred acquisition costs should be excluded from the tax calculations in the years that they are released.

The current tax treatment of DAC for a life insurer is supported by the IRD's General Insurance Reserving Industry Guidelines which specifically allow general insurers to consider the timing of deductions for DAC under the deductibility provisions in the Income Tax Act 2004. The guidelines are confirmation of the IRD's long standing approach to allow general insurers to deduct DAC up-front.

The following factors also need to be considered with respect to the Officials' preferred tax treatment of DAC for life insurers:

- International Accounting Standards are likely to change to allow a life insurer to recognise DAC as an expense when it is incurred (Refer to the IASB's project report on Insurance Contracts (Phase II), December 2006 and current preference to deduct policy acquisition costs when incurred.)
- Difficulties would likely arise in establishing a consistent and reliable approach to spreading DAC.
- Negative tax payment cash flow issues are likely to arise due to the long term nature of life policies and the fact that 100% of policy acquisition costs would be paid up front with associated tax deduction entitlements being deferred.

Appendix A : Feedback on questions specifically raised by Officials in paper No.2

Chapter 2 – Shareholders’ Income (continued)

3. “What alternatives are there to taxing profits from conventional participating business from that outlined?”

ISI feedback:

Some issues have been identified around the proposal for taxing profits from conventional participating business. These include the need to closely define the boundaries of participating profit pools, the shareholder gates from the pools, the expenses to be attributed to the pools, and the potential for double taxation of investment income.

It is understood that the intention in the discussion paper is to tax policyholders only on the investment income generated within the with-profit pool (after taking into account the Australasian shares capital gains exemption). It is also understood that the with-profits pool expenses are to be deductible against the policyholder income.

If the total of the investment income generated within the with-profits pool is taxed in the policyholder’s hands and the transfers from the with-profits pool to the shareholders is also taxed in the shareholders hands, then there is effectively double taxation of investment income. The taxation of the transfers to the shareholders should therefore recognise the tax already paid on the investment gains and that amount should be allowable as a deduction from the shareholder taxation base. We would welcome the opportunity to work with Officials’ to seek to resolve this issue.

Some clarification will be required around the appropriate levels of expenses to be attributed to with-profits pool. The accounting basis may be appropriate but will require further investigation.

It is expected that the boundaries of participating pools will need some clarification, as will the definitions around shareholder gates. It should be recognised that participating pools do not necessarily have a pre-specified shareholder gate and therefore legislation would need to recognise there is some variability in that regard.

Appendix A : Feedback on questions specifically raised by Officials in paper No.2

Chapter 2 – Shareholders’ Income (continued)

4. “What general corporate tax issues are raised by this model that require consideration?”

ISI feedback:

Revenue account presumption

The Income Tax Act 2004 currently codifies that property held by a life insurer is held on revenue account.¹⁷ It is stated in OP2 that all investments that form part of the shareholders life insurance business would continue to be held on revenue account.¹⁸

Whilst we acknowledge there is a line of old case law and legislative history surrounding the ability of life insurers to distinguish between capital and revenue assets, we question why life insurance companies (and their shareholders’ interests) should be treated any differently to other companies in today’s marketplace? For example, if a life company owns a building which is not attributable to policyholders, is held on long-term capital account, and is kept separate from other life insurance business activities, why shouldn’t the life insurer be afforded a capital account treatment similar to other corporate taxpayers?

The continued codification of life insurers holding property on revenue account is also likely to present difficulties when considering the interaction of this provision with other codifications provided for under the Income Tax Act 2004 (eg. as under the PIE regime).

This matter should be investigated as part of any life insurance taxation review.

¹⁷ Section EY 45. We understand this codification had its origins in the 1989 reforms.

¹⁸ OP2. Para 3.20.

Tax compliance

Although a number of tax adjustments to accounting profit are currently required in the Life base (ie. shareholder) income tax computation, it appears likely that full top-down tax calculations will be required for both the shareholder and policyholder calculations under the Officials' segregated cashflow model. Life insurers may no longer be able to adopt the normal starting point of accounting net profit before tax with tax adjustments to arrive at taxable income. Consideration will therefore need to be given to:

- The need for additional system requirements to extract an increased level of specific tax formulae information; and
- Reliance being placed on an increased number of figures in tax computations which do not tie into audited financial accounts. The inherent risk of errors in tax computations is therefore likely to increase.

Appendix A : Feedback on questions specifically raised by Officials in paper No.2

Chapter 3 Savings

1. **“Feedback is sought on all aspects of the officials’ suggested tax treatment of savings, in particular regarding:**
 - **practical compliance difficulties (and costs of compliance);**
 - **extending a realised capital gains exclusion for Australasian equities to participating non-unit linked products;**
 - **information technology systems capabilities;**
 - **particular products that may require specific treatment – for example, annuities: and**
 - **issues (if any) relating to income and expense allocation between shareholders and policyholders.”**

ISI feedback:

Compliance costs

Given the practical compliance difficulties noted in our response to Chapter 2, Question 4 we anticipate that the costs of tax compliance for life insurers will increase under the Officials’ suggested model. The extent to which accounting elements can be adopted for tax purposes will have a significant impact on compliance costs. If two separate top-down calculations are required with a number of tax specific calculations which are not based on accounting income (eg. premium splits, tax risk reserves movements, investment income splits, fee splits, etc) then the increase in costs may be substantial. Transitional measures including implementing new systems to accommodate the proposed tax calculation methodology are also expected to be costly and will take some time.

Extension of realised capital gains exclusion for Australasian equities to participating non-unit linked products

We are supportive of extending the Australasian equity exclusion to investment income for participating non-unit linked product investments. However, it should also be extended to any savings product which has an element of policyholder taxation. Statutory criteria or guidelines should be able to be formulated to satisfy Officials’ concerns that investment tax benefits will pass to policyholders.

Information technology system capabilities

For the reasons addressed above key changes to current information technology systems will be required to accommodate the split of cashflows for the proposed shareholder and policyholder tax computations and to calculate risk and claims reserves.

Particular products that may require specific treatment – for example, annuities

As noted in the main body of this letter we are of the view that any review of New Zealand’s life insurance taxation regime should encapsulate the tax treatment of annuities. The increasing market for reverse annuity mortgage products should also be addressed.

We also request that the long-standing uncertainty surrounding the tax treatment of income protection insurance is resolved as part of the wider life insurance tax review.

We have not had significant time to undertake a full review of life products and further work will be required to ensure all product types are covered.

Issues (if any) relating to income and expense allocation between shareholders and policyholders

We understand the intention of the Officials' model is to tax investment gains attributable to policyholders and to allow a deduction for investment expenses. This will require allocation of expenses by function and product group. Some Life insurers may not be geared up to do this at present so systems changes/development will be required. As the allocation of expenses typically requires judgement any prescribed methodology would be very difficult to legislate. We therefore favour a principles-based approach to expense apportionment.

Appendix A : Feedback on questions specifically raised by Officials in paper No.2

Chapter 3 Savings (continued)

2. **“Instead of a 33% rate on policyholder income there have been suggestions that the life insurer could segment its business into categories and apply an average policyholder proxy rate against the net investment income within each. Officials do not favour this as it still over-taxes policyholders on the lowest tax rate, and gives a comparative benefit to middle and higher marginal rate taxpayers. Feedback is invited on this suggestion.”**

ISI feedback:

We note that the Officials rate of 33% also represents an “average policyholder proxy rate” as it would over-tax policyholders on lower marginal rates and under tax policyholders on higher marginal rates. Accordingly, the focus of the analysis shouldn’t be on whether an average policyholder proxy rate should be used or not (as all rates are averages). The key question should be what is the most appropriate rate which is representative of the underlying policyholders?

In determining an appropriate rate we are opposed to a 33% rate on the basis traditional product policyholders tend, in the majority, to be represented in the age group of those retired or approaching retirement (as noted by Officials’ in OP1 – page 8). Accordingly we believe a rate lower than 33% would be appropriate.

The issue of segmentation will need to be examined more closely during the next steps of the consultative process. If segmentation is to be applied we are of the view that it should be provided for on an elective basis.

There may be possible discretionary mechanisms for passing the differential tax rates to policyholders – such as differential bonuses or crediting rates or direct attribution/apportionment of income based on surrender values.

Appendix A : Feedback on questions specifically raised by Officials in paper No.2

Chapter 3 Savings (continued)

- 3. Would the elective attribution solution for unit-linked products discussed above, if included in legislation, actually be used by any life insurer?**

ISI feedback:

This will be dependent on the decision made by each life insurer but it is expected that some would.

Appendix A : Feedback on questions specifically raised by Officials in paper No.2

Chapter 4 Other matters

1. Does the current income tax definition of “life insurance” need to be changed, and in what way?

ISI feedback:

The income tax definition of life insurance will depend on the nature of any changes to the current regime. The current exclusion for death benefits provided under either accident or medical insurance may no longer be required if a general insurance basis for taxation is adopted in respect of all term risk policies. The classification of savings policies will need to be separately considered.

Work undertaken as part of the wider Ministry of Economic Development’s Review of Financial Products and Providers should be considered in relation to this issue.

Appendix A : Feedback on questions specifically raised by Officials in paper No.2

Chapter 4 Other matters (continued)

- 2 Life insurers in New Zealand have a wide variety of balance dates and officials consider that starting any new rules on an income year basis would create competitive advantages and disadvantages. A specific commencement date is preferred. Officials seek feedback on why any new rules should not apply from a specific date.**

ISI feedback:

We are supportive of the Officials' preference to create a level playing field between industry participants. However a final decision on whether to adopt any new regime from either a set date or the insurer's balance date will need to be considered in conjunction with wider transitional aspects.

If a specific commencement date is adopted Officials' will need to consider whether they are comfortable in tax calculations being performed with figures from interim periods that may not be audited. The estimated costs and complexity for insurers preparing part year calculations should also be considered.

Appendix A : Feedback on questions specifically raised by Officials in paper No.2

Chapter 4 Other matters (continued)

3. **What is the nature of existing contracts for products that may be adversely affected (based on the model put forward by this paper) and the transitional rules required to deal with them?**

ISI feedback:

Many life insurance companies have products which have a fixed premium for a number of years, or single premium products, which have been priced on the current taxation basis. Such products include level premium term insurances, stepped premium renewable term policies, single premium mortgage protection insurances, and non profit whole of life or endowment insurances. It is likely that a number of these products do not have the contractual ability for the life insurance company to change the premiums even upon a change in taxation legislation.

Without some transition or facilitating legislation, such products may become totally unprofitable and could impact on the financial security of other policyholders.

Proper regard needs to be had to such contracts when framing transitional arrangements such as grandfathering existing policies, or drafting enabling legislation so that premiums may be changed without a contractual right to do so.

The extent of the issue needs to be explored and quantified and possible transitional arrangements devised to avoid the adverse impacts that could affect the general public and wider New Zealand economy.

Reinsurance

There may be some reinsurance products that also need to be considered in similar circumstances.

As previously noted OP2 does not cover the issue of reinsurance in sufficient detail.

Appendix A : Feedback on questions specifically raised by Officials in paper No.2

Chapter 4 Other matters (continued)

4. If the PHB is discontinued (as a consequence of the segregated approach), should PHB tax losses carried forward into the new rules be forfeited by the life insurer?

ISI feedback:

This question is unable to be answered without the formulation of details in respect of transitional measures. The key objective will be to ensure that shareholders and policyholders are not double taxed either upon transition or once they have entered a new regime. In principle:

- Policyholder losses should definitely be able to be offset against policyholder income arising from any grandfathered policies.
- Unrealised investment gains wrapped up in policyholder losses carried forward should be able to be offset against future policyholder investment income to avoid double taxation.

Current life office base tax losses should be able to be carried forward.

Appendix A : Feedback on questions specifically raised by Officials in paper No.2

Chapter 4 Other matters (continued)

- 5. Should credit balances in the imputation credit account and/or policyholder credit account arising from payments of tax on the LOB in excess of the PHB liability be fully or partially retained?**

ISI feedback:

Again, this question is unable to be answered without the formulation of details in respect of transitional measures. Consistent with the issue surrounding retention of policyholder losses the key objective will be to ensure that shareholders and policyholders are not double taxed either upon transition or once they have entered a new regime. We recommend rigorous modelling and testing of various memorandum account scenarios is undertaken to ensure the risk of unforeseen tax liabilities is addressed prior to implementation of any transitional measures.

Appendix B: List of ISI Members

American International Assurance
AMP Financial Services
Asteron Life Ltd
AXA New Zealand
BNZ Investments and Insurance*
CIGNA Life Insurance NZ Ltd
Equitable Group
Fidelity Life Assurance Co Ltd
Gen Re LifeHealth
Hannover Life Re of Australasia Ltd
ING New Zealand Ltd
Medical Assurance Society NZ Ltd
Munich Reinsurance Co of Australasia Ltd
Public Trust
RGA Reinsurance Co. of Australia Ltd
Save and Invest Ltd
Sovereign Ltd
Swiss Re Life & Health Australia Ltd
TOWER Limited
Westpac/ BT Funds Management Ltd

Associate Members

Bell Gully Buddle Weir
Bravura Solutions
Buddle Findlay
Burrowes and Company
Chapman Tripp
Davies Financial & Actuarial Ltd
Deloitte Touche Tohmatsu
Ernst & Young
InvestmentLink (New Zealand) Ltd
KPMG
Kensington Swan
Melville Jessup Weaver
Mercer Human Resource Consulting Ltd
Morningstar Research Ltd
Phillips Fox
PricewaterhouseCoopers
Russell Investment Management
Russell McVeagh
Simpson Grierson

*BNZ Investments and Insurance is a member of ISI but has advised that it does not support the ISI submission in its current form and will be making a separate submission.