

INVESTMENT SAVINGS & INSURANCE ASSOCIATION OF NZ INC

Submission
to the
Finance & Expenditure Select Committee
on the
Life Insurance Taxation Proposals
in the
Taxation (International Tax, Life Insurance
and Remedial Matters) Bill

11 December 2008



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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 (International Taxation, Life Insurance, and Remedial Matters) Bill (“the Bill”).

This submission focuses primarily on the new rules proposed in respect of the taxation of life insurance. Another submission has been prepared by ISI which deals with other matters contained in the Bill including the impact on funds management arising out of proposed amendments to the Portfolio Investment Entity Rules, the Offshore Investment Rules and the International Financial Reporting Standards rules as they apply to financial arrangements.

ISI counts amongst its membership (list of members in Appendix) all the major life insurers that operate within New Zealand. Consequently, it is well positioned to comment on the impact of the proposed legislation, both in terms of a wide macro appreciation of the impacts and with respect to the detail of the actual charging provisions.

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

2.0 Summary of Recommendations

ISI’s recommendations are broken down into two categories:

- recommendations relating to the over all policy and structure of the proposed legislation; and
- recommendations relating to specific technical aspects of the proposed legislation.

2.1 General Recommendations

Social policy

The Committee should consider fully the social policy impact of the proposals. Officials’ doubts that the “benefit” of existing tax rules are being passed onto policyholders are baseless. All other things being equal, ISI predicts significant increases in premium as a consequence of the new rules.

Compliance costs

Given the highly technical and specialist nature of life insurance and life insurance taxation, we recommend that the more technical of the proposed rules would benefit from being redrafted in consultation with a panel of recognised industry experts.

We recommend that more effort is made to align the calculations and allocations of taxable income with calculations that are required for other regulatory purposes.

2.2 Technical Recommendations

Application dates

Given the complexity of the rules, ISI recommends deferring the date on which the proposed rules come into force for one year after enactment to ensure that life insurers have implemented systems to comply with the new regime. At the very least, the date at which the rules come into force should be deferred until 1 April 2010.

We recommend that insurers are provided with a choice of application dates – their first balance date after 1 April 2010 (or whatever date the rules ultimately apply from) or a “hard date” of 1 January 2011.

In addition there should be a period of six months from the date of the enactment of the legislation and the requirement to identify new policies which will be subject to the new rules.

Application to existing policies

ISI recommends that the question of whether a policy pre or post dates the effective date of the new rules should be determined according to the point of time at which a bona fide application for the policy is received by the insurer. Policies that are reinstated should be treated on the same basis as the original policy.

Transitional provisions – “level” term policies

ISI recommends that paragraph EY 29(2)(a) is clarified to confirm that where the insurer is bound for whatever reason to maintain the same level of premium in respect of a given existing policy, the policy should be grandfathered for the period of the level premium.

Transitional provisions – grandfathering of rate for age policies

ISI considers that the five year grandfathering period for rate for age policies is too short: we recommend that variable premium policies should be grandfathered for the “life” of the policy (that is, they should be fully grandfathered). If this is not considered to be appropriate we recommend that rate for age policies should be grandfathered for a minimum period equal to the average period for which a rate for age policy is expected to be maintained (we believe that that is approximately ten years).

Transitional provisions – allowance for increases in cover

ISI recommends that term insurance policies sold prior to the effective date of the transitional rules with a future insurability option should continue to be treated as subject to the transitional rules once the insurance cover under these policies has increased. In addition term group insurance where a number of lives are covered under a single master policy should also be grand-parented for the minimum term of five years irrespective of increases in the insurance cover of greater than 10%.

Transitional provisions – deemed disposed and reacquisition of investment assets

ISI recommends that proposed section EZ 61 be amended to apply only to those investments that are not otherwise subject to specific tax regimes such as the portfolio investment entity (“PIE”) and fair dividend rate (“FDR”) regimes.

Shareholder base income: profit participation policies

ISI recommends that proposed section EY 21 be clarified to ensure that it does not require life insurers to treat any capital gains exclusion applied within wholesale PIE

funds, in which shareholder assets are invested, to be reversed in the calculation of taxable shareholder income derived from profit participation policies.

Life fund PIEs

ISI recommends that the tax payable on income derived by Life Fund PIEs should be restricted to 21% (commensurate with the lowest prescribed investor rate), within the policyholder base calculation. Or alternatively, that Life Fund PIEs be able to apply a blended prescribed investor rate to the Life Fund's taxable income, within the policyholder base calculation, provided the life insurer could evidence the rate used by confirming the tax rates of no less than 25% of investors.

Reserving adjustments

ISI recommends that the methodology for determining "Profit Margin" in the legislation should be aligned with the MoS approach, whilst recognising that separate calculations will be necessary, in order to ensure certainty and consistency across the industry.

ISI recommends that adjustments for outstanding claims reserves are calculated without discounting.

Participating business

ISI recommends that the provisions used to allocate taxable income of participating business to the stakeholder base and policyholder base are replaced with the following formulae:

- Tax on the $(1 - r)$ portion of the fund. This should be $(1 - r) \times (\text{tax rate} \times (I_{\text{pie}} - E))$.
- Tax on the r portion of the fund. This should be $(r \times \text{tax rate} \times (I_{\text{s}} - E) + s \times \text{tax rate} \times (I_{\text{s}} - I_{\text{pie}})) - (\text{i.e. the tax due on the shareholders' funds plus the additional tax from } (I_{\text{s}} - I_{\text{pie}}) \text{ on the shareholders' interest contained in the policy liability})$.
- The imputation credit account should be credited with $(r + s) \times \text{tax rate} \times (I_{\text{s}} - E)$ as this is the total tax paid by the shareholders.

ISI recommends that some facility should be included in the proposed rules for capital transfers from the account of the shareholder to the policyholders' one.

Taxation of capital guaranteed investment contracts

ISI recommends that the adjustment required to be made to shareholder income related to movements in the capital guarantee reserves is incorrect and should be removed. Further, we recommend that the draft legislation should be amended to contemplate the situation where the shareholder is required to contribute funds to the policyholder account to support the capital guarantee.

Expenses and charges

ISI recommends that proposed section EY 16 should be amended to ensure that all charges made by the life insurer that are not related to risk are deductible against policyholder income. We also recommend that specific provision is made in the rules to allow insurers to "gross up" the amounts charged to policyholders to ensure that the position continues to reflect the contractual formulation contained in existing savings policies.

3.0 General Comments

3.1 Social Implications

Reform of the current life tax regime has been mooted for a number of years. ISI accepts that the current rules governing the taxation of life insurance lack a principled basis. However, in pursuing a principled solution, ISI considers that the broader social implications of the reform have been down played by Officials and should be more fully considered.

In the Regulatory Impact Statement (“the RIS”) that prefaces the Bill at page 84 Officials assert that:

“It is not possible to determine how premiums may change as a result of the reforms. This is because it is not known where the incidence of the tax benefit of the current under taxation of life insurance rests. In particular, different life insurance businesses operate under different structures, many within wider financial service provider groups, and cross-subsidisation of products and business lines could occur.”

Further at page 85:

“Any change from the status quo may result in an increase to life premiums to the extent that the tax cost is directly passed on to policyholders. The industry has asserted that any change from the status quo could result in premiums increasing, on an all things being equal basis, by 1% to 30%. The calculations supporting the industry’s analysis were not provided, and given the competitive market for life product increases would seem to be at the extreme end of the scale.”

We make the following observations:

- The second excerpt indicates that the competitive state in the market will act to control prices for life products following the regime change. The first excerpt provides a number of reasons why Officials found it impossible to identify where the tax benefits of the existing reform falls. It is because of the fierce competition in the market that the tax benefits are passed through to policyholders in the form of lower premiums. The RIS includes contradictory statements where it suggests that competition will on one hand ensure that insurers will not pass the additional cost through but on the other has not ensured that the benefit is passed to policyholders under the existing regime.
- Different insurers have different structures. However, the state of competition in the market will tend to force insurers to reduce premiums to the lowest level they can achieve. Consequently, Officials’ view effectively confirms that any benefit from the regime is passed through in pricing to policyholders.
- The ISI’s position has always been that the increase in premiums will be at the higher end of the scale. In the submission to Officials in respect of the third discussion document, ISI indicated that the increase in premiums could be in the range of 20% to 30%, all other things being equal. This view was developed from individual insurers calculating the potential impact of the regime change and then assessing the level of premium increase necessary to maintain the existing level of profit.
- If life insurers were absorbing the benefit from the existing regime themselves, it would be expected that the returns of life companies would be significantly better than companies in other industries. There is no evidence that that is the case. ISI is concerned that the potential impact on profitability caused by the regime change

may ultimately force rationalisation in the industry which will mitigate the competitive pressures in the market. This will in turn put additional pressure on premium prices.

At page 85, Officials note that “[i]nternational research suggests that while life insurance premium prices are a factor in demand, other more important factors such as income, age, education and dependants are more influential. There is no compelling evidence to suggest that tax preferences alone influence demand.” We do not dispute the international research reviewed by Officials. We do however dispute the implication that demand for life insurance is not sensitive to price – that is, demand for it is totally inelastic. If it is accepted that the tax preference is reflected in the level of the premium, then all other things being equal in a competitive market, elimination of that preference will result in increases to premiums and reduction in demand. New Zealanders are chronically under and uninsured by world standards even with the benefit of the existing “tax preference”. Can the country afford to further reduce the levels of cover to which the proposed measures will inevitably lead?

At page 79, Officials indicate that in the Regulatory Impact Analysis Unit’s view, it “was not possible to obtain quantitative estimates of the level of costs (including the impact on overall premium prices and compliance costs) and impact on the demand for life insurance as part of a formal quantitative cost-benefit analysis.” We find this surprising. One of the members commissioned such a report from the New Zealand Institute of Economic Research (“NZIER”) which was provided to Officials. That report indicated that a 30% increase in premiums would result in a 17% permanent reduction in policies. This amounts to approximately 250,000 policies. The report indicated that even a more modest increase of premiums of, say, 10% would likely see a decline in total policy numbers of 6.1% or more than 130,000 policies.

Officials assert at page 80 that “[t]o the extent that preferences are received by life insurers, this can distort the decisions by consumers and investors in terms of their choice of saving product or investment compared to other businesses and entities that are required to pay tax on their profits.” The savings policy market in New Zealand has been declining for many years. The majority of insurers no longer write policies of this nature because there is little demand for them. The benefits of multi rate PIEs available to other investment providers have hastened their demise.

The important role that life insurance has in the context of a formal savings plan has been over-looked. Savings can be seen as a form of self-insurance. However, at the time when the safety net is most needed – early in life when families are often carrying considerable liabilities in the form of mortgages - savings are not at a sufficient level to replace life cover. Is it right that the taxpayer should have to pick up the cost of the preference created by KiwiSaver to invest for the long term at the expense of the short to medium term?

Officials point to the proposed transitional provisions to support their arguments that the impact of the new regime will be muted. The transitional provisions will reduce the impact of the new regime in respect of existing business, for as long as those provisions apply. The impact on the premiums of existing business is effectively only being deferred – ultimately there will be a significant impact, it simply will not be immediate. On the other hand, new entrants to the market (in particular young families) are likely to bear the full brunt of the effect of the proposals.

We recommend that the Committee considers the wider ramifications of the proposed reform.

3.2 Compliance Costs

ISI has worked closely with Officials when developing the proposals and prior to the drafting of the proposed legislation. We are gratified to see that a number of the concerns that we raised are reflected in the Bill. Less pleasingly, important aspects of our discussions are not reflected there. At page 87 of the RIS Officials note that “many of the proposed changes are similar to processes currently required for financial accounting purposes.” This is of particular importance. Where they do not transgress established tax principles, the processes should not merely be similar; they should be fully aligned in order to mitigate compliance costs. A theme running through some of our more technical submissions is the divergence in the proposed rules from established procedures necessitating actuarial calculations and certification requirements which will exist purely for tax purposes and which may not be clearly articulated in the draft legislation.

Further, while we might agree in principle with the high level approach that has been taken with respect to the taxation of the separate products, in a number of instances the rules as drafted do not result in the desired outcomes. Given the highly technical and specialist nature of life insurance and life insurance taxation, we recommend that the more technical of the proposed rules would benefit from being redrafted in consultation with a panel of recognised industry experts.

Officials state that “[s]ystems and processes set up at the start of the rules may result in high initial costs for some insurers...” but this is somehow acceptable because they “...apply to a relatively small number of large businesses which are already expert in life insurance taxation and actuarial practice.” As noted above, unless there is a good reason why the existing actuarial or financial reporting numbers cannot be used (an appropriate reason would be an outcome that is divergent from established tax precepts) it is simply not good enough to prescribe variations that require costly new processes which have very little effect on the total tax ultimately determined simply because it is a small number of companies which will have to bear the cost and because they have the expertise to make the changes.

In the same vein, much is made of the extension of PIE benefits to policyholders who save through savings policies. As Officials note, Industry has specifically and explicitly identified the costs of implementing changes to “ensure compliance with the PIE rules, such as paying tax on behalf of policyholders on the basis of their marginal tax rates” as being prohibitive. It is because of these costs that the incidence of life insurers taking up the proposals is likely to be very small indeed. We would be surprised if the cost to the tax base of these initiatives outweighed the increased tax from the proposed change to the taxation of risk as is asserted on page 84. We comment in greater detail on this point elsewhere in the submission.

4.0 Technical Recommendations

4.1 Application Date

Summary and recommendations

The new life tax rules contained in the Bill are proposed to apply from the beginning of life insurers' first tax year commencing on or after 1 April 2009. Transitional rules contained in proposed section EY 29 apply to policies "entered into" prior to 1 April 2009. Policies entered into between 1 April and the first day of the life insurer's first income year beginning after 1 April 2009 are taxed under the existing rules. This gives rise to two issues:

- ISI has identified significant issues with the rules as currently proposed. Given that the rules are not likely to be considered by the Committee until early into the New Year it appears to be unlikely that the rules in their final form will be enacted until shortly before 1 April at best. Given the complexity of the rules, ISI recommends deferring the date on which the proposed rules come into force for one year after enactment to ensure that life insurers have implemented systems to comply with the new regime. At the very least, the date at which the rules come into force should be deferred until 1 April 2010.
- Insurers with a balance date later in calendar year 2009 will have a significant advantage over insurers with an earlier one. Although the desire to ease the complexities arising from the introduction of the rules by synchronising their application date with an insurer's balance date would be the preferred option under normal circumstances, the commercial advantage posed by this proposal should be addressed. We recommend that insurers are provided with a choice of application dates – their first balance date after 1 April 2010 (or whatever date the rules ultimately apply from) or a "hard date" of 1 January 2011.

Discussion

The new rules for the taxation of risk business come into force from 1 April 2009. However, they do not actually apply until the life insurer's first balance date after 1 April 2009. Transitional rules are proposed to apply to policies entered into before 1 April 2009.

The impact of these rules can be summarised as follows:

- Policies entered into before 1 April 2009 continue to be taxed under the existing basis in accordance with the transitional provisions.
- Policies entered into after the life insurer's first balance date on or after 1 April 2009 are taxed according to the proposed new rules.
- Policies entered into on or after 1 April 2009 but before the first day of the life insurer's first income year beginning after 1 April 2009 are taxed on the existing basis until the life insurer's first balance date and according to the new rules thereafter. For example, if a life insurer has a 30 June balance date a policy entered on, say, 1 May 2009 will be taxed under the existing rules until 30 June 2009 and under the new rules thereafter. A policy entered into on 1 July 2009 would always be taxed under the new rules.

The purpose of these rules is to reduce complexity. It is significantly easier for a life insurer to change the basis of taxation for policies on a balance date than to do so mid way through a financial year. Under normal circumstances, this would be the

desired approach. However, this approach has potentially significant commercial implications.

For example, an insurer with a June balance date who writes a policy on 1 April 2009 will derive taxable income from that policy in accordance with the existing regime for three months. If the same policy was written by an insurer with a December balance date, that insurer would have the benefit of that treatment for a further six months (nine months in total). For the December balance date insurer, the differential in applicable tax rates could also be built into the pricing of the policy to effectively make it more attractive, thereby giving that insurer a competitive advantage.

We agree with the Officials' guiding principles for determining an appropriate transitional regime, which is that the transitional rules should not benefit insurers with a balance date that is later in the year. We consider that the proposal as it stands confers exactly that benefit in three ways:

- the late balance date insurer has a longer period of being taxed in a similar way to the existing regime in respect of policies written on or after 1 April.
- the late balance date insurer has a longer period in which to write policies for which that benefit accrues.
- having attracted new business through pricing that benefit in, the insurer is likely to retain the business and benefit for a significant period into the future.

We recommend that insurers should have the option of calculating tax on new business written on or after the appropriate application date under the existing methodology until 31 December 2010 or, **at the insurer's election**, the insurer's first balance date after 1 April 2010.

We are also concerned that the proposed timeframes for application of the rules are too short for the proposed legislation to be comprehensively scrutinised and then for insurers to implement systems to capture the necessary information and to comply with the proposed regime. We identify some significant issues in this submission. Due to the complexity of life insurance and life insurance tax, these issues will require some time to work through. Assuming that the Committee commences consideration of the issues raised in February 2009, it is abundantly clear that there will be insufficient time for the issues to be resolved and the legislation enacted and then for life insurers to adapt their systems by the time that the rules come into force.

Given the likely complexity of the new rules and their interface with insurers' businesses, a reasonable period should be provided for the implementation of the rules. At the very least, the rules should not come into force until 1 April 2010. Based on our recent experience with the PIE legislation, a reasonable time for the new rules to come into force would be nine to twelve months after enactment. Therefore, if the rules were enacted in, say May 2009, they should come into force in May 2010.

ISI also considers that the legislation regarding the application of the transition provisions to certain contracts is uncertain. It is not acceptable to expect life insurers to incur costs in developing processes to identify new policies which will be subject to the new rules as from 1 April 2009, where the submission process is not complete and there is uncertainty regarding the policies that will be subject to the transitional rules.

ISI submits that a reasonable period of time is required following the enactment of the legislation in its final form before a life insurer is required to identify new policies which will be subject to the new rules. Currently it is proposed that policies entered into after 1 April 2009 continue to be taxed under the existing rules until the life insurer's first balance date. ISI submits that there should be a period of at least six months from the date of the enactment of the legislation and the requirement to identify new policies which will be subject to the new rules. This is to allow the life insurers sufficient time to implement processes to identify this new business.

4.2 Transitional Provisions – Application to Existing Policies

Summary and recommendations

Whether a life insurance policy is to be taxed under the existing or proposed rules depends on whether it is "entered into" before the effective date (currently 1 April 2009). ISI is concerned that the term "entered into" will exclude a significant number of policies for which the insurer is effectively "on risk" as at the effective date but which are not "entered into" until after that date. In particular there are circumstances where:

- (a) the insurer is in the process of collecting or considering additional medical information – a process that is time consuming and may take a number of months; or
- (b) a policy entered into before the effective date (currently 1 April 2009) lapses for non payment of premium and is subsequently reinstated – which technically may give rise to a new contract, although in practice all parties treat it as if the original contract is revived.

To alleviate this issue, the question of whether a policy pre or post dates the effective date of the new rules should be determined according to the point of time at which a bona fide application for the policy is received by the insurer. Policies that are reinstated should be treated on the same basis as the original policy. ISI recommends that the relevant part of proposed subsection EY 29(1) is replaced with the following:

This section applies to a life insurance policy, other than an annuity, which was entered into –

- (a) before [1 April 2009]; or
- (b) after [1 April 2009] but:
 - (i) for which an application was received by the insurer before [1 April 2009]; or
 - (ii) which is a reinstatement of a policy entered into before [1 April 2009] and which lapsed due to non payment of premium,

And which meets the requirements of subsection (2).

[Subsection (2) to contain the elements currently contained in paragraphs EY 29 (1)(a) and (b) and the remaining subsections to be renumbered accordingly.]

Discussion

The current proposal relating to policies that are subject to the transitional rules requires such policies to be "entered into" before the proposed application date of the new regime (proposed subsection EY 29(1)). Presumably this is intended to be a strictly legal test based on the point at which a binding contract is formed.

The "offer" in respect of a life insurance policy comes in the form of an application from a prospective policyholder. Because the prospective life to be insured is largely

unknown except for the details that are entered on the application, the insurer often requires significant additional information (usually in the form of a medical examination and copies of relevant doctor's notes) to determine whether cover should be subject to exclusions or the basic premium should be adjusted. It is common in the life insurance industry for policies to become effective on a provisional basis pending the completion of the information collection process.

It is not unusual for the collection of information, the consideration of that information and the determination of exclusions or adjustments to premium to take some time to complete (on occasion it may take a number of months), particularly where the medical examination reveals some kind of condition that the insurer wishes to exclude from coverage under the policy.

Under the current formulation contained in the Bill, a prospective policyholder will not be able to take advantage of a premium priced under the current tax methodology where the policy contract has not been formally completed before the effective date (currently 1 April 2009) despite the fact that the application may have been under the consideration of the insurer for a number of weeks and perhaps months.

Exclusions to policies require careful consideration. It is not commercially feasible for insurers to expedite the process of reviewing the application, considering the supporting material and making a decision whether additional medical information is required. Further, specifying a date by which policies must be entered into in order to qualify for grandfathering may lead to significant bottlenecks in processing. Given that only a finite number of policies will be able to be processed, how will the insurer choose the policies to which to give precedence? There are obviously significant issues concerning customer equity to be considered.

Policies which are not "entered into" by the relevant date will have to be repriced – the insurer will be required to contact the applicant and advise them of the new premium structure and request confirmation of whether they still wish to go ahead with the application. This will result in significant compliance cost for the insurer particularly in terms of costs already sunk into medical examinations and consideration of the underwriting.

An alternative approach, which will alleviate this problem, is for the key date for the application of the new regime to be the date on which a policy application is received.

The second problem with the current formulation is in the case of policies that are reinstated. It is not uncommon for policyholders to miss premium instalments which may lead to the policy lapsing. In these situations, market practice is for insurers to revive the policy within a minimal period after lapse (typically up to 90 days) if the unpaid premium is met. ISI understands that reinstatement of a policy in this situation technically may give rise to a new contract. If so, the reinstated policy potentially would fall outside of the transitional provisions. This would require insurers to offer reinstatement only on adjusted premiums which reflect the new tax rules. In addition, there could be administrative complexities for insurers in identifying policies that have been reinstated and are subject to the new tax treatment, because a reinstated policy might be treated and recorded on insurer's systems as never having lapsed. The insurer effectively regards itself as "on risk" in relation to a lapsed policy for the period during which it is willing to reinstate the policy. ISI therefore submits that, to the extent that a reinstated policy would give rise to a new contract, it should be treated on the same basis as the original policy.

ISI recommends that proposed subsection EY 29(1) is replaced with the following:

This section applies to a life insurance policy, other than an annuity, which was entered into –

- (a) before [1 April 2009]; or
- (b) after [1 April 2009] but:
 - (i) for which an application was received by the insurer before [1 April 2009]; or
 - (ii) which is a reinstatement of a policy entered into before [1 April 2009] and which lapsed due to non payment of premium,

And which meets the requirements of subsection (2).

[Subsection (2) to contain the elements currently contained in paragraphs EY 29 (1)(a) and (b) and the remaining subsections to be renumbered accordingly.]

4.3 Transitional Provisions – “level” term policies

Summary and recommendations

Transitional provisions applying to level term policies existing at the date at which the proposed new rules come into force are intended to apply until the policy ceases to be in force. For a policy to be a level one, the proposed legislation requires that the rate of premium is “always the same amount and cannot be changed” (proposed paragraph EY 29(2)(a)).

Most level term policies contain a contractual clause allowing the insurer to alter the level of premium where there is a law change. This is because level term policies are expected to be held for a considerable amount of time but must be priced according to applicable law and assumptions at inception of the policy. Consequently, if the words “cannot be changed” refer to the situation where on a contractual basis at least, the insurer is able to change the rate of premium (whether or not they actually intend to change the rate or are prohibited to do so in accordance with equity or consumer protection law) most level term premiums will not actually be subject to the intended transitional adjustment.

ISI recommends that paragraph EY 29(2)(a) is clarified to confirm that where the insurer is bound for whatever reason to maintain the same level of premium in respect of a given existing policy, the policy should be grandfathered for the period that insurer is required to maintain the level of the premium.

Discussion

As the name suggests, level term policies are policies for which the premium is held at the same level over the term of the policy or for a specific period of time. Premiums for life risk are determined according to mortality tables. All other things being equal, as a person gets older so the probability of death increases and the premium increases. In order to set the premium for the level period, the relevant rates from the mortality tables are averaged over the period for which the premium is to be held level. Relative to a comparable rate for age policy, the level term premium is more expensive in the earlier years of its currency.

As time progresses the difference in premium diminishes until the premium for a level term policy becomes less expensive than a comparable annual renewable policy. In order for a policyholder to derive the expected benefit from this type of policy, they must hold it for a reasonable period of time. The total premium and therefore the average premium is calculated according to actuarial assumptions and applicable laws at the time that the policy was taken out. It is a fundamental commercial risk mitigation device to permit a life insurer to change the level of premium if required by a change in law including a change in tax law.

Proposed section EY 29(2)(a) requires that a life policy with a level term can be grandfathered for more than five years only where "the rate of premiums payable is always the same amount **and can not be changed.**" (Emphasis added). The existence of a contractual right to change the level of the premium appears to contravene the specific wording of proposed section EY 29(2) (a).

Despite the existence of that contractual right, other aspects of the law may have the effect of compelling the insurer to maintain the level of the premium even in circumstances where there is a law change. Take for example the situation where an agent of the insurer represents to the prospective policyholder that the insurer will not change the level of the premium. Reinforcing this position, printouts detailing various scenarios imply that the premium will not be varied. Putting aside the various forms of consumer protection legislation that may be applicable, it is likely that the law of equity will prevent the insurer varying the contract.

We understand that Officials may have been focusing on a strict contractual analysis when they formulated the drafting of proposed subsection EY 29(2) (a). ISI recommends that the ambit of that subsection should be clarified to ensure that policies subject to non contractual prohibitions on variations of premiums also fall within the ambit of the transition allowed for level term policies.

4.4 Transitional Provisions – Period of grandfathering for rate for age policies

Summary and Recommendations

There are good commercial and social policy reasons why grandfathering for rate for age policies should extend beyond the proposed five years.

ISI considers that the five year grandfathering period for rate for age policies is too short: we recommend that variable premium policies should be grandfathered for the "life" of the policy (that is, they should be fully grandfathered). If this is not considered to be appropriate, we recommend that rate for age policies should be grandfathered for a minimum period equal to the average period for which a rate for age policy persists (we believe that this would be approximately ten years).

Discussion

Officials have recognised that the level of premium for a number of risk products cannot be varied. These products include level term, single premium, guaranteed premium and group life policies with a guaranteed premium period (together referred to as "fixed premium policies"). In recognition that the insurer could be forced into a position whereby the products become unprofitable as a consequence of the introduction of the proposed regime, the Bill permits the existing tax treatment of the fixed premium policies in force at the time that the new regime applies to be "grandfathered" for the duration of the level/guaranteed period. ISI strongly supports this position.

One very significant type of policy has been omitted from "full" grandfathering. Officials have taken the view that rate for age policies should only be grandfathered for a period of five years from the application of the rules. They have selected this period on the basis that they believe that it will give insurers sufficient opportunity to re-price policies before the new regime applies.

Rate for age policies comprise the majority of term life policies. Across the entire industry, we estimate that more than 600,000 New Zealanders hold these policies. Policies are taken out for a number of reasons; in recent years, banks have often encouraged borrowers to take out policies of this type in order to provide security

over the funds lent for the purchase of a home. Given the current turbulence in world financial markets, it is possible that banks will more strongly pursue this approach. Such policies provide a level of security that cannot be matched (at least at the outset) by self insurance through a savings scheme.

Officials appear to regard rate for age contracts in a similar vein to fire and general policies. That is that the insurer is able to fully review the terms and conditions of the policy on an annual basis and adjust them to the circumstances that the insurer finds itself in. On the contrary, rate for age policies are taken out on the expectation that they will be a long term commitment. The vast majority of such policies are taken out to cover a long term financial obligation (for example a mortgage) or as a component of a long term savings plan and are usually modelled for prospective policyholders over significant periods exceeding five years.

The ability of the insurer and the insured to change the terms of rate for age policies reflects the expectation that those policies will have a significant degree of longevity. With the exception of age, the attributes of the insured cannot be reassessed. On the other hand, policyholders are restricted in their ability to increase their coverage to events specifically defined in the policy. The nature of those events again reveals the expectation that the policy will be of significant duration – significant events such as the birth of children or the acquisition of a home or referencing the sum insured to some price index to ensure that it will not be significantly eroded over time.

Rate for age policies are demonstrably not intended to be “annually renewable” in the sense that fire and general policies are. Although most rate for age policies allow for increases in premium due to changes in the tax regime, the ability of insurers to protect their profitability in those circumstances should not outweigh the fact that actually increasing premiums in such circumstances is contra to the nature of the relationship between the insurer and the policyholder and their respective expectations.

“Full” grandfathering should be extended to all term life policies. There are a number of commercial and policy reasons why this should be the case:

- Rate for age policies are priced using mortality tables based on the age of the policyholder. Consequently, each year that the policy is maintained, the premium increases. In the case of a fixed premium policy, the premiums for which are determined according to the same mortality tables, the yearly premium is totalled and then averaged over the expected duration of the policy to derive the annual premium. Consequently, over the period that cover is held, the total premium paid will be, all other things being equal, approximately the same whether the premium is fixed or rate for age. The proposal to extend full grandfathering to fixed policies and not to rate for age ones introduces an element of economic inequality and with it prejudices rate for age policy holders relative to those who took out fixed term policies.
- Should the insurers pass through the expected additional tax cost, premiums could conceivably increase by 20% - 30% (see the ISI submission of 3 May 2007 in respect of the third discussion document) at the end of the transitional period. Existing policyholders will not have foreseen an increase of that magnitude and it is unlikely that such an increase will have been factored into their expectations if they took out their rate for age policy before the enactment of the change of tax regime. Particularly where the policy is linked to a mortgage, policyholders may have no choice but to bear the extra cost. In the alternate, where they are not required to maintain a particular level of cover, policyholders may decide to discontinue the cover or significantly reduce it which may have significant consequences in the event of the death

of the policyholder. Nothing short of full grandfathering will protect these policyholders. In the context of such a significant increase, it is unrealistic for officials to contend that five years will be ample time to get policyholders used to the idea that premiums will increase. Viewed another way, although Officials are correct that the proposed transitional provisions will mitigate the impact of the proposed regime's introduction, the impact is one which is simply being deferred rather than eliminated.

- It is possible that insurers will come under pressure from policyholders to convert rate for age policies into fixed ones before the new regime comes into force. This is obviously highly inefficient given that both types of policy achieve exactly the same outcome and are priced almost identically. If a significant number of policyholders follow this course of action, insurers will bear significant costs in terms of advising policyholders and re-documenting policies.
- There is a history of transitional provisions allowing total grandfathering of existing contractual relationships where there has been a change in tax regime. Examples of these in recent times are the grandfathering of financial arrangements when the legislation creating Division 2 of the financial arrangement rules was given Royal assent on 20 May 1999 and the effective full grandfathering of sale and lease back arrangements involving intangible property entered into prior to 29 March 2004.
- There should be no philosophical objection to applying the proposed regime only to new business rather than having a specified period of grandfathering.

We are concerned that a five year period of grandfathering was determined as appropriate only because it is consistent with the period which was allowed to Australian insurers when their new rules were implemented in 2000. We are unclear as to the basis used by Officials in Australia to determine an appropriate level of grandfathering. However, our view is that if "full" grandfathering is not an option then the grandfathering period should be determined according to the average persistency of such policies which we would expect to be up to ten years. We consider this is appropriate on the grounds that this is the expected duration of such policies and that the underlying basis of the pricing for that period should not be upset by the proposed change in tax law applying to risk business.

ISI believes that these are compelling reasons for extending the period of grandfathering for rate for age policies to the "life" of the policy ("life" in this case being the period for which the policy continues to be rolled over subject to the limits against variation contained in proposed paragraph EY 29(1)(b)). In the event that the Committee does not consider that this is appropriate, ISI recommends that the grandfathering period is extended to the average period that a rate for age policy would be expected to persist.

4.5 Transitional Provisions – Allowance for increases in cover

Summary and Recommendations

Term insurance policies sold prior to the effective date of the transitional rules with a future insurability option should continue to be treated as subject to the transitional rules once the insurance cover under these policies has increased.

In addition, term group insurance where a number of lives are covered by a single master policy should also be grandfathered for the minimum term of five years, irrespective of increases in the insurance cover of greater than 10%.

The proposed section EY 29 (1) (b) should be amended to include the following exclusion: “except where the increase in the insurance cover arises due to a future insurability option or on a group life insurance policy.”

Discussion

Subsection (1) of proposed section EY 29 allows for increases in policies by the greater of 10% of the previous year’s insurance cover or the percentage change in the consumer price index to be eligible for grand-parenting on the current tax basis.

However, these policies are often sold with a future insurability option or business future insurability option whereby a policy can be increased (without underwriting evidence) at various times throughout the life of the policy (at policy anniversary dates contractually set at outset) or at various life changing events (such as purchase of a house, the entrance into marriage or civil union, the birth or adoption of a child).

From a systems point of view, it would be too difficult to separate out various components of the policy for different tax treatments. Given that the ability to effect these increases is guaranteed at the time the policy is sold, we believe that such instances should also be covered by the grand-parenting rules, even though the increase in sum insured might exceed 10%.

In our view, the transitional rules should also cover group insurance whereby a single policy covers a scheme with a number of lives insured. For this category of business, although the underlying premium rates are guaranteed for a period, the sum insured could conceivably increase by more than 10% if the number of members covered in a group scheme increases together with an increase in the salaries of existing members (for group benefits, the sum insured is usually linked to the members’ salary).

The potential impact of the tax changes on the premiums for these products is also significant and the same rationale for applying grandfathering to individual term life insurance should also apply to the group term life policies.

ISI considers that limitation on increases to insurance cover exceeding 10% in a year should not apply to the policies outlined above entered into prior to the effective date (currently proposed to be for policies entered into after 1 April 2009) and that these policies should be eligible for grandfathering.

4.6 Transitional Provisions – Deemed disposal and re-acquisition of investment assets

Summary and recommendations

Proposed section EZ 61 requires that life insurers treat all property supporting actuarial reserves as having been disposed of and reacquired immediately before the date on which the new rules are proposed to apply. ISI is concerned that this notional disposal will subject certain assets to tax more than once.

ISI recommends that proposed section EZ 61 be amended to apply only to those investments that are not otherwise subject to specific tax regimes such as the PIE and FDR regimes.

Discussion

Proposed section EZ 61 states:

Immediately before the first day of the income year beginning on or after 1 April 2009, all of the property of a life insurer that supports actuarial reserves for the purposes of the policyholder income formula in section EY 43 (Policyholder income formula) is treated as disposed of, for market value consideration, to a third person, and immediately reacquired from that person for the same consideration.

EZ 61 requires a notional disposition to be included in the Life Office Base calculation covering the period immediately prior to adoption of the new life insurance rules. We understand from discussions with Officials that the purpose of this provision was to crystallise tax obligations on revenue account property so as to align the life office and policyholder tax bases and we recognise that similar transitional adjustments are common in the introduction of new tax regimes. However, in this instance we are concerned that a notional disposal will effectively double tax investments subject to the PIE and FDR rules, where tax is also payable under these rules. We are also concerned in principle that a notional disposal will bring to account amounts that are not subject to tax when earned by any other investors in PIEs or FDR assets.

Examples:

Policyholder investment subject to FDR

Purchased 1 January 2009	\$100,000
Market value 31 December 2009	\$120,000
FDR income for 2010 tax year	\$ 5,500

Without notional disposal 2010 tax year

• Life office base taxable income	\$ 5,500 per EX 53
• Policyholder base taxable income EY 43B	\$ 5,500 per EY 43 (1) & EY 43B

With notional disposal 2010 tax year

• Life office base taxable income proposed	\$ 25,500 per EX 53 plus EZ 61
• Policyholder base taxable income EY 43B	\$ 5,500 per EY 43 (1) & EY 43B

The \$5,500 FDR taxable income (2010 tax year) is effectively taxed twice.

Policyholder investment subject to PIE

Purchased 1 January 2008	\$200,000
Market value 31 December 2008	\$250,000
Market value 31 December 2009	\$300,000
Portfolio investor allocated income for 2009 tax year	\$ 20,000
Portfolio investor allocated income for 2010 tax year	\$ 10,000

Without notional disposal 2010 tax year

- Life office base taxable income \$ 10,000 per CP 1
- Policyholder base taxable income \$ 50,000 per EY 43
(assuming no PILF adjustment)

With notional disposal 2010 tax year

- Life office base taxable income \$110,000 per CP 1 plus
proposed EZ 61
- Policyholder base taxable income \$ 50,000 per EY 43
(assuming no PILF adjustment)

The PIE allocated taxable income (2009 & 2010 tax years) is effectively taxed twice.

Consequently, we recommend that proposed section EZ 61 be amended to apply only to those investments that are not otherwise subject to specific tax regimes such as the PIE and FDR regimes.

4.7 Shareholder Base Gross Income: profit participation policies

Summary and recommendations

Proposed section EY 21 defines how shareholder gross income from participating business is to be determined. Paragraph (a) of the formula specified in that section specifies 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. 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. If the latter is the case, we consider that such a position is totally unwarranted and is not supported by policy. In any case, ISI recommends that proposed section EY 21 be clarified to ensure that it does not require life insurers to treat any capital gains exclusion applied within wholesale PIE funds, in which shareholder assets are invested, to be reversed in the calculation of taxable shareholder income derived from profit participation policies.

Discussion

For an income year, a life insurer has shareholder base gross income to the extent to which it has an amount for profit participation policies calculated using the formula –

$$\text{Adjusted asset base gross income} * \frac{(1 - \text{liabilities proportion}) * \text{gate}}{(1 + \text{gate})}$$

In the formula, -

(a) adjusted asset based gross income is the amount of annual gross income that the life insurer would have for the profit participation policies’ asset base, if the life insurer is treated as having no assets other than the asset base, section CX 55 is ignored, and amounts under section EY 28 are ignored.

It is unclear how the ‘Adjusted asset base gross income’ reference to section CX 55 (as amended by this Bill) should be interpreted. Section CX 55 now provides that a life insurer can treat capital gains derived from the disposal of directly held qualifying New Zealand and listed Australian equities as excluded income to the extent to which the amount is actuarially determined to be policyholder base gross income.

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 totally inequitable for a life insurer to be required to take these gains into consideration in the calculation of the profit from participating business. Consequently, we assume that the purpose of the exclusion from section EY 21 is to ensure that only policyholders and not shareholders are able to benefit from the directly held equity exclusion in CX 55.

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

4.8 Life Fund PIEs

Summary and recommendations

The Bill contains a proposal to extend the application of the PIE regime to “Life Fund PIEs”. The proposed tax rate applying to taxable income derived by a Life Fund PIE is the company tax rate (currently 30%) unless the insurer elects to attribute income to policyholders at their prescribed investor rate. There are a significant number of policyholders who save via a Life Fund PIE who have a marginal tax rate of less than 30%. However, it is not economically viable for life insurers to put in place the systems necessary to attribute income specifically to a given policyholder.

ISI recommends that the tax payable on income derived by Life Fund PIEs should be restricted to 21% (commensurate with the lowest prescribed investor rate) within the policyholder base calculation. Or alternatively, that Life Fund PIEs be able to apply a blended prescribed investor rate to the Life Fund’s taxable income, within the policyholder base calculation, provided the life insurer could evidence the rate used by confirming the tax rates of no less than 25% of investors.

Discussion

Proposed legislation in subpart HM introduces provisions for Life Fund PIEs. A Life Fund PIE is proposed to be defined as:

a separate identifiable fund forming part of a life insurer that holds investments subject to life insurance policies under which benefits are directly linked to the value of the investments held in the fund.

ISI members are pleased that the Government has recognised that many policyholders are currently being overtaxed in relation to investments made through savings policies.

In our previous submissions to the Discussion Documents on life tax reform we noted the practical difficulties and costs to a Life Insurer in directly attributing investment income legally derived by a life insurer to policyholders and applying their respective prescribed investor rates. Fund managers incurred enormous expense in developing systems when the PIE rules were first enacted. Those costs are not expected to be recouped for many years. Life insurers are acutely aware that they would have to incur similar costs to deliver PIE functionality to wholesale and retail investment funds and cannot see value in recommending that shareholders incur further expenditure to upgrade systems for legacy products, where the benefit is perceived as arising principally to policyholders. In any case, relatively speaking, very few new investment-linked or insurance bond products are sold and the prospect of return on such shareholder expenditure is very limited.

Nevertheless, the simple fact remains that through no fault of their own policyholders investing in those funds will continue to be disadvantaged relative to individuals investing directly into PIEs. Further, there may be significant financial loss or loss of tangible benefits for policyholders to reposition themselves by extracting their investments and investing into PIEs.

We have previously suggested that a pragmatic approach would be to allow life insurers the option of polling policyholders to evidence a blended prescribed investor rate for application in the policyholder base, or alternatively that a 19.5% prescribed investor rate be permitted. We believe this is a practical solution and repeat this recommendation here.

4.9 EY 23 to 26 Reserving Adjustments: premium smoothing

Summary and recommendations

The proposed legislation adjusts shareholder taxable income on non participation policies for movements in Premium Smoothing Reserve (“PSR”) and Unearned Premium Reserve (“UPR”). ISI supports the intent of the legislation. However, based on the formula contained in the proposed legislation, the adjustment relating to PSR will always be zero. We assume that this is an error. The formula for the “Profit Margin” element of the formula is loosely based on the margin on services (“MoS”) valuation methodology. ISI recommends that the method for determining “Profit Margin” in the legislation should be aligned with the MoS approach in order to ensure certainty and consistency across the industry. Although the methodology is to be aligned, separate calculations will be necessary.

The adjustments relating to movements in outstanding claims reserves are proposed to be calculated on a net present value basis (that is, the balance of the reserve is effectively discounted reflecting the timing at which a physical payment will have to be made). While this accords with the methodology used for financial reporting purposes, it is not appropriate for tax purposes and, in fact, would overturn established law and practice. ISI recommends that adjustments for outstanding claims reserves are calculated without discounting.

Discussion

As it currently stands, the formula for the life insurer’s PSR will always equal zero. This is because the elements of “Profit Margin” as defined actually cancel out against the other elements of the PSR formula. We assume that this is an error of drafting.

While we support the intent of the adjustment, we are concerned that the current definitions of the elements contained in the various formulae are not specific enough. The approach of the draft legislation is loosely based on the MoS valuation methodology. We consider that the tax regime should follow the MoS valuation methodology more closely to reduce compliance costs.

In the alternative, the draft legislation needs to be more specific as to the application of the preferred methodology. Currently the legislation is silent whether the Profit Margin for a given class of policies should be carried forward from year to year or should be recalculated annually. In principle, under the MoS valuation methodology the profit margin for a class of policies is carried forward from year to year, and only changed when a best estimate assumption is changed. To avoid doubt, this approach should be specified in the legislation rather than relying upon it being implied.

Further, it is unclear whether separate profit margin percentages should be maintained for each subsequent year’s new business or whether it is intended that each year’s new business should be combined with the existing business and an average profit margin percentage calculated.

Our submission on the third discussion document raised the issue of whether a PSR could be used for all elements of “composite” products – that is, products which have a life component and also a non life component such as a trauma rider benefit or total and permanent disability rider benefit. Although these rider benefits are not taxed as life insurance, the basis for taxing these products will be essentially the same if the proposed basis of taxation is adopted for life business. Under these circumstances the insurer should be able to apply a consistent PSR reserving basis for the rider benefits and the underlying life benefits. This would reduce the costs of complying with the legislation.

The purpose of the reserving adjustments is to recognise the difference in the timing of premiums derived relative to the risk accepted where the premiums are level or guaranteed for a period of time. We suggest that the clarity of EY 23 (4) (b) (ii) could be improved by referring to ‘a material **timing** mismatch occurs’ as there are other situations where a mismatch between the risk component and the premium payable could be said to occur (for example acquisition costs are front loaded).

Also for the sake of clarity, a different term should be used in place of “Profit Margin”. The term is correctly defined in EY 25 (5) and is conceptually the contribution to profit and recoupment of acquisition costs. This differs from the definition of profit margin under MoS, which is purely the contribution to profit, reflecting what is commonly understood as profit margin. To avoid confusion and to recognise that different calculations are involved in tax calculations as opposed to financial reporting calculations, a terminology such as “Contribution to profit and recoupment of acquisition costs” should be used in place of “Profit Margin” in the tax legislation.

Gross value of outstanding claims reserves

The new rules propose that the adjustment for outstanding claims for non-participation policies should be made on a present value basis. Such an approach is a fundamental departure from accepted tax principles that have been established by case law at the highest level (for example Mitsubishi and the judgment of the Australian Full Federal Court in *FC of T v Mercantile Mutual Insurance (Workers Compensation) Limited & Anor* 99 ATC 4404) and have been followed by insurers for a significant period of time.

ISI strongly opposes the proposal. Officials have not provided any analysis or policy arguments to support their proposal. One potential ground for support is that it allows the accounting treatment to be used without adjustment for tax purposes. However, if it is merely a question of ease of compliance, insurers should be able to elect to use this basis if it is not going to adversely impact them from a financial perspective.

We understand that the genesis of the proposal may have arisen through an agreement that Inland Revenue recently reached with fire and general insurers. The basic rationale for the agreement was that the accounting basis gave rise to a more appropriate outcome than the gross basis that had been previously used by fire and general insurers. We understand that instrumental to that outcome is the fact that prudential margins applied to claims reserves were accepted by Officials as being deductible (although we note that the Mercantile Mutual Insurance case also supported the deductibility of prudential margins). For life insurance purposes there is generally no requirement to provide for a prudential margin. Consequently, we do not accept that the discounted value of reserves together with a prudential margin give a more appropriate result than the gross value of reserves alone.

Currently, the new rules relating to fire and general insurers apply specifically and only to those insurers who use Appendix D of IFRS 4. Typically, life insurers will not be subject to Appendix D in relation to policies issued by the life insurer, and thus life insurers are not subject to these new rules. However, there have been informal indications from Officials that consideration may be given in the course of reviewing submissions on the Bill as to whether the scope of these provisions should be expanded to include life insurers in respect of some or all of their business. For the same reasons as those discussed above, any such extension of scope is unwarranted, and would inappropriately reverse well-settled taxation principles of when and to what extent claims are incurred.

We are also concerned that the adoption of the net present value approach for both fire and general and life business can then be used as a precedent to be applied to non life policies (disability type policies offered by life insurers). As with life business,

we do not accept that the discounted value of reserves together with a prudential margin give a more appropriate result than the gross value of reserves alone.

We recommend that the tax adjustments for outstanding claims reserves underpinning the life business are calculated without taking discounting into consideration.

4.10 Taxation of Participating Business

Summary and recommendations

The proposed legislation in essence taxes participating business on the following basis:

Investment Income minus Expenses plus Other Profit

In principle, we agree that profits from participating business should be taxed on an income minus expenses basis.

The methodology for determining the shareholder and policyholder shares of taxable income from participating business contained in proposed sections EY 17 and EY 21 incorrectly allocates income between the shareholder and the policyholder. This occurs because the variable “liabilities proportion” comprises both shareholder and policyholder assets and consequently is not an appropriate basis for allocation. The immediate issue is that the correct base does not bear the correct amount of tax and does not receive the correct amount of imputation credits. Of longer term concern is the possibility that there will be a differential rate of tax between the policyholder and shareholder accounts which will result in the incorrect total amount of tax being paid on that income. ISI recommends that the allocation formula is replaced with the one set out below.

ISI recommends that some facility should be included in the proposed rules for capital transfers from the account of the shareholder to the policyholders’ one.

Discussion

Allocation of tax payable

The proposed legislation attempts to separately identify shareholder and policyholder components via a number of formulae 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 not clearly defined and should be clarified in the legislation. We understand that it is intended to represent policy liabilities as applied in a MoS approach.

Proposed section EY 17 defines the policyholders’ share of participating business as $(1+p \times g)/(1+g)$.

Proposed section EY 21 defines the shareholders’ share as $(1-p) \times g / (1+g)$.

ISI considers that this does 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.

Consequently, a different basis is required to correctly allocate income to the shareholders’ and policyholders’ respective accounts. Each part of the fund needs to be taxed consistently with the mechanism that manages participating funds (i.e. the

gate). What this means is that the shareholders' interest represented by future transfers must be taxed in the same way as the rest of the policy liability – if this is not done, then whatever tax is charged to that portion of policy liabilities will be allocated largely to policyholders, which is not correct.

Bearing this in mind, it is reasonable to define the shareholders' interest as the proportion of the participating assets that are represented by:

Shareholders' retained funds + Present Value of future shareholder transfers

These are both discernable from insurers' financial accounts. We consider that this should be the basis of allocation between shareholders and policyholders and we demonstrate below how these can be incorporated into formulae that determine the correct allocation of taxable income.

Define r as (shareholder retained funds / total participating funds) and s as (PV of future shareholder transfers / total participating funds).

ISI considers that there should be three elements to the taxation of participating business and that these should be reflected in the proposed rules:

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

This approach allows the gate mechanism to work as intended and ensures that the appropriate amount of taxable income from participating business is attributed to both the shareholders and policyholders. We recommend that it replace the proposed methodology.

Other Profit

ISI has previously submitted that an "Other Profit" item is unnecessary and we continue to adhere to that view. Investment Income minus Expenses is all that is required to determine the correct amount of taxation in relation to participating business.

We understand that Officials are concerned about future participating contract developments that may result in Investment Income minus Expenses being manipulated. While we cannot envisage what the terms of such a policy would be, we understand the concern. If "Other Profit" is to be retained, we recommend that it be restricted to apply to future product developments rather than imposing it on existing business.

In the event that the "Other Profit" element is retained, ISI has concerns with the mechanics of the formula that is currently proposed. A net premium approach has been adopted for expected cash flows and a gross premium approach for actual cash flows. The justification for this is not clear.

Further, the net premium valuation methodology proposed is a wholly new valuation basis that is not currently employed by life insurers. Apart from the compliance cost of calculating these valuations solely for tax purposes, we understood that Officials did not want to depart from methodologies currently under use by life insurers for such purposes as financial reporting to leverage off the assurance provided by

external regulators reviewing them. If an item such as “Other Profit” is to be included as taxable income, it should be defined consistently with the MoS approach, which would allow the calculation to be based on numbers produced as part of annual reporting, rather than imposing a further valuation requirement.

ISI notes that where the “Other Profit” amount is actually a loss, that loss is not allowed to be used to reduce other shareholder tax but must be carried forward and offset against future “Other Profit” income. We see no justification for this approach and recommend that the restriction be removed.

Capital Transfers

ISI notes that the proposals do not allow for the situation where shareholder funds outside the participating fund are required to support it. This would be a rare and extreme event, but it is possible. In this instance, a shareholder transfer (akin to a capital injection to the participating business) should be treated as deductible to the shareholders and taxable to the policyholders to the extent that the transfer supports benefits already accrued to policyholders and/or future bonuses to policyholders. It is possible that subsequent to such a transfer, the shareholder is able to recover part or all of its contribution. If this occurs the rules should provide for the corollary of the treatment described above (i.e. the transfer is deductible to the policyholders and taxable to the shareholders).

4.11 Taxation of Capital Guaranteed Investment Contracts

Summary and recommendations

The approach of the draft legislation is to tax *non-participating* capital guaranteed investment contracts in a manner consistent with non-participating non-capital guaranteed investment savings contracts and *participating* capital guaranteed investment contracts in a manner consistent with participating non-capital guaranteed contracts. The ISI supports this general approach.

However, ISI recommends that the adjustment required to be made to shareholder income related to movements in the capital guarantee reserves is incorrect and should be removed. Further, we recommend that the draft legislation should be amended to contemplate the situation where the shareholder is required to contribute funds to the policyholder account to support the capital guarantee.

Discussion

Capital guaranteed investment products (also commonly known as investment account products) are essentially savings contracts that have a capital guarantee element (i.e. it is guaranteed that the account balance cannot fall). They are a relatively minor life insurance product with only a small amount of fund inflows.

The approach to managing these products differs across the industry and primarily depends on whether the underlying savings product is participating or not.

Non Participating Capital Guaranteed Investment Contracts

Non participating capital guaranteed investment contracts are managed in a similar manner to non-participating savings contracts, with the shareholder profit derived via a fee charged to the policyholder funds. The capital guarantee element is supported by a capital guarantee reserve (“CGR”) - this is a portion of the policyholder return which has been set aside. In times of poor investment performance the CGR will typically be drawn upon to “top up” the amount credited to policyholders. In times of good investment performance a portion of the investment return will typically be added to the CGR to support future crediting rates. There may be extreme circumstances (essentially where the fund is insolvent) where the shareholder will be

required to inject money into the CGR to ensure there are sufficient funds to support the capital guarantee. These circumstances should be very rare.

The draft legislation generally applies to these products in a manner consistent with non-participating non-capital guaranteed investment savings contracts. The ISI supports this general approach.

The draft legislation requires that shareholder income or loss is adjusted for movements in the CGR. We consider this is incorrect. As noted above, the CGR is made up of policyholder funds so any movement in it should not be attributed to the shareholder. However, policyholder income should not be adjusted for the movement either, as it is simply a transfer between different policyholder funds both of which are already subject to tax.

As noted above, there may be extreme circumstances where the shareholder is required to contribute funds to support the capital guarantee. In the rare instance the shareholder is required to contribute funds, we consider that it is appropriate that this contribution is tax deductible to the shareholder and taxable to the policyholder.

We recommend that the following amendments should be made to the proposed legislation:

- All asset movements between the CGR and policyholder accounts should be excluded from policyholder income and policyholder expense. This is because it is simply a transfer between different policyholder funds. The investment income from both of these funds is already taxed under the draft legislation. For absolute clarity, the CGR should be taxed as policyholder money. We believe the draft legislation as it stands achieves this;
- All asset movements between shareholder funds and the CGR should be included in shareholder expense/income and similarly in policyholder income/expense. As asset transfers of this nature should only be required in rare circumstances we recommend that they are required to be actuarially certified.

Participating Capital Guaranteed Investment Contracts

Participating capital guaranteed investment contracts are managed in a similar manner to a traditional with-profit contract, with the shareholder profit derived via a prescribed share of the amount credited to the policyholder. The capital guarantee element is supported by Policyholder Retained Profits (PRP) in a similar manner to CGR for non participating contracts. Once again there may be circumstances where the shareholder will be required to inject money to support the capital guarantee.

The draft legislation generally applies to these products in a manner consistent with other participating contracts. The ISI supports this general approach but notes comments made elsewhere within this submission related to participating contracts also apply to Participating Capital Guaranteed Investment Contracts.

We also note that under the current legislation there is no allowance for the extreme situation where the shareholder may be required to contribute funds to support the capital guarantee. We recommend that the proposed legislation is amended to ensure that all asset movements between shareholder funds and policyholder funds to support the capital guarantee are included in shareholder expense/income and similarly policyholder income/expense. Such transfers should only be required in extreme circumstances and the ISI recommends that they are required to be actuarially certified.

4.12 Expenses and Charges (other than in relation to life and non-life risk) under Savings Policies

Summary and recommendations

Life insurers charge policyholders a variety of fees and expenses relating to the execution and administration of savings policies. These fees are proposed to be taxable to the life insurer in accordance with proposed section EY 19. We understand that they are intended to be deductible to the policyholder in accordance with proposed section EY 16 to the extent that they do not relate to the risk element of the policy.

In order that this intention is reflected in the legislation ISI recommends that proposed section EY 16 should be amended to ensure that all charges made by the life insurer that are not related to risk are deductible against policyholder income. We also recommend that specific provision is made in the rules to allow insurers to “gross up” the amounts charged to policyholders to ensure that the position continues to reflect the contractual formulation contained in existing savings policies.

Discussion

ISI understands that the intention is that expenses and charges (other than in relation to life and non-life risk) will be taxable as part of shareholder income and should be deductible as a policyholder expense. From the shareholder’s perspective the fees are proposed to be brought to tax in accordance with paragraph EY 19(2)(c). That paragraph applies to “fees and commissions” derived by the life insurer and will include fees and commissions referable to the risk component of the policy which are not deductible against policyholder base income. Fees and commissions are deductible from policyholder base income in accordance with section EY 16 which specifies that expenditure is deductible to the extent to which it is incurred in deriving policyholder base income (i.e. income from investments). The difference in wording between the two sections could lead to confusion – in particular, section EY 16 could be taken as restricting the deductibility of expenses beyond those related to risk. We recommend that proposed section EY16 be modified to state that the section applies to all expenses and charges (other than in those relating to life and non-life risk).

Existing life policies generally allow fees to be charged against policyholder income. These policies express the amount of the expense on an after tax basis because under the existing life office tax basis the charging of fees by the insurer against policyholder income is not a taxable event - the charge is made within one taxable entity. However, by effectively splitting the life insurer into two and effectively treating each as a separate taxable entity, these charges become subject to tax. In order that the life insurer maintains the same level of fee income under the proposed rules as under the existing rules, it is necessary to “gross up” the fee. That is, the fee must be increased by an amount equal to the tax payable on the income. The corollary is that policyholders are entitled to a deduction for the “grossed up” amount of the fee. We recommend that insurers be able to gross up existing fees for the purposes of EY16 and EY19 (2) (c). This will avoid the compliance costs and administrative problems associated with notifying policyholders of a new gross fee which will be economically equivalent to the old after tax fee.

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