

**INVESTMENT SAVINGS & INSURANCE ASSOCIATION OF NZ INC**

Submission  
to the  
Finance & Expenditure Select Committee  
on the

Taxation (Consequential Rate Alignment and  
Remedial Matters) Bill

25 August 2009



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# Investment Savings and Insurance Association of New Zealand Inc.

## 1.0 Introduction

The Investment Savings and Insurance Association of New Zealand Inc. (“ISI”) welcomes the opportunity to comment on the Taxation (Consequential Rate Alignment and Remedial Matters) Bill (“the Bill”).

ISI represents the issuers and managers of life insurance, superannuation and managed funds that in total have responsibility for approximately \$60 billion of assets. As well as interests in life insurance, managed funds and superannuation, ISI members are key providers of KiwiSaver and include all 6 default KiwiSaver scheme providers.

A list of ISI members appears at the end of this document.

As well as comments on the Bill, this submission includes recommendations for further adjustment to the life insurance provisions of the reported back Taxation (International Tax, Life Insurance and Remedial Matters) Bill. We consider these adjustments are essential to achieve the objects of that Bill.

ISI would welcome the opportunity to appear before the Committee to speak to our submission.

## 2.0 Recommendations

ISI’s recommendations are broken down into two sections:

- recommendations relating to the Taxation (Consequential Rate Alignment and Remedial Matters) Bill; and
- recommended adjustments to the reported back Taxation (International Tax, Life Insurance and Remedial Matters) Bill.

### 2.1 Taxation (Consequential Rate Alignment and Remedial Matters) Bill

#### 2.1.1 Support for Alignment of Rates

ISI supports the general policy of the Bill to adjust the tax rates applicable to investment earnings on savings vehicles to bring them into line with the recent adjustments to tax rates and thresholds.

#### 2.1.2 Clause 49 (10) - definition of Prescribed Investor Rate

Paragraph (d) allows for an investor to be on a 21% PIR "if they notify a PIE before 1 April 2010 that 19.5% is their applicable rate". An investor could fit into two PIR categories based on their previous two year's income or 21% if they were previously on 19.5%. Extending this out 2 years, an investor could still correctly be on a 21% PIR if they previously notified the PIE that they were on 19.5% regardless of their previous two year's income.

Paragraphs (b), (c) and (e) can overlap given the references to “either” of the preceding 2 income years.

We recommend excluding proposed clause 49(10)(d) from the definition of Prescribed Investor Rate in order to prevent an investor remaining on a 21% Prescribed Investor Rate indefinitely and instead allow for the 19.5% default to 21% in the definition of “portfolio investor rate”.

Portfolio investor rate could be amended so that investors who have previously notified a 19.5% rate are defaulted to 21% if they do not notify the PIE otherwise. This amendment could be made by inserting a new paragraph (c) into the definition of portfolio investor rate in section YA1 of the Income Tax Act as follows:

- (a) 30%, if paragraphs (b), ~~and~~ (c) **and (d)** do not apply; or
- (b) if paragraph ~~(e)-(d)~~ does not apply, the rate than an investor who has provided their tax file number to the entity under section 28B of the Tax Administration Act 1994 notifies -
  - (i) to the entity as the prescribed investor rate for the investor and the period; and
  - (ii) in the latest notice before the time; and
  - (iii) the Commissioner has not notified the entity to disregard the rate that the investor has notified to the entity; or
- (c) 21%, if the investor notifies the entity before 1 April 2010 that 19.5% is their applicable rate and has not subsequently made a notification under paragraph (b); or**
- ~~(e)(d)~~ 0%, if...

### **2.1.3 Clauses 44 and 81 – Amounts withheld from distributions to holders of FIF attributing interests**

It appears such taxpayers (holders of FIF attributing interests) need to also be deemed to be deriving “resident passive income” to enable them to claim a tax credit given the impact of section CD 36 and EX 59.

### **2.1.4 Clause 37 - Life insurers’ policyholder net losses**

The replacement of section IT (1) with revised wording results from the remedial amendments recommended by the Rewrite Advisory Panel.

As Section IT (1) is to be repealed by the life insurance tax provisions of the Taxation (International Tax, Life Insurance and Remedial Matters) Bill we recommend that the amendment in this Bill should be deleted.

## **2.2 Taxation (International Tax, Life Insurance and Remedial Matters) Bill (as reported from the Finance and Expenditure Committee)**

The following issues have been discussed with officials and we recommend that they should be added into the Taxation (Consequential Rate Alignment and Remedial Matters) Bill.

### **2.2.1 Section EY 30 (3) – Group life master policies**

Section EY30(3) has been drafted to look through the Group Life master policy to the underlying lives covered and restricts grandparenting to those in place before the grandparenting start day.

Thus, for existing Group schemes in place on 1 July 2010 only individual lives covered at that date can be grandparented. Any new lives added would fall into the new regime. Splitting these 2 components and providing separate pricing for each would create major difficulties and increase costs.

We recommend that this section should be amended to allow grandparenting of any new lives added to a group life scheme in place on 1 July 2010.

### 2.2.2 Grand parenting of compulsory workplace business

Proposed section EY 30(4) deals with grand parenting of "employer sponsored group policies" (essentially existing compulsory workplace business). We support the changes to the Bill as reported back in this area except for the requirement in section EY 30(4)(c), which requires that insurers trace through to underlying lives covered and only those lives covered on application date of the new rules are subject to grand parenting. We consider that it will be practically difficult, if not impossible, for insurers to trace through to underlying lives covered for the following key reasons:

- In many cases, life insurers are not notified on a timely basis of members joining and leaving the schemes or the dates on which entry or exit occurs. We understand that, for some large public sector schemes, the life insurer may never be provided this information.
- Assuming that life insurers do have the required information in respect of dates of entry and exit of members, systems changes required to track those lives covered before the application date separately from those covered after that date and the ongoing costs of administering different premium rates for those lives subject to different tax treatments is considered to be onerous.

From initial work performed, our expectation is that the impact on tax revenue through allowing grand parenting to apply to new lives added after the application date is not significant and we recommend that proposed section EY 30(4)(c) should be removed.

### 2.2.3 Meaning of "cannot be changed" and "guarantee"

In response to submissions on the requirement in the Bill as introduced that the rate of premium for level term policies "cannot be changed" if those policies were to qualify for extended grand parenting, the Officials' Report states that:

*"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."*

This refers to the rate of premium not changing whereas proposed section EY 30(5)(a) refers to policies "for which the amount of each premium is the same". The rate of premium and the amount of premium are not necessarily the same. For example: a policy that is "level premium" with indexation may have the same premium rate applying for the life of the policy but the premium amount and the sum assured increases by a fixed percentage each year (or CPI).

Packaged within a policy may be different benefits/riders, one of which is a level term death cover. The current wording of the bill seems to imply that the premium for the

whole policy must remain the same. So if a level term death policy has other life insurance benefits or riders attached, or a policy fee that may increase while the level term cover premium remains the same, then the level term portion is only grand parented for 5 years.

We recommend that the bill should be worded in such a way to allow for both these scenarios to be grand parented for the full term of the benefit/rider and for the benefits/riders on a policy to be treated on a look through basis.

#### **2.2.4 Section EY 30 (4) - Credit card repayment insurance (“CCRI”)**

Proposed section EY 30(4) deals with grand parenting of CCRI. Again, we support the intent of the changes in this area but are concerned that the section will not apply to all CCRI. The definition of "credit card repayment insurance" in section EY 30(11) effectively requires that there is a master policy in place between the life insurer and the card provider. In practice, this is not always the case; legal arrangements may be such that there are individual policies entered into between the life insurer and card holders. The same issues identified in submissions and accepted by Officials exist whether there is a master policy or not.

For that reason, we recommend that the definition of "credit card repayment insurance" should be revised to include policies issued directly to card holders.

#### **2.2.5 Sections EY 16 and EY 20 - Expense Deductibility**

A submission was made to allow insurers to gross up fees charged to policyholders in respect of policies in existence on the application date of the new life tax rules. The submission was made because the level of fees charged in those contracts reflects the fact that under existing rules they are neither taxable in the hands of insurers nor deductible by policyholders. The proposed rules alter this position giving rise to a transfer in value from insurers to policyholders. The submission was rejected for two reasons:

- if the legislation permitted a gross up it might imply that such an event was expected or mandatory; and
- existing contracts will be subject to grandfathering.

Our response to the first ground for rejection is that the Act contains any number of provisions which are elective. We do not understand how the requirement to make an election in this case could be any more expected or mandatory than a decision to elect into the PIE rules or the tax consolidation rules. Our response to the second ground for rejection is that the existing transitional provisions do not address this matter. The transitional rules specifically address the question of taxable income flowing from risk and do not address at all the question of fees.

We can understand Officials' reluctance to enact provisions which "amend contractual terms". Consequently, we appreciate their lack of support for the original submission to statutorily enable insurers to vary existing contracts. We have therefore sought to make a recommendation which, rather than disturb the existing contractual relationship, effectively ensures that the understanding underpinning that bargain is preserved in the new regime.

We recommend that in respect of insurance contracts in existence at application date, insurers can elect to disapply draft sections EY 16 and EY 19 to exclude fees from the calculation of policyholder base allowable deductions and shareholder base income where the quantum of those fees was determined on the assumption that they would be outside the tax net.

### 2.2.6 Cover Review Period

Section EY 30(2)(c), as currently drafted, provides that where the amount of life insurance cover increases by more than the greater of the thresholds in paragraphs (i) and (ii), the grandfathering for that policy ceases to apply from the start of that relevant income year rather than from the point when the cover increases. It is submitted there should be the option for the grandfathering to apply for that part of the relevant income year until when the cover increases.

### 2.2.7 Drafting Points

EY 1 (3) – The income and deductions must also be apportioned to any life fund PIE.

EY 17(2)(b)(i) and (ii) - The words "retained earnings" should be added for clarity. The sections would then read:

“(b) retained earnings average is an actuarially determined amount that is the average of the following 2 proportions:

“(i) the proportion of the value of the policies’ asset base that is attributable to the life insurer’s share holders’ retained earnings at the end of the year before the income year:

“(ii) the proportion of the value of the policies’ asset base that is attributable to the life insurer’s shareholders’ retained earnings at the end of the income year:”

EY 17 (3) – We recommend that “policyholder unvested liabilities” should be defined.

EY 18 uses the formula in section EY 17(1), with a modification to replace "asset base gross income" with annual total deductions. It is not clear why the "net transfers" would still be included in the modified formula. We have the same comment regarding section EY 22.

EY 19 (1)(a) – We question why “claims” is included when EY 19 (1) (c) includes life reinsurance claims.

EY 20 (1)(a) – We question why “premiums” is included when EY 20 (1)(c) includes life reinsurance premiums and EY 20 (1)(e) includes premium buy-back.

EY 24 (2)(ii) – As the current provisions dealing with mortality profit in sections EY 25 to EY 34 and the definition of “mortality profit” are being repealed, we recommend that the term “mortality profit” should be defined for the purpose of section EY 24 (2)(ii).

EY 24 (4)(a) and (b) – The term “present value(s) (gross)” needs clarification.

EY 25 – It is not clear whether in EY 25 (3) “a reserving amount” can be a positive or negative amount, or whether the PSR would be on a net of reinsurance basis where applicable.

EY 30 – It is not clear whether the references to “the life insurer has not policyholder base income or policyholder base allowance deduction for the policy” are intended to exclude what would be savings and participating policies.

## **List of ISI Members**

### **ISI MEMBERS**

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