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**AN ANALYSIS OF THE APPROPRIATENESS OF THE FOUR FUNDS
APPROACH FOR THE TAXATION OF LIFE INSURERS IN SOUTH AFRICA
INCLUDING A QUALITATIVE COMPARISON TO THE RECENTLY
ENACTED APPROACH ADOPTED IN NEW ZEALAND AND
RECOMMENDATIONS FOR IMPROVEMENT TO THE APPROACH**

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DECLARATION

I, Peter Allen Donaldson, hereby declare that the work on which this research paper is based is my original work (except where acknowledgements indicate otherwise) and that neither the whole work nor any part of it has been, is being, or is to be submitted for another degree in this or any other university.

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ABSTRACT

Section 29A of the Income Tax Act No. 58 of 1962 contains a special set of rules for the taxation of life insurers. These rules were originally enacted in 1993 and are commonly referred to as the four funds approach. The rules have remained largely unchanged since their original enactment despite ongoing changes in the life insurance industry in particular with regards to new product offerings.

The four funds approach is conceptually sound when compared to theoretical principles applicable to the taxation of life insurers. This is because the approach provides for the taxation of both the underwriting profits of the life insurer, and the savings income of the life insurer earned on behalf of policyholders, on an accrual basis.

However, there are shortcomings in the four funds approach which include:

- 1) the methodology it prescribes for the taxation of underwriting profits as a result of a lack of distinction drawn in the approach between the risk and savings business of a life insurer; and
- 2) the use of a proxy tax rate (currently 30%), rather than investor marginal rates, to tax investment income earned by the life insurer on behalf of individual policyholders, resulting in a lack of tax neutrality between life wrapped investment products and alternative investment products such as collective investment schemes.

The above two issues were considered when a new approach to taxing life insurers was recently enacted in New Zealand, effective from 1 July 2010. Much insight can be gained from the New Zealand approach when considering improvements that can be made to the four funds approach to address identified shortcomings.

To address the issue of the appropriate taxation of underwriting profits, it is recommended that a distinction be drawn in the approach between the risk and savings business of a life insurer. Such an approach would entail a life insurer having to allocate its income and expenses related to risk business directly to the corporate fund, and the savings income earned on behalf of policyholders to its policyholder funds. With the separation of risk and

savings business, the expense relief ratio, which seems to have little theoretical justification, could be eliminated from the legislation with the expenses of the life insurer being subject to deduction in terms of normal income tax principles.

To address the issue of tax neutrality between life wrapped investment products and alternative investment products, it is recommended that a new fund be created for linked life wrapped investment products. The trustee principle should be retained in that the income of such products should be taxed at the life company level. However, the income should not be taxed at the proxy rate of tax applicable to the individual policyholder fund but should rather be attributed to the underlying investors and taxed at their marginal rates.

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ABBREVIATIONS AND GLOSSARY

Act / Income Tax Act	Income Tax Act No. 58 of 1962
AFS	Annual financial statements
ASISA	Association of Savings and Investment South Africa
CF	Corporate fund
CGR	Capital guarantee reserve
CGT	Capital gains tax
CIS	Collective investment scheme, commonly referred to as a unit trust
CPF	Company policyholder fund
EDS	Expected death strain
Four funds approach	Four funds approach for the taxation of long-term insurers in South Africa
FSB	Financial Services Board
GDP	Gross domestic product
GLA	Group life assurance
GNI	Gross national income
IBNR claims reserve	Incurred but not reported claims reserve
IPF	Individual policyholder fund
ISI	Investment, Saving and Insurance Association of New Zealand

LAC	Life Assurance Committee
LOB	Life office base
LT Act	Long-term Insurance Act, 1998 (Act No. 52 of 1998)
New Zealand approach	The recently enacted approach for the taxation of long-term insurers in New Zealand which is effective from 1 July 2010.
PHB	Policyholder base
PHI	Permanent health insurance
PIE	Portfolio investment entity, a term defined in New Zealand tax legislation
Policyholder funds	The IPF, CPF and UPF
PSR	Premium smoothing reserve
RSA	Republic of South Africa
SARS	South African Revenue Services
UPF	Untaxed policyholder fund
UPR	Unearned premium reserve
VAT	Value-added tax

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1. INTRODUCTION

1.1. An overview of long-term insurance

Insurers play an important role in the South African and global economy as they provide a means of savings and risk pooling for their policyholders which mainly include, individuals, corporates and retirement funds. Insurers provide a means of savings as premiums charged by an insurer are invested to meet future claims/benefits. Insurers also provide a means of risk pooling as they pool the risks of different policyholders so that those whose insured risk eventuates are compensated in part out of the premiums by those who do not file claims (Oliver, 2004: 16).

Oliver (2004: 16) describes the services offered by an insurer as an intermediary service whereby the insurer underwrites some of the residual risk associated with risk pooling (being the risk that premiums charged by the insurer are insufficient to meet its future claims obligations) and may assume some savings risk (being the risk that investment returns will be less than those required to meet future claims obligations). Insurers also offer a savings mechanism of “pooling” whereby premiums/contributions of an individual investor are pooled with premiums/contributions of other investors and invested in a spread of underlying assets for the benefit of the underlying investors.

Insurance can be grouped into three broad categories: long-term or “life” insurance, short-term or “general” insurance and reinsurance. Long-term insurance broadly encompasses insurance contingent on human life whereas short-term insurance involves the insurer underwriting losses from events not contingent on human life (Oliver, 2004: 16 and 17). Long-term insurance tends to have a high proportion of savings element because most policies have multi-year terms with payoffs to policyholders during or at the end of their lifetime whereas short-term insurance tends to have a greater risk pooling element but a smaller savings element as contracts have a shorter term. Re-insurance is a transaction between two insurers

whereby one insurer purchases insurance to cover all or part of the risks the other insurer does not wish to cover. Re-insurance can be long- or short-term but tends to be focussed on risk pooling (Oliver, 2004: 17).

The business of a long-term insurer (also referred hereinafter to as an “insurer”, “life insurer”, “life company” and “life office”) is fundamentally different to an ordinary business in that the products it offers have long-term capital and profit implications which can stretch for the lifetime of an individual. The long-term nature of the business drives the need for actuarial involvement in the determination of the prices it charges for its products (i.e. premium rates) and the valuation of its liabilities for financial and regulatory reporting purposes. Regulatory oversight is also required to ensure that the life insurer holds sufficient capital to meet its future claim obligations.

Long-term insurers can be organisationally structured in two ways: as a mutual organisation or as a company. Mutual insurers are owned by their policyholders who are the ultimate bearers of savings and residual risks (Oliver, 2004: 17). Some of the profits earned by the mutual organisations may be re-distributed to their policyholders over time.

In contrast, insurers structured as a company have shareholders who are distinct from policyholders. Shareholders hold shares in a demutualised company and bear the residual risk of risk pooling and possibly savings risk in return for the expectation that the insurer will make profits over time from the policies that it underwrites and from investment returns on the excess assets it holds (i.e. assets in excess of its policyholder liabilities). The policyholders are clients of the life company – they pay premiums to the life company for the purposes of obtaining a claim or benefit from the life company in the future. In certain instances, the insurer may write policies whereby the policyholders participate in the profits of the insurer with respect to a certain book of business.

The international trend over the past twenty years has been for mutual organisations to demutualise and become separate companies. This has been driven by a need for

access to a broader capital base, better management accountability and to facilitate international expansion (Oliver, 2004: 17).

1.2. An overview of the South African long-term insurance industry

The South African long-term insurance industry is dominated by four South African insurance companies¹, with a host of other insurance companies. All of the largest insurers are structured as companies following the demutualisation in 1998 of historically the two largest life insurers in South Africa, being Old Mutual and Sanlam. There are five main re-insurance companies², all of which are subsidiaries of global companies.

Insurers wishing to write long-term insurance in South Africa are required to be registered under the LT Act. The FSB is the government appointed agency responsible for the oversight of and monitoring compliance with the LT Act. ASISA is the industry body representing the interests of life companies in South Africa.

The South African long-term insurance industry had approximately R1 380 billion in assets under management in 2009³. By comparison, assets held by local CISs as at 31 December 2009 were R786 billion⁴.

Net premiums (i.e. gross premiums less re-insurance premiums) received by direct / primary insurers (excludes re-insurers) in 2009 were R295 million, increasing by 11.5% from 2008⁵ and the insurance industry in South Africa has seen steady growth in recent times, despite the recent global financial crises.

¹ The four main long-term insurance companies which each have a market share of more than 10% determined with reference to assets are: Old Mutual (28%), Sanlam (17%), Momentum Group (12%) and Liberty Group (11%) (Registrar of Long-term Insurance (2009: 40-41)).

² The five main re-insurance companies which each have a market share of more than 10% determined with reference to assets are: Swiss Re Life and Health (32%), General Re (20%), Hannover Life (20%), Munich Re (16%) and RGA (10%) (Registrar of Long-term Insurance (2009: 41)).

³ Registrar of Long-term Insurance (2009: 41).

⁴ Statistics per ASISA available at www.asisa.co.za

⁵ Net premium statistics are obtained from: Registrar of Long-term Insurance (2009: 9).

A description of the products available in the South African long-term insurance market is given in the following section. For now, however, it's useful to give a brief summary of premiums by policy type (as defined in the LT Act) and reported on annual basis by the Registrar of Long-term Insurance.

The majority of premiums received by primary insurers are in respect of “fund policies”⁶ and “life policies”⁷. In 2009, fund policies made up 55.5% (2008: 51%) of total primary insurance net premiums, life policies made up 38.5% (2008: 44%) of net premiums⁸. Disability⁹, health¹⁰, assistance¹¹ and sinking fund policies¹² made up the remaining 6% in 2009 and 5% in 2008.

Of the total premiums received by primary insurers, 60.9% (2008: 58.6%) were in respect of linked business¹³ where no risk is actually undertaken by the insurer.

In summary, life insurers primarily operate in the South African market as 1) a savings mechanism for retirement funds; 2) providing life cover for individuals in the event of death; and 3) providing annuities for individuals for their retirement. However, other aspects of insurance business such as disability and health business, even though are currently a small proportion of business, are in growth phases¹⁴. The majority of savings policies are linked investment policies where no underlying risk is undertaken by the insurer.

⁶ Fund policies are those policies held by registered pension, medical aid and similar type funds of funds.

⁷ Life policies are those policies which either have a payout on death of the insured or will pay an annuity to the insured for a period of time.

⁸ Statistics per Registrar of Long-term Insurance (2009: 8).

⁹ These are policies which pay a benefit on the permanent or temporary disability of the individual. The benefit may be in the form of a lump sum benefit or an income benefit (commonly referred to as PHI).

¹⁰ These are dread disease/severe illness type policies which pay a benefit on the policyholder falling ill due to diseases such as cancer, heart attack, stroke etc.

¹¹ These are typically funeral policies which have a payout on death.

¹² These are policies, other than life policies, where the insurer in return for a premium, undertakes to provide one or more payouts to the insured, on a fixed or determinable future date.

¹³ Linked policies are those where the amount of the policy benefit is not guaranteed by the insurer and the benefit is determined solely by reference to the value of assets specified in the policy and held by or on behalf of the insurer for the purposes of the policy.

¹⁴ Registrar of Long-term Insurance (2009: 4).

1.3. A description of products offered by South African long-term insurers

The types of policies a life insurer may write depend on its life licence granted by the FSB under the LT Act.

Policies can be broadly classified into three different product offerings: Pure risk products, investment or savings products, and mixed or bundled products.

- 1) Pure risk products, such as death, disability and dread disease policies, payout benefits to policyholder/beneficiaries upon the happening of the insured event (death, disability, severe illness etc). They have no investment component.

These policies may provide cover to the insured for an insured's whole life, (commonly referred to as a whole of life policy) or for a specific policy term (commonly referred to as a term insurance policy).

Pure risk policies are often held as "group" policies¹⁵.

- 2) Investment or savings type products function as a savings vehicle and are often referred to as life wrapped investment products. They can be further subdivided into two categories:
 - Linked investments products which are insurance products where the return earned by the policyholder is dependent on the returns earned on the underlying investments and the insurance company assumes no savings risk. These products are usually unitised, similar to CISs.
 - Non-linked investment products are insurance products where the return earned by the investor is not wholly dependent on the returns earned on the underlying investments. An example is a smoothed bonus investment policy where investment returns are smoothed over

¹⁵ Group policies are those where typically an employer either directly (known as an "unapproved" policy), or through a registered pension fund (known as an "approved" policy), holds a policy which will pay benefits in the event of death or disability of the employee. The employer then has an agreement with the employee to pay the benefits to the employee / nominated beneficiaries of the employee. This type of life cover is known as GLA.

the term of the policy. In this case, the insurance company assumes some savings risk.

Investment products offered by insurers include policies such as “pooled products” whereby the investor holds an interest with other investors in a portfolio of underlying assets, fixed term endowments which have a payout/s on the expiration of a fixed term, and certain annuity contracts. Annuities can be in the form of a guaranteed annuity or a living annuity. A guaranteed annuity is where the annuitant receives a steady stream of payments until death and the underlying investment risk is retained by the insurer. A living annuity¹⁶ is where the policyholder is entitled to withdraw between 2.5% and 17.5% of the corpus of the policy per annum with the remaining portion of the investment balance becoming payable to the insured’s nominated beneficiaries on death. In the case of living annuities, the investment risk is borne by the policyholder.

Policies which have an investment component may be described as a “with profits” or “participating” policy. This means that policyholders share in the profits with shareholders from the book of business underwritten by the insurer. “Without profits” policies do not share in profits made by the insurer in underwriting the policies.

3) Mixed or bundled products contain elements of both risk and savings products.

Examples of mixed products include the following:

- Traditional whole of life insurance policies which mature on death or when the policy is surrendered for a cash value.
- Traditional endowment policies which provide for a payout in the event of the death of the insured or the attainment of a specific age by the insured.

¹⁶ Per the Explanatory Memorandum to the Taxation Laws Amendment Bill, 2011 it is proposed that “living annuities” be renamed as a “retirement income draw down account” (“RIDDA”) to more accurately describe the investment product as drawdown type facility rather than an annuity and that regulation be passed to extend the offering of these type of annuities (where no risk is underwritten by the insurer) to entities other than insurers.

- Universal life type policies which are principally risk policies but also have an investment account attached to them.

Investment products described above where the insurer underwrites some of the savings risk (such as guaranteed annuities, bonus smoothing investment policies and “with profits” policies) technically fall into the mixed products category.

The premiums paid by the insured for mixed products will generally be split between the portion covering the risk and savings components of the policy.

There has been a trend over the past twenty years from the selling of traditional type products containing both a risk and savings elements to the selling of pure risk and pure savings policies. This has been driven in part by a demand by policyholders to understand the types of products offered by insurers and also the rise of CISs as an alternative savings mechanism¹⁷. This trend can be seen from the product offerings of new participants in the insurance market in the last ten years, such as Discovery Life, which typically sells risk only policies and Coronation Life, which sells investment only type policies. The Registrar of Long-term Insurance (2009: 5) noted as a challenge / opportunity facing the life insurance industry a move away from investment products towards risk products.

In addition to the variety of products available, there are different mechanisms for pricing products. Standard premium offerings include age rated premiums, level and single premiums. Age rated premiums increase with age of the insured. Level premiums remain constant throughout the term of the policy or are stepped in the sense that they are constant for a specific term with a stepped increase at a future premium renewal date. Single premiums are paid upfront by the policyholder to cover the insured for the term of the policy. Premiums may also be “loaded” which is effectively an additional premium charged by the insurer after taking into account the insured’s circumstances, such as medical history.

¹⁷ Based on a discussions held with Peter Tripe, AIS Director at Deloitte, and Luke Barlow, Tax Director at Deloitte, in July 2011.

There are many variations of the products and pricing mechanisms offered by South African insurers all of which are designed to meet individual policyholder needs. The above descriptions are not intended to be exhaustive, but rather give an overview of products available in the South African market.

The South African insurance industry is known to be characterised by a set of fairly complex insurance products, similar to the offerings in first world countries such as the United Kingdom and Australia, but have comparatively lower volumes when compared to these countries¹⁸.

1.4. The taxation of policyholders holding long-term policies

Premiums paid in respect of a long-term insurance policy, in general, do not qualify for deduction in the hands of a policyholder. Exceptions to this general rule exist for income protection policies where the proceeds of the policy will constitute gross income in the hands of the policyholder, and “key-man insurance policies”, provided that the policy meets the requirements for deduction under section 11(w) of the Act¹⁹.

Benefits (excluding those derived from income protection and key-man insurance policies) received by policyholders are tax-free: they do not constitute gross income for the taxpayer (being a receipt of a capital nature) and the capital gain or loss made by the policyholder is disregarded in most instances from CGT in terms of paragraph 55 to the Eighth Schedule to the Act.

¹⁸ Based on a discussion held with Neil Mackenzie, CFO of RGA Reinsurance Company of South Africa Ltd in December 2010.

¹⁹ Section 11(w) of the Act was recently amended by the Taxation Laws Amendment Act No. 7 of 2010. Per the Explanatory Memorandum on the Taxation Laws Amendment Bill, 2010, the entire section was substituted for a new section intended to curb plans originally designed to take advantage of a potential tax mismatch between the company, in whose name a policy resides, and an employee or director who ultimately stands to benefit from the policy. The section is still under review by National Treasury and SARS. There are proposed draft amendments to section 11(w) in the Taxation Laws Amendment Bill, 2011 which requires the taxpayer to state in their policy agreement that the section applies to the policy.

The tax consequences explained above will be different for taxpayers who trade in “second hand” insurance policies. Assuming such policies are bought and sold or held with a profit-making intention, the taxpayer will be fully taxed on the profits made on the realisation of the policy under normal income tax principles²⁰.

1.5. An overview of the four funds approach

Section 29A of the Act contains the special rules for the taxation of life insurance companies in South Africa. The rules are commonly referred to as the four funds basis of taxation or the four funds approach. This four funds approach was originally introduced in 1993 and is still applicable today. It is founded on the trustee principle which recognises that the life insurer holds and administers assets on behalf of its policyholders with excess assets representing the shareholder’s interests. The result of the trustee principle is that the income derived on policyholder assets is taxed in the life company rather than in the hands of all the policyholders. Tax is paid on the build-up of funds in the life company and benefits paid to policyholders are post tax.

The four funds approach distinguishes between the taxation of income derived from policyholder assets and the income derived from shareholder assets. Furthermore, to ensure that the tax paid in respect of an insurance policy is commensurate with a policyholder’s tax position, it distinguishes between the different types of policyholders’ *viz.* individuals, companies, tax exempt institutions and policyholders where income is specifically taxed in their hands such as annuitants. The four funds are each regarded as separate taxable entities within the life insurer and are known as the following:

- The individual policyholder fund (“IPF”)
- The company policyholder fund (“CPF”)
- The untaxed policyholder fund (“UPF”)
- The corporate fund (“CF”).

²⁰ The proceeds will constitute gross income in terms of the gross income definition in section 1 of the Act and the expenditure incurred to acquire the policy will be a deductible expense under section 11(a) of the Act.

The IPF, CPF and UPF represent the policyholders' interests whereas the CF represents the shareholders' interests.

The establishment of the four funds requires a life insurer to allocate its assets, liabilities, income and expenses across the four funds for the purposes of determining:

- the taxable income of the IPF, CPF and CF (the UPF is tax exempt); and
- the underwriting profits which emerge for shareholders from its underwriting of risks. These profits emerge in the IPF, CPF and UPF but are specifically transferred and taxed in the CF (referred to as "transfers"), subject to certain exceptions explained in detail in the forthcoming chapters.

The tax rate applicable to the income of the IPF is the proxy rate of 30% which regarded to be the average tax rate for individuals. The tax rate applicable to the income of the CPF and CF is the corporate tax rate which is currently 28%.

1.6. Definition of the research problem, methodology and scope of study

The four funds approach has remained largely unchanged since its introduction in 1993. Whilst there have been some amendments to the legislation since its introduction, most notably to the treatment of expenses and transfers between the four funds, the trustee principle and the distinction between different classes of policyholders has been retained.

This dissertation seeks to determine whether the four funds approach is still appropriate and if so, whether refinements should be made to the legislation to improve the approach. In determining the appropriateness of the four funds approach, a qualitative comparison will be made with:

- 1) Theoretical principles for the taxation of life insurance companies; and
- 2) The recently enacted approach for the taxation of life insurers in New Zealand.

It is hoped that the New Zealand approach can provide some guidance on the appropriate method of taxation for life insurers where shortcomings are identified in the four funds approach.

New Zealand has been chosen as a country of comparison to South Africa for the following reasons:

- New Zealand is part of the Commonwealth group of countries to which South Africa belongs, and elements of the South African system of taxation have previously been based on principles derived from New Zealand legislation, most notably VAT legislation (Surtees, P, 2011:1).
- The New Zealand life insurance industry offers a similar array of products to those available in the South African insurance market, even though the product mix is slightly different – in New Zealand more than 50% of annual premiums are received in respect of term insurance policies which are pure risk policies²¹ whereas in South Africa more than 50% of products are linked investment products.
- The New Zealand model for taxing life insurance is similar to the current four funds approach and reflects a similar policy stance by its revenue authorities. In New Zealand, premiums paid by policyholders are generally not deductible in the hands of policyholders and benefits received by policyholders are generally tax free in the hands of policyholders. Tax is paid by the life company on savings income on behalf of policyholders. Underwriting profits made by the insurer are subject to tax in the shareholders' hands. The New Zealand model has been recognised as arguably the purest model internationally in that both underwriting income for the life insurer and savings income attributable to policyholders are taxed on an accrual basis (Olivier (2004: 27)).

²¹ New Zealand Policy Advice Division of the Inland Revenue, *Taxation (International Taxation, Life Insurance, and Remedial Matters Bill): Officials' Report to the Finance and Expenditure Committee on Submissions on the Bill Volume 3* (2009: 3).

- New Zealand is the latest Commonwealth country to have recently undergone changes to its approach for the taxation of life insurance companies. The new tax rules were enacted in mid-2009 and are effective from 1 July 2010. They replaced the existing tax rules which were enacted in 1990. The new tax rules seek not only to differentiate between shareholders and policyholders, but also to distinguish between the risk and savings business of an insurer and to tax each appropriately. In addition, the tax rules allow an insurer to make an election that linked investment products are taxed under the New Zealand PIE rules which are applicable for collective investment vehicles, thereby improving the tax neutrality for the different investment products. The distinction between the risk and savings business of an insurer may be of particular relevance in the South African context where such a distinction is not currently drawn in the four funds approach.

In preparing an analysis on the appropriateness of four funds tax, the following specific questions have been identified which require further investigation and which will be addressed by this dissertation:

- Whether the underwriting profits of an insurer, and the savings income earned by an insurer on behalf of policyholders, is taxed appropriately under the four funds approach. If not, whether a distinction should be made in the four funds approach between the risk and savings business of an insurer, similar to the approach adopted in New Zealand.
- Whether the trustee principle is still relevant and if so, whether the savings income earned on behalf of individual policyholders in respect of life wrapped investment products is appropriately taxed at a proxy rate as opposed to individuals' marginal tax rates.
- Whether the tax treatment of expenses incurred by a life company under the four funds approach is appropriate, especially considering that the deduction

of certain expenditure is limited by the expense relief ratio which is prescribed by the legislation. This results in a different tax treatment of expenditure when compared to normal income tax principles which are applicable to alternative investment products such as CISs.

Two further questions have also been identified during the course of research which require an individual in-depth study and will not be addressed by this dissertation:

- Whether the IPF proxy tax rate of 30% is the most appropriate tax rate to incentivise individuals to save through a life insurance company; and
- What value of policyholder liabilities should be used to calculate transfers between the policyholder funds and the CF?²² This questions stems from pending industry changes for financial reporting purposes flowing from Phase II of IFRS4 *Insurance Contracts* and pending regulatory changes to the valuation of policyholder liabilities flowing from *Solvency Assessment and Management* (“SAM”), the new regulatory framework based on the principles established in Solvency II²³, with certain adjustments.

1.7. Chapter outline

Chapter 2 describes the origin and history of the four funds tax legislation. Owing in part to the current legislation being founded upon principles originally enacted in 1993, it is still relatively new in comparison to other income tax legislation and there is no South African case law on the topic.

Various literature has been published on four funds tax. Past literature has focussed on the theoretical framework of the legislation. More recently the literature’s scope has been extended to identify potential shortcomings of the legislation and

²² The value of policyholder liabilities / actuarial reserves is a key input into an insurer’s tax calculation as a higher value of liabilities allocated to a policyholder fund results in a lower transfer from the policyholder fund to the CF and therefore the less tax payable by the life company.

²³ Solvency II is the new European regulatory framework applicable to European life insurers due for implementation on 1 January 2014.

suggestions for possible alternatives to address such shortcomings which require a further detailed study. Theoretical frameworks for taxing long-term insurers will be considered in Chapter 3. Shortcomings in the four funds approach, when compared to the theoretical frameworks and the taxation of alternative investment products, will be highlighted in Chapter 4.

This dissertation will extend past literature by investigating shortcomings in the four funds approach in further detail. It also considers New Zealand's recently adopted approach to taxing life insurers in Chapter 5 and whether the four funds approach should be refined to contain elements of the New Zealand approach in order to address shortcomings identified. This will be assessed in Chapter 6. The dissertation concludes with a summary of main findings in Chapter 7.

It is hoped that the study will be of use to participants in the life insurance industry, SARS and to National Treasury.

2. A HISTORICAL BACKGROUND TO FOUR FUNDS TAX

2.1. Introduction

The four funds approach was first enacted in 1993 following the recommendations of the Jacobs Committee in 1992. The Jacobs Committee was established with the over-arching objective to conduct an investigation and to provide recommendations for the promotion of equal competition for funds in South African financial markets.

Prior to the four funds approach, life insurers in South Africa were taxed in terms of section 28 of the Act and the previous Sixth Schedule of the Act.

Section 28 of the Act required a long-term insurer to determine its taxable income in accordance with a formula. The formula essentially taxed the life insurer on its gross amount of taxable investment income less 55% of expenses. Gains derived on policies which qualified as “non-standard policies”, based on a definition of a “standard policy” in the Sixth Schedule to the Act, were also taxed. This gave rise to punitive double taxation on these policies.

The Sixth Schedule was originally introduced to serve as a demarcation between the business areas of deposit-taking institutions (such as banks) and life-insurers when life insurers started entering into the markets traditionally serviced by deposit-taking institutions (Jacobs, 1992: 86). Various developments in the financial sector ensued to address the demarcation issues and it was no longer appropriate to address the demarcation issues in fiscal legislation.

Owing to developments in the financial sector, the criticisms of the Sixth Schedule in relation to the tax neutrality between industries in the financial sector, the complexity of the Sixth Schedule, and the need for the protection of the fiscus, the Jacobs Committee recommended that the Sixth Schedule to the Act be repealed *in toto*, and the interests of the fiscus be catered for in a proposed replacement provision in the Act (Jacobs, 1992: 88).

2.2. The Jacobs Committee Report (1992)

2.2.1. The principles underlying the four-funds approach recommended by the Jacobs Committee

The income tax system for life insurers has historically been guided by the “trustee principle”, which was present in the former section 28 of Act. *“This principle, in short, entails that life insurers are deemed to be holding and investing funds on behalf of their policy holders, and that they should pay income tax on the income derived therefrom on a similar basis”* (Jacobs, 1992: 89). Although the trustee principle has been previously criticised in the past, it had been accepted by fiscal authorities as being appropriate and had enjoyed past support in the industry (Jacobs, 1992: 89).

Following much consultation between participants in the life insurance industry, the FSB and the Commissioner for Inland Revenue, it was agreed that the new basis of taxation for life insurers be governed by the following principles (Jacobs, 1992:89):

“– The ‘trustee principle’ should be adhered to in respect of all income representative of the insurer’s constituent body of policyholders and should reflect all relevant aspects of their taxation, including the effective tax rate.

– All income that an insurer receives and that is not representative of the policyholders (and hence not subject to the ‘trustee principle’) should be subject to normal corporate tax.

– Tax neutrality and competitive neutrality between life insurers inter se and between the life-insurance industry and other financial industries must result, as far as possible, from the new system.

– Tax neutrality must prevail, as far as possible, between different classes of policyholders. In particular, there should be no tax advantages for corporate policyholders. (It is accepted that this principle cannot be fully served as to allow for the various individual tax rates of the individual constituent policyholders of an insurer, and that an average rate must be used in this case.)”

The proposed mechanism for applying the above mentioned principles was through “the four-funds approach”. This approach involved “*the maintenance of four funds for tax purposes to which, save as may be qualified, the general principles of taxation will apply.*” (Jacobs, 1992: 90-91). These were described by Jacobs (1992: 90) as follows:

- The IPF: “*A fund for taxed policies owned by individuals, which is to be taxed, on a representative basis, at the average tax rate of individual policyholders.*”
- The CPF: “*A fund for policies belonging to companies and other corporate bodies that are subject to company tax, which is to be taxed, on a representative basis, at the corporate tax rate.*”
- The UPF: “*A fund for approved fund business²⁴, annuity business²⁵ and policies belonging to those bodies that are not subject to tax, which will not be taxed.*”
- The CF: “*A fund representing the corporate reserves of the life insurer, which is to be taxed on normal company-tax principles.*”

²⁴ At the time of the Jacobs Committee Report, the benefits derived by the policyholders related to fund business and annuity business were taxable in the underlying policyholders’ hands and thus the policies were to be allocated to the UPF. In terms of current legislation, retirement funds are not subject to tax on their income and annuitants are taxed directly on annuity income in their hands and therefore these policies are still allocated to the UPF.

2.2.2. Specific elements of four funds tax recommended by the Jacobs Committee (Jacobs, 1992: 91 – 96)

Various recommendations were made by the Jacobs Committee concerning different aspects of the proposed four funds system, including the following:

- The methodology for the determination of taxable income of the IPF, CPF and CF;
- The segregation of assets across funds;
- The maintenance of separate revenue accounts for the funds;
- The calculation of liabilities;
- Transfers between the funds; and
- The phasing-in of the new system.

Recommendations concerning the phasing-in of the new system are not relevant for the purposes of this paper and have not been addressed.

Taxable income of the IPF, CPF and CF

The taxable income of the IPF and CPF was defined by the Jacobs Committee as follows:

$$\text{IPF: } I - F * E - T_i$$

$$\text{CPF: } I - F * E - T_c$$

where:

I: Investment income allocated to the fund which included interest and rentals plus realised gains or losses in respect of fixed-interest bearing securities which were taxable in conformity with normal principles at the time. Dividends were excluded as in general they were exempt from tax and so were capital gains on fixed property and shares, subject to the normal principles governing the distinction between capital and revenue.

E: Expenses allocated to the fund which included investment expenses and tax allowances. Selling expenses were included but were to be spread over a period of five years.

F: Expense apportionment ratio which was calculated as the ratio of taxable income to total income. This accounted for the fact that interest (I) was taxable and, in general, dividends (“D”) and capital gains (“C”) were not subject to tax.

$$F = \frac{I}{I + D + C}$$

At the time of its publication, there was still uncertainty as to the appropriateness of the inclusion of capital gains or losses in the above formula (Jacobs, 1992: 93).

Ti and Tc: Transfers from the IPF and CPF to the CF respectively excluding “special transfers” (described below).

The tax rate to be applied to the IPF’s taxable income was the average individual policyholder tax rate. At the time, a rate of 30% was considered appropriate. Although it was noted that this rate would be perceived as being advantageous to wealthy investors which paid tax at the maximum marginal rate, in the interests of neutrality, it was proposed that other financial institutions such as banks be permitted to offer investment products through a separate subsidiary company which would be subject to the same system of taxation (Jacobs, 1992: 99).

The taxable income of the CF was defined as:

$$CF: \quad I - E + Ti + Tc + Tu + M$$

Where

I: Investment income allocated to the fund similar to that described above.

E: Deductible expenses and tax allowances which would be available to the company in normal circumstances.

Ti, Tc and Tu: Amounts transferred from the IPF, CPF and UPF to the CF respectively excluding “special transfers” (explained below).

M: Non-insurance taxable income, net of related expenses.

Owing to the fact that the different funds were considered to be different taxpayers, losses of one fund could not be set-off against the income of another fund.

Segregation of assets

It was envisaged that segregated assets be held for each of the four funds. Where particular assets were held to cover specific liabilities (such as linked portfolios) they were to be allocated to the appropriate fund, whereas other assets were to be allocated to the funds in a way that was consistent with the nature of the liabilities and manner in which the insurers business was conducted.

Separate revenue accounts

Separate revenue accounts were to be drawn up for each fund at the end of the tax year. Premiums and claims were to flow directly to the various funds. Investment income was to flow to the funds depending on the fund in which the assets were held. Expenses associated with the issuance and maintenance of policies were to be allocated to the funds depending on the allocation of the policies, and other expenses were to be allocated in a manner appropriate to the way in which the business of the insurer was conducted²⁶.

²⁶ In practice, other expenses may include items such as audit fees which cannot be attributed directly to a fund. Such expenses may be apportioned between policyholders and shareholders based on assets or attributed to each fund if another more reasonable basis does not exist. Other expenses are often apportioned between the policyholder funds in proportion to the premiums earned by each fund.

Calculation of liabilities

The calculation of liabilities was to be the same as the minimum basis as set out in the Insurance Act, 1943²⁷ subject to certain adjustments, plus any additional reserves that the Registrar of Insurance²⁸ required the insurer to hold. The proposed valuation of liabilities has not been considered in further detail as it is outside of the scope of this paper.

Transfers between the funds

Transfers between the policyholder funds and the CF were to be determined at the end of each tax year by the surplus/shortfall of assets in each of the policyholder funds²⁹.

Transfers between the funds were to be made at a fair market value and were to be treated as a sale and repurchase by each fund for tax purposes.

It was foreseen that circumstances could arise where there was a transfer from the CF to a policyholder fund and the CF would not have sufficient taxable income in the year against which the transfer amount could be offset. Consequently, insurers could elect that the transfer deduction be limited to the taxable income in the CF before the transfer, with the excess being declared as a “special transfer”. Such a special transfer was not subject to tax in the policyholder fund. Subsequent transfers from that policyholder fund to the CF would likewise be regarded as a special transfer, with the effect that they would not qualify for deduction in the

²⁷ This has subsequently been replaced with the LT Act.

²⁸ Now referred to as the Registrar of Long-term Insurance.

²⁹ The four funds approach requires an insurer to allocate its assets at the beginning of the tax year to the policyholder funds equal to the policyholder liabilities of each fund in the previous year, with excess assets allocated to the CF. Investment income is allocated annually to the funds based on the allocation of assets. Premiums, claims and expenses are also allocated to each fund annually. Policyholder liabilities are calculated for each fund annually. These items are used to prepare a build-up of assets for each fund on an annual basis referred to as a “fund build-up”. The fund build up is used to calculate “transfers” between the policyholder funds and the CF. Transfers of assets between the policyholder funds and the CF are required to be made on an annual basis calculated with reference to the surplus or shortfall of the market value of assets in a fund over the policyholder liabilities of the fund at the end of the tax year.

policyholder fund nor would they be subject to tax in the CF. This was to be until such time as the special transfers from that policyholder fund to the CF were cumulatively equal to the special transfers from the CF to that policyholder fund.

Direct transfers between the various policyholder funds could be required as and when there was a change in the tax status of a particular policy, for example when a company-owned policy is ceded to an individual.

2.3. The 1993 legislation

The Income Tax Act, 1993³⁰ enacted the majority of the changes proposed by the Jacobs Committee by introducing section 29 to the Act (Clover, 2008).

The Explanatory Memorandum³¹ described the introduction of section 29 into the Act as follows:

“The Bill gives effect to what is termed the four-fund approach for the taxation of life insurers and their policyholders, as recommended by the Jacobs Committee. This approach is based on the recognition that insurers hold and administer certain of their assets on behalf of various categories of policyholder, while the balance of their assets represents, in the case of proprietary insurers, shareholder’s equity, and in the case of mutual insurers, funds to which current policyholders are not entitled and which should thus be treated as corporate funds. The application of this approach requires that insurers allocate their assets and liabilities to separate funds representative of the various policyholder or corporate interests and that each fund be taxed as a separate entity in accordance with applicable taxation principles.”

³⁰ Act no. 113 of 1993

³¹ The Explanatory Memorandum on the Income Tax Amendment Bill, 1993.

Some important points in respect of the 1993 legislation, as are relevant for the purposes of this paper, are contained in

- 1) Section 29(2) provided that the ordinary rules for the determination of taxable income apply, but subject to certain modifications as specified in the section.
- 2) Section 29(4) described each of the four-funds. The allocation of business to each of the three policyholder funds was dependent on the owner of the policy defined in subsection 1 as “the person who is entitled to enforce any benefit provided for in the policy”.
- 3) Section 29(6), provided for the insurer to determine the value of its policyholder liabilities for each of the policyholder funds at the end of the year of assessment. To the extent that the market value of assets held by the fund exceeded the value of its policyholder liability, the insurer was required to transfer assets equal to the surplus from the policyholder fund to the corporate fund. In the case where the market value of assets held by the fund were less than the value of its policyholder liability, the insurer was required to transfer assets equal to the shortfall from the corporate fund to its policyholder fund.
- 4) Section 29(7) provided that such transfer of assets between funds take place at market value and treated as a purchase and sale by one fund to another.
- 5) Section 29(10) provided for the calculation of “special transfers” which in terms of section 29(14) were to be disregarded for income tax purposes. The “special transfers” were those envisaged by the Jacobs Committee i.e. transfers from the CF to a policyholder fund where there was insufficient taxable income in the CF prior to the transfer against which to offset the transfer from the CF. In referring to “special transfers” the Explanatory

Memorandum³² said that the special transfer was essentially one of capital and therefore under normal rules would not be deductible in the CF³³.

- 6) Section 29(12) exempted the income of the UPF from tax together with transfers from the CF to the UPF.
- 7) Section 29(13) provided that the taxable income of each fund be determined separately in accordance with the provisions of the Act as if each fund had been a separate taxpayer.
- 8) Section 29(14) provided certain modifications to the normal rules for calculating the taxable income of the IPF, CPF and CF including the following:
 - Selling expenses (i.e. commissions on premiums) were to be allowed as a deduction over 5 years;
 - Transfers were to be deducted from the income of the transferring fund and be included in the income of the receiving fund.
 - Transfers between funds for a change in the ownership of the policy and “special transfers” would not qualify for deduction in the transferring fund nor be required to be included in the income of the receiving fund.
 - Premiums and claims and re-insurance premiums and claims were to be disregarded. In terms of the Explanatory Memorandum³⁴, this was because premiums to the body of policyholders were an investment of capital and the investment income represented their only gain under a policy.

³² The Explanatory Memorandum on the Income Tax Amendment Bill, 1993.

³³ It is questionable whether special transfers are in fact capital in nature. This is explored in further detail in chapter 4.

³⁴ The Explanatory Memorandum on the Income Tax Amendment Bill, 1993.

- 9) Section 29(16) provided that assets, expenditure and liabilities be allocated to a fund if they related exclusively to the business conducted by the fund whereas other assets, expenditure and liability were to be allocated in a manner consistent with which the business was conducted.

The most notable deviation of the 1993 legislation from that proposed by the Jacobs Committee was the absence of an expense apportionment ratio to place a restriction on the value of deductible expenditure. It was also unclear from the legislation whether normal income tax rules³⁵ applied to limit expenditure qualifying for deduction against the income of the fund, although the reference to the determination of taxable income to be done in accordance with the principles of the Act seemed to suggest this was the case. The absence of an expense apportionment ratio resulted in amendments to the legislation in 1999.

2.4. Amendments made in 1999

Section 29 of the Act was replaced in 1999 by section 29A of the Act. Whilst the main elements of the four funds approach as described above were retained, there were a number of significant amendments to the legislation, particularly in respect of the treatment of expenses and transfers between the funds. Other amendments concerned the valuation of liabilities and transitional arrangements for the amendments.

The Explanatory Memorandum³⁶ in its reasoning for the amendments stated that it was apparent that the amount of tax being paid by the long-term insurance industry was decreasing despite substantial profits being reflected in the annual financial statements of insurers.

³⁵ Under normal income tax rules, expenditure incurred for the purpose of producing exempt income does not qualify for deduction. Expenses incurred for the dual purpose of earning exempt and taxable income (i.e. non-exempt income) should be apportioned in a reasonable manner such as in the same ratio of taxable income (i.e. non-exempt income) to total income (exempt and non-exempt).

³⁶ The Explanatory Memorandum on the Revenue Laws Amendment Bill, 1999.

More specifically, the following deficiencies, causing the lower tax yields in the industry, were identified by the Explanatory Memorandum³⁷ in the four funds approach:

- *“Where the expenditure does not so exclusively relate to business in any one fund, the expenditure is allocated to the different funds in the proportion that business is conducted in the respective funds. The bulk of these expenses are allowed as a deduction against the investment income of policyholder funds. As the base of the taxable income which mainly consists of investment income in each respective policyholder fund is relatively small compared to the amount of the deductible expenses, especially the selling expenses, the taxable income in the policyholder funds is drastically reduced.*
- *Furthermore, an insurer charges administrative and management fees in respect of the income or assets of the policyholders. These charges are at present not taxed appropriately as transfers from one fund to another. Although taxable in the transferee fund, these charges are fully deductible in the transferor fund.*
- *The current system of transfers provides for opportunities to defer taxation.”*

It is not clear whether the lack of an expense apportionment ratio and the treatment of transfers in the original legislation was the underlying cause of the problem that tax payable by the life industry was decreasing. There are a number of factors which could have driven the reduction in tax payable, one being a lack of distinction between risk and savings products resulting in inappropriate taxation of underwriting profits. That being said, section 29A(11) of the Act was drafted to deal with the deficiencies noted and focussed on the deductibility of expenditure

³⁷ The Explanatory Memorandum on the Revenue Laws Amendment Bill, 1999.

and transfers. However, it seems that this may have been an attempt by the legislators to remedy the problem without properly addressing its root cause.

2.4.1. Deductibility of expenditure

Briefly stated, section 29A(11) provided the following in relation to the deductibility of expenditure:

- Expenditure incurred which was directly attributable to the income of the fund was deductible in full; and
- Expenditure allocated to the fund which was incurred in respect of the selling and administration of policies, and other expenditure allocated to the fund excluding that directly related to the earning of exempt income, qualified for limited relief. The proportion of this expenditure qualifying for deduction was limited to the following ratio, commonly referred to as the expense apportionment or expense relief ratio:

$$Y = \frac{(I + R)}{(I + 3R + 6D)} \times \frac{100}{1}$$

where:

Y represented the percentage to be determined

I represented interest income

R represented rental income

D represented dividend income

It is not apparent how the above ratio was determined. In dealing with the expense relief ratio, the Explanatory Memorandum³⁸ said the following:

³⁸ The Explanatory Memorandum on the Revenue Laws Amendment Bill, 1999.

“The underlying principle of apportionment is to exclude that portion of the expenses attributable to non-taxable income, such as dividend income and capital gains. An appropriate method of apportioning these expenses would have been an asset-based approach. It does, however, appear that such a basis is susceptible to manipulation. For that reason an income based formula is proposed on a basis that would more or less produce the same result as an asset-based approach. Such formula will be closely monitored to ensure that it produces the appropriate apportionment ratio.”

Clover (2008: 17), in referring to the above formula, said the following:

“It would appear that the intention of the tax authorities was to use a formula along the lines of:

$$\frac{I + R}{I + R + D + G}$$

where I, R and D are as above and G is capital appreciation (Hartwig, 1994: 5.6), but because of concerns about the calculation of G it was decided to use an adjusted formula based only on I, R and D as a proxy. The proposed formula would then be sensible if the total return on property was expected to be around three times the rental yield and the total return on equities was expected to be around six times the dividend yield.”

Owing to the introduction of the expense relief ratio, the requirement to spread selling and administration expenses over a period of 5 years was removed.

2.4.2. Transfers

Briefly stated, section 29A(11) provided the following in relation to transfers:

- Transfers made to the CF from a policyholder fund (i.e. those transfers made when there was a surplus of assets in the policyholder fund at the end of the year) were to be taxed in full in the CF, whilst the transfer value qualified for limited relief in the policyholder fund. The relief granted was the transfer value multiplied by 50%, multiplied by the expense relief ratio, limited to the taxable income in the fund prior to transfers³⁹. The effect of the limitation was to reduce taxable income to zero.
- Transfers made from the CF to a policyholder fund owing to the deficit created in the policyholder fund, would not qualify as a deduction in the CF and were not taxable in the policyholder fund. However, the balance of such transfers were to be carried forward to the following year of assessment, available for set-off against future transfers made from that policyholder fund to the CF.

It is not apparent from the Explanatory Memorandum⁴⁰ why the transfer to the CF should be multiplied by either 50% or the expense relief ratio.

From the policyholder's perspective, the profit transfer can possibly be viewed as an expense similar to any other third party expense and therefore some sort of expense apportionment should be applied. However, the application of 50% does not seem to have any theoretical backing.

2.5. Amendments made in 2001

In 2001, further amendments were legislated following the enactment of CGT legislation and the move to a residence based system of taxation which in turn

³⁹ Expressed as a formula:
 Relief = $T/2 \times Y$, limited to TIp,
 Where: T = transfer value;
 Y = expense relief ratio; and
 TIp = taxable income of the policyholder fund prior to transfers

⁴⁰ The Explanatory Memorandum on the Revenue Laws Amendment Bill, 1999.

meant that certain foreign dividends became taxable in the hands of the insurer. The amendments were centred on changes to the expense relief ratio owing to the fact that certain policyholder expenditure was incurred by the life insurer for the purposes of generating taxable capital gains and taxable foreign dividends.

Individuals became subject to an inclusion in their taxable income of 25% of the net capital gain in a particular year whereas companies are subject to 50% inclusion rate. The difference in capital gain inclusion rates between individuals and corporates necessitated that different expense apportionment formulas be applied in the IPF and CPF.

The revised expense relief ratios enacted in the 2001 legislation are the ones which apply today and are as follows:

IPF:

$$Y = \frac{(I + R + F)}{(I + 2,5R + 4,75F + 4,75L)} \times \frac{100}{1}$$

CPF:

$$Y = \frac{(I + R + F)}{(I + 2R + 3,5F + 3,5L)} \times \frac{100}{1}$$

Where:

Y represents the percentage to be determined

I represents interest income

R represents rental income

F represents taxable foreign dividends

L represents dividend income (other than taxable foreign dividends)

Again, no justification was given in the Explanatory Memorandum⁴¹ as to how the factors used to weight non-interest income were determined.

2.6. Current legislation

Although some other minor textual and other amendments have been made to section 29A of the Act since 2001, the 2001 legislation effectively reflects the form of the legislation that exists today.

Section 29A is contained in Appendix A. A summary of section 29A is contained in Appendix B.

2.7. Conclusion

The four funds approach was recommended by the Jacobs Committee in 1992 to address deficiencies and complexities in the previous basis for the taxation of life insurers. The recommendations of the committee were enacted substantially as recommended. Underlying the four funds approach is the trustee principle which was retained from the previous legislation. This principle recognises that insurers hold and administer certain of their assets on behalf of policyholders.

There have been some changes to the legislation since the original enactment thereof, most notably in 1999 and 2001 which primarily concerned the treatment of expenses and transfers. Such changes have been aimed at limiting the deductions of the insurer in respect of its expenditure and transfers from its policyholder funds to the CF. Little explanation is available concerning the rationale for the formulae prescribed in the legislation used to limit the deductibility of expenditure and transfers.

⁴¹ The Explanatory Memorandum on the Taxation Laws Amendment Bill, 2001.

3. A THEORETICAL ANALYSIS OF THE TAXATION OF LIFE INSURANCE

3.1. Introduction

Hartwig (1994) prepared a research paper focusing on laying a conceptual framework for the taxation of life insurance and evaluated the four funds approach in light of the framework (Hartwig, 1994: 2). Clover (2008) extended Hartwig's theoretical analysis and further evaluated the four funds approach, proposing possible changes that should be considered. Following from Clover's paper, a tax sub-committee to the LAC (the previous industry body representing life insurers) was established to investigate and expand on the issues raised by Clover and to offer possible recommendations where shortcomings were identified. The results of these investigations have been collated in an unpublished report submitted to the LAC in June 2009.

Oliver (2004) also evaluated the theoretical principles for the taxation of life insurance and briefly described various approaches which have been adopted internationally.

This chapter focuses on the theoretical analyses prepared by Hartwig, Clover and Olivier. The following chapter will seek to evaluate the four funds approach against these theoretical principles.

3.2. The applicability of normal income tax principles to life insurance

Hartwig (1994: 4) considered the application of normal income tax principles to the taxation of "pure insurance" defined as:

"... the pooling of risks where there is a zero sum game for the group as a whole, after allowing for expenses, profit for the underwriter and interim reserving for fluctuations."

Under normal income tax principles, a life insurer “*would be taxed on the excess of total income over total expenditure, with allowance for reserving*” (Hartwig, 1994: 4) i.e. premiums would be regarded as gross income and benefits, with an allowance for an increase in policyholder reserves established for future claims, would be a deductible expense⁴².

In considering such an approach, Hartwig (1994: 4) noted that it would be inappropriate to life insurers who enter into the savings market to any appreciable extent as the investment income factor would be totally excluded from the tax net. If no additional tax is imposed on investment income attributable to policyholders, then life insurers would gain an unreasonable advantage over other savings media (Hartwig, 1994: 4). Hartwig (1994: 6) noted that the problem would be solved if policyholders were taxed on the benefits they receive, when they receive them, similar to other savings media, but this is not practical for life policies as benefits are usually deferred until the policy matures or becomes a claim.

Clover (2008: 4) expands on the difficulties that arise from taxing life insurance companies on normal income tax principles. He raises two main issues stemming from the long-term contractual nature of policies:

- 1) Premiums may be structured in such a way that premiums received in a particular period may not be matched to the cost of benefits and expenses in the same period. An extreme example is a block of single-premium whole-life policies. If normal income-tax rules were to apply, the company would have a large taxable gain on this block of business in the first year and taxable losses in each subsequent year until the business went off its books.⁴³
- 2) Policies have a break-even point where cumulative income exceeds the cumulative outgo at some point during the term of the policy. Any excess of income over outgo can be returned to policyholders in the form of benefits.

⁴² Short-term insurers are taxed in accordance with this broad framework under section 28 of the Act.

⁴³ Assuming an allowance is granted for claim and expense reserving, the unwinding of the interest factor in the actuarial reserve over the subsequent years of the policy will create taxable losses for the entity.

Therefore life insurance is not necessarily a zero-sum game and the policyholders as a group can make a net gain equal to the investment return earned (less margins). In the example of single-premium whole-life policies, the single premium paid would ordinarily be smaller than the death benefit received. It could reasonably be argued that this savings element of the benefits received by policyholders should be subject to tax.

Clover (2008: 5) concludes that *“the long-term nature of life policies therefore leads to “the mix of savings return, savings and risk intermediation, and risk pooling (all of which can give rise to income) inherent in a life policy.” (Oliver, 2004) Many of the difficulties in taxing life insurance relate to the problem of separately identifying each of these components and taxing them in an appropriate manner. ... it would seem reasonable for the risk pooling element of the benefits to be free of tax⁴⁴, the savings return element of the benefits to be taxed as policyholder income and the profits generated by carrying out the business of a life office to be taxed as corporate income.”*

Based on Clover’s comments it appears necessary to separate out the two distinct income streams attributable to the activities of the life company: underwriting income and savings income.

3.3. The taxation of underwriting income

The taxation of underwriting income concerns the taxation of the business income of the life company. In the interests of neutrality in the financial sector such income should be taxed according to normal income tax rules (Oliver, 2004: 21). An appropriate formula suggested by Oliver (2004: 22) for taxing underwriting income is as follows:

$$\text{Underwriting income} = (P + I) - (C + E) - V$$

⁴⁴ The risk pooling between policyholders should be free from tax since it represents a transfer of wealth and not the direct generation of income (Oliver: 2004: 20).

Where:

P = premiums

I = investment income

C = claims

E = expenses related to underwriting and investment

V = change in reserves (actuarial reserves which reflect the accrual of claims over time)

It is suggested by Oliver (2004: 21) that an expense reserve should be deducted from underwriting expenses to take into account the fact the many expenses such as agent commissions are front-end loaded (i.e. payable in the first year or years of the policy) but are incurred to produce a long-term stream of underwriting income. Expense reserves are often set off against the actuarial reserve in practice. The change in actuarial reserves should also take into account any discontinuance profits or losses from surrendered policies (Oliver, 2004: 22).

Of importance in the above formula is that although it includes investment income, such income is largely set off by the reserve movement (which will increase with investment earnings) (Oliver, 2004: 22). As investment earnings generally accrue for the benefit of policyholders, the only inclusion of investment earnings in underwriting income should be those in excess of the originally estimated earnings from non-participating policies when the policy was written (Oliver, 2004: 22).

The major difficulty in applying such a formula to a life company is the judgements and uncertainties that are taken into account when determining an appropriate reserve figure (Oliver, 2004: 22). Regulatory requirements and accounting standards tend to focus on the solvency of the life company and err on the side of being conservative. This conservatism requires generous reserves which, if used in the calculation of taxation, decreases the underwriting income of the life company.

3.4. The taxation of savings income

The taxation of savings income concerns the taxation of net investment income i.e. investment income (I) less investment expenses (E), commonly referred to as I - E that accrues each year for the benefit of the policyholders and is not attributable to shareholders (Oliver, 2004: 22). As noted above, such income is effectively excluded from underwriting income by virtue of the increase in reserves in the underwriting income formula. Savings income should therefore be taxed separately.

There are a number of problems associated with taxing savings income including:

- The attribution of savings income between policyholders and shareholders;
- The timing of the taxation of savings income. Taxing the full savings element only at the time of the benefit payment would constitute a deferral of tax, which is unlikely to be acceptable to the SARS (Clover, 2008: 5).
- The manner in which the income is taxed i.e. whether it should be taxed in the hands of the policyholders at their applicable marginal tax rates or at the life company level where the life company acts as a proxy for policyholders. In the case where the life company is taxed as a proxy for policyholders, there is the additional problem of deciding on the appropriate tax rate (Clover, 2008: 5).

3.5. International models

The ideal position referred to by Oliver (2004: 25) is to tax life companies on underwriting income and policyholders fully on savings income as it accrues for their benefit.

Oliver (2004: 25-27) describes four broad approaches which have been adopted internationally for the taxation of life companies. These are the following:

- UK Model: The life office is taxed on net investment income as a proxy for policyholder tax on savings income and underwriting profits are excluded from the tax base.
- US Model: The life office is taxed on underwriting income and tax on savings income is deferred until such income is attributed to policyholders (benefits are taxed in the policyholders' hands).
- Continental Europe Model: The life office is taxed on underwriting income but either the savings component is exempt or policyholder benefits are taxed after the offset of premiums.
- New Zealand Model: The life office is taxed on underwriting income and savings income is taxed on an accrual basis at the life office level. Australia has moved closer to this model from the UK Model.

The four funds approach falls under the New Zealand model in that underwriting income is taxed (through the mechanism prescribed for transfers) and savings income is taxed on an accrual basis at the life company level. The main downfall of the New Zealand model is the taxation of policyholders at a proxy rate as opposed to the marginal rates of individual policyholders.

3.6. The Hartwig Model

Hartwig (1994: 8) proposed the principles referred to below as being fundamental to the design of a basis for taxing life insurance in the South African context. These are similar to the ideal model described by Oliver (2004), with the exception that the life company, and not the underlying policyholder, should be taxed on savings income as it accrues.

*“(a) The insurer must pay tax in respect of policyholders’ interests **during the roll-up stage**, so that there is no tax deferral. The full payout to the policyholder may then be regarded as having been taxed already.*

(b) If there are to be reasonably level tax playing fields in the tussle between life insurer and other savings media, the insurer should be acknowledged as being taxed as a proxy for the policyholder. This has implications for the tax rate (which should be in line with that applicable to the body of policyholders) and the tax basis (which should be consistent with principles of individual taxation).

(c) The profits of the corporate entity must be separately determined and taxed in accordance with company tax principles. Although one can debate it in theory, in practice one probably has to extend this to mutuals as well.” (emphases as in the original)

3.6.1. Basis for the taxation of policyholders’ interests

Hartwig (1994: 13) concluded that a reasonable basis for calculating the tax payable on policyholders’ interests could be expressed in terms of the following formula:

$$(I_p - E_p * r - T) * t_p$$

Where

I_p = investment fruits on policyholders’ funds which include only those elements which would normally be taxed in the hands of the policyholders;

E_p = expenses incurred on behalf of policyholders which include all expenses attributable to policyholders, with initial expenses being spread over a period of 5 to 8 years;

r = the ratio of taxable investment income to total investment income;

T = profits/surplus earned from policyholders, but not distributed to policyholders or held in reserve for them.

t_p = the average policyholder tax rate;

The starting point in the derivation of the above formula is that, when viewed as a whole, the interests of policyholders over a year can be

expressed as the benefits they receive (“B”), less premiums paid (“P”) plus the increase in reserves set aside for them (“ ΔR ”) i.e. $\Delta R + B - P$.

The reserve build-up can be expressed as follows:

$$\Delta R = I_p + P - B - E_p - T$$

where

ΔR = increase in policyholder reserves

B = benefits paid to policyholders

P = premiums paid by policyholders

I_p = total investment fruits earned on policyholders’ funds

E_p = expenses incurred on behalf of policyholders

T = profits withheld from policyholders

When expressed differently:

$$\Delta R + B - P = I_p - E_p - T$$

This leads to the conclusion that $(I_p - E_p - T)$ “is a reasonable representation of the increase in policyholders’ interests and hence a starting point for calculating the taxable income on their behalf.” (Hartwig (1994: 10)

In coming to this conclusion, Hartwig (1994: 10) noted that “it is reasonable to exclude profits/losses from underwriting experience and discontinuances provided these are retained within the policyholder group. .. The only exception is profit withdrawn from the policyholders’ pool for the benefit of the underwriter as a corporate entity – this should be taxed as trading profit to the underwriter, and as a deductible loss to the policyholder body,”

Hartwig (1994: 11) conceded that the expenses attributable to an individual policy should only be allowed as a deduction when that policy is contributing enough income against which the expenses may be set-off and

that a reasonable remedy to this problem is to spread initial expenses over a period of years.

Hartwig (1994: 12) noted that if the whole of I_p is not taxed, then the whole of E_p should not be deducted – i.e. you should reduce E_p by the ratio of taxable investment fruits over total investment fruits.

Clover (2008: 8) suggested a slight modification to the formula suggested by Hartwig for taxing policyholder interests. The formula suggested by Clover is:

$$(I_p - E_p * r - T * r) * t_p$$

The reason for such a modification can be illustrated by means of an example. If an insurer writes a block of profitable business in its CPF which generates dividend income only, the profits will be taxed in full in the CF, but a deduction for such profits will be given in the CPF in terms of the rules for transfers, resulting in the profits arising from the business being tax free. To remedy this, the deduction of the profits in the CPF (i.e. T) should be subject to the same ratio as that applied to other expenses to ensure that only a proportion of expenditure qualifies for deduction.

The modified formula suggested by Clover for taxing policyholder income is broadly consistent with current legislation with the exception that:

- 1) The expense relief ratio in the four funds approach is determined in accordance with a specific formula and not the ratio of taxable income to exempt income.
- 2) the deduction in a policyholder fund for transfers between the corporate fund and shareholder fund is limited to 50% of the amount of the transfer and tax losses cannot be generated through transfers.

The reasoning for the expense relief ratio formula and the limitation of deduction for transfers made to the CF was due to lower taxable income earned by insurers despite rising profits reflected in their AFS (see chapter 2 where the 1999 amendments to the four funds approach were discussed). However, there does not appear to be strong theoretical reasons supporting these treatments.

3.6.2. Taxation of the corporate entity

In referring to the taxation of the corporate entity, Hartwig (1994: 14) noted that “*it is fundamental that the tax basis should deal separately and properly with both policyholder interests and corporate profits.*”

Hartwig (1994: 15) derived the following formula for the tax payable of the corporate entity:

$$(I_c - E_c + T) * t_c$$

Where

I_c = income not allocated to policyholders

E_c = expenses not allocated to policyholders

T = represents the net undistributed surplus arising from policyholder funds, regardless of source: underwriting, expenses, surrenders, investment income or gains. *The only criterion is that it was not distributed to or reserved exclusively for policyholders* (emphasis as in the original).

t_c = corporate tax rate

In deriving the above formula, Hartwig (1994: 15) considered that if the insurer was taxed as an ordinary company, its taxable income would be its total income less total outgo, with amounts reserved for policyholders being

allowed as an expense⁴⁵. This would be consistent with the formulae for banks and general insurers. Hence the taxable income for the corporate entity can be expressed as follows:

$$\begin{aligned} &= (P + I) - (B + E + \text{^R}) \\ &= I - E - (B - P + \text{^R}) \text{ (rearranging)} \\ &= I - E - (I_p - E_p - T) \text{ (refer above)} \\ &= (I - I_p) - (E - E_p) + T \text{ (rearranging)} \\ &= I_c - E_c + T \end{aligned}$$

where the subscript c refers to income and expenses not allocated to policyholders and therefore allocated to the corporate entity.

This formula is consistent with the basis for taxing the CF under the four funds approach, although special rules exist for cases where underwriting losses occur (see Chapter 2 for a discussion on the rules pertaining to special transfers).

3.7. Conclusion

The four funds approach seems to fit well within the theoretical framework for taxing life insurance companies, both in a South African context and an international context. This is because investment income attributable to policyholders is taxed on an accrual basis in policyholder funds (albeit at a proxy rate) and underwriting profits are taxed in the corporate fund (through the taxing of “transfers” in the CF) on an accrual basis. However, there are some notable shortcomings in the four funds approach, particularly with respect to the treatment of transfers, expenses and underwriting profits and losses. This is discussed in further detail in the next chapter.

⁴⁵ This is consistent with the tax treatment of banks and general insurers.

4. SHORTCOMINGS IN THE FOUR FUNDS APPROACH WHEN COMPARED TO THEORETICAL PRINCIPLES AND THE TAXATION OF ALTERNATIVE INVESTMENT PRODUCTS

4.1. Introduction

This chapter explores the shortcomings in the four funds tax approach when compared to the theoretical principles explained in the previous chapter and the taxation of alternative investment products.

The main alternative investment product is a CIS and offers investors an alternative to investing in life wrapped linked investment policies (hereinafter also referred to as “linked investment products”), where no risk is assumed by the insurer. Whilst there are some non tax related differences between these products, in the interest of tax neutrality, the tax treatment of such products should, at a minimum, be broadly consistent with one another.

4.2. Identification of shortcomings in the four funds approach

Whilst the four funds basis is largely consistent with the theoretical frameworks and principles discussed in chapter 3, there are some notable shortcomings in the four funds approach which are discussed in detail in this chapter.

The main shortcomings identified include the following:

- 1) Although a distinction is drawn between the tax treatment of policyholders and shareholders in the four funds approach, and also different classes of policyholders, there is no distinction drawn between different types of business written by an insurer, namely risk and savings business. As a consequence, underwriting profits and losses are not separately identified and taxed, and the tax paid on the savings made on behalf of policyholders may not be appropriate.

- 2) Although savings income made by the insurer on behalf of policyholders is subject to tax when it accrues, this is at a proxy rate and not at the marginal rates applicable to individual investors.

Other shortcomings identified include the following:

- 3) Special transfers from the CF to the policyholder funds are not deductible in the CF and not taxable in the policyholder funds, whilst transfers from the policyholder funds to the CF are fully taxed in the CF and qualify for deduction (although limited) in the policyholder fund which funded the transfer. Therefore there is inconsistency in the two approaches.
- 4) The deduction for transfers in a policyholder fund is limited to 50% of the transfer value and the taxable income in the policyholder fund determined before transfers. The transfer does not qualify for a deduction in full although the transfer is fully taxed in the CF. Therefore an element of double taxation exists.
- 5) The calculation of transfers takes into account unrealised investment gains and losses and exempt income such as dividend income. Therefore the four funds approach subjects to tax unrealised gains and exempt income and unrealised losses as qualifying for deduction which is inconsistent with normal income tax principles⁴⁶.
- 6) It was conceded by Hartwig that it would be appropriate to spread initial expenses over a period of years, whereas under the four funds approach initial selling and administration expenses are allowable in full in the year incurred subject to the expense relief ratio.

⁴⁶ This is because transfers are determined with reference to the market value of assets in the policyholder fund at the end of the tax year less the value of policyholder liabilities allocated to such fund. The market value of assets includes any unrealised investment gains or losses and exempt dividends accrued in respect of the assets, which may not be reflected in the value of policyholder liabilities, (an exception to this exists in the case of linked investment products).

- 7) Expenses for life insurers are subject to a special set of rules which differ to the normal income tax principles applied to alternative investment products earning exempt and taxable income such as CISs. In CISs the ratio of taxable to exempt income is used to apportion expenditure qualifying for deduction, whereas in the case of insurers the expense relief formula applies to limit expenditure qualifying for deduction.
- 8) The tax treatment of capital gains differs between linked investment products and CISs. In the interests of tax neutrality between investment products, the tax treatments should be similar.

4.3. No distinction between risk and savings business

An insurer's business includes the following primary functions as referred to in chapter 1:

- 1) The underwriting of risks, including the residual risk of risk pooling, and some savings risk for savings policies such as smoothed bonus policies and guaranteed annuities. This gives rise to underwriting profits and losses for the insurer;
- 2) Offering a mechanism whereby investors' funds are pooled together and invested in a portfolio of underlying assets. This gives rise to savings income made by the insurer on behalf of its policyholders which will be paid to policyholders when benefits accrue to the policyholders.

An insurer may also earn other income unrelated to insurance activities such as administration fee income for administering business on behalf of other insurers.

The four funds approach does not wholly distinguish between the different income streams attributable to an insurer's insurance business. This gives rise to the potential that the business profits of the insurer are not appropriately taxed and is a possible reason for the decline in tax being paid by insurers in the late 1990's despite increasing accounting profits being reflected in the AFS of insurers.

An example of the inappropriate result arising from the lack of distinction between risk and savings business

Take for instance the following example: An insurer writes two types of business for individuals:

- 1) A pure risk life product where there are high initial selling and administration expenses. The typical cash flow of such a policy on a cumulative basis is negative in its initial stages, positive in its interim stages with a dip at the end of the policy when the benefit is paid to the policyholder. Reserves are set up by the insurer to recognise the future cash flow implications of the policy and to smooth profits over the term of the policy. Initially underwriting losses may be incurred on the book as a result of expenses and reserves exceeding premiums and investment income but over time, the book is expected to be profitable.
- 2) A bonus smoothing savings product where the initial selling and administration expenses are low and investment returns exceed expenses from inception of the policy. Reserves will be set-up for the future benefits payable under the policies which could include estimated “bonus” declarations. Such a product may be profitable from inception.

Under the four funds approach, tax will be payable as follows:

In the IPF

Tax will be payable based on investment income less a deduction for expenses and transfers to the CF from the policyholder fund.

The gross investment income from the risk policy and the savings policy will be aggregated.

Expenses associated with each policy will also be aggregated together. Assuming that both policies invest only in RSA bonds which yield taxable interest, the expense relief ratio will have no impact and expenses will be deductible in full against investment income. Assuming that the proportion of expenses to investment income is larger for the risk policy than the savings policy, total expenses may outweigh total investment income with the result that an overall net loss is generated in the policyholder fund before transfers.

Furthermore the underwriting losses of the risk policy will be aggregated with the underwriting profits arising from the savings policy to determine taxable transfers/special transfers. If the underwriting losses from the risk policy exceed the underwriting profits of the savings policy the result will be that no taxable transfers are generated and the excess losses will create a balance of special transfers available for offset against future underwriting profits made in the IPF.

In the CF

No tax will be payable in the CF as no profit transfers are generated. No deduction will be available for the net underwriting loss being the combined result of underwriting the risk and the savings products.

In summary

The result of the above is that a tax benefit is created in the policyholder fund in that savings income that would otherwise be taxable is non-taxable due to the high expenses of the risk product, and profit transfers that would otherwise be created from the book of savings business are reduced to nil as a result of the underwriting losses from the risk policy. Such a tax benefit may be passed on to the current or future policyholders of the savings product.

A further problem is that the underwriting losses on the risk policy qualify for a deduction in part, in that they reduce the profit transfer generated from the savings product to zero, but the excess losses are not available for offset against other

shareholder income as would be the case in a normal business where the losses of certain product lines can be fully offset against the income generated from other products.

Comments made by the tax sub-committee to the LOA

The above issue arising from the aggregation of savings and risks products in policyholder funds was considered by the tax sub-committee to the LAC in their unpublished report. The tax sub-committee noted that a deduction for transfers in the policyholder fund as currently allowed under the four funds approach is appropriate for products with a significant investment component but it is inappropriate for products that do not have a significant investment component, such as pure risk products. The reasoning of the committee appears to be that losses from the underwriting of pure risk products can be set-off against investment income made from profitable investment products through the transfer deduction granted in the policyholder fund with the net result that policyholders are not taxed on the investment income attributable to them, and the underwriting losses still qualify for deduction in that they reduce the otherwise taxable transfer arising from profitable investment products. Therefore the policyholders stand to benefit in that they are allowed a deduction for what is essentially a shareholder cost.

4.4. The taxation of policyholders at a proxy rate

The taxation of individual policyholders at a proxy rate under the trustee principle rather than the marginal rates applicable to them was recognised by Clover (2008: 33) as possibly the single biggest weakness of the four funds approach.

This is a particular concern for linked investment products which offers investors an alternative to investing in CISs and consequently results in a lack of tax neutrality between investment products.

CISs are taxed as trusts on a “flow through principle” with the income of the fund being taxed in the investors’ hands at their marginal rate of tax provided that it is distributed by the CIS within 12 months of its year-end⁴⁷. For an overview of the taxation of CISs please refer to Appendix C.

There are some important non-tax related differences between the investment products offered by a life insurer and a CIS, such as the term of the investment⁴⁸ and range of investment products available⁴⁹. Even though there are non-tax related differences, the differing tax treatments often result in investors choosing one or other investment type purely for tax reasons⁵⁰. This is particularly true for high income earners who are taxed at the highest marginal tax rate (40%) and have fully utilised their annual interest exemption. The fact that a pure linked endowment policy offered by an insurer which is effectively taxed at a 30% rate (the proxy rate applicable to the IPF), makes the endowment policy particularly attractive when compared with a CIS.⁵¹

If the investment income of a life insurer earned on behalf of policyholders can be attributed to the underlying policyholders so that the income is subject to tax at their marginal rates as opposed to a proxy rate, this will theoretically be a better result than the current approach as it will result in improved tax neutrality between different investment products.

⁴⁷ In terms of section 25BA of the Act.

⁴⁸ An investment in a CIS is entirely discretionary and there are no restrictions relating to when an investor can disinvest (subject to the rules of the CIS). On the other hand, a restriction period applies to an endowment policy whereby the amount which an investor can withdraw during the first five years of a policy is limited in terms of Part 4 of the Regulations to the LT Act.

⁴⁹ A much broader range of investments is available through an insurer than a CIS. For example, only life companies are able to offer annuity type products and investment products which require capital backing such as smoothed bonus type products. National Treasury and SARS is currently investigating expanding the range of investment products available to investors outside of a life licence, to include living annuity type products where all risk is borne by the underlying investor and no capital backing is required.

⁵⁰ Based on discussion with Mike Tappan, member of The Financial Planning Institute of South Africa in July 2011.

⁵¹ The converse also holds true in that low income type earners in a marginal tax bracket of 18% or 25% will view a market linked endowment policy as unattractive due to the relatively high effective tax rate of the policy (30%) in comparison to an investment in a CIS where the income will be taxed at their marginal rate and they will be able to utilise their annual interest exemption.

4.5. Treatment of transfers from the CF to policyholder funds

It is not clear why transfers from the CF to policyholder funds are treated as non-deductible in the CF. Such transfers are accumulated in each policyholder fund as a balance of special transfers available only for utilisation against future taxable transfers made by that policyholder fund.

Transfers from the CF to policyholder funds can arise from underwriting losses being incurred by an insurer. There are numerous factors for such underwriting losses such as the fact that a book of business may be in its initial stages and will become profitable in its later stages, premiums were possibly incorrectly priced in that insufficient loadings were charged on inception of the policy, mortality experience can be worse than expected, investment experience can be worse than expected and there are a host of other reasons.

Underwriting losses are a normal business cost for an insurer. Underwriting losses experienced on a book of business are akin to losses on a product line which may be experienced by a manufacturer. Such losses are ordinarily deductible against the income generated from other profitable product lines, and are not ring-fenced to future profits from other product lines.

Underwriting losses should qualify for deduction in the CF and should not be ring-fenced to the underlying policyholder funds where the losses were generated.

4.6. Limitation of the deduction of transfers from policyholder funds to the CF

No clear justification has been given as to why limitations are imposed on the value of transfers deductible in policyholder funds.

The limitation of the deduction potentially creates double taxation as noted by Clover (2008: 21). The reason for this is as follows:

Take for instance a life insurer that writes only an investment product for individuals. Tax will be payable on the net investment income in the policyholder fund, less a deduction for transfers. Profits should arise during the term of policies for the insurer, of which a portion of the profits will be as a result of the positive net investment income of the policy. The profits will give rise to a taxable transfer which will be fully taxed in the CF. However, only 50% of the transfer value will qualify for a deduction in the policyholder fund. This results in 50% of the profits attributable to the positive net investment income being taxed in both the policyholder fund and the CF.

4.7. Methodology for calculating transfers between funds

Transfers between policyholder funds and the CF are determined with reference to the excess of the market value of assets at the end of the year over policyholder liabilities. In the fund build-up used to calculate the closing market value of assets, all investment income is taken into account including movements in unrealised investment gains and losses and exempt income such as local and certain foreign dividends. The result is that tax is paid by the insurer on both unrealised investment gains and exempt dividends, whereas unrealised losses qualify for deduction.

This is inconsistent with normal income tax principles where companies and individuals are not taxed on exempt income, and are only required to account for gains or losses associated with the disposal of investments on realisation of such investments.

Although this is not an issue for linked investment products where the value of policyholder liabilities takes into account items such as unrealised investment gains/losses, for other insurance products this is not necessarily the case.

4.8. Spreading of initial expenses

Initial expenses usually constitute sales and administration type expenses. These expenses are often front-end loaded in that the majority of the expenses are incurred by the insurer at the inception of the policy. However, the benefit attributable to the expense is receivable by the insurer over the term of a policy.

Hartwig (1994: 12) conceded that it would be appropriate to spread initial expenses over a period of five to eight years. Even though the original four funds legislation required selling expenses to be spread over a five year period, there is no similar requirement under the current legislation. Provided that a reserve adjustment is made to spread expenses, over the estimated policy term, the current approach for non-spreading of expenses is acceptable⁵².

4.9. Appropriateness of the treatment of expenses and the expense relief formula

The expenses of an insurer typically include investment related fees for managing a portfolio of assets, selling expenses paid to advisors for selling policies, administration expenses incurred in administering policies, and other operational type expenses. These expenses are incurred for the purposes of:

- 1) generating premium income and ultimately underwriting profits for the insurer; and
- 2) producing savings income on behalf of policyholders.

Under the four funds approach, expenses are fully deducted in the computation of the market value of assets used to determine transfers used to tax underwriting profits. The treatment of expenses is consistent with the treatment of income which is also fully included in the determination of the market value of assets.

⁵² Refer to Oliver (2004: 21) where expense reserves are often set-up in practice and offset against actuarial reserves to take into account that expenses are incurred upfront, the benefit for which is received over the term of the policy.

Expenses allocated to policyholder funds qualify for deduction against the investment income allocated to the fund. Expenses directly attributable to the earning of the income of the fund (such as investment related fees) are deductible in terms of normal income tax principles based on the ratio of taxable to total income which is consistent with the treatment of expenses in a CIS.

However, selling, administration and other operating expenditure qualify for deduction against the income of the policyholder fund after applying the expense relief formula⁵³ applicable to that fund. No clear rationale has been provided by SARS for the theoretical basis of its expense relief formula. Clover (2008: 21) described the expense relief formula as a seemingly arbitrarily component in the four funds approach.

The expense relief formula results in differing treatment between linked investment policies of an insurer and the treatment of expenses in a CIS. In the interest of tax neutrality between investment products, the treatment should be consistent.

4.10. Differences in the taxation of capital gains between life wrapped linked investment products and CISs

CGT is payable in a linked investment product on capital gains made when underlying assets held by the life company are disposed. The CGT inclusion rate applicable for the IPF is 25% and for the CPF is 50% which is consistent with the CGT inclusion rates of the underlying policyholders.

No CGT is payable on the disposal of assets in a CIS. However, unit holders are subject to CGT when they ultimately dispose of their units⁵⁴. Furthermore,

⁵³ Refer to chapter 2 where the expense relief formula is discussed. In essence, the formula places adverse weightings on rental income, taxable foreign dividends and exempt local and foreign dividends, where the underlying assets are buildings and shares which typically generate greater taxable capital gains over time when compared to interest bearing investments.

⁵⁴ In terms of paragraph 61 of the Eighth Schedule to the Act.

individual investors can use the annual capital gains exclusions against capital gains made on disposal of their units in a CIS.

Whilst the treatment of capital gains for a linked investment product is theoretically more correct than for a CIS in that capital gains are taxed on an accrual basis (i.e. when the underlying assets are disposed), the difference in tax treatments is contrary to the overarching principle of ensuring tax neutrality between alternative investment products.

4.11. Conclusion

Even though the four funds approach seems to fit well with theoretical frameworks developed for the taxation of life insurers, there are still a number of shortcomings identified with the four funds approach. Two principle shortcomings have been identified which result in a number of peripheral shortcomings:

- 1) the lack of distinction between the underwriting activities of an insurer and the savings activities of the insurer which results in the underwriting profits and losses of the insurer being inappropriately taxed in terms of the current transfer rules; and
- 2) the taxation of savings income earned on behalf of individual policyholders at a proxy rate rather at investors' marginal rates.

It is hoped that the recently enacted New Zealand approach to the taxation of life insurers, considered in the next chapter, will offer potential solutions to the shortcomings identified in the four funds approach.

5. THE NEW ZEALAND APPROACH TO THE TAXATION OF LONG-TERM INSURERS AND A QUALITATIVE COMPARISON TO THE FOUR FUNDS APPROACH

5.1. Introduction

The purpose of this chapter is to explore the recent enactment of a new approach adopted in New Zealand for the taxation of long-term insurers. The chapter begins with a brief look into the New Zealand life insurance industry in comparison to the South African industry previously considered in chapter 1. It briefly describes the former approach to the taxation of long-term insurers in New Zealand and reasons for changes to the current approach. It then goes on to perform a principle based review of the recently enacted legislation. A comparative analysis will be performed between the new approach and the four funds approach. Differences between the two approaches will be highlighted and an evaluation made of the New Zealand approach made against the theory.

It is hoped that the New Zealand approach, or elements thereof, can shed some light on an appropriate approach for the taxation of life insurers, particularly in instances where shortcomings in the four funds approach have been highlighted in the previous chapter.

5.2. An overview of the New Zealand life insurance industry and a comparison to South Africa's life insurance industry

New Zealand's life insurance industry, similar to South Africa's, plays two important roles in the New Zealand economy, namely:

- 1) it enables people and businesses to manage the financial risk of individuals' deaths thereby promoting financial stability and facilitating commerce; and

- 2) it provides a vehicle for savings and investment thereby assisting individuals to save for their retirement and other needs⁵⁵.

In the early to mid 1990's several large life offices demutualised to form separate life companies. The majority of life offices in New Zealand currently operate as companies.⁵⁶ Many of the large life companies operate within a financial service group of companies which offer a range of savings products and general insurance⁵⁷. Overseas owned life insurance companies play a significant part in the life insurance industry in New Zealand.⁵⁸

Life insurers are required to have a deposit lodged with the Public Trust, in terms of the Life Insurance Act, 1908 to conduct insurance business. Regulatory compliance of the industry is monitored by the Government Actuary and Ministry of Economic Development. ISI is the current industry body representing the interests of life insurers.

Statistics in terms of the total value of assets managed by life insurers are not readily available and therefore it is difficult to determine the size of the industry compared to South Africa's on this basis. However, life insurers in New Zealand are required to report the value of annual premiums on risk and mixed savings and risk business on a quarterly basis which can be used as a broad measure of the size of the industry in comparison to South Africa's industry.

Annual in-force premiums for pure risk and mixed savings and risk business⁵⁹ at the end of 2010 were approximately NZ \$ 1.783 billion⁶⁰ which translates to approximately R10.5 billion⁶¹, significantly less than annual long-term insurance premiums in South Africa in 2009 of R295 billion received by primary insurers.

⁵⁵New Zealand Law Commission, *Life Insurance: A Discussion Paper* (2003: 4).

⁵⁶New Zealand Law Commission, *Life Insurance: A Discussion Paper* (2003: 26).

⁵⁷New Zealand Policy Advice Division of the Inland Revenue, *Life Insurance Tax Reform: Officials' Paper No. 1 – Scope of the Review* (2006: 4-5).

⁵⁸New Zealand Law Commission, *Life Insurance: A Discussion Paper* (2003: 30)

⁵⁹Pure savings and investment business statistics are not reported by the ISI.

⁶⁰Obtained from the quarterly statistics report for quarter ended 31 December 2010 published by ISI and available at <http://www.isi.org.nz/stats.htm>

⁶¹The NZD/ZAR exchange rate at 31 December 2010 was R5.8979/NZD per www.oanda.com

Of the total premiums received in South Africa, approximately R115 billion⁶² related to non-linked business i.e. business where some risk is underwritten by the insurer.

The size of the New Zealand insurance market, with respect to premiums flows, is significantly less than the South African market. Some reasons for this are the following:

- New Zealand's population is approximately one tenth of that of South Africa⁶³;
- New Zealand's life industry is underdeveloped in that its penetration⁶⁴ is broadly the same as Poland and the Czech Republic and well behind the UK and Australia⁶⁵. On the other hand, South Africa has the third highest penetration in the world after Taiwan and the United Kingdom⁶⁶.
- South Africa's insurance market is dominated by investments made in life companies by registered pension and similar funds. This is not the case with the New Zealand market where investments by pension funds are made through other investment channels. This was as a result of tax changes made in New Zealand in the late 1980's which resulted in life insurers segregating superannuation business (i.e. pension fund business) into separate superannuation companies⁶⁷; and
- Annuities (both linked and non-linked annuities) are currently offered in South Africa only through insurance companies and represent a sizable block of business. The annuity market is very small in New Zealand as the

⁶² Calculated as total premiums of R295 billion less 60.9% of premiums in respect of linked investment business (see chapter 1 for more detail on the premium split in the South African market).

⁶³ South Africa's population is approximately 49.3 million compared to New Zealand's of 4.3 million. (2009 statistics per World Development Indicators published by the World Bank, available at <http://data.worldbank.org>).

⁶⁴ Penetration is commonly measured as premiums as a % of GDP.

⁶⁵ Market Publishers (2011: 1).

⁶⁶ Erlwanger, N (2011: 4).

⁶⁷ New Zealand Law Commission. *Life Insurance: A Discussion Paper* (2003: 27).

majority of potential annuitants are taxed at lower marginal rates than that the proxy tax rate applicable to life companies. Therefore the product is not perceived to offer value to investors⁶⁸.

The split of annual in-force premiums of life insurers in New Zealand for pure risk and mixed savings and risk business, as published by the ISI as at December 2010,⁶⁹ was the following:

- Traditional policies⁷⁰9%
- Risk policies⁷¹83%
- Group policies.....7%
- Annuities.....1%

Such a strong presence of risk-only type policies has not always been the case. Up to 1990, most insurance policies sold were traditional whole of life and endowment type products. Term insurance policies represented less than 10% of annual premiums received whereas now they represent more than 50% of annual premiums received⁷². The product range of pure risk policies has also expanded over the past 20 years and there has been a significant growth in trauma, replacement income and accidental death type policies⁷³.

Unit trusts have also emerged since the 1980's as a major competitor for savings in the New Zealand financial industry that would otherwise have been invested in whole of life policies, endowment policies and insurance bond products⁷⁴.

⁶⁸ New Zealand Policy Advice Division of the Inland Revenue, *Life Insurance Tax Reform: Officials' Paper No.1 – Scope of Review* (2006: 10).

⁶⁹ Obtained from the quarterly statistics report for quarter ended 31 December 2010 published by ISI and available at <http://www.isi.org.nz/stats.htm>.

⁷⁰ Includes traditional whole of life and endowment policies which have a savings and risk element (7%), and the premiums for the savings portion of unbundled policies (2%).

⁷¹ Includes policies with no savings component such as term life insurance policies (47%), dread disease/trauma policies (13%), disability income replacement policies (14%) and other risk policies (9%).

⁷² New Zealand Policy Advice Division of the Inland Revenue, *Taxation (International Taxation, Life Insurance, and Remedial Matters) Bill: Officials' Report to the Finance and Expenditure Committee on Submissions on the Bill (Volume 3)* (2009: 3).

⁷³ New Zealand Law Commission. *Life Insurance: A Discussion Paper* (2003: 32).

⁷⁴ New Zealand Law Commission. *Life Insurance: A Discussion Paper* (2003: 27).

The split of premiums is notably different to that in South Africa and can in part be attributed to the differences between the two industries explained above. Whilst there is a notable difference in product mix, this study is still valuable owing to the following reasons:

- The majority of investments held by life insurers in South Africa are linked investment products held by the insurer on behalf of registered pension funds or similar institutions.⁷⁵ Such policies are allocated to the UPF and generate no significant profits for insurers other than fees and consequently do not have a significant impact on the tax payable by a life company in South Africa. When comparing the tax impact of a potential product mix between New Zealand and South Africa, these policies should therefore be excluded.
- The source of profits is the same for insurers operating in South Africa and New Zealand⁷⁶, even though profits from underwriting business is likely to be more dominant than savings income in the New Zealand context.
- Both the New Zealand and South African approaches to taxing life insurers seek to tax savings income and underwriting profits on an accrual basis and therefore the methodology employed to do this is useful for a comparative study such as this one.
- Even though the product mix is different, the types of life products available in both markets are similar – refer to the following section below.

5.3. A description of products offered by New Zealand life insurers

Long-term insurance products available in the New Zealand market are similar to those available in the South African market. The products can broadly be classified

⁷⁵ These institutions are tax exempt institutions in South Africa.

⁷⁶ Profits are generated from the underwriting activities of an insurer, the savings activities undertaken by the insurer on behalf of policyholders and other non-insurance business activities.

into two categories: products with a savings and risk element and pure risk products. For a brief description of the different product types, please refer to Appendix D.

5.4. A description of the former approach to the taxation of long-term insurers and reasons for change

5.4.1. The taxation of policyholders

Before considering the former approach, it's useful to note that under both the former and new approach, generally speaking, the policyholder does not get a tax deduction for life insurance premiums paid (excluding certain income protection and "key person" insurance policies) and claims received by policyholders/beneficiaries are not taxable. The preferred approach of the New Zealand Inland Revenue has historically been and continues to be that tax is paid by the life company as a proxy for policyholders.

5.4.2. Brief description of the former approach

Special rules have historically applied to life insurers. The former approach to the taxation of life insurers was enacted in 1990 (hereinafter referred to as the "1990 approach"). It replaced an old regime in terms of which only investment income relating to life insurance policies were taxed and only deductions of expenses relating to that investment income qualified as admissible deductions. Premium income was not taxable and outgoings relating to premiums were not deductible. Under the 1990 approach, life insurers were subject to tax for the first time on both their underwriting income and their investment income. Consequently they could claim deductions for all their expenditure incurred in earning that income⁷⁷.

⁷⁷ New Zealand Inland Revenue, *Appendix C to TIB Volume Two, No. 3, October 1990 : New Taxation Regime for Life Insurers* (1990: 1).

Under the 1990 approach, a two tier system applied, consisting of a life office base (“LOB”) and a policyholder base (“PHB”)⁷⁸.

The taxable income of the LOB consisted of the following:

- The gross income of the insurer, including realised gains on equities⁷⁹ and other property, but excluding premiums from policyholders and life reinsurance claims received from re-insurers. This included the total investment income of the insurer (i.e. including that attributable to policyholders);
- less expenses, (excluding reinsurance premiums paid and claims credited to policyholders);
- plus underwriting income. Underwriting income arose from three sources and was determined by formulae laid down in the legislation. The three sources were the following:
 - Profit on mortality, being the expected death strain (“EDS”) (a defined concept which in simple terms, represented expected claims) less the actual death strain (in simple terms, actual claims);
 - Profit on termination risks (also referred to as discontinuance profit); and
 - Premium loading, which was deemed to be 20% of the EDS and 1% of the reserves released on death in the case of life annuities. The formula was intended to account for the profit

⁷⁸ The description of the 1990 regime has been obtained from the following sources:

- New Zealand Law Commission, *Life Insurance: A Discussion Paper* (2003: 67).
- New Zealand Policy Advice Division of the Inland Revenue, *Life Insurance Tax Reform: Officials’ Paper No.1 – Scope of Review* (2006: 8).
- New Zealand Policy Advice Division of the Inland Revenue, *Taxation of the Life Insurance Business: Proposed New Rules – A Government Discussion Document* (2007: 10-11).
- The Explanatory Note to the Taxation (International Taxation, Life Insurance, and Remedial Matters) Bill, 2008.

⁷⁹ It should be noted that there is no tax on capital gains in New Zealand, although certain gains are subject to tax.

and expenses of the life insurer from providing the risk spreading function to policyholders.

Income accruing for the benefit of policyholders was taxed in the hands of the life insurer on a proxy basis at a single rate under the PHB. The taxable income of the PHB was calculated in terms of a formula representing the increase in policyholder interests for the year equal to:

- Increase in policyholder reserves;
- Plus benefits paid to policyholders;
- Less premiums received from policyholders;
- Plus underwriting income

The tax base was then grossed up by $(1 - \text{LOB tax rate})$ to derive at the before tax amount necessary to provide the after tax benefit implicit in policies.

Tax paid on the LOB generated imputation tax credits which could be used against the tax liability of the PHB thereby avoiding double taxation on income.

5.4.3. Criticisms of the 1990 approach which led to the implementation of a new approach

There were two major problems identified by the New Zealand Inland Revenue to the 1990 approach which led to the introduction of a new approach for the taxation of life insurers in New Zealand, namely:

- 1) The approach under-taxed term insurance profits; and
- 2) The approach over-taxed savings income.⁸⁰

⁸⁰ New Zealand Policy Advice Division of the Inland Revenue, *Taxation of the Life Insurance Business: Proposed New Rules – A Government Discussion Document* (2007: 10-11)

Term insurance profits

At the time the former tax rules were enacted, the majority of life insurance products being sold were traditional whole of life and endowment products with a risk and savings element. As noted above, term insurance products (pure risk policies) represented less than 10% of the market.

The main element in the taxation of underwriting profits under the 1990 approach was the premium loading formula which bore no resemblance to actual business profits. In the case of many term insurance products, expenses which were fully deductible in the determination of taxable income were considerably more than 20% of the expected claims which was added in the determination of taxable income in terms the formula for underwriting profits. The result was that the application of the formula resulted in the creation of artificial tax losses. Furthermore, the more profitable the insurer as a result of lower than expected claims, the higher the tax losses that would result.

With the term insurance market growing to over 50% of annual premiums received by life insurers, the former approach had the unintended consequence of providing significant tax benefits to the life insurance industry, which was not the intent of the legislation.

Savings income

The method for determining the taxable income of the PHB resulted in tax being paid on behalf of policyholders on unrealised investment gains. Tax was also paid on behalf of policyholders at a proxy rate and not at PIE marginal rates applicable to alternative savings products.

Investors considering investing in life products as a means of saving can alternatively choose to invest directly in an investment or through a PIE. A PIE is defined as:

“A collective investment vehicle that elects to be a PIE for tax purposes. The difference between PIEs and other investment vehicles is that PIEs are not subject to tax on trading in New Zealand and some listed Australian equities, and most PIEs may attribute income to individual investors and apply tax at their rate.”⁸¹

Investors holding direct investments or an investment in a PIE are not taxed on realised investment gains on New Zealand and Australian equity investments. They are also taxed at investors’ PIE marginal rates and not a proxy rate of tax. The PIEs rules previously excluded life insurance products.

As a consequence, there was a lack of tax neutrality between the savings income generated in a life company when compared to PIEs. Life insurers were also unfairly prejudiced being subject to more tax (through taxation on realised investment gains on New Zealand and Australian equity investments) which could lead to a distortion of consumer decisions as to the type of savings vehicle to use.

Consequence of the shortcomings of the 1990 approach

The consequence of the identified shortcomings was that a complete new approach to the taxation of life insurers was required to better tax life insurers on their actual results. Furthermore, the PIE rules required amendment so that the savings products of life companies could be incorporated into the rules where relevant and feasible.

⁸¹ New Zealand Policy Advice Division of the Inland Revenue, *Taxation of the Life Insurance Business: Proposed New Rules – A Government Discussion Document* (2007: 2).

5.5. The new approach to the taxation of long-term insurers

5.5.1. Introduction

The new approach for the taxation of long-term insurers is effective for new policies written by the insurer after 1 July 2010. Insurers can elect for the regime to apply from the beginning of the insured's year that includes 1 July 2010. Special transitional / grandfathering rules have been introduced for in-force policies on 30 June 2010. In general the grandfathering rules apply for five years, however, special periods apply for some group and level premium policies⁸².

The new approach was enacted through amendments made to the Income Tax Act 2007 by the Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009. Further minor amendments were made through the Taxation (Consequential Rate Alignment and Remedial Matters) Act 2009 and the Taxation (Annual Rates, Trans-Tasman Savings Portability, KiwiSaver, and Remedial Matters) Act 2010.

The new approach was enacted after much consultation between the New Zealand Policy Advice Division of the Inland Revenue, New Zealand National Treasury, government and industry participants in the life insurance industry. These consultations were published in a number of documents⁸³, which together with the underlying legislation, have been used to formulate the analysis prepared below.

⁸² Deloitte, *Forward Focus: Insurance and Wealth Management* (2010: 2).

⁸³ A discussion of the changes proposed under the new approach and record of consultations are collated in the following documents:

- New Zealand Policy Advice Division of the Inland Revenue, *Life Insurance Tax Reform: Officials' Paper No. 1 – Scope of the Review* (September 2006);
- New Zealand Policy Advice Division of the Inland Revenue, *Life Insurance Tax Reform: Officials' Paper No. 2 – Suggestions for Reform* (February 2007);
- New Zealand Policy Advice Division of the Inland Revenue, *Taxation of the Life Insurance Business: Proposed New Rules – A Government Discussion Document* (December 2007);
- New Zealand Policy Advice Division of the Inland Revenue, *Taxation (International Taxation, Life Insurance and Remedial Matters) Bill: Commentary on the Bill* (July 2008);
- Taxation (International Taxation, Life Insurance and Remedial Matters) Bill: Explanatory Note – published with the bill (2008);

5.5.2. Overview of the new approach

The new rules seek to address the shortcomings identified in the 1990 approach in that it:

- 1) Seeks to tax the risk business of a life insurer on actual profits similar to the treatment of general insurers; and
- 2) Extend the tax benefits of the PIE rules to savers in life products.

Under the new rules, life insurers are now taxed on two bases, namely the shareholder base (representing income derived for the benefit of shareholders) and the policyholder base (representing income derived for the benefit of policyholders). Furthermore, the PIE rules have been amended to:

- 1) extend the benefits of the non-taxation of New Zealand and Australian realised gains on equities to policyholder investment income; and
- 2) permit life insurers to elect to attribute investment income from investment-linked products to policyholders and to tax the income at their PIE marginal tax rates.

Under the new rules subparts CR 1 and 2 and DR 1 and 2 of the Income Tax Act 2007 bring into account as income and allowable deductions the amounts determined for the shareholder base and policyholder base in a tax year. Subpart EY of the Income Tax Act 2007 contains detailed rules for apportioning the income and the expenditure of the life insurer between the two bases. Subpart EY is contained in Appendix E.

Essentially the shareholder base consists of the following elements:

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- New Zealand Policy Advice Division of the Inland Revenue, *Taxation (International Taxation, Life Insurance and Remedial Matters) Bill: Officials' Report to the Finance and Expenditure Committee on Submissions on the Bill: Volume 3* (May 2009); and
 - *Taxation (International Taxation, Life Insurance and Remedial Matters) Bill: As reported from the Finance and Expenditure Committee: Commentary* (2009) – this was the final bill which was enacted.

- risk income, comprising of the risk component of premiums net of reinsurance, less the risk component of claims net of reinsurance; less changes in the value of reserves relating to risk business; less expenses related to risk business;
- plus the shareholder's share of profits from participating / "with profits" policies;
- plus net investment income earned on shareholder funds;
- plus fees income from investment management and other services;
- plus income from annuities;
- plus income from other sources determined under normal income tax principles.

Tax is payable on shareholder base income at the corporate rate (currently 28%). Other provisions applying to corporate shareholders, including imputation credit rules, loss rules and grouping apply to the life insurer's shareholder income.

The policyholder base consists of the following elements:

- net investment income from policyholder funds; and
- the policyholders' share of profits from participating policies.

Tax is payable on policyholder base income by the life insurer on behalf of the policyholders at a proxy rate of 28% (equivalent to the highest marginal rate applicable for qualifying savings under the PIE rules but slightly less than the highest marginal rate applicable to individuals which is currently 33%) which is a final tax. However, the life insurer can elect to attribute investment income from investment linked products to policyholders and so subject the income to tax at the investors' PIE marginal rates (which are individual marginal rates as modified by the PIE rules).

Policyholder net investment income is ring-fenced in the sense that it cannot be offset by losses incurred on shareholder income.

The treatment of the constituent items of the shareholder and policyholder base is explored in more detail in the next section.

5.5.3. Calculation of the shareholder base

The method for calculating the shareholder base income is specified in sections EY1, EY 3-4, EY 19 - EY 31.

Net risk income

The business of the insurer needs to be split into three constituent elements⁸⁴, namely:

- Non-profit participation policies;
- Profit participation policies; and
- Annuities

The net risk income component of the shareholder base is calculated for non-profit participation policies only. Separate rules apply to profit participation policies and annuities.

The net risk income of the insurer is the actual profits made by the insurer from the risk component of non-participatory life insurance products (excluding annuities). The risk components of premiums and claims (net of re-insurance) and expenses are taxable/deductible under sections EY19 and 20. Premiums from traditional participatory business are not treated as income under the new rules, being in substance principal amounts invested by policyholders⁸⁵, and similarly claims on such policies are not treated as deductible expenses.

Special rules apply in respect of the calculation for risk reserves used to determine the net risk income. These are contained in sections EY 23 – 27.

⁸⁴ Refer to section EY 3.

⁸⁵ New Zealand Policy Advice Division of the Inland Revenue, *Taxation (International Taxation, Life Insurance and Remedial Matters) Bill: Commentary on the Bill* (2008: 49).

Although outside the scope of this dissertation, it is useful to note that the following actuarially determined reserves are taken into account in determining the net risk income of the shareholder base:

- An outstanding claims reserve⁸⁶, which includes an IBNR claims reserve, provision for claims reported but not paid at year-end and a risk margin to take into account uncertainty;
- A PSR⁸⁷ or a UPR⁸⁸. A PSR is applicable during the period the premium rate is contractually guaranteed or where level premiums are payable. A UPR is applicable where premiums are stepped yearly or are not contractually guaranteed and represents the unexpired premium of a policy⁸⁹.
- A CGR⁹⁰. This represents a reserve for guarantees furnished by the insurer that capital invested will be returned to the policyholder or a minimum return on capital will be paid.

Share of profits from participating policies

The net return from participating policies is shared between shareholders and policyholders. Owing to the complex nature of these products, specific rules apply to allocate the income. These are contained in sections EY 17-18 (for policyholders), and EY 21-22 and EY 28-29 (for shareholders).

Generally speaking, profit participation policies typically involve a group of members (policyholders) which pool their money together, generate income, self insure and periodically increase their vested entitlement to the pool by way of bonus allocations. Expenses associated with running the pool are met from within the pool. A manager (the shareholder) provides the services associated with running the pool and may underwrite some of the risks of the pool. The manager is rewarded by periodically transferring money from

⁸⁶ Refer to section EY 24.

⁸⁷ Refer to section EY 25.

⁸⁸ Refer to section EY 26.

⁸⁹ New Zealand Policy Advice Division of the Inland Revenue, *Taxation of the Life Insurance Business: Proposed New Rules – A Government Discussion Document* (2007: 25).

⁹⁰ Refer to section EY 27.

the pool. Typically, the reward is linked to the vesting of the increases in the entitlements to members.⁹¹

The new rules (in sections EY 17 – 18 and EY 21-22) seek to appropriately allocate the income between shareholders and policyholders in terms of a formula. In the case of the shareholder base, the formula takes the income from the underlying asset base and multiplies it by the sum of two proportions representing the shareholder's existing share in the asset base (the retained earnings average) and the shareholders expected share in the asset base from future bonus declarations (the future shareholders transfers average) and then subtracts amounts transferred from shareholders for the benefit of policyholders (net transfers). Expenses incurred in generating the income follow the income allocation.

Other profits in respect of participating policies are included in the shareholder base for existing and new business determined in terms of a formulae prescribed in sections EY 28 and EY 29.

Net investment income

The net investment income of an insurer related to non-participatory policies is required to be allocated between the shareholder base and the policyholder base in terms of sections EY4, EY15-16 (allocation to policyholders) and EY 19-20 (allocation to shareholders) depending on for whose benefit the income is derived.

Whilst the investment income related to pure risk products accrues for the benefit of shareholders, mixed savings and risk products will contain an element of investment income which accrues for the benefit of policyholders and shareholders. Section EY15 contains a prescribed formula for calculating the policyholder share of such investment income with

⁹¹ New Zealand Policy Advice Division of the Inland Revenue, *Taxation (International Taxation, Life Insurance and Remedial Matters) Bill: Commentary on the Bill* (2008: 52).

reference to the proportion of the average surrender value of assets to the average value of savings assets. However, insurers can use an alternate formula if it is actuarially determined and gives rise to a more equitable and reasonable result.

Investment income allocated to the shareholder base for non-participating policies is the total income not allocated to the policyholder base. Deductions related to the earning of the income follow the income allocation.

Fee income from investment management and other services

Fee income derived from services offered to policyholders can be explicitly charged to policyholders or implicitly charged through higher premiums. Either way, the fee income is included in the shareholder base. Expenses incurred in deriving the fee income are deductible (refer to EY 19 and 20). If explicitly charged by the life company to policyholders, the expense from a policyholder perspective will qualify for deduction in the policyholder base to the extent that it relates to the derivation of investment income.

Income from annuities

Annuity income is taxed in a method consistent with the 1990 approach (refer EY 31), with the result that the net investment income arising from annuity premiums is taxed as part of the shareholder base. It has been noted that further work is required to integrate the treatment of annuities into the new rules for life insurance⁹².

⁹² New Zealand Policy Advice Division of the Inland Revenue, *Taxation (International Taxation, Life Insurance and Remedial Matters) Bill: Commentary on the Bill* (2008: 49).

Other income

Other income unrelated to insurance activities is taxed in the shareholder base in terms of normal income tax principles.

5.5.4. Calculation of the policyholder base

The method for calculating the policyholder base income is specified in sections EY1, EY2, EY4, and EY 15-18.

Net investment income

Investment income earned on behalf of policyholders is subject to tax in the policyholder base. This is the investment income from non-participatory policies which have a savings element. As described under the shareholder base above, a default formula contained in section EY15 will apply to determine the allocation of investment income to the policyholder base unless the company chooses to apply an alternate formula, provided that it is actuarially determined and gives rise to a more equitable and reasonable result. Expenses incurred to generate such income qualify for deduction.

All the net investment income allocated to the policyholder base will be subject to tax at the proxy rate, excluding investment income on investment-linked products which the insurer elects to be taxed at the policyholders' marginal PIE rates.

Share of profits from participating policies

The policyholders' share of profits from participating policies comprises of income (less related expenses) from these policies allocated to the policyholder base in terms of a prescribed formula contained in section EY17. Essentially the formula is the converse of the formula used to allocate income to the shareholder base (described above).

5.5.5. Transitional provisions

Transitional provisions for in-force policies as at 30 June 2010 are given in section EY 30. These are outside the scope of this study.

5.6. A brief evaluation of the New Zealand approach against theoretical principles

Overall, the New Zealand approach fits well with the theoretical principles referred to in the preceding chapters in that the legislation looks at the insurer's business as a whole and seeks to tax the different elements appropriately. It also seeks tax neutrality between life wrapped investment products and alternative investment products. In doing so:

- 1) Underwriting profits attributable to risks underwritten by the insurer are taxed on an accrual basis similar to the treatment of the underwriting profits of a general insurer. When compared to the treatment of the business profits of a normal company, allowance is correctly made for the insurer for actuarial reserves to take into account the long-term nature of policies and the fact that profits arise over the term of policies.
- 2) Savings income earned on behalf of policyholders is taxed in the life company on an accrual basis. The tax rate applicable to the income is a proxy rate for policyholders for pragmatic reasons, although in the case of investment linked business the insurer has the option to elect that the income be taxed at the marginal PIE rates for investors.

The following points are general observations regarding the new legislation which may require further consideration once the impact of the new legislation is reviewed.

- The reserves allowed in the determination of the insurer's underwriting profits are those reserves prescribed by tax legislation. The insurer may have additional reserves from an accounting and regulatory viewpoint which may result in the insurer reflecting different taxable profit when compared to profits reported for accounting / regulatory purposes. The different treatment of reserves could also raise compliance costs.
- The allocation of premiums, claims, investment income, expenses and reserves between risk and savings business could present a challenge for the insurer and an additional compliance burden to the extent that the insurer's administration systems are not set up for reporting on this basis.
- The allocation of investment income and profits from participating policies is done in terms of a prescribed formula. Whether the formula generates a correct result needs to be reviewed over the next few years.
- Initial expenses in writing policies with a risk element are allowed in full when incurred and not spread over the term of the policy which may be a more appropriate method for treatment of such expenses.
- The treatment of annuities still needs to be brought into the new approach.

5.7. A comparison of the New Zealand approach to the four funds approach

A comparison between the New Zealand approach for taxing life insurers and the four funds approach is contained in Appendix B.

5.8. Conclusion

The New Zealand life insurance industry has shown significant change over the past twenty years with a shift away from traditional whole of life and endowment policies which have a risk and savings element to pure risk products. Pure risk

products now make up more than 50% of industry premiums received by life insurers. The change in product mix and the shortcomings revealed in the existing approach necessitated a change in the rules for the taxation of life insurers. Two main objectives of the new rules were to appropriately tax the underwriting profits of life insurers and to enhance the tax neutrality between life wrapped investment products and alternative investment products as far as possible.

The new tax rules draw a distinction between shareholders and policyholders, and different insurance products, namely participating and non-participating policies. Net risk income (consisting of the risk elements of premiums, claims, reserves, investment income and expenses of non-participating policies) is taxed in the shareholder base. Investment income and profits from participating policies is apportioned between policyholders and shareholders in terms of prescribed formulae. Net investment income attributable to the savings element of non-participating policies earned on behalf of policyholder's is taxed in the policyholder base. The insurer can elect that investment income from linked investment products be attributed to individual investors and taxed at their marginal PIE rates.

The new rules fit in well with theory but do present some practical challenges for insurers such as distinguishing between different classes of business. It will take some time to determine the effectiveness of the new rules owing to the transitional periods applicable to in-force policies.

The rules contain some notable differences to the four funds approach applicable to South African insurers, namely the method used to determine the underwriting profits of the insurer and the fact that a portion of savings income can be attributed to underlying policyholders. Whether certain elements of the New Zealand approach should be incorporated into the four funds approach is considered in more detail in the next chapter.

6. RECOMMENDATIONS FOR IMPROVEMENTS TO THE FOUR FUNDS APPROACH

6.1. Introduction

A number of shortcomings were identified with the four funds approach in chapter 4. A new approach to the taxation of life insurance companies was recently enacted in New Zealand and considered in chapter 5. The main purpose of this chapter is to consider whether aspects of the New Zealand approach can be incorporated into the four funds approach to address identified shortcomings.

The main shortcomings identified in chapter 4 were the following:

- A lack of distinction in the four funds approach between risk and savings business resulting in the inappropriate taxation of underwriting profits (i.e. those profits arising from the assumption of the residual risk of risk pooling and/or the assumption of savings risk for investment products); and
- The taxation of individual policyholders at a proxy rate as opposed to the marginal rates of underlying investors, giving rise to a lack of tax neutrality between life wrapped linked investment products and alternative investment products such as CISs.

Additional shortcomings identified included the mechanism for the determination of transfers, the deductibility and treatment of special transfers, the treatment of expenses and specifically the application of the expense relief ratio, and the difference in the treatment of capital gains for linked investment products when compared to CISs.

The New Zealand approach offers a number of solutions to the shortcomings identified with the four funds approach and therefore provides valuable insight into possible improvements that can be made to the four funds approach.

Possible improvements considered in detail in this chapter include the following:

- 1) separating risk and savings business and the elimination of transfers;

- 2) distinguishing between different insurance products;
- 3) attributing investment income of life wrapped linked investment products to underlying investors;
- 4) eliminating the expense relief ratio with expenses being subject to apportionment based on normal income tax principles; and
- 5) treating capital gains of life wrapped linked investment products and CISs consistently.

6.2. Separating risk and savings business and the elimination of transfers

The separation of the risk and savings business of an insurer is fundamental to taxing the underwriting profits of the insurer and the savings income earned on behalf of policyholders appropriately. This can be seen from the New Zealand approach where such a distinction is clearly made, in response to one of the main objectives of the new legislation being the appropriate taxation of underwriting profits.

Distinguishing between the underwriting and savings activities of the insurer will not only help to address the shortcoming in the four funds approach relating to the inappropriate taxation of underwriting profits, but it also will help to address a number of the specific shortcomings in the four funds approach concerning the mechanism for calculating transfers and the deductibility of transfers and special transfers. This is because the rules pertaining to transfers provide the current means for the taxation of underwriting profits under the four funds approach. Such rules can be eliminated in their entirety as a result of the adoption of the alternative approach, similar to the New Zealand approach, discussed below.

In terms of the taxation of underwriting profits, the income and expenses pertaining to the underwriting of risks by the insurer should be allocated to and taxed directly in the CF. The New Zealand approach gives a good example of the mechanism as to how this can be achieved. In brief, under the New Zealand approach the risk portion of premiums, investment income, claims, expenses and policyholder reserves are taxable / deductible in the shareholder base (equivalent

to the CF in the four funds approach)⁹³. Special provisions in the New Zealand approach provide for an allowance for actuarially determined policyholder reserves pertaining to risk business, such as IBNRs and UPRs which is necessary because of the long-term nature of life insurance policies where anticipated profits emerge over a long policy term.

As provided for in the New Zealand approach, the separation of risk and savings business requires a distinction to be drawn by the insurer between different product types, namely pure risk products, pure savings products where no risk is underwritten by the insurer (i.e. linked investment products) and mixed products, which have a savings and risk component. The distinction between different products is considered in more detail in the next section below.

A distinction between risk and savings business could be drawn on inception of the policy. The allocation of claims, investment income, expenses and reserves could possibly follow the initial allocation of premiums with actuarially determined adjustments annually where the initial allocation is no longer considered appropriate.

In terms of the taxation of savings income earned by the insurer on behalf of policyholders, this income should be allocated to and taxed in the policyholder funds, similar to the current four funds approach. Investment related expenses and other expenses incurred in generating the investment income allocated to the policyholder funds should be deductible against such income. Similar to the New Zealand approach, premiums and claims (and consequently policyholders' reserves) related to savings income attributable to policyholders should not be taxable/deductible in either the policyholder funds or the CF as, in substance, they represent capital flows.

⁹³ For further detail in respect of the exact mechanics of the legislation please refer to Chapter 5.

6.3. Distinguishing between different insurance products

Under the four funds approach, the only product distinguished is annuities because annuity income is taxed directly in policyholders' hands and therefore does not need to be taxed at the life company level.

In order to make a distinction between the underwriting and savings activities of an insurer as referred to above, a life company will need to distinguish between the following product types (in addition to annuities):

- Pure risk products, which should be allocated directly to the CF;
- Pure savings products where no risk is underwritten by the insurer – i.e. linked investment products. A new policyholder fund should be created for such products to allow for the attribution of the investment income of the product to the underlying investors so that it can be taxed at marginal rates. This is discussed in further detail in the next section below.
- Mixed products⁹⁴ – the risk component of these policies should be allocated to the CF whereas the savings component of these policies should be allocated to the IPF, CPF, or UPF.

A potential difficulty arises with splitting the premiums, claims, investment income etc of mixed products into risk and savings components and allocating the items between the CF and policyholder funds. To overcome the difficulty an option which should be considered in further detail is to have default formulae prescribed by legislation similar to those in the New Zealand approach. The formulae adopted in the New Zealand legislation could be used as a starting point but will probably need to be tailored to the South African context. The splitting of premiums, claims, investment income etc of mixed products is a complex matter which should require the involvement of an actuary. It is recommended that certification for the allocation by a registered actuary is provided for in the legislation.

⁹⁴ Mixed products include an array of products such as smoothed bonus type products, products with investment guarantees, participating type policies, universal life products, and traditional endowment products with a payout on death or the attainment of a specified age.

In respect of products with a savings component, it should be noted that the investment income accrues to the life company, even though it is for the ultimate benefit of the policyholders. As the income of these products accrues to the life company, it should be taxed at the life company level. It would be unacceptable to tax the investment income of products with a savings component in policyholders' hands on an accrual basis as this would amount to them being liable for tax on income they would not yet have received⁹⁵. On account that the life company level is the appropriate level at which to tax the investment income of products with a savings component, the trustee principle underpinning the four funds approach is still appropriate and should be retained. It should be noted that the principle was retained in the New Zealand approach.

6.4. Attributing investment income of life wrapped linked investment products to underlying investors

Linked investment products are usually structured as a unitised portfolio of assets whereby investors hold units in a portfolio which represents their interest in the portfolio. These products function in a similar way to CISs. However, an important difference is that the underlying investment income of the linked investment product accrues to the insurer and is retained within the product unlike a CIS where the income is usually distributed to unit holders.

An important aspect of the trustee principle is that the income earned by the life company should reflect all the relevant aspects of the policyholders' taxation, including their tax rates. Whilst it is not practically possible to attribute the investment income of all products with a savings component to underlying investors (especially if products are not unitised), the attribution of investment income could potentially be done by life insurers for linked investment products. This is recognised in the New Zealand approach where the insurer can elect that

⁹⁵ The income will only accrue to policyholders when the policyholders receive their benefits under the policy.

savings income of linked investment products is not taxed at the proxy rate but is rather taxed at the marginal PIE rates of investors.

It is recommended that the four funds approach be amended to draw a distinction between linked investment products and other products with a savings element. Such a distinction would allow for at least some of the savings income earned on behalf of individual policyholders to be taxed at marginal rates rather than at the proxy rate for the IPF. This will help to enhance tax neutrality between linked investment products and CISs.

The easiest way to facilitate such a change is to allocate linked investment products to an entirely new and separate fund. The tax paid by the life company in the new fund should represent the tax that would have been payable if the investment income is distributed to the underlying investors during the year of assessment.

This will require the insurer to attribute the investment income of the linked investment product to its various investors. For individual investors (excluding annuitants), a pragmatic option may be for the insurer to pay tax on the investment income of the product at the marginal rate of individuals in the individuals' previous year of assessments. Failure by the insurer to obtain this information from the underlying investor could result in the insurer being liable for tax on the income based on the highest marginal rate of tax for individuals (currently 40%).

6.5. Eliminating the expense relief ratio with expenses being subject to apportionment based on normal income tax principles

The expense relief ratio represents a seemingly arbitrary component of the four funds approach and appears to have very little, theoretical backing. The expense relief ratio currently applies for deductions claimed against the investment income of an insurer in its policyholder funds for selling and administration of policy expenses and other general operating expenses.

Selling and administration of policy expenses and other general operating expenses are not directly related to the earning of investment income. These expenses would normally be substantially associated with the business activities of the insurer being the determination, processing and collection of premiums and payment of claims. It is therefore questionable whether they should even be granted a deduction against investment income at all.

Following a segregation of risk and savings business, it is recommended that normal income tax principles for the apportionment of expenditure be applied to determine the deductibility of expenditure and the expense relief ratio be eliminated.

Investment related expenses incurred directly to produce taxable and exempt income should be apportioned based on the ratio of the underlying income. If taxable capital gains contribute a significant component of underlying investment returns, then the ratio should take this into account. An asset based approach, rather than an income based approach, for apportionment of expenditure should be considered and this is a topic for a possible further study.

Upfront acquisition expenses incurred in selling insurance policies should be apportioned between risk and savings business. The portion related to the risk business should be deductible in full in the CF (as the premiums are fully taxable), with potentially an inclusion of a reserve adjustment to take into account the fact the premiums will be received over a significant number of years. The portion related to the savings business should potentially not qualify for deduction in the policyholder funds as the associated premiums will not be taxable.

Similarly, ongoing selling and administration expenses and general operating expenditure should be apportioned between risk and savings business. To the extent that the expenses relate to the risk business or the derivation of taxable investment income, the expenses should qualify for deduction in the CF or the policyholder funds as appropriate.

6.6. Treating capital gains of life wrapped linked investment products and CISs consistently

The treatment of capital gains between linked investment products and CISs is currently inconsistent. This is because capital gains in linked investment products are taxed on an accrual basis (i.e. when assets are disposed by the life company) whereas CISs are not subject to CGT but the underlying investors are subject to CGT when they dispose of their units.

In the interest of tax neutrality between alternative investment products, the tax treatment of capital gains should be consistent. Although the treatment of capital gains in linked investment products is theoretically superior to that of CISs, pragmatically the best approach would be to exempt capital gains from tax in linked investment products and tax the underlying unit holders of these products on the disposal of their units. This could easily be done if a new fund is created for linked investment products as recommended in point 6.4 above.

6.7. Conclusion

Whilst the four funds approach matches up well with theoretical principles a number of shortcomings in the approach have been identified. These relate mainly to:

- 1) the lack of distinction in the approach between risk and savings business resulting in the inappropriate taxation of underwriting profits; and
- 2) the lack of tax neutrality between life wrapped linked investment products and alternative investment products such as CISs, mainly as a result of the income of linked investment products being subject to tax at the proxy rate.

The New Zealand approach considered similar shortcomings in its previous approach to the taxation of life insurers which resulted in the adoption of a new approach. Much insight can be gained from the New Zealand approach in determining improvements that should be made to the four funds approach to address identified shortcomings.

In summary, having considered the New Zealand approach, the main recommendations for improvement to the four funds approach, include the following:

- The separation of risk and savings business of the insurer, with profits from risk business being allocated directly to and taxed in the CF and savings income earned on behalf of policyholders allocated to and taxed in the policyholder funds. The concept of transfers between the policyholder funds and the CF should be done away with in its entirety.
- Life wrapped linked investment products should be distinguished and allocated to a separate tax fund. Tax should be paid in this new fund by the life company based on the marginal rates of the underlying investors. Capital gains should not be taxed in the fund but on the disposal of units in the product, similar to the treatment of CISs.
- The expense relief ratio should be done away with entirely. Expenses qualifying for deduction in the determination of taxable underwriting profits (such as acquisition expenses, ongoing selling and administration expenses and operating expenses) and taxable investment income (such as investment related fees), should be subject to apportionment based on normal income tax principles.

7. CONCLUSION

The purpose of this dissertation has been to assess the appropriateness of the four funds approach to the taxation of life insurers in South Africa. This assessment has been made against theoretical principles and, in the case of life wrapped investment products, against the approach for the taxation of alternative investment products. Shortcomings in the four funds approach have been identified and improvements to the approach have been recommended. In considering possible improvements to the four funds approach, the study has considered the recently enacted approach to taxing life insurers in New Zealand to determine whether items of the New Zealand approach can be incorporated into the four funds approach to address shortcomings identified.

After introducing the South African life insurance industry and the approach to the taxation thereof in chapter 1, this study then considered the history of four funds tax legislation in chapter 2. Chapter 3 focussed on theoretical principles for taxing life insurers contained in various South African and international literature. Chapter 4 highlighted shortcomings in the four funds approach when evaluated against theoretical principles and, in the case of life wrapped investment products, against the taxation of CISs which offer an alternative investment product for investors. The recently enacted approach to taxing life insurers in New Zealand was considered in chapter 5. Principles contained in the New Zealand approach were applied to recommend improvements that could be made to the four funds approach in chapter 6.

Fundamental to the appropriate taxation of life insurers is the taxation of underwriting profits and savings income earned on behalf of policyholders on an accrual basis. Whilst the four funds approach achieves this, there are flaws in the approach to the appropriate taxation of underwriting profits owing to the special rules prescribed in the legislation concerning transfers and special transfers between the policyholder funds and the CF. Savings income attributable to individuals is also subject to tax at a proxy rate and not at the marginal rates of the underlying investors which is the case for other investment products.

The above issues were considered when the New Zealand approach to taxing life insurers was recently enacted and thus provide a valuable resource for improvements that can be made to the four funds approach. Having reviewed the principles of the New Zealand approach, the following recommendations are made to improve the four funds approach:

- The separation of risk and savings business of a life insurer, with profits from risk business being allocated directly to and taxed in the CF and savings income earned on behalf of policyholders allocated to and taxed in the policyholder funds. The concept of transfers between the policyholder funds and the CF should be done away with in its entirety.
- Life wrapped linked investment products should be distinguished and allocated to a separate tax fund. Tax should be paid in this new fund by the life company based on the marginal rates of the underlying investors. Capital gains should not be taxed in the fund but on the disposal of units in the product, similar to the treatment of CISs.
- The expense relief ratio should be done away with entirely. Expenses qualifying for deduction in the determination of taxable underwriting profits (such as acquisition expenses, ongoing selling and administration expenses and operating expenses) and taxable investment income (such as investment related fees), should be subject to apportionment based on normal income tax principles.

The above recommendations are based on a principle based review of the New Zealand legislation. A more in-depth study should be performed in respect of the practical implementation of the New Zealand approach so that problems identified in implementation can be avoided if the above recommendations are made to the four funds approach.

In summary, this study has revealed the following answers to the research questions posed in chapter 1:

Whether the underwriting profits of an insurer, and the savings income earned by an insurer on behalf of policyholders, is taxed appropriately under the four funds approach. If not, whether a distinction should be made in the four funds approach between the risk and savings business of an insurer, similar to the approach adopted in New Zealand.

The underwriting profits and savings income of an insurer are not appropriately taxed under the four funds approach. A distinction between the risk and savings business of an insurer should be made in the four funds approach, similar to that of the New Zealand approach.

Whether the trustee principle is still relevant and if so, whether the savings income earned on behalf of individual policyholders in respect of life wrapped investment products is appropriately taxed at a proxy rate as opposed to individuals' marginal tax rates.

The trustee principle is still relevant. Where possible, such as in the case of linked investment products, savings income earned on behalf of individual policyholders should be attributed to the policyholders and subject to tax at the life company level but at the individuals' marginal tax rates rather than at a proxy rate.

Whether the tax treatment of expenses incurred by a life company under the four funds approach is appropriate, especially considering that the deduction of certain expenditure is limited by the expense relief ratio which is prescribed by the legislation.

The tax treatment of expenses incurred by a life company is not appropriate. Upon the separation of the risk and savings business of an insurer, expenses should qualify for deduction in terms of normal income tax principles.

APPENDIX A: SECTION 29A OF THE INCOME TAX ACT

29A. Taxation of long-term insurers.—(1) For the purposes of this section—

“**business**” means any long-term insurance business as defined in section 1 of the Long-term Insurance Act;

“**insurer**” means any long-term insurer as defined in section 1 of the Long-term Insurance Act;

“**Long-term Insurance Act**” means the Long-term Insurance Act, 1998 (Act No. 52 of 1998);

“**market value**”, in relation to any asset, means the sum which a person having the right freely to dispose of such asset might reasonably expect to obtain from a sale of such asset in the open market;

“**owner**”, in relation to a policy, means the person who is entitled to enforce any benefit provided for in the policy: Provided that where a policy has been—

- (a) ceded or pledged solely for the purpose of providing security for the performance of any obligation, the owner shall be the person who retains the beneficial interest in such policy; or
- (b) reinsured by one insurer with another insurer, the reinsurance policy shall be deemed to be owned by the owner of the insurance policy so insured;

“**policy**” means a long-term policy as defined in section 1 of the Long-term Insurance Act;

“**policyholder fund**” means any fund contemplated in subsection (4) (a), (b) or (c);

“**value of liabilities**”, means an amount equal to the value of the liabilities of the insurer in respect of the business conducted by it in the fund concerned calculated on the basis as shall be determined by the Chief Actuary of the Financial Services Board in consultation with the Commissioner.

(2) The taxable income derived by any insurer in respect of any year of assessment commencing on or after 1 January 2000, shall be determined in accordance with the provisions of this Act, but subject to the provisions of this section.

(3) Every insurer shall establish four separate funds as contemplated in subsection (4), and shall thereafter maintain such funds in accordance with the provisions of this section.

[Sub-s. (3) amended by s. 23 (a) of Act No. 20 of 2006.]

(4) The funds referred to in subsection (3) shall be—

(a) a fund, to be known as the untaxed policyholder fund, in which shall be placed assets having a market value equal to the value of liabilities determined in relation to—

(i) business carried on by the insurer with, and any policy of which the owner is, any pension fund, pension preservation fund, provident fund, provident preservation fund, retirement annuity fund or benefit fund;

[Sub-para. (i) substituted by s. 21 of Act No. 3 of 2008.]

(ii) any policy of which the owner is a person where any amount constituting gross income of whatever nature would be exempt from tax in terms of section 10 were it to be received by or accrue to that person: Provided that an insurer shall not deal with a policy in terms of the provisions of this subparagraph unless it has satisfied itself beyond all reasonable doubt that the owner of such policy is such a person or body;

[Sub-para. (ii) amended by s. 16 of Act No. 16 of 2004.]

(iii) any annuity contracts entered into by it in respect of which annuities are being paid;

(b) a fund, to be known as the individual policyholder fund, in which shall be placed assets having a market value equal to the value of liabilities determined in relation to any policy (other than a policy contemplated in paragraph (a)) of which the owner is any person other than a company;

(c) a fund, to be known as the company policyholder fund, in which shall be placed assets having a market value equal to the value of liabilities

determined in relation to any policy (other than a policy contemplated in paragraph (a)) of which the owner is a company; and

- (d) a fund, to be known as the corporate fund, in which shall be placed all the assets (if any) held by the insurer, and all liabilities owed by it, other than those contemplated in paragraphs (a), (b) and (c).

(5) For the purposes of subsection (4), where the owner of a policy is the trustee of any trust or where two or more owners jointly own a policy—

- (a) if all the beneficiaries in such trust or all such joint owners are funds, persons or bodies contemplated in subsection (4) (a), the owner of such policy shall be deemed to be such a fund, person or body, as the case may be; or
- (b) where paragraph (a) is not applicable and all the beneficiaries in such trust or all such joint owners are persons other than a company, the owner of such policy shall be deemed to be a person other than a company; or
- (c) where paragraphs (a) and (b) are not applicable, the owner of such policy shall be deemed to be a company.

(6) An insurer who becomes aware that, in consequence of—

- (a) a change of ownership of any policy issued by it; or
- (b) any change affecting the status of the owner of any policy,

the assets held by it in relation to such policy should in terms of the provisions of subsection (4) be held in a policyholder fund other than the policyholder fund in which such assets are actually held, shall forthwith transfer from such last-mentioned fund to such first-mentioned fund assets having a market value equal to the value of liabilities determined on the date of such transfer in relation to the said policy.

(7) Every insurer shall within a period of four months after the end of every year of assessment redetermine the value of liabilities in relation to each of its policyholder funds as at the last day of such year, and—

- (a) where the market value of the assets actually held by it in any such fund exceeds the value of liabilities in relation to such fund on such last day, it

shall within the said period transfer from such fund to its corporate fund assets having a market value equal to such excess; or

- (b) where the market value of the assets actually held by it in any such fund is less than the value of liabilities in relation to such fund on such last day, it shall within the said period transfer from its corporate fund to such fund assets having a market value equal to the shortfall,

and such transfer shall for the purposes of this section be deemed to have been made on such last day.

(8) Any transfer of an asset effected by an insurer between one fund and another fund shall be effected by way of a disposal of such asset at the market value thereof and shall for the purposes of this Act be treated as an acquisition or disposal of such asset, as the case may be, in each such fund.

[Sub-s. (8) substituted by s. 15 (1) (a) of Act No. 5 of 2001 with effect from 1 October, 2001.]

(9) Subject to the provisions of subsection (11) (d), there shall be exempt from tax any income received by or accrued to an insurer from assets held by it in, and business conducted by it in relation to, its untaxed policyholder fund.

(10) The taxable income derived by an insurer in respect of its individual policyholder fund, its company policyholder fund and its corporate fund shall be determined separately in accordance with the provisions of this Act as if each such fund had been a separate taxpayer and the individual policyholder fund, company policyholder fund, untaxed policyholder fund and corporate fund, shall be deemed to be separate companies which are connected persons in relation to each other for the purposes of subsections (6), (7) and (8) and sections 9B, 20, 24I, 24J, 24K, 24L and 26A and the Eighth Schedule to this Act.

[Sub-s. (10) substituted by s. 15 (1) (b) of Act No. 5 of 2001 and by s. 39 (1) of Act No. 60 of 2001 deemed to have come into operation on 1 October, 2001.]

(11) In the determination of the taxable income derived by an insurer in respect of its individual policyholder fund, its company policyholder fund and its corporate fund in respect of any year of assessment—

(a) the amount of any expenses, allowances and transfers to be allowed as a deduction in the policyholder funds in terms of this Act shall, subject to subsections (11A), (11B) and (11C), be limited to the total of—

(i) the amount of expenses and allowances directly attributable to the income of such fund;

(ii) such percentage of the amount of—

(aa) all expenses allocated to such fund which are directly incurred during such year of assessment in respect of the selling and administration of policies; and

(bb) all expenses and allowances allocated to such fund which are not included in subparagraph (i), but excluding any expenses directly attributable to any amounts received or accrued which do not constitute income as defined in section 1,

which percentage shall—

(AA) in the case of the individual policyholder fund, be determined in accordance with the formula

$$Y = \frac{(I + R + F)}{(I + 2,5R + 4,75F + 4,75L)} \times \frac{100}{1} \quad ;$$

(BB) in the case of the company policyholder fund, be determined in accordance with the formula

$$Y = \frac{(I + R + F)}{(I + 2R + 3,5F + 3,5L)} \times \frac{100}{1} \quad ;$$

in which formulae—

(A) “Y” represents the percentage to be applied to such amount;

(B) “I” represents the gross amount of any interest as defined in section 24J of this Act, received by or accrued to such fund;

(C) “R” represents the rental income of such fund after deduction of expenses directly attributable to such income; and

(D) “L” represents the dividend income (other than taxable foreign dividends) of such fund; and

[Item (D) substituted by s. 15 (1) (e) of Act No. 5 of 2001 applicable in respect of years of assessment commencing on or after 1 January, 2002.]

(E) “F” represents the taxable foreign dividends of such fund; and

[Sub-para. (ii) amended by s. 15 (1) (d) of Act No. 5 of 2001 applicable in respect of years of assessment commencing on or after 1 January, 2002. Item (E) added by s. 15 (1) (f) of Act No. 5 of 2001 applicable in respect of years of assessment commencing on or after 1 January, 2002.]

(iii) such percentage, determined in accordance with the formula contemplated in subparagraph (ii), of 50 per cent of the amount transferred from the policyholder fund in terms of subsection (7) (a), to the extent that the amount of such transfer is required to be included in the income of the corporate fund during such year of assessment in terms of paragraph (d) (i) of this subsection: Provided that the amount of this deduction in terms of this subparagraph shall not exceed the balance of the amount of the income of the policyholder fund remaining after taking into account any other amounts allowed to be deducted from the income of such fund in terms of this section;

[Para. (a) amended by s. 15 (1) (c) of Act No. 5 of 2001 applicable in respect of years of assessment commencing on or after 1 January, 2002.]

(b)

[Para. (b) deleted by s. 30 of Act No. 74 of 2002.]

(c)

[Para. (c) deleted by s. 36 of Act No. 59 of 2000.]

(d) any amount required to be transferred—

(i) to the corporate fund in terms of the provisions of subsection (7) (a) shall be included in the income of the corporate fund; and

(ii) from the corporate fund in terms of the provisions of subsection (7) (b) shall not be deducted from the income of the corporate fund,

for purposes of determining the taxable income of such fund for the year of assessment in respect of which the value of liabilities in relation to its

policyholder funds was redetermined in terms of that subsection: Provided that where any amount is transferred from the corporate fund to any policyholder fund as contemplated in subparagraph (ii), any subsequent transfers from the policyholder fund to the corporate fund of any amounts which in the aggregate do not exceed the total amount of such transfer, shall not be included in the income of the corporate fund in terms of the provisions of subparagraph (i) of this paragraph;

- (e) subject to the provisions of paragraph (a) (iii), no amount transferred to or from the corporate fund in terms of the provisions of subsection (7), shall be deducted from or included in the income of the policyholder fund from or to which such amount was transferred, as the case may be;
- (f) the amount of any transfer contemplated in subsection (6) or (8) shall not be deducted from the income of the fund from which it is transferred and shall not be included in the income of the fund to which it is transferred; and
- (g) premiums and reinsurance claims received and claims and reinsurance premiums paid shall be disregarded.

(11A) For the purposes of subsection (11), the percentage of the amount of expenses, allowances and transfers contemplated in subsection (11) (a) (ii) (aa) and (bb) and subsection (11) (a) (iii) to be allowed in respect of the first five years of assessment commencing on or after 1 January 2002, shall be reduced by an amount determined in accordance with the provisions of subsections (11B) and (11C).

[Sub-s. (11A) inserted by s. 15 (1) (g) of Act No. 5 of 2001 and substituted by s. 15 (1) of Act No. 19 of 2001 applicable in respect of years of assessment commencing on or after 1 January, 2002.]

(11B) The amount referred to in subsection (11A) means—

- (a) in respect of the year of assessment commencing on or after 1 January 2002, but before 1 January 2003, five-sixths of the difference between the percentage determined in accordance with subsection (11) (a) (ii) (hereinafter referred to as the new percentage) and the percentage determined in accordance with subsection (11C) (hereinafter referred to as the old percentage);

- (b) in respect of the year of assessment commencing on or after 1 January 2003, but before 1 January 2004, four-sixths of the difference between the new percentage and the old percentage;
- (c) in respect of the year of assessment commencing on or after 1 January 2004, but before 1 January 2005, three-sixths of the difference between the new percentage and the old percentage;
- (d) in respect of the year of assessment commencing on or after 1 January 2005, but before 1 January 2006, two-sixths of the difference between the new percentage and the old percentage; and
- (e) in respect of the year of assessment commencing on or after 1 January 2006, but before 1 January 2007, one-sixth of the difference between the new percentage and the old percentage.

[Sub-s. (11B) inserted by s. 15 (1) (g) of Act No. 5 of 2001 applicable in respect of years of assessment commencing on or after 1 January, 2002.]

(11C) The old percentage referred to in subsection (11B) shall be determined in accordance with the formula

$$Y = \frac{(I + R + F)}{(I + 3R + 6L + 6F)} \times \frac{100}{1},$$

in which formula—

- (a) “Y” represents the percentage to be determined; and
- (b) “I”, “R”, “L” and “F” shall bear the same meaning as the symbols contemplated in subsection (11) (a) (ii).

[Sub-s. (11C) inserted by s. 15 (1) (g) of Act No. 5 of 2001 applicable in respect of years of assessment commencing on or after 1 January, 2002.]

(12) In the allocation of any asset, expenditure or liability to any fund contemplated in subsection (4), an insurer shall, when establishing such fund and at all times thereafter—

- (a) to the extent to which such asset, expenditure or liability relates exclusively to business conducted by it in any one fund, allocate such asset, expenditure or liability to that fund; and

(b) to the extent to which such asset, expenditure or liability does not relate exclusively to business conducted by it in any one fund, allocate such asset, expenditure or liability in a manner which is consistent with and appropriate to the manner in which its business is conducted.

(13)

[Sub-s. (13) deleted by s. 52 of Act No. 7 of 2010.]

(14)

[Sub-s. (14) deleted by s. 52 of Act No. 7 of 2010.]

(15)

[Sub-s. (15) deleted by s. 23 (b) of Act No. 20 of 2006.]

(16)

[S. 29A inserted by s. 30 of Act No. 53 of 1999. Sub-s. (16) deleted by s. 23 (c) of Act No. 20 of 2006.]

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APPENDIX B: SUMMARY TABLE OF THE FOUR FUNDS APPROACH AND THE NEW ZEALAND APPROACH TO THE TAXATION OF LONG-TERM INSURERS

Category	Four funds approach	New Zealand approach	Key differences
Applicable legislation	Section 29A of the Income Tax Act No.58 of 1962	Subpart EY of the Income Tax Act 2007	Not applicable
Key objectives of the legislation	<ul style="list-style-type: none"> • The trustee principle should apply in respect of income earned by the life company on behalf of policyholders. Policyholder income should be taxed in a way which would yield a similar result to that obtained if income was taxed in the hands of the underlying policyholders • Income of the insurer not subject to the trustee principle should be subject to tax at the corporate rate. 	<ul style="list-style-type: none"> • To tax risk business on actual profits made from underwriting activities. • To tax savings income earned on behalf of policyholders in a manner consistent with, and at tax rates applicable to, other financial products to ensure tax neutrality between alternative financial products as far as possible. 	The New Zealand approach retains the trustee principle in that the life insurer retains the responsibility for paying tax on policyholders, but where possible, seeks to attribute investment income to underlying policyholders and tax such income at marginal PIE rates of investors and not at a proxy rate.

	<ul style="list-style-type: none"> • Tax neutrality between life insurers and other financial industry participants should be maintained as far as possible. • Tax neutrality should be maintained between different classes of policyholders as far as possible (although this is not entirely possible between individual policyholders with the taxation of individual policyholder income at a proxy rate). 		
Taxation of policyholders vs. shareholders	A distinction is drawn between shareholders and policyholders, and also different classes of policyholders. Four separate funds are maintained which are deemed to be separate taxpayers. The four funds are:	A distinction is drawn between shareholders and policyholders with the calculation of separate tax bases, namely the shareholder base and policyholder base. Different classes of policyholders are not distinguished as the proxy tax rate	The four funds approach distinguishes between different classes of policyholders (i.e. individuals, corporate, tax exempt institutions etc) holding life insurance products. Such a distinction is not drawn under the

	<ul style="list-style-type: none"> • the CF representing shareholder interests; • the IPF representing individual policyholders' interests; • the CPF representing company policyholders' interests; and • The UPF representing tax exempt institutions and annuitants which are subject to tax in their own hands. 	<p>applicable to the policyholder base is equivalent to the corporate tax rate. Superannuation (i.e. pension fund) business is segregated in separate companies.</p>	<p>New Zealand approach as it is not necessary for such a distinction to be drawn in the New Zealand context.</p>
<p>Taxation of different products</p>	<p>No distinction is drawn between different types of life insurance products, with the exception of annuities where the benefits are taxed in the individuals' hands.</p>	<p>A distinction is drawn between the risk and savings business of an insurer. Furthermore, participating ("with profits") and non-participating ("without profits") policies are distinguished as special formulae apply to apportion the investment income and profits of participating policies between shareholders and policyholders.</p>	<p>Under the New Zealand approach the following classes of business / products are distinguished, which is not the case under the four funds approach:</p> <ul style="list-style-type: none"> • Risk and savings business; • Participating and non-participating products; and • Linked investment products at the option of the insurer.

		<p>Annuities are also treated separately.</p> <p>The insurer also has the option to attribute income from linked investment products to investors and subject the income to tax at marginal PIE rates and not the proxy rate.</p>	
Taxation of underwriting profits	<p>Underwriting profits are calculated for each tax fund through a mechanism known as the fund build-up. Underwriting profits are calculated as the market value of assets in the policyholder fund less the value of policyholder liabilities in the tax fund at the end of the tax year. The market value of assets in a fund is calculated as the opening value of assets (equal to the prior</p>	<p>Underwriting profits are calculated in the shareholder base with reference to the risk element of premiums, claims, and reserves and associated investment income and expenses. The risk element of premiums is the total premiums earned by the life insurer less premiums of participating policies and the premiums representing the deposit / savings element of non-</p>	<p>The New Zealand approach seeks to tax underwriting profits based on the underwriting activities of the insurer and how the insurer manages its business between the risks it underwrites and the savings mechanism it offers investors.</p> <p>The four funds approach taxes underwriting profits through the “transfer” mechanism prescribed in</p>

	<p>year closing value of policyholder liabilities) plus premium income, plus investment income (including realised and unrealised gains) on assets of the fund, less policyholder claims, expenses and tax. If there is a surplus of assets, the surplus is transferred to the CF and taxed in full in CF whilst qualifying for limited relief in the policyholder fund. If there is a shortfall, the shortfall is “transferred” from the CF to the policyholder fund (known as a “special transfer”) and is not deductible in the CF and not taxable in the policyholder, but can be utilised against surpluses generated by the particular fund in the future.</p>	<p>participating policies. Claims and expenses follow the same allocation principles. Specific reserves (such as IBNR and other claim reserves, UPRs and CGRs) qualify for deduction in the determination of underwriting profits.</p>	<p>terms of the legislation.</p>
<p>Taxation of savings income</p>	<p>Savings income earned on policyholder assets is allocated to</p>	<p>Savings income earned for the benefit of policyholders (including</p>	<p>Only savings income earned in respect of the savings element of</p>

	<p>policyholders and taxed in the policyholder funds.</p> <p>Savings income earned on surplus assets (i.e. shareholder assets) is taxed in the CF.</p>	<p>participating and non-participating policyholders) is allocated to and taxed in the policyholder base. An insurer can elect that the net investment of investment linked products be attributed to individual investors and taxed at their marginal PIE rates – refer to chapter 5 for more detail.</p> <p>Savings income not allocated to policyholders is taxed in the shareholder base.</p>	<p>policies is allocated to policyholders under the New Zealand approach.</p> <p>All savings income attributable to policyholder assets (held in respect of both risk and savings policies) is allocated to policyholders under the four funds approach.</p> <p>The New Zealand approach allows the insurer to attribute income associated with linked investment products to individual policyholders and tax such income at PIE marginal rates.</p>
Timing of taxation of policyholders	Tax is payable when income from the underlying assets accrues to the life company.	Tax is payable when income from the underlying assets accrues to the life company.	No difference
Responsibility for	Tax is levied on the life company	Tax is levied on the life company	No difference

collecting the tax	which pays tax on behalf of the policyholders.	which pays tax on behalf of the policyholders.	
Final or withholding tax for policyholders	The tax levied on the life company is a final tax. No withholding taxes apply for policyholders.	The tax levied on the life company is a final tax. No withholding taxes apply for policyholders.	No difference
Applicable tax rates	<ul style="list-style-type: none"> • IPF: 30% (a proxy rate, assumed to represent the average tax rate of individuals) • CPF: 28% (the current corporate tax rate) • UPF: Exempt from tax • CF: 28% (the current corporate tax rate) 	<ul style="list-style-type: none"> • The shareholder base: 28% (the current corporate tax rate) • The policyholder base: 28% (a proxy rate equivalent to the current highest marginal PIE rate for individual investors). If the insurer elects to attribute net investment income related to linked investment products to individual investors, tax is payable at marginal PIE rates of investors. 	<p>Under the four funds approach, the IPF proxy rate is lower than the highest marginal tax rate applicable to individuals (currently 40%).</p> <p>When considering the proxy tax rate in isolation, life wrapped investment products offer a tax benefit to wealthy individuals.</p> <p>The tax rate of the policyholder base in New Zealand is equivalent to the highest PIE marginal rate (in respect of non attributed income)</p>

			<p>When considering the proxy tax rate in isolation, there is no specific tax advantage to investors for investing in a life wrapped investment products.</p> <p>In the New Zealand approach, the insurer can elect to attribute net investment income related to linked investment products to underlying investors with the result that the income is taxed at the marginal PIE rates of the investors.</p>
<p>Deductibility of expenses (acquisition costs, ongoing administration expenses, general operating expenses, and investment related expenses)</p>	<p><i>Acquisition expenses, ongoing administration expenses and general operating expenses</i></p> <p>The legislation refers to “selling and administration of policies” expenses and “other” expenses.</p>	<p><i>Acquisition expenses, ongoing administration expenses and general operating expenses</i></p> <p>These expenses will be allocated to the shareholder base, except to the extent that they relate to investment</p>	<p><i>Acquisition expenses, ongoing administration expenses and general operating expenses</i></p> <p>Acquisition expenses, ongoing administration expenses and general operating expenses associated with</p>

	<p>These expenses are deductible in against the investment income of the applicable policyholder fund, but subject to the expense relief ratio, which takes into the account the type of income earned in the policyholder funds and places an adverse weighting on rental and dividend income. A portion of the general operating expenses may be allocated to the CF where it will qualify for deduction under normal income tax principles.</p> <p><i>Investment related expenses</i> Expenses directly attributable to the earning of investment income are deductible in full, subject to apportionment under normal income tax principles where the</p>	<p>income allocated to the policyholder base for participatory and non-participatory policies. There are no specific rules governing the deductibility of expenses.</p> <p><i>Investment related expenses</i> These expenses need to be apportioned between the shareholder base and policyholder base depending on the allocation of income from participating and non-</p>	<p>risk products or the risk element of savings products is deductible in the shareholder base in the New Zealand approach. There are no specific rules governing their deductibility. Under the four funds approach, these expenses, in general, are deductible in the policyholder funds, subject to the expense relief ratio.</p> <p><i>Investment related expenses</i> No difference</p>
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	purpose of the expenditure is to generate taxable and exempt income.	participating policies. There are no specific rules governing the deductibility of expenses.	
Comparison of life-wrapped investment products to equivalent investment products.	<p>An alternative product is a CIS, although there are non-tax related differences between CISs and life wrapped investment products.</p> <p>CISs are taxed on a flow through principle and income earned by the CIS distributed within 12 months of year-end retains its nature and is taxed in the underlying investors' hands at marginal rates. Life wrapped products in comparison are subject to tax at a proxy rate.</p> <p>Acquisition type expenses do not qualify for deduction but are added to the base cost of an investor's</p>	<p>Alternative products are managed funds such as CISs which are subject to the PIE rules.</p> <p>The method of calculating investment income and the treatment of expenses is consistent with investment products subject to the PIE rules. There is no CGT applicable in New Zealand.</p> <p>Provided that the insurer elects to attribute the income of its linked investment products to the underlying investors, the income will be subject to tax at the same rates.</p>	<p>The New Zealand approach more closely aligns life wrapped products to equivalent investment products in that the treatment of investment income and expenses are similar and the net investment income of products is potentially subject to tax at the same rates in the case of linked investment products.</p> <p>Under the four funds approach, the treatment of expenses and capital gains differ between life wrapped and alternative investment products and the net investment income is subject to tax at a different rate, being the proxy rate, compared to</p>

	<p>investment in a CIS used to determine the capital gain of the investor on realisation of the investor's units.</p> <p>Other expenses of a CIS are subject to deduction in terms of normal income tax principles whereas the expenses of a life wrapped investment product are subject to the expense relief ratio.</p> <p>Capital gains made on underlying assets are taxed in the life company's hands when the assets are disposed, whereas capital gains made on the disposal of assets by a CIS are exempt because the unit holder is taxed on capital gains made on the realisation of units.</p>		<p>the marginal rates applicable to alternative investment products.</p>
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APPENDIX C: A SUMMARY OF THE TAX TREATMENT OF CISs

Description	Summary of rules
General principles	<p>A CIS is taxed on a flow through principle similar to a trust. Provided that all income is distributed⁹⁶ out of the CIS to the underlying unit holders within 12 months of the year-end of the trust⁹⁷, the income retains its nature⁹⁸ and is taxed in the hands of the unit holders of the CIS.</p> <p>Owing to the flow through principle, investors are taxed on distributed income at their marginal rates. In the case of individuals, they can also apply their annual interest income exemption⁹⁹ to interest distributions and annual capital gains exclusions¹⁰⁰ to capital gains made on the disposal of units.</p>
Investment income	<p>Generally speaking, the investment income of a CIS will consist of taxable interest, rent, foreign dividends, and realised gains (to the extent that investments are held on revenue accounts), and exempt local dividends. Provided that all income is distributed by the CIS within 12 months of its year-end, the income will not be subject to tax in the CIS.</p>
Expenses	<p><i>Initial advisor fees and administration expenses (Acquisition type expenses)</i></p>

⁹⁶ Distributions made to unit holders of a CIS are usually net of a deduction of expenses incurred in the production of the CIS's investment income.

⁹⁷ In terms of section 25BA of the Act.

⁹⁸ Income exemptions such as section 10(1)(k) which exempts most local dividends and certain foreign dividends can be applied by the underlying investors

⁹⁹ The interest exemption available in terms of section 10(1)(i) of the Act for persons under the age of 65 is R22 300 and persons over the age of 65 is R32 000. The first R3 700 of the exemption applies to taxable foreign dividends and interest. These exemptions are applicable for the 2011 year of assessment and are adjusted annually.

¹⁰⁰ The annual exclusion for capital gains in terms of paragraph 5 of the Eighth Schedule to the Act which is applicable to individuals is R17 500. This is increased to R120 000 in the year of death. These exemptions are applicable for the 2011 year of assessment and are adjusted annually.

	<p>Initial advisor fees and administration fees are included in the base cost of an investor's interest in the CIS for CGT purposes and are therefore deducted in the determination of capital gains made on the ultimate disposal of units.</p> <p><i>Ongoing advisor fees, administration expenses, investment related fees and other expenses</i></p> <p>Ongoing fees in a CIS can be structured in two ways: either by way of the redemption of units used to fund the expenses or through the CIS paying the expenses out of investment income available for distribution (i.e. expenses are taken into account in determining the unit price and reduce income distributions to unit holders). The former gives rise to a CGT loss for the unit holder¹⁰¹, available for offset against other capital gains, whilst the latter is the more common and tax efficient approach as a portion of the expenditure will qualify for deduction against investment income. The proportion of expenses which qualify for deduction in the CIS is determined by the ratio of taxable investment income in the CIS to total investment income.</p>
Capital gains	<p>No CGT is payable in respect of the gains made by a CIS on the disposal of the underlying investments held on capital account in the CIS. The unit holder is responsible for CGT payable in respect of gains made on the redemption of units in the CIS.¹⁰²</p>

¹⁰¹ This is because there a nil proceeds whilst there is still a base cost attributable to the units redeemed.

¹⁰² In terms of paragraph 61 of the Eighth Schedule to the Act

APPENDIX D: A SUMMARY OF LONG-TERM INSURANCE PRODUCTS OFFERED IN NEW ZEALAND

The list of products and related descriptions presented below¹⁰³ is intended to provide an overview of the main products available in the New Zealand long-term insurance industry. The list is not intended to be exhaustive.

Products with a risk and savings element

- Whole of life insurance – these are policies which have a guaranteed sum insured whilst also providing a share of the life office’s profits (i.e. participating or “with profits” type policies). The share of profits or “bonuses” adds to the benefit that will be received on death or maturity of the policy. The policy can be cashed in or surrendered before maturity, but the amount received by the insurer is generally at the discretion of the insurer.
- Endowment insurance – these policies have similar features to whole of life policies but the sum insured is payable upon the survival of the insured’s life to a certain age or date, or upon death.
- Investment bonds – these are savings policies with capital guarantees for both the capital balance and declared interest.
- Unit-linked policies – these are savings policies where the policyholder shares directly in the returns of an underlying asset pool with no performance guarantee. The investment risk is fully borne by the policyholder¹⁰⁴.

¹⁰³ New Zealand Policy Advice Division of the Inland Revenue, *Life Insurance Tax Reform: Officials’ Paper No. 1 – Scope of the Review* (2006: 6-7).

¹⁰⁴ Technically these policies would qualify as pure savings type policies rather than mixed risk and savings type policies.

- Annuities – these are savings policies whereby policyholders receive regular payments until death in return for an upfront lump sum paid by the policyholder to the life office.

Pure risk policies

- Term life insurance – these are policies where the sum insured is payable only if death occurs during the policy term.
- Trauma insurance¹⁰⁵ – these are policies which provide cover in the event of a certain trauma such as a severe accident or a specified medical condition.
- Disability insurance – these are policies which provide an income or lump sum benefit payable based on the insured's income in the event of a defined permanent or temporary disability.

¹⁰⁵ These products are similar to dread disease/sever illness policies in South Africa

APPENDIX E: NEW ZEALAND'S TAX LEGISLATION APPLICABLE TO LONG-TERM INSURERS

Subpart EY—Life insurance rules

Introductory provisions

EY 1 What this subpart does

Two bases

(1) This subpart provides for the taxation of life insurers on 2 separate bases, the policyholder base and the shareholder base. Sections EY 2 and EY 3 describe the general apportionment of income and deductions between the 2 bases under this Part. Section LA 8B (General rules particular to life insurers) provides some general rules for tax credits relating to the 2 bases. Parts L and O include tax credit rules and memorandum account rules specific to the 2 bases.

Schedular policyholder base income and PIE scheduler income

(2) Section EY 2 uses the assessable income in a life insurer's policyholder base income, and the life insurer's policyholder base allowable deductions, to calculate their schedular policyholder base income. A life insurer's schedular income derived by their life fund PIE that is a multi-rate PIE is excluded from their schedular policyholder base income, along with deductions for that income.

Counting once

(3) Income and deductions must be apportioned to either the policyholder base or the shareholder base. There is no doublecounting.

Defined in this Act: assessable income, deduction, income, life fund PIE, life insurance, life insurer, life reinsurance, memorandum account, multi-rate PIE, policyholder base, policyholder base income, schedular policyholder base income, shareholder base, tax credit

Section EY 1: substituted, on 1 July 2010, by section 185(1) of the Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009 (2009 No 34).

EY 2 Policyholder base

Policyholder base income

- (1) A life insurer has policyholder base income,—
- (a) for savings product policies that are not profit participation policies, under section EY 15:
 - (b) for profit participation policies, under section EY 17:
 - (c) under section EY 27(4).

Policyholder base allowable deductions

- (2) A life insurer has policyholder base allowable deductions,—
- (a) for savings product policies that are not profit participation policies, under section EY 16:
 - (b) for profit participation policies, under section EY 18:
 - (c) under section EY 27(4):
 - (d) under section EZ 61 (Allowance for cancelled amount: spreading):
 - (e) under section LE 2B (Use of remaining credits by life insurer on policyholder base).

Schedular policyholder base income

- (3) A life insurer's **schedular policyholder base income** is the amount given by subtracting their policyholder base allowable deductions for an income year, and any amount carried forward to the income year under subsection (5), from the assessable income in their policyholder base income for the income year.

Cap on subtracting: ring-fencing policyholder base allowable deductions

- (4) Despite subsection (3), the total amount that is subtracted under subsection (3), including an amount carried forward to the current year under subsection (5), is no more than the amount of the assessable income in the life insurer's policyholder base income for the income year.

Excess allocations: carrying forward and re-instating next year

- (5) Any excess not able to be subtracted in the current year because of subsection (4) is carried forward to the next income year.

Exception

(6) Despite subsections (3) to (5) a life insurer's schedular income derived by their life fund PIE that is a multi-rate PIE is excluded from their schedular policyholder base income, along with deductions for that income.

Defined in this Act: amount, assessable income, income year, life fund PIE, life insurance, life insurer, multi-rate PIE, policyholder base allowable deduction, policyholder base income, profit participation policy, savings product policy, schedular income, schedular policyholder base income

Section EY 2: substituted, on 1 July 2010, by section 185(1) of the Taxation International Taxation, Life Insurance, and Remedial Matters) Act 2009 (2009 No 34).

EY 3 Shareholder base

Shareholder base income

(1) A life insurer has shareholder base income,—

- (a) for policies that are not profit participation policies, under section EY 19: *see also* subsection (3), for reserves:
- (b) for profit participation policies, under sections EY 21, EY 28, and EY 29:
- (c) for annuities, under section EY 31.

Shareholder base allowable deductions

(2) A life insurer has shareholder base allowable deductions,—

- (a) for policies that are not profit participation policies, under section EY 20: *see also* subsection (3), for reserves:
- (b) for profit participation policies, under sections EY 22 and EY 28:
- (c) for the period and policies described in section EY 30, under that section:
- (d) for annuities, under section EY 31.

Reserves

(3) Under sections EY 23 to EY 27, a life insurer calculates reserving amounts for life insurance policies, other than annuities, that have a life risk component and are not profit participation policies. A reserving amount may be income included in their shareholder

base income, or a deduction that is included in their shareholder base allowable deduction, as provided by the relevant sections.

Defined in this Act: deduction, life insurance, life insurance policy, life insurer, life risk, profit participation policy, shareholder base allowable deduction, shareholder base income

Section EY 3: substituted, on 1 July 2010, by section 185(1) of the Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009 (2009 No 34).

EY 4 Apportionment of income of particular source or nature, and of tax credits

Default basis

(1) For a class of policies, income of a particular source or nature, and tax credits received, are apportioned between the policyholder base and shareholder base—

(a) in the same proportion as the policyholder base income relating to the particular source, nature, or credits bears to the life insurer's total gross gains relating to the particular source, nature, or credits, in the case of the policyholder base:

(b) in the same proportion as the shareholder base income relating to the particular source, nature, or credits bears to the life insurer's total gross gains relating to the particular source, nature, or credits, in the case of the shareholder base.

More equitable or reasonable basis

(2) For a class of policies, the life insurer may use a basis of apportionment that is different from the basis described in subsection (1), if that basis results in an amount, actuarially determined, that is more equitable and reasonable than an amount determined using the basis described in subsection (1).

Defined in this Act: actuarially determined, amount, class of policies, income, life insurer, policyholder base, policyholder base income, shareholder base, shareholder base income, tax credit

Section EY 4: substituted, on 1 July 2010, by section 185(1) of the Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009 (2009 No 34).

EY 5 Part-year tax calculations

Part-year tax calculations

(1) For their life insurance and for their general insurance contracts outstanding claims reserve, a life insurer does part-year tax calculations, described in subsection (2), if they do not have an early life regime application day and 1 July 2010 is not the first day of their income year.

First year part-year calculations: description

(2) For calculating their income tax liability for the tax year that corresponds to the income year that includes 1 July 2010, where 1 July 2010 is not the first day of the income year, the life insurer treats references, in the new life insurance rules and in the rules they replace, to an income year or a tax year as if they are references to 2 separate tax years and corresponding income years (the **part-years**) within that first tax year, divided by 1 July 2010 (for example: a rule to calculate an amount of policyholder income for an income year under the replaced rules means the calculation is done for the relevant part-year before 1 July 2010. A rule to calculate an opening reserve amount under sections EY 23 to EY 27 at the beginning of an income year under the new rules means the calculation is done on 1 July 2010, at the beginning of the relevant part-year).

Part-year calculations: effect

(3) The part-year calculations may give rise to income and deductions for the income year, but they do not create any part-year tax return obligations. The 2 part-year calculations compose 1 income tax liability for 1 income year.

Part-year calculations for transfers

(4) Where a life insurer (the **transferor**) transfers life insurance business to another life insurer (the **transferee**), the transferor does a part-year calculation, as described in subsection (2), for each class of policy in the transferred business, but only for their part-year ending on the day the transfer occurs. The transferee also does a part-year calculation for the transferred policies, as described in subsection (2), but only for their part-year starting on the day the transfer occurs. The transferee's relevant opening part-year reserve amounts under sections EY 23 to EY 27 equal the transferor's relevant closing part-year reserve amounts, and if the life reinsurance associated with a class of policies is not assigned by the transferor to the transferee, those reserve amounts are calculated without subtracting relevant life reinsurance amounts.

Part-year calculations for transfers: effect

(5) Transferor's and transferee's part-year calculations may give rise to income and deductions for the income year, but they do not create any part-year tax return obligations.

Part-year calculations: end of transitional adjustments

(6) If, for a life insurance policy, the transitional adjustment under section EY 30(7) is calculated for part of an income year, because section EY 30 ceases to apply to the policy before the end of the income year, the life insurer does part-year tax calculations for the policy for the income year, as described in subsection (2), but the income year is divided by the day that section EY 30 ceases to apply. The effect of the part-year calculations is described in subsection (3).

Part-year calculations: end of transitional adjustments [Repealed]

(7) *[Repealed]*

Defined in this Act: amount, class of policies, deduction, early life regime application day, income, income tax liability, income year, life insurance, life insurance policies, life insurer, life reinsurance, outstanding claims reserve

Section EY 5: substituted, on 1 July 2010, by section 185(1) of the Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009 (2009 No 34).

Section EY 5(3) heading: amended (with effect on 1 July 2010), on 7 September 2010, by section 45(1) of the Taxation (Annual Rates, Trans-Tasman Savings Portability, KiwiSaver, and Remedial Matters) Act 2010 (2010 No 109).

Section EY 5(4): amended (with effect on 1 July 2010), on 7 September 2010, by section 45(2) of the Taxation (Annual Rates, Trans-Tasman Savings Portability, KiwiSaver, and Remedial Matters) Act 2010 (2010 No 109).

Section EY 5(6) heading: substituted (with effect on 1 July 2010), on 7 September 2010, by section 45(3) of the Taxation (Annual Rates, Trans-Tasman Savings Portability, KiwiSaver, and Remedial Matters) Act 2010 (2010 No 109).

Section EY 5(6): substituted (with effect on 1 July 2010), on 7 September 2010, by section 45(3) of the Taxation (Annual Rates, Trans-Tasman Savings Portability, KiwiSaver, and Remedial Matters) Act 2010 (2010 No 109).

Section EY 5(7) heading: repealed (with effect on 1 July 2010), on 7 September 2010, by section 45(3) of the Taxation (Annual Rates, Trans-Tasman Savings Portability, KiwiSaver, and Remedial Matters) Act 2010 (2010 No 109).

Section EY5(7): repealed (with effect on 1 July 2010), on 7 September 2010, by section 45(3) of the Taxation (Annual Rates, Trans-Tasman Savings Portability, KiwiSaver, and Remedial Matters) Act 2010 (2010 No 109).

EY 6 Actuarial advice and guidance

The Commissioner may seek the advice of an actuary on anything that is required to be actuarially determined, or any related matter.

Defined in this Act: actuarially determined, actuary, Commissioner

Section EY 6: substituted, on 1 July 2010, by section 186(1) of the Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009 (2009 No 34).

Section EY 6: amended, on 1 May 2011, by section 82 of the Financial Markets Authority Act 2011 (2011 No 5).

EY 7 Meaning of claim

Meaning in life insurance rules

(1) In the life insurance rules, **claim**—

(a) means the amount that a life insurer is liable to pay under a life insurance policy because the contingency against which the life insured is covered under the policy has occurred; subsections (2) to (5) expand on “the amount that a life insurer is liable to pay”:

(b) excludes a payment made by a life insurer on the transfer of some or all of its life insurance business:

(c) in the expression “claim arising”, does not have the meaning given to the word “claim” in paragraph (a) or (b).

Cash and non-cash benefits

(2) For the purposes of subsection (1)(a), the amount that a life insurer is liable to pay includes—

(a) a payment on the death of a life insured:

(b) a payment on maturity:

(c) a payment of a cash bonus:

(d) a payment on the surrender of a policy:

- (e) an annuity payment:
- (f) a benefit other than in cash.

Advance or amount in actuarial reserves

- (3) For the purposes of subsection (1)(a), the amount that a life insurer is liable to pay does not include—
- (a) an advance against the security of the policy; or
 - (b) a bonus or other discretionary amount added to the actuarial reserves.

Amount before certain subtractions

- (4) For the purposes of subsection (1)(a), the amount that a life insurer is liable to pay means the amount before the subtraction of the following amounts payable to the life insurer:
- (a) an advance against the security of the policy; and
 - (b) an unpaid premium for the policy; and
 - (c) interest on an amount referred to in paragraph (a) or (b).

Amount zero

- (5) For the purposes of subsection (1)(a), the amount that a life insurer is liable to pay may be zero.

Defined in this Act: actuarial reserves, amount, business, claim, interest, life insurance, life insurance policy, life insurance rules, life insured, life insurer, pay, premium

Compare: 2004 No 35 s EY 7

Section EY 7(1)(b): amended, on 1 July 2010, by section 187(1) of the Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009 (2009 No 34).

EY 8 Meaning of life insurance

Meaning

- (1) **Life insurance** means insurance under which—
- (a) person A (the **life insurer**) is liable to provide person B (the **policyholder**) with a benefit described in subsection (2); and

(b) the life insurer is entitled to receive consideration in return, either from the policyholder or from some other person.

Benefits

(2) The benefits are—

(a) a benefit whose payment is contingent on the death of 1 or more human beings, including an annuity whose term is contingent on human life; or

(b) a benefit whose payment is contingent on the survival of 1 or more human beings to a date, or an age, specified as part of the insurance, including an annuity whose term is contingent on human life; or

(c) a benefit that is an annuity whose term is not contingent on human life, if the life insurer enters into the arrangement to provide the annuity as part of their business of providing life insurance.

Exclusion: death benefits provided under accident or medical insurance

(3) **Life insurance** does not include accident or medical insurance under which—

(a) 1 or more benefits are payable for the death of the person whose life is insured; and

(b) all the benefits referred to in paragraph (a) are—

(i) payable if the death is caused by a specified cause named in the policy; or

(ii) payable incidentally to the provision of accident or medical benefits, if the death is caused by a specified cause named in the policy.

Exclusion: death benefits provided by superannuation funds

(4) **Life insurance** does not include an arrangement in which—

(a) a superannuation fund is liable to pay, as a benefit to a beneficiary of the fund, a lump sum on—

(i) the death of 1 or more human beings specified in the trust deed; or

(ii) the survival of 1 or more human beings specified in the trust deed to a date, or an age, specified in the trust deed; and

(b) the lump sum is made up of—

(i) superannuation contributions made by or for the beneficiary; and

(ii) allocated investment earnings attributable to contributions made by or for the beneficiary; and

(iii) any other allocation from the profits of the superannuation fund attributable to contributions made by or for the beneficiary.

Defined in this Act: arrangement, business, life insurance, life insurer, pay, superannuation contribution, superannuation fund

Compare: 2004 No 35 s EY 8

EY 9 Meaning of life insurance policy

Life insurance policy means a policy to the extent to which it states the terms under which life insurance is covered.

Defined in this Act: life insurance, life insurance policy

Compare: 2004 No 35 s EY 9

EY10 Meaning of life insurer

Meaning

(1) **Life insurer** means a person carrying on a business of providing life insurance.

Exclusion

(2) A person carrying on a business of providing life insurance in an income year is treated as not carrying on a business of providing life insurance while the person has full reinsurance.

Inclusion

(3) An association of persons, a body of persons, or a trustee is treated as carrying on a business of providing life insurance to the extent to which—

(a) the association, body, or trustee provides life insurance; and

(b) the consideration for the provision is something other than natural love and affection.

Parties to policies treated as being unrelated

(4) Every life insurance policy entered into by the association, body, or trustee as insurer is treated as entered into with an unrelated party, even if the life insurer and the policyholder are, for example,—

(a) an association and a member of the association; or

(b) a trustee and a beneficiary of the trust.

Relationship with subpart HE

(5) Subpart HE (Mutual associations) does not apply to the business of providing life insurance of the association, body, or trustee.

Defined in this Act: business, full reinsurance, income year, life insurance, life insurance policy, life insurer, trustee

Compare: 2004 No 35 s EY 10

EY11 Superannuation schemes providing life insurance

Benefits treated as life insurance

(1) The provision by a trustee of a superannuation scheme of a benefit to a member or beneficiary of the scheme is treated as the provision of life insurance if the trustee provides life insurance to any member or beneficiary, unless subsection (2) applies.

Exemption for certain schemes

(2) A trustee of a superannuation fund is treated as not carrying on the business of life insurance for an income year if the fund meets all the requirements of subsections (3) to (9) for the income year.

Fund must be registered

(3) At all times in the income year, the fund must be registered under the Superannuation Schemes Act 1989.

Trustee cannot be a life insurance company

(4) At all times in the income year, no trustee of the fund is a company carrying on the business of providing life insurance to which the Life Insurance Act 1908 applies.

Nature of funds

(5) At all times in the income year, the fund must be 1 of the following kinds:

(a) a fund established by an employer, or a group of employers who are associated, to provide benefits only to persons who are employees of, or related by employment to, such an employer, or to another associated employer who agrees after the fund's establishment to make contributions to it:

(b) a fund constituted under the Government Superannuation Fund Act 1956 that provides benefits only to persons who are employees of, or related by employment to, an employer who agrees or is required to contribute, or on whose behalf contributions are made, to the fund:

(c) a fund constituted under the National Provident Fund Act 1950, the National Provident Fund Restructuring Act 1990, or the National Provident Fund Restructuring Amendment Act 1997 that has as its trustee the Board of Trustees of the National Provident Fund.

Only certain fund beneficiaries allowed

(6) At all times in the income year, each beneficiary of the fund must be—

(a) a natural person that is an employee of or related by employment to an employer of the kind referred to in subsection (5)(a) or (b):

(b) a natural person that is a beneficiary of the fund, in the case of a fund referred to in subsection (5)(c) (which refers to funds related to the National Provident Fund):

(c) an employer of members of the fund, to the extent of the employer's contingent interest in a fund surplus.

Significant employer superannuation contributions required

(7) At all times in the income year, each employer is required by the trust deed or Act constituting the fund to make or is making, or having made on their behalf, superannuation contributions to provide to a significant extent the fund benefits, except to the extent to which subsection (10) applies.

No avoidance effect

(8) The fund must not have been established, and must not be being used at any time in the income year, in a way that has the effect of defeating the intent and application of the life insurance rules.

FMA approval required

(9) The trustee of the fund must have made a written application to the FMA for, and the FMA must have granted, approval that the fund is for the income year one that complies with subsections (3) to (8).

Exemptions to requirements of subsection (7)

(10) Subsection (7) does not apply if—

(a) the FMA is satisfied that, for the income year, subsection (7) would have been complied with but for the fund assets exceeding the accrued benefits from the fund:

(b) the fund is one referred to in subsection (5)(c) (which refers to funds related to the National Provident Fund).

Limited superannuation contributions disregarded for subsection (7)

(11) For the purposes of subsection (7), superannuation contributions that are merely nominal or that only meet the costs of administration and investment management are disregarded.

Notice by FMA

(12) The FMA must notify the trustee of a superannuation fund as soon as practicable after determining that—

(a) the fund complies with subsections (3) to (8) for an income year:

(b) the fund ceases to comply with the subsections for an income year.

Objection under Superannuation Schemes Act

(13) A person dissatisfied with the FMA's decision may appeal against the decision under section 23 of the Superannuation Schemes Act 1989 and has no right of objection under the Tax Administration Act 1994.

Meaning of related by employment

- (14) In this section, a person is **related by employment** to an employer if the person is—
- (a) a former employee, in the case of deferred benefits relating to prior employment:
 - (b) a relative or dependent of an employee, in the case of benefits arising from the employee's or former employee's membership in the fund.

Defined in this Act: associated, company, employee, employer, income year, life insurance, life insurance rules, related by employment, relative, superannuation contribution, superannuation fund, superannuation scheme, trustee

Compare: 2004 No 35 s GD 8(1), (3)–(8)

Section EY 11(3): amended, on 1 May 2011, by section 82 of the Financial Markets Authority Act 2011 (2011 No 5).

Section EY 11(5) heading: substituted (with effect on 1 April 2010), on 21 December 2010 (applying for the 2010–11 and later income years), by section 57(1) of the Taxation (GST and Remedial Matters) Act 2010 (2010 No 130).

Section EY 11(5): substituted (with effect on 1 April 2010), on 21 December 2010 (applying for the 2010–11 and later income years), by section 57(1) of the Taxation (GST and Remedial Matters) Act 2010 (2010 No 130).

Section EY 11(7) heading: amended (with effect on 1 April 2008), on 6 October 2009, by section 188(1) of the Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009 (2009 No 34).

Section EY 11(7): amended (with effect on 1 April 2008), on 6 October 2009, by section 188(1) of the Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009 (2009 No 34).

Section EY 11(9) heading: amended, on 1 May 2011, by section 85(1) of the Financial Markets Authority Act 2011 (2011 No 5).

Section EY 11(9): amended, on 1 May 2011, by section 85(1) of the Financial Markets Authority Act 2011 (2011 No 5).

Section EY 11(10)(a): amended, on 1 May 2011, by section 85(1) of the Financial Markets Authority Act 2011 (2011 No 5).

Section EY 11(11) heading: amended (with effect on 1 April 2008), on 6 October 2009, by section 188(2) of the Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009 (2009 No 34).

Section EY 11(11): amended (with effect on 1 April 2008), on 6 October 2009, by section 188(2) of the Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009 (2009 No 34).

Section EY 11(12) heading: amended, on 1 May 2011, by section 85(1) of the Financial Markets Authority Act 2011 (2011 No 5).

Section EY 11(12): amended, on 1 May 2011, by section 85(1) of the Financial Markets Authority Act 2011 (2011 No 5).

Section EY 11(13): amended, on 1 May 2011, by section 82 of the Financial Markets Authority Act 2011 (2011 No 5).

Section EY 11 list of defined terms **superannuation contribution**: inserted (with effect on 1 April 2008), on 6 October 2009, by section 188(3) of the Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009 (2009 No 34).

EY12 Meaning of life reinsurance

Meaning

(1) Life reinsurance—

(a) means a contract of insurance between a life insurer and another person (**person C**) under which the life insurer is secured, fully or partially, against a risk by person C:

(b) does not include a contract that—

(i) secures against financial risk unless, in the contract, it is incidental to securing against life risk:

(ii) is, or is part of, a tax avoidance arrangement.

“Fully” and “partially”

(1B) The words “fully” and “partially” describe the extent to which the life insurer is secured against life risk; they do not describe the term for which the reinsurance is provided.

Full reinsurance

(2) The life insurer has **full reinsurance** if all the following apply:

(a) the life insurer offered or was offered or entered into a life insurance policy or policies,—

(i) in the case of a life insurer resident in New Zealand, as part of their business of providing life insurance; or

(ii) in the case of a life insurer not resident in New Zealand, as part of their New Zealand business; and

(b) the life insurer holds a life reinsurance policy or policies covering every life insurance policy described in paragraph (a); and

(c) the life insurer is fully secured against liability under the life insurance policy or policies by the life reinsurance policy or policies; and

(d) the life insurer offered or was offered or entered into the life reinsurance policy or policies in New Zealand.

Partial reinsurance

(3) The life insurer has **partial reinsurance** if all the following apply:

(a) the life insurer—

(i) holds a life reinsurance policy or policies fully securing them against liability for 1 or some, but not all, of the life insurance policies described in paragraph (b); or

(ii) holds a life reinsurance policy or policies for all the life insurance policies described in paragraph (b) but only partially securing them against liability; or

(iii) holds a life reinsurance policy or policies partially securing them against liability for 1 or some, but not all, of the life insurance policies described in paragraph (b); and

(b) the life insurer offered or was offered or entered into the life insurance policy or policies covered by the life reinsurance policy or policies,—

(i) in the case of a life insurer resident in New Zealand, as part of their business of providing life insurance; or

(ii) in the case of a life insurer not resident in New Zealand, as part of their New Zealand business; and

(c) the life insurer offered or was offered or entered into the life reinsurance policy or policies in New Zealand.

Exclusion: financial arrangements and general insurance

(4) To the extent to which a contract is a financial arrangement or is insurance that secures a life insurer against liability that arises from insurable events other than death or survival of a human being, that contract is not life reinsurance.

Other definitions

(5) In this Act,—

life financial reinsurance is a contract that may be life reinsurance under subsection (1)(a), but is not included under subsection (1)(b)

financial risk—

(a) means risk, whether or not specific to a party to the relevant arrangement relating to risk, that is contingent on a valuation or disposal of financial arrangements, or contingent on profitability or creditworthiness, or contingent on a variable such as future expenditure:

(b) does not include life risk

life reinsurer means a person in the position of person C.

Relationship with subject matter

(6) Section EZ 62 (Reinsurance transition: life financial reinsurance may be life reinsurance) overrides this section.

Defined in this Act: business, financial arrangement, financial risk, full reinsurance, life financial reinsurance, life insurance, life insurance policy, life insurer, life reinsurance, life reinsurance policy, life reinsurer, New Zealand business, offered or was offered or entered into, partial reinsurance, resident in New Zealand

Compare: 2004 No 35 s EY 11

Section EY 12(1) heading: substituted, on 1 July 2010, by section 189(1) of the Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009 (2009 No 34).

Section EY 12(1): substituted, on 1 July 2010, by section 189(1) of the Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009 (2009 No 34).

Section EY 12(1B) heading: inserted, on 1 July 2010, by section 189(1) of the Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009 (2009 No 34).

Section EY 12(1B): inserted, on 1 July 2010, by section 189(1) of the Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009 (2009 No 34).

Section EY 12(4) heading: substituted, on 1 July 2010, by section 189(2) of the Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009 (2009 No 34).

Section EY 12(4): substituted, on 1 July 2010, by section 189(2) of the Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009 (2009 No 34).

Section EY 12(5) heading: added, on 1 July 2010, by section 189(2) of the Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009 (2009 No 34).

Section EY 12(5): added, on 1 July 2010, by section 189(2) of the Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009 (2009 No 34).

Section EY 12(6) heading: added, on 1 July 2010, by section 189(2) of the Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009 (2009 No 34). Section EY 12(6): added, on 1 July 2010, by section 189(2) of the Taxation

(International Taxation, Life Insurance, and Remedial Matters) Act 2009 (2009 No 34).

Section EY 12 list of defined terms **financial arrangement**: inserted, on 1 July 2010, by section 189(3) of the Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009 (2009 No 34).

Section EY 12 list of defined terms **financial risk**: inserted, on 1 July 2010, by section 189(3) of the Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009 (2009 No 34).

Section EY 12 list of defined terms **life financial reinsurance**: inserted, on 1 July 2010, by section 189(3) of the Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009 (2009 No 34).

EY13 Meaning of life reinsurance policy

Life reinsurance policy means a policy to the extent to which it states the terms under which life reinsurance is covered.

Defined in this Act: life reinsurance, life reinsurance policy

Compare: 2004 No 35 s EY 12

EY14 Life insurance and life reinsurance: how sections relate

Life insurance definitions

(1) Sections EY 8 to EY 11 define terms relating to life insurance.

Life reinsurance definitions

(2) Sections EY 12 and EY 13 define terms relating to life reinsurance.

Life insurance term usually includes life reinsurance term

(3) A reference in this Act to any of the terms defined in sections EY 8 to EY 11 includes the equivalent term in sections EY 12 and EY 13—for example, **life insurer** includes **life reinsurer**—unless the context requires otherwise.

Defined in this Act: life insurance, life insurer, life reinsurance, life reinsurer

Compare: 2004 No 35 s EY 13

Policyholder base

Heading: inserted, on 1 July 2010, by section 190(1) of the Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009 (2009 No 34).

Non-participation policies

Heading: substituted, on 1 July 2010, by section 190(1) of the Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009 (2009 No 34).

EY15 Policyholder base income: non-participation policies

What is included

(1) For an income year, a life insurer's income is included as their policyholder base income if it relates to life insurance policies that are not profit participation policies, and it—

(a) does not relate to life risk components of premiums and claims:

(b) is investment income that—

(i) is included in investment income gains or losses in the financial statements of the life insurer; and

(ii) is not a premium; and

(iii) is fairly attributable to savings product policies.

Certain income: basis of apportionment

(2) Despite subsection (1), if an amount of investment income is included in a life insurer's policyholder base income under subsection (1), but may also be shareholder base income under section EY 19, ignoring section EY 19(1)(d), then the investment income is included in policyholder base income to the extent provided by the formula—

$$\text{Income} \quad \times \quad \frac{\text{average surrender value}}{\text{average savings assets}}$$

Definition of items in formula

(3) In the formula,—

(a) **income** is the income described in subsection (2):

(b) **average surrender value** is, for the savings product policies to which the income relates, the average surrender value of the policies for the income year. The life insurer may determine an equitable and reasonable basis for the measurement of the average:

(c) **average savings assets** is, for the savings product policies to which the income relates, the average market value of assets held by the life insurer for the policies for the income year. The life insurer may determine an equitable and reasonable basis for the measurement of the average.

More equitable or reasonable basis of apportionment

(4) Despite subsections (2) and (3), for investment income described in subsection (2), the life insurer may use a basis of apportionment that is different from the one described in subsections (2) and (3), if that basis results in an amount, actuarially determined, that is more equitable and reasonable than an amount determined using the basis described in subsections (2) and (3).

Treatment of de minimis life risk component amounts

(5) An amount of income relating to a policy that, but for this subsection, is an amount related to the life risk of a premium or life reinsurance claim, is treated as not relating to the relevant life risk component for the purposes of subsection (1), if—

- (a) the life insurer has actuarially determined that the life risk is 1% or less of the premium or life reinsurance claim; and
- (b) chooses to apply this subsection for the policy.

Defined in this Act: actuarially determined, amount, claim, income, income year, life insurance policy, life insurer, life reinsurance, life risk, life risk component, market value, premium, policyholder base income, profit participation policy, savings product policy, shareholder base income, surrender value

Section EY 15: substituted, on 1 July 2010, by section 190(1) of the Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009 (2009 No 34).

Section EY 15(5): amended, on 1 July 2010 (applying for income years beginning on or after 1 July 2010), by section 32(1) of the Taxation (Consequential Rate Alignment and Remedial Matters) Act 2009 (2009 No 63).

EY16 Policyholder base allowable deductions: non-participation policies

What is included

(1) For an income year, a life insurer's deduction that relates to life insurance policies that are not profit participation policies is included as their policyholder allowable deduction to

the extent to which it is incurred in relation to their policyholder base income under section EY 15.

Basis of apportionment

(2) Despite subsection (1), if a deduction is included in a life insurer's policyholder base allowable deduction under subsection

(1), but may also be a shareholder base allowable deduction under section EY 20, ignoring section EY 20(1)(d), the life insurer must use a basis of apportionment for the deduction which is—

(a) the same as in section EY 15(2) and (3) with necessary modifications; or

(b) is the same as in section EY 15(4) with necessary modifications.

Defined in this Act: deduction, income year, life insurance policy, life insurer, premium loading, premium loading formula, policyholder base allowable deduction, policyholder base income, profit participation policy, shareholder base allowable deduction

Section EY 16: substituted, on 1 July 2010, by section 190(1) of the Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009 (2009 No 34).

Profit participation policies

Heading: inserted, on 1 July 2010, by section 190(1) of the Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009 (2009 No 34).

EY17 Policyholder base income: profit participation policies

What is included

(1) For an income year, a life insurer has policyholder base income to the extent to which they have an amount for profit participation policies calculated using the formula—

asset base gross income \times (1 - retained earnings average - future shareholder transfers average) + net transfers.

Definition of items in formula

(2) In the formula,—

(a) **asset base gross income** is the amount of annual gross income that the life insurer would have for the policies' asset base, if—

(i) the life insurer is treated as having no assets other than the asset base; and

(ii) amounts under sections EY 28 and EY 29 are ignored:

(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 shareholder's 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 shareholder's retained earnings at the end of the income year:

(c) **future shareholder transfers 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 present value (net) of future transfers to the life insurer's shareholders for future bonus declarations that are able to be supported by the supporting asset base at the beginning of the income year:

(ii) the proportion of the value of the policies' asset base that is attributable to the present value (net) of future transfers to the life insurer's shareholders for future bonus declarations that are able to be supported by the supporting asset base at the end of the income year:

(d) **net transfers** is the amount transferred to the benefit of policyholders from shareholders in relation to profit participation policies.

Meaning of supporting asset base

(3) **Supporting asset base** means the asset base for relevant policies excluding—

(a) the value of assets supporting the life insurer's policyholder unvested liabilities:

(b) the value of assets attributable to the life insurer's shareholders.

Defined in this Act: actuarially determined, amount, annual gross income, asset base, income year, life insurer, policyholder base income, present value (net), profit participation policy, supporting asset base

Section EY 17: substituted, on 1 July 2010, by section 190(1) of the Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009 (2009 No 34).

Section EY 17(2)(b)(i): amended, on 1 July 2010, by section 33(1) of the Taxation (Consequential Rate Alignment and Remedial Matters) Act 2009 (2009 No 63).

Section EY 17(2)(b)(ii): amended, on 1 July 2010, by section 33(2) of the Taxation (Consequential Rate Alignment and Remedial Matters) Act 2009 (2009 No 63).

Section EY 17(2)(d): amended, on 1 July 2010, by section 33(3) of the Taxation (Consequential Rate Alignment and Remedial Matters) Act 2009 (2009 No 63).

Section EY 17(3)(a): amended, on 1 July 2010, by section 33(4) of the Taxation (Consequential Rate Alignment and Remedial Matters) Act 2009 (2009 No 63).

EY18 Policyholder base allowable deductions: profit participation policies

For an income year, a life insurer has policyholder base allowable deductions equal to the amount they would have, for profit participation policies, under the formula in section EY 17(1), if—

- (a) the life insurer is treated as having no assets other than the asset base; and
- (b) the item **asset base gross income** is treated as being the annual total deduction for the policies' asset base; and
- (c) the item **net transfers** is ignored.

Defined in this Act: amount, annual total deduction, asset base, income year, life insurer, policyholder base allowable deduction, profit participation policy

Section EY 18: substituted, on 1 July 2010, by section 190(1) of the Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009 (2009 No 34).

Section EY 18(b): amended, on 1 July 2010, by section 34(1) of the Taxation (Consequential Rate Alignment and Remedial Matters) Act 2009 (2009 No 63).

Section EY 18(c): added, on 1 July 2010, by section 34(1) of the Taxation (Consequential Rate Alignment and Remedial Matters) Act 2009 (2009 No 63).

Shareholder base

Heading: inserted, on 1 July 2010, by section 190(1) of the Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009 (2009 No 34).

Non-participation policies

Heading: inserted, on 1 July 2010, by section 190(1) of the Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009 (2009 No 34).

EY19 Shareholder base income: non-participation policies

What is included

- (1) For an income year, a life insurer's income is included as their shareholder base income if it relates to life insurance policies that are not profit participation policies, and it—
- (a) relates to life risk components of premiums and claims, other than for annuities, and is not described in paragraphs (b) to (d):
 - (b) relates to fees and commissions:
 - (c) relates to the life risk component of life reinsurance claims:
 - (d) is investment income that is not included as their policyholder base income under section EY 15:
 - (e) is not otherwise accounted for in this subpart, for the income year.

Treatment of de minimis life risk component amounts

- (2) An amount of income relating to a policy that, but for this subsection, is an amount related to the life risk of a premium or life reinsurance claim, is treated as not relating to the life risk component for the purposes of subsection (1), if—
- (a) the life insurer has actuarially determined that the life risk is 1% or less of the premium or life reinsurance claim; and
 - (b) chooses to apply section EY 15(5) for the policy.

No double-counting

- (3) If an amount is included as shareholder base income under sections EY 23 to EY 29, it is not included under this section.

Defined in this Act: actuarially determined, amount, claim, income year, life insurer, life insurance policy, life reinsurance, life risk, life risk component, policyholder base income, premium, profit participation policy, shareholder base income

Section EY 19: substituted, on 1 July 2010, by section 190(1) of the Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009 (2009 No 34).

Section EY 19(2): amended, on 1 July 2010 (applying for all income years beginning on or after 1 July 2010), by section 35(1) of the Taxation (Consequential Rate Alignment and Remedial Matters) Act 2009 (2009 No 63).

EY20 Shareholder base allowable deductions: non-participation policies

What is included

(1) For an income year, a life insurer's deduction is included as their shareholder base allowable deduction if it relates to life insurance policies that are not profit participation policies, and it—

(a) relates to life risk components of premiums and claims, other than for annuities, and is not described in paragraphs (b) to (e):

(b) relates to fees and commissions:

(c) relates to the life risk component of life reinsurance premiums:

(d) is a deduction in relation to investment income that is not included as their policyholder base allowable deduction under section EY 16:

(e) is a premium payback amount, and—

(i) section EY 19 applies or has applied to include the original premium as shareholder base income; and

(ii) section EY 30(7) does not apply or has not applied to calculate a transitional amount for the original premium:

(f) is not otherwise accounted for in this subpart, for the income year.

No double-counting

(2) If an amount is included as shareholder base allowable deduction under sections EY 23 to EY 29, it is not included under this section.

Defined in this Act: amount, claim, deduction, income year, life insurance policy, life insurer, life reinsurance, life risk component, policyholder base allowable deduction, premium, premium payback amount, profit participation policy, shareholder base allowable deduction, shareholder base income

Section EY 20: substituted, on 1 July 2010, by section 190(1) of the Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009 (2009 No 34).

Profit participation policies

Heading: inserted, on 1 July 2010, by section 190(1) of the Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009 (2009 No 34).

EY21 Shareholder base income: profit participation policies

What is included

(1) For an income year, a life insurer has shareholder base income to the extent to which they have an amount for profit participation policies calculated using the formula—

$$\text{asset base gross income} \times (\text{retained earnings average} + \text{future shareholder transfers average}) - \text{net transfers.}$$

Definition of items in formula

(2) In the formula,—

(a) **asset base gross income** is the amount of annual gross income that the life insurer would have for the profit participation policies' asset base, if—

(i) the life insurer is treated as having no assets other than the asset base; and

(ii) amounts under sections EY 28 and EY 29 are ignored:

(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 shareholder's 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 shareholder's retained earnings at the end of the income year:

(c) **future shareholder transfers 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 present value (net) of future transfers to the life insurer's shareholders for future bonus declarations that are able to be supported by the supporting asset base at the beginning of the income year:

(ii) the proportion of the value of the policies' asset base that is attributable to the present value (net) of future transfers to the life insurer's shareholders for future bonus

declarations that are able to be supported by the supporting asset base at the end of the income year:

(d) **net transfers** is the amount transferred to the benefit of policyholders from shareholders in relation to profit participation policies.

Defined in this Act: actuarially determined, amount, annual gross income, asset base, income, income year, life insurer, present value (net), profit participation policy, shareholder base income, supporting asset base

Section EY 21: substituted, on 1 July 2010, by section 190(1) of the Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009 (2009 No 34).

Section EY 21(2)(b)(i): amended, on 1 July 2010, by section 36(1) of the Taxation (Consequential Rate Alignment and Remedial Matters) Act 2009 (2009 No 63).

Section EY 21(2)(b)(ii): amended, on 1 July 2010, by section 36(2) of the Taxation (Consequential Rate Alignment and Remedial Matters) Act 2009 (2009 No 63).

Section EY 21(2)(d): amended, on 1 July 2010, by section 36(3) of the Taxation (Consequential Rate Alignment and Remedial Matters) Act 2009 (2009 No 63).

EY22 Shareholder base allowable deductions: profit participation policies

For an income year, a life insurer has shareholder base allowable deductions equal to the amount they would have, for profit participation policies, under the formula in section EY 21(1) if—

- (a) the life insurer is treated as having no assets other than the asset base; and
- (b) the item **asset base gross income** is treated as being the annual total deduction for the policies' asset base; and
- (c) the item **net transfers** is ignored.

Defined in this Act: amount, annual total deduction, asset base, income year, life insurer, profit participation policy, shareholder base allowable deduction

Section EY 22: substituted, on 1 July 2010, by section 190(1) of the Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009 (2009 No 34).

Section EY 22(b): amended, on 1 July 2010, by section 37(1) of the Taxation (Consequential Rate Alignment and Remedial Matters) Act 2009 (2009 No 63).

Section EY 22(c): added, on 1 July 2010, by section 37(1) of the Taxation (Consequential Rate Alignment and Remedial Matters) Act 2009 (2009 No 63).

Non-participation policies: reserves

Heading: inserted, on 1 July 2010, by section 190(1) of the Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009 (2009 No 34).

EY23 Reserving amounts for life insurers: non-participation policies

Reserves

(1) Sections EY 24 to EY 27 apply to calculate a life insurer's reserving amounts for life insurance policies, other than annuities, that have a life risk component and that are not profit participation policies.

Actuarial determination

(2) All reserving amounts must be actuarially determined, for each class of policies.

Positive and negative amounts: shareholder base income or shareholder base allowable deduction

(3) If a reserving amount calculated under sections EY 24 to EY 27 is a positive amount, the life insurer has that amount as income included in their shareholder base income. If a reserving amount calculated under sections EY 24 to EY 27 is a negative amount, the life insurer has that amount as a deduction included in their shareholder base allowable deductions.

Which reserve can be used when?

(4) For an income year, for a relevant class of policies, a life insurer has a reserving amount described in—

(a) section EY 24, for outstanding claims reserves (the **outstanding claims reserving amount**):

(b) section EY 25, for premium smoothing reserves (the **premium smoothing reserving amount**) if the life insurer chooses to calculate a premium smoothing reserving amount and the PSR periods for policies in the class of policies begins, continues or ends in the income year:

(c) section EY 26, for unearned premium reserves (the **unearned premium reserving amount**), if the life insurer chooses to not calculate a premium smoothing reserving amount:

(d) section EY 27, for capital guarantee reserves (the **capital guarantee reserving amount**).

Choice

(5) Despite subsection (4)(b) and (c), a life insurer may not change between calculating a premium smoothing reserving amount and an unearned premium reserving amount for a class of policies once the premium smoothing reserving amount is used for the class of policies. If a policy in a class of policies does not meet the relevant requirements described in subsection (6), then a life insurer has an unearned premium reserving amount for that class of policy.

Meaning of PSR period

(6) **PSR period** means, for a policy in the relevant class of policies, a period beginning, continuing or ending in the income year for which—

- (a) premiums payable are level or substantially level, and the period is 1 or more years; or
- (b) there is a material mismatch between the incidence of life risk components and the timing of premiums payable, and the period is 1 or more years.

Defined in this Act: actuarially determined, amount, class of policies, deduction, income year, life insurance policy, life insurer, life risk, life risk component, premium, profit participation policy, PSR period, shareholder base allowable deduction, shareholder base income

Section EY 23: substituted, on 1 July 2010, by section 190(1) of the Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009 (2009 No 34).

EY24 Outstanding claims reserving amount: non-participation policies not annuities

Calculation of reserving amount

(1) For an income year (the **current year**), a life insurer has an outstanding claims reserving amount for a class of policies calculated using the formula—

opening outstanding claims reserve - closing outstanding claims reserve.

Definition of items in formula

(2) In the formula in subsection (1),—

(a) **opening outstanding claims reserve** is—

(i) the amount of the life insurer's closing outstanding claims reserve for the class of policies, for the income year before the current year (the **prior year**); or

(ii) if the life insurer has no closing outstanding claims reserve for the prior year, the amount that would be the outstanding claims reserve for the class of policies, using subsections (3) and (4) with necessary modifications, calculated at the end of the prior year, but using a basis consistent with the one that the insurer used for tax purposes in that prior year (for example, if IBNR liability was not accounted for, for tax purposes, in the prior year, the opening balance calculation does not take into account IBNR liability):

(b) **closing outstanding claims reserve** is the amount of the life insurer's outstanding claims reserve calculated under subsections (3) and (4) for the class of policies at the end of the current year.

Outstanding claims reserve calculation

(3) A life insurer's outstanding claims reserve is calculated for the relevant policies using the formula—

$$\text{life risk claims incurred} + \text{life risk claims reported} + \text{risk margin.}$$

Definition of items in formula

(4) In the formula in subsection (3),—

(a) **life risk claims incurred** is the actuarially determined estimate of present values (gross) for the life risk components of claims not yet reported to the life insurer before the end of the current year, but the insured-against event has occurred. The life risk components must take into account the probability of the claims being paid, and future expenses for administering the claims, but the present value (gross) of relevant life reinsurance claims must be subtracted from the total:

(b) **life risk claims reported** is the present values (gross) of the life risk components of claims reported but not yet paid. The life risk components must take into account the probability of the claims being paid, and future expenses for administering the claims, but

the present values (gross) of relevant life reinsurance claims must be subtracted from the total:

(c) **risk margin** is the appropriate margin for the life risk components of claims described in paragraph (a) or (b), to the extent to which the margin is actuarially determined, reflects the from the use of the relevant best estimate assumptions, and is not already included in the life risk components of the claims.

Defined in this Act: amount, best estimate assumptions, claim, class of policies, income year, life insurer, life reinsurance, life risk, life risk component, mortality profit present value (gross)

Section EY 24: substituted, on 1 July 2010, by section 190(1) of the Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009 (2009 No 34).

Section EY 24(2)(a)(ii): amended (with effect on 1 July 2010), on 21 December 2010, by section 58(1) of the Taxation (GST and Remedial Matters) Act 2010 (2010 No 130).

Section EY 24(2)(a)(ii): amended (with effect on 1 July 2010), on 7 September 2010, by section 46(1) of the Taxation (Annual Rates, Trans-Tasman Savings Portability, KiwiSaver, and Remedial Matters) Act 2010 (2010 No 109).

EY25 Premium smoothing reserving amount: non-participation policies not annuities

Calculation of reserving amount

(1) For an income year (the **current year**), a life insurer has a premium smoothing reserving amount for a class of policies, during the policies' PSR periods, calculated using the formula—

opening premium smoothing reserve - closing premium smoothing reserve.

Definition of items in formula

(2) In the formula,—

(a) **opening premium smoothing reserve** is—

(i) the amount of the life insurer's closing premium smoothing reserve for the class of policies, for the income year (the **prior year**) before the current year; or

(ii) the amount that would be the premium smoothing reserve for the class of policies, using the principles in subsection (3) with necessary modifications, calculated at the end of

the prior year, if the life insurer has no closing premium smoothing reserve for the prior year:

(b) **closing premium smoothing reserve** is the amount of the life insurer's premium smoothing reserve calculated under the principles in subsection (3) for the class of policies, calculated at the end of the current year.

Premium smoothing reserve calculation: principles

(3) A premium smoothing reserve for policies in a class of policies, during their PSR periods, is calculated using the following principles:

(a) the premium smoothing reserve must allow the calculation of a reserving amount for an income year, such that the reserving amount plus the life risk component of premiums for the policies for the income year must equal the expected life risk proportion:

(b) the life risk component of premiums plus reserving amount recognised for tax purposes during the policies' PSR periods must equal the total life risk component of premiums recognised for financial reporting purposes during the PSR periods.

Best estimate assumptions for PSR

(4) Closing and opening premium smoothing reserve amounts must be actuarially determined, using best estimate assumptions.

Special grouping rule for the purposes of best estimate assumptions

(5) For the purposes of determining premium smoothing reserve amounts, life insurance policies may be grouped together if the policies have in common,—

(a) substantially the same contractual terms and conditions, other than their PSR periods; and

(b) substantially the same assumptions for pricing their life risk.

Meaning of expected life risk proportion

(6) In this section, **expected life risk proportion** means a proportion of the total life risk and life risk renewal expenses of premiums for life insurance policies in the relevant class during their PSR periods, where that proportion fairly reflects the life risk and an amount of life risk renewal expenses expected to be borne in that income year if the policies were still existing at the earlier of—

- (a) the end of the income year:
- (b) immediately before the end of the policies' PSR period.

Defined in this Act: amount, , actuarially determined, best estimate assumptions, class of policies, expected life risk proportion, income year, life insurance policy, life insurer, life risk, life risk component, premium, PSR period

Section EY 25: substituted, on 1 July 2010, by section 190(1) of the Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009 (2009 No 34).

Section EY 25(2)(a)(ii): amended (with effect on 1 July 2010), on 7 September 2010, by section 47(1) of the Taxation (Annual Rates, Trans-Tasman Savings Portability, KiwiSaver, and Remedial Matters) Act 2010 (2010 No 109).

EY26 Unearned premium reserving amount: non-participation policies not annuities

Calculation of reserving amount

(1) For an income year (the **current year**), a life insurer has an unearned premium reserving amount for a class of policies calculated using the formula—

opening unearned premium reserve - closing unearned premium reserve.

Definition of items in formula

(2) In the formula,—

(a) **opening unearned premium reserve** is—

(i) the amount of the life insurer's closing unearned premium reserve for the class of policies, for the income year before the current year; or

(ii) the amount that would be the unearned premium reserve for the class of policies, using subsection (3) with necessary modifications, calculated at the end of the prior year, if the life insurer has no closing unearned premium reserve for the income year before the current year:

(b) **closing unearned premium reserve** is the amount of the life insurer's unearned premium reserve under subsection (3) for the class of policies, calculated at the end of the current year.

Unearned premium reserve

(3) A life insurer's unearned premium reserve is the amount of the premium in the current year or a prior year, for the relevant policies, that relates to life risk components and relevant costs, in income years after the current year, but subtracting relevant life reinsurance premiums.

Defined in this Act: amount, class of policies, income year, life insurer, life reinsurance, life risk component
Section EY 26: substituted, on 1 July 2010, by section 190(1) of the Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009 (2009 No 34).

Section EY 26(2)(a)(ii): amended (with effect on 1 July 2010), on 7 September 2010, by section 48(1) of the Taxation (Annual Rates, Trans-Tasman Savings Portability, KiwiSaver, and Remedial Matters) Act 2010 (2010 No 109).

EY27 Capital guarantee reserving amount: non-participation policies not annuities

Calculation of reserving amount

(1) For an income year (the **current year**), a life insurer has a reserving amount for a class of policies calculated using the formula—

opening capital guarantee reserve - closing capital guarantee reserve.

Definition of items in formula

(2) In the formula,—

(a) **opening capital guarantee reserve** is—

(i) the amount of the life insurer's closing capital guarantee reserve for the class of policies, for the income year before the current year; or

(ii) the amount that would be the capital guarantee reserve for the class of policies, using subsection (3) with necessary modifications, calculated at the end of the income year before the current year, if the life insurer has no closing capital guarantee reserve for the income year before the current year:

(b) **closing capital guarantee reserve** is the amount of the life insurer's capital guarantee reserve under subsection (3) for the class of policies, calculated at the end of the current year.

Capital guarantee reserve

(3) A life insurer's capital guarantee reserve is the net amount of credits and debits on account of a risk-linked provision for future obligations in relation to a guarantee, for the class of policies, by the life insurer that capital invested will be returned or that a minimum return on capital will be paid.

Reflex in policyholder base

(4) For the current year, if the reserving amount under this section is positive, the life insurer has that amount as a deduction included in their policyholder base allowable deductions. For the current year, if the reserving amount under this section is negative, the life insurer has that amount as income included in their policyholder base income.

Reflex in policyholder base: exception

(5) Despite subsection (4), for the current year, the life insurer does not have that amount as income included in their policyholder base income to the extent to which the amount represents payment on account of lost capital in the policyholder base.

Defined in this Act: amount, class of policies, income year, life insurer, pay, policyholder base, policyholder base allowable deduction, policyholder base income

Section EY 27: substituted, on 1 July 2010, by section 190(1) of the Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009 (2009 No 34). Section EY 27(2)(a)(ii): amended (with effect on 1 July 2010), on 7 September 2010, by section 49(1) of the Taxation (Annual Rates, Trans-Tasman Savings Portability, KiwiSaver, and Remedial Matters) Act 2010 (2010 No 109).

*Shareholder base other profit: profit
participation policies*

Heading: inserted, on 1 July 2010, by section 190(1) of the Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009 (2009 No 34).

EY28 Shareholder base other profit: profit participation policies that are existing business

Calculation of income

(1) For an income year, a life insurer has an amount, for profit participation policies that are existing business, that is calculated using the formula—

$$\text{other profit} \times \frac{\text{gate}}{(1 + \text{gate})}.$$

Definition of items in formula

(2) In the formula in subsection (1),—

(a) **other profit** is the amount calculated for the income year under subsection (4):

(b) **gate** is the proportion of a policyholder's share of profits from the asset base that is used in the formula that calculates a transfer to the benefit of the life insurer's shareholders from the profits of the asset base, as described in paragraph (a)(iii) of the definition of **profit participation policy**.

Formula: negative amounts and positive amounts

(3) If, for an income year, the formula in subsection (1) calculates a positive amount, that amount is included as income in the life insurer's shareholder base income. If it is a negative amount, then that amount is included as a deduction in the life insurer's shareholder base allowable deductions.

Other profit

(4) For the purposes of the item **other profit** in subsection (2), an amount is calculated, for the income year (the **current year**) for profit participation policies that are existing business, using the following formula:

$$\begin{aligned} & (\text{premiums} - \text{premiums estimate}) - (\text{claims} - \text{claims estimate}) \\ & - (\text{closing policy liabilities} - \text{estimated closing policy liabilities}). \end{aligned}$$

Definition of items in formula

(5) In the formula in subsection (4),—

(a) **premiums** is the amount of premiums for policies for the current year, but subtracting relevant life reinsurance premiums:

(b) **premiums estimate** is the actuarially determined total amount of premiums that the life insurer expected, using best estimate assumptions, to receive in the current year for policies that were in force at the start of the current year or are first entered into in the current year, after subtracting the present value (net) of relevant life reinsurance premiums:

(c) **claims** is the amount of claims for the current year, after subtracting relevant life reinsurance claims:

(d) **claims estimate** is the actuarially determined total amount of claims that the life insurer expected, using best estimate assumptions, to receive in the current year for policies that were in force at the start of the current year or are first entered into in the current year, after subtracting the present value (net) of relevant life reinsurance claims:

(e) **closing policy liabilities** is the total amount of policy liabilities for policies determined at the end of the current year for vested benefits after the previous year's bonus declaration:

(f) **estimated closing policy liabilities** is the total estimated policy liabilities at the end of the current year for policies in force at the start of the current year and expected to be in force at the end of the current year, taking into account vested benefits after the previous year's bonus. The estimated policy liabilities must not take into account any future bonus declarations, and must use best estimate assumptions.

Meaning of policy liabilities

(6) For the purposes of subsection (5), **policy liabilities** means, for a policy, an actuarially determined amount that is the present value (net) of future claims, plus the present value (net) of future expenditure or loss, plus the present value (net) of future tax payments, less the present value (net) of future premiums. Relevant life reinsurance premiums and claims must be subtracted.

Basis of best estimate assumptions in actuarially determining items

(7) The same best estimate assumptions must be used for actuarially determining the items **premiums estimate**, **claims estimate**, and **policy liabilities** in this section. The assumptions may be appropriate for the start of the year, or for the end of the year, but once the choice is made between start of the year and end of the year, that basis may not be changed.

Meaning of existing business

(8) For the purposes of this section and section EY 29, **existing business** means, for a policy, that it is—

(a) issued on or before 30 June 2009; or

(b) issued after 30 June 2009, if—

(i) issued on the same substantial and material terms, conditions, and bonus entitlements as profit participation policies that the life insurer issued on or before 30 June 2009, ignoring any annual increase in life insurance cover that is less than 10% or less than annual percentage change in the consumer price index:

(ii) issued as the result of conversion rights in a policy issued on or before 30 June 2009.

Defined in this Act: actuarially determined, amount, best estimate assumptions, claim, existing business, income year, life insurance, life insurance policy, life insurer, life reinsurance, premium, present value (net), profit participation policy

Section EY 28: substituted, on 1 July 2010, by section 190(1) of the Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009 (2009 No 34).

EY29 Shareholder base other profit: profit participation policies that are new business

Calculation of income

(1) For an income year, a life insurer has an amount, for profit participation policies that are new business, that is calculated using the formula—

$$\text{other profit} \times \frac{\text{gate}}{(1 + \text{gate})} - \text{previous negative amount.}$$

Definition of items in formula

(2) In the formula in subsection (1),—

(a) **other profit** is the amount calculated for the income year under subsections (5) to (9):

(b) **gate** is the proportion of a policyholder's share of profits from the asset base that is used in the formula that calculates a transfer to the benefit of the life insurer's shareholders from the profits of the asset base, as described in paragraph (a)(iii) of the definition of **profit participation policy**:

(c) **previous negative amount** is the amount from the previous year described in subsections (3) and (4).

Formula: negative amounts and positive amounts

(3) If, for an income year, the formula in subsection (1) calculates a positive amount, that amount is included as income in the life insurer's shareholder base income. If it is a negative amount, then that amount is not included as a deduction in the life insurer's shareholder base allowable deductions, but *see* subsection (4).

Negative amounts: carry forward

(4) The amount by which the amount calculated using the formula in subsection (1) is less than zero is carried forward to the next income year, to be used under this section in the formula as the item **previous negative amount** in that next year.

Other profit

(5) For the purposes of the item **other profit** in subsection (2), an amount is calculated, for the income year (the **current year**) for profit participation policies that are new business, using the following formula:

$$\begin{aligned} & (\text{premiums} - \text{premiums estimate}) - (\text{claims} - \text{claims estimate}) \\ & - (\text{closing policy liabilities} - \text{estimated closing policy liabilities}). \end{aligned}$$

Definition of items in formula

(6) In the formula in subsection (5),—

(a) **premiums** is the amount of premiums for policies for the current year, but subtracting relevant life reinsurance premiums:

(b) **premiums estimate** is the amount of valuation premiums that the life insurer expected, using best estimate assumptions, to receive in the current year for policies that are in force at the start of the current year, or are first entered into in the current year, after subtracting the present value (net) of relevant life reinsurance premiums:

(c) **claims** is the amount of claims for the current year, after subtracting relevant life reinsurance claims:

(d) **claims estimate** is the actuarially determined amount of claims that the life insurer expected, using best estimate assumptions, to receive in the current year for policies that are in force at the start of the current year, or are first entered into in the current year, ignoring surrenders and after subtracting the present value (net) of relevant life reinsurance claims:

(e) **closing policy liabilities** is the amount of policy liabilities for policies determined at the end of the current year for vested benefits after the previous year's bonus declaration:

(f) **estimated closing policy liabilities** is the estimated policy liabilities at the end of the current year for policies in force at the start of the current year and expected to be in force at the end of the current year, taking into account vested benefits after the previous year's bonus. The estimated policy liabilities must not take into account any future bonus declarations, and must use best estimate assumptions.

Meaning of valuation premiums

(7) In this section, **valuation premiums** means the amount of premiums payable for a policy, actuarially determined by reference to the premium formula used when the policy was first entered into, or, if the premium formula is unavailable, by reference to mortality, expense, and other assumptions applicable to premiums for similar policies at the beginning of the income year in which the policy was first entered into. The valuation premiums must not include any allowance for future bonus declarations or future shareholder profits. The amount of the valuation premium for a policy must not change, unless significant changes to the policy justify changing the valuation premium.

Meaning of policy liabilities

(8) In this section, **policy liabilities** means, for a policy, an actuarially determined amount that is the present value (net) of future mortality and maturity claims, plus the present value (net) of future expenditure or loss, plus the present value (net) of future tax payments, less the present value (net) of future valuation premiums. The amount of policy liabilities must not include any allowance for surrenders or the payment of surrender values and relevant life reinsurance premiums and claims must be subtracted. The minimum amount of policy liabilities for a policy is the current surrender value of the policy.

Basis of best estimate assumptions in actuarially determining items

(9) The same best estimate assumptions must be used for actuarially determining the items **premiums estimate, claims estimate, and policy liabilities** in this section. The assumptions may be appropriate for the start of the year, or for the end of the year, but once the choice is made between start of the year and end of the year, the assumptions must not be changed.

Meaning of new business

(10) For the purposes of this section, **new business** means, for a policy, that it is not existing business under section EY 28.

Defined in this Act: actuarially determined, amount, best estimate assumptions, claim, existing business, income year, life insurance policy, life insurer, life reinsurance, new business, premium, present value (net), profit participation policy, valuation premiums

Section EY 29: substituted, on 1 July 2010, by section 190(1) of the Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009 (2009 No 34).

Section EY 24(2)(a)(ii): amended (with effect on 1 July 2010), on 21 December 2010, by section 58(1) of the Taxation (GST and Remedial Matters) Act 2010 (2010 No 130).

Transitional adjustments and annuities

Heading: inserted, on 1 July 2010, by section 190(1) of the Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009 (2009 No 34).

EY30 Transitional adjustments: life risk

When this section applies: treatment of old and new policies

(1) This section applies to life insurance policies described in subsections (2) to (4). For the purposes of this section, a policy (the **new policy**) is treated as being issued at the same time as another policy (the **old policy**) that the new policy replaces, if the replacement is caused by—

(a) reinstating the old policy due to a lapse by the insured in premium payments, if the new policy comes into force within 90 days of the lapse, and the life insurer treats the new policy and old policy the same; or

(b) the life insurer being sold, or the life insurer selling its rights and obligations under the old policy.

Separation of products into separate policies for purposes of transitional adjustment

(1B) If a life insurance policy is comprised of 2 or more life insurance product types that are capable of being sold separately, and the life insurance cover amounts for each product type are separately identified in the policy, then each of the product types may be treated as a separate life insurance policy for the purposes of this section.

Life insurance policies

(2) This section applies to a life insurance policy, excluding an annuity, a multiple life policy through which the life insurer can look to the individual lives covered, credit card repayment insurance, and a workplace group policy, if the policy is issued by the life insurer before the grandparenting start day or if the life insurer receives an application and a deposit in money before the grandparenting start day for the policy which is issued after that day, and—

(a) the life insurer has no policyholder base income or policyholder base allowable deduction for the policy; and

(b) the policy meets the relevant requirements for the relevant period described in subsection (5)(a) to (c); and

(c) the amount of life insurance cover at the finish of a cover review period, or at the finish of any shorter period, if the life insurer chooses to measure within the cover review period, has not increased by more than the greater of 10% and the percentage change in the consumer price index for the relevant period, as compared to the amount of life insurance cover at the beginning of the relevant cover review period; and

(d) no new or replacement individual life is covered for a period beginning after the grandparenting start day.

Multiple life policies

(3) This section applies to a multiple life policy through which the life insurer can look to the individual lives covered, if the policy is issued by the life insurer before the grandparenting start day or if the life insurer receives an application and a deposit in

money before the grandparenting start day for the policy which is issued after that day, and—

(a) the life insurer has no policyholder base income or policyholder base allowable deduction for the policy; and

(b) the policy meets the requirements for the period described in subsection (5)(c), or, looking through to the individual lives covered, to the extent to which the policy meets the requirements for the period described in subsection (5)(a), (b), or (c); and

(c) to the extent to which, looking through to the individual lives covered, the cover was first in place before the grandparenting start day; and

(d) the substantial and material terms and conditions of the policy do not change on or after the grandparenting start day; and

(e) either—

(i) to the extent to which, looking through to the individual lives covered, the amount of life insurance cover at the finish of a cover review period, or at the finish of any shorter period if the life insurer chooses to measure within the cover review period, has not increased by more than the greater of 10% and the percentage change in the consumer price index for the relevant period, as compared to the amount of life insurance cover at the beginning of the relevant cover review period; or

(ii) in the case of a policy that is life reinsurance, to the extent to which a relevant underlying life insurance policy is, or would be ignoring section EY 10(2), one that this subsection or subsection (2) applies to.

Credit card repayment insurance and workplace group policies

(4) This section applies to a credit card repayment insurance and to a workplace group policy, if the policy is issued by the life insurer before the grandparenting start day or if the life insurer receives an application and a deposit in money before the grandparenting start day, and—

(a) the life insurer has no policyholder base income or policyholder base allowable deduction for the policy; and

(b) the policy, if it is a credit card repayment insurance, meets the requirements for the period described in subsection (5)(c), or, if it is a workplace group policy, meets the requirements for the period described in subsection (5)(d); and

(c) *[Repealed]*

(d) the substantial and material terms and conditions of the policy do not change on or after the grandparenting start day.

Requirements and periods for which this section applies

(5) The following are the requirements and periods for the purposes of subsections (2)(b), (3)(b), and (4)(b), for a policy:

(a) for a life insurance policy for which only 1 premium is ever payable, or for which the amount of each premium is the same, the period that—

- (i) starts on the grandparenting start day; and
- (ii) finishes on the day that the policy ceases to be in force:

(b) for a life insurance policy for which the premium is set for a continuous period beginning before the grandparenting start day and for which the premium does not go up in that period (the **continuous rate period**) ignoring any increase directly linked to the percentage change in the consumer price index if that increase was the subject of agreement before the grandparenting start day, the period that starts on the grandparenting start day and ends on the later of the following:

- (i) the day that is the last day of the continuous rate period;
- (ii) whichever day described in paragraph (c)(i) and
- (ii) is earlier:

(c) for a life insurance policy for which the premium may vary each year, the period that starts on the grandparenting start day and ends on the earlier of the following:

- (i) the day that the policy expires;
- (ii) the day that is before the 5 years anniversary of the grandparenting start day:

(d) for a life insurance policy for which the premium may vary each year, the period that starts on the grandparenting start day and ends on the earlier of the following:

- (i) the day that the policy expires;
- (ii) the day that is before the 3 years anniversary of the grandparenting start day.

When this section does not apply: life insurance cover increase for whole cover review period

(5B) This section does not apply for a policy for the whole of an income year if a cover review period finishes in the year and, for that cover review period, there has been an increase in the amount of life insurance cover as described in subsection

(2)(c) or (3)(e) and the life insurer has not made an election for measuring within the cover review period under those subsections.

When this section does not apply: continuity

(5C) This section does not apply for a policy for any period after this section has ceased to apply for the policy.

When this section does not apply: once-only opt out

(6) This section does not apply to a class of policies after the life insurer irrevocably chooses in a notice received by the Commissioner that this section does not apply for the class.

Adjustment

(7) A life insurer has an amount of shareholder base allowable deduction for a policy calculated using the following formula, to the extent to which this section applies for the relevant income year for the policy—

$$\begin{aligned} & \text{premiums} - \text{total net reserving amounts} \\ & - (1.2 \times \text{expected death strain}). \end{aligned}$$

Definition of items in formula

(8) In the formula,—

(a) **premiums** is the life insurer's total premiums for the income year or part of the income year, as applicable, for the policy, but subtracting relevant life reinsurance premiums:

(b) **total net reserving amounts** is the total of reserving amounts for the income year or part of the income year, as applicable, for the policy, under section EY 25 or EY 26 (as applicable), but treating amounts that are shareholder base income as negative amounts, and amounts that are shareholder base allowable deductions as positive amounts:

(c) **expected death strain** is the amount calculated under the expected death strain formula (life) in accordance with sections EZ 53 to EZ 60 (which relate to the transitional adjustment for expected death strain) for the income year or part of the income year, as applicable, for the policy.

Negative amounts

(9) If subsection (7) gives a negative amount for a policy, it is ignored for that policy.

Meaning of cover review period

(10) **Cover review period** means—

(a) the relevant income year, if the life insurer has not chosen a different period under paragraph (b):

(b) a period of a year that has a starting and anniversary date that the life insurer irrevocably chooses, for a class of policies, in a return of income for the tax year corresponding to the income year in which the grandparenting start day is included.

Meaning of credit card repayment insurance

(11) **Credit card repayment insurance** means a life insurance policy, if the benefits of the cover are for the repayment of an outstanding debt balance of a credit card, or life reinsurance to the extent to which it reinsures such a life insurance policy.

Meaning of employer sponsored group policies [Repealed]

(12) *[Repealed]*

Meaning of grandparenting start day

(13) **Grandparenting start day** means—

(a) 1 July 2010, if paragraph (b) does not apply:

(b) a life insurer's early life regime application day, if the life insurer irrevocably chooses that day as their grandparenting start day.

Meaning of multiple life policy

(14) **Multiple life policy**—

(a) means a life insurance policy with multiple individuals' life insurance cover grouped under it, if the group of individuals is identified in the policy:

(b) does not include—

(i) a workplace group policy:

(ii) credit card repayment insurance:

(iii) life reinsurance to the extent to which it reinsures a workplace group policy or credit card repayment insurance.

Meaning of workplace group policy

(15) **Workplace group policy** means a life insurance policy with multiple individuals' life insurance cover grouped under it, or life reinsurance to the extent to which it reinsures such a life insurance policy, if—

(a) the individuals under the policy are—

(i) a group that includes, or consists of, a class of employees of an employer or group of employers, and may include 1 or more of the employers or directors of the employers, and the policy is sponsored by the employers or by the trustees of a superannuation scheme:

(ii) members of a union registered under the Employment Relations Act 2000 or members of an industry association, and the union or association is the sponsor of the policy:

(iii) the spouses, civil union partners, and de facto partners of employees or members described in subparagraphs (i) and (ii); and

(b) in the case of the sponsor being the employer,—

(i) the employer is required to offer an employee who is a member of the relevant class the opportunity to join the life insurance policy; and

(ii) the life insurer and the employer have entered an agreement about who pays the premium.

Defined in this Act: amount, Commissioner, cover review period, credit card repayment insurance, class of policies, early life regime application day, grandparenting start day, group life master policy, income year, life insurance, life insurer, life reinsurance, pay, policyholder base allowable deduction, policyholder base income, shareholder base allowable deduction, shareholder base income, workplace group policy

Section EY 30: substituted, on 1 July 2010, by section 190(1) of the Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009 (2009 No 34).

Section EY 30(1B) heading: inserted (with effect on 1 July 2010), on 7 September 2010, by section 50(1) of the Taxation (Annual Rates, Trans-Tasman Savings Portability, KiwiSaver, and Remedial Matters) Act 2010 (2010 No 109).

Section EY 30(1B): inserted (with effect on 1 July 2010), on 7 September 2010, by section 50(1) of the Taxation (Annual Rates, Trans-Tasman Savings Portability, KiwiSaver, and Remedial Matters) Act 2010 (2010 No 109).

Section EY 30(2): amended (with effect on 1 July 2010), on 7 September 2010, by section 50(2) of the Taxation (Annual Rates, Trans-Tasman Savings Portability, KiwiSaver, and Remedial Matters) Act 2010 (2010 No 109).

Section EY 30(2): amended, on 1 July 2010, by section 38(1) of the Taxation (Consequential Rate Alignment and Remedial Matters) Act 2009 (2009 No 63).

Section EY 30(2)(c): substituted (with effect on 1 July 2010), on 7 September 2010, by section 50(3) of the Taxation (Annual Rates, Trans-Tasman Savings Portability, KiwiSaver, and Remedial Matters) Act 2010 (2010 No 109). Section EY 30(2)(d): added (with effect on 1 July 2010), on 7 September 2010, by section 50(3) of the Taxation (Annual Rates, Trans-Tasman Savings Portability, KiwiSaver, and Remedial Matters) Act 2010 (2010 No 109).

Section EY 30(3) heading: substituted (with effect on 1 July 2010), on 7 September 2010, by section 50(4)(a) of the Taxation (Annual Rates, Trans-Tasman Savings Portability, KiwiSaver, and Remedial Matters) Act 2010 (2010 No 109).

Section EY 30(3): amended (with effect on 1 July 2010), on 7 September 2010, by section 50(4)(b) of the Taxation (Annual Rates, Trans-Tasman Savings Portability, KiwiSaver, and Remedial Matters) Act 2010 (2010 No 109).

Section EY 30(3)(b): amended (with effect on 1 July 2010), on 21 December 2010, by section 59(1) of the Taxation (GST and Remedial Matters) Act 2010 (2010 No 130).

Section EY 30(3)(b): amended (with effect on 1 July 2010), on 7 September 2010, by section 50(4)(c) of the Taxation (Annual Rates, Trans-Tasman Savings Portability, KiwiSaver, and Remedial Matters) Act 2010 (2010 No 109).

Section EY 30(3)(b): amended, on 1 July 2010, by section 38(2) of the Taxation (Consequential Rate Alignment and Remedial Matters) Act 2009 (2009 No 63).

Section EY 30(3)(e): substituted (with effect on 1 July 2010), on 21 December 2010, by section 59(2) of the Taxation (GST and Remedial Matters) Act 2010 (2010 No 130).

Section EY 30(4) heading: amended, on 1 July 2010, by section 38(3) of the Taxation (Consequential Rate Alignment and Remedial Matters) Act 2009 (2009 No 63).

Section EY 30(4): amended (with effect on 1 July 2010), on 7 September 2010, by section 50(6) of the Taxation (Annual Rates, Trans-Tasman Savings Portability, KiwiSaver, and Remedial Matters) Act 2010 (2010 No 109).

Section EY 30(4): amended, on 1 July 2010, by section 38(4) of the Taxation (Consequential Rate Alignment and Remedial Matters) Act 2009 (2009 No 63).

Section EY 30(4)(b): substituted, on 1 July 2010, by section 38(5) of the Taxation (Consequential Rate Alignment and Remedial Matters) Act 2009 (2009 No 63).

Section EY 30(4)(c): repealed, on 1 July 2010, by section 38(5) of the Taxation (Consequential Rate Alignment and Remedial Matters) Act 2009 (2009 No 63).

Section EY 30(5): amended, on 1 July 2010, by section 38(6) of the Taxation (Consequential Rate Alignment and Remedial Matters) Act 2009 (2009 No 63).

Section EY 30(5)(b): amended (with effect on 1 July 2010), on 7 September 2010, by section 50(7) of the Taxation (Annual Rates, Trans-Tasman Savings Portability, KiwiSaver, and Remedial Matters) Act 2010 (2010 No 109).

Section EY 30(5)(c)(ii): amended, on 1 July 2010, by section 38(7) of the Taxation (Consequential Rate Alignment and Remedial Matters) Act 2009 (2009 No 63).

Section EY 30(5)(d): added, on 1 July 2010, by section 38(7) of the Taxation (Consequential Rate Alignment and Remedial Matters) Act 2009 (2009 No 63).

Section EY 30(5B) heading: inserted (with effect on 1 July 2010), on 7 September 2010, by section 50(8) of the Taxation (Annual Rates, Trans-Tasman Savings Portability, KiwiSaver, and Remedial Matters) Act 2010 (2010 No 109).

Section EY 30(5B): inserted (with effect on 1 July 2010), on 7 September 2010, by section 50(8) of the Taxation (Annual Rates, Trans-Tasman Savings Portability, KiwiSaver, and Remedial Matters) Act 2010 (2010 No 109).

Section EY 30(5C) heading: inserted (with effect on 1 July 2010), on 7 September 2010, by section 50(8) of the Taxation (Annual Rates, Trans-Tasman Savings Portability, KiwiSaver, and Remedial Matters) Act 2010 (2010 No 109).

Section EY 30(5C): inserted (with effect on 1 July 2010), on 7 September 2010, by section 50(8) of the Taxation (Annual Rates, Trans-Tasman Savings Portability, KiwiSaver, and Remedial Matters) Act 2010 (2010 No 109).

Section EY 30(7): amended (with effect on 1 July 2010), on 7 September 2010, by section 50(9) of the Taxation (Annual Rates, Trans-Tasman Savings Portability, KiwiSaver, and Remedial Matters) Act 2010 (2010 No 109).

Section EY 30(8)(a): amended (with effect on 1 July 2010), on 7 September 2010, by section 50(10) of the Taxation (Annual Rates, Trans-Tasman Savings Portability, KiwiSaver, and Remedial Matters) Act 2010 (2010 No 109).

Section EY 30(8)(b): amended (with effect on 1 July 2010), on 21 December 2010, by section 59(3) of the Taxation (GST and Remedial Matters) Act 2010 (2010 No 130).

Section EY 30(8)(b): amended (with effect on 1 July 2010), on 7 September 2010, by section 50(11) of the Taxation (Annual Rates, Trans-Tasman Savings Portability, KiwiSaver, and Remedial Matters) Act 2010 (2010 No 109).

Section EY 30(8)(c): amended (with effect on 1 July 2010), on 7 September 2010, by section 50(12) of the Taxation (Annual Rates, Trans-Tasman Savings Portability, KiwiSaver, and Remedial Matters) Act 2010 (2010 No 109).

Section EY 30(11) heading: substituted, on 1 July 2010, by section 38(8) of the Taxation (Consequential Rate Alignment and Remedial Matters) Act 2009 (2009 No 63).

Section EY 30(11): substituted, on 1 July 2010, by section 38(8) of the Taxation (Consequential Rate Alignment and Remedial Matters) Act 2009 (2009 No 63). Section EY 30(11): amended (with effect on 1 July 2010), on 7 September 2010, by section 50(13) of the Taxation (Annual Rates, Trans-Tasman Savings Portability, KiwiSaver, and Remedial Matters) Act 2010 (2010 No 109).

Section EY 30(12) heading: repealed, on 1 July 2010, by section 38(9) of the Taxation (Consequential Rate Alignment and Remedial Matters) Act 2009 (2009 No 63).

Section EY 30(12): repealed, on 1 July 2010, by section 38(9) of the Taxation (Consequential Rate Alignment and Remedial Matters) Act 2009 (2009 No 63).

Section EY 30(14) heading: substituted (with effect on 1 July 2010), on 7 September 2010, by section 50(14) of the Taxation (Annual Rates, Trans-Tasman Savings Portability, KiwiSaver, and Remedial Matters) Act 2010 (2010 No 109).

Section EY 30(14): substituted (with effect on 1 July 2010), on 7 September 2010, by section 50(14) of the Taxation (Annual Rates, Trans-Tasman Savings Portability, KiwiSaver, and Remedial Matters) Act 2010 (2010 No 109).

Section EY 30(14): amended, on 1 July 2010, by section 38(10) of the Taxation (Consequential Rate Alignment and Remedial Matters) Act 2009 (2009 No 63).

Section EY 30(15) heading: added, on 1 July 2010, by section 38(11) of the Taxation (Consequential Rate Alignment and Remedial Matters) Act 2009 (2009 No 63).

Section EY 30(15): substituted (with effect on 1 July 2010), on 7 September 2010, by section 50(15) of the Taxation (Annual Rates, Trans-Tasman Savings Portability, KiwiSaver, and Remedial Matters) Act 2010 (2010 No 109).

Section EY 30(15): added, on 1 July 2010, by section 38(11) of the Taxation (Consequential Rate Alignment and Remedial Matters) Act 2009 (2009 No 63). Section EY 30 list of defined terms **employer sponsored group policy**: repealed, on 1 July 2010, by section 126 of the Taxation (Consequential Rate Alignment and Remedial Matters) Act 2009 (2009 No 63).

Section EY 30 list of defined terms **pay**: inserted (with effect on 1 July 2010), on 7 September 2010, by section 50(16) of the Taxation (Annual Rates, Trans-Tasman Savings Portability, KiwiSaver, and Remedial Matters) Act 2010 (2010 No 109).

Section EY 30 list of defined terms **workplace group policy**: added, on 1 July 2010, by section 126 of the Taxation (Consequential Rate Alignment and Remedial Matters) Act 2009 (2009 No 63).

EY31 Annuities

When this section applies

(1) This section applies when a life insurance policy is an annuity.

Adjustment

(2) For the income year, a life insurer has an amount calculated for the relevant annuities using the formula—

closing actuarial reserves - $(0.99 \times \text{expected death strain})$.

Definition of items in formula

(3) In the formula,—

(a) **closing actuarial reserves** is the life insurer's closing actuarial reserves (active annuities), calculated in accordance with section EZ 59(2) (Meaning of actuarial reserves):

(b) **expected death strain** is the amount calculated under the expected death strain formula (active annuities) in accordance with sections EZ 53 to EZ 60 (which relate to the transitional adjustment for expected death strain) for the income year.

Positive and negative amounts

(4) If the formula in subsection (2) gives a positive amount, the life insurer has that amount as income included in their shareholder base income. If the formula in subsection (2) gives a negative amount, the life insurer has that amount as a deduction included in their shareholder base allowable deductions.

Defined in this Act: amount, income year, life insurance policy, life insurer, shareholder base allowable deduction, shareholder base income Section EY 31: substituted, on 1 July 2010, by section 190(1) of the Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009 (2009 No 34).

EY32 Mortality profit formula: when partial reinsurance exists

[Repealed]

Section EY 32: repealed, on 1 July 2010, by section 190(1) of the Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009 (2009 No 34).

EY33 Mortality profit formula: individual result may be negative only in some cases

[Repealed]

Section EY 33: repealed, on 1 July 2010, by section 190(1) of the Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009 (2009 No 34).

EY34 Mortality profit formula: negative result

[Repealed]

Section EY 34: repealed, on 1 July 2010, by section 190(1) of the Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009 (2009 No 34).

EY35 How discontinuance profit is calculated

[Repealed]

Section EY 35: repealed, on 1 July 2010, by section 190(1) of the Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009 (2009 No 34).

EY36 Discontinuance profit for income year

[Repealed]

Section EY 36: repealed, on 1 July 2010, by section 190(1) of the Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009 (2009 No 34).

EY37 Discontinuance profit formula (existing policies)

[Repealed]

Section EY 37: repealed, on 1 July 2010, by section 190(1) of the Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009 (2009 No 34).

EY38 Discontinuance profit formula (new policies)

[Repealed]

Section EY 38: repealed, on 1 July 2010, by section 190(1) of the Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009 (2009 No 34).

EY39 Discontinuance profit formula (existing policies): when partial reinsurance exists

[Repealed]

Section EY 39: repealed, on 1 July 2010, by section 190(1) of the Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009 (2009 No 34).

EY40 Discontinuance profit formula (new policies): when

partial reinsurance exists

[Repealed]

Section EY 40: repealed, on 1 July 2010, by section 190(1) of the Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009 (2009 No 34).

EY41 Discontinuance profit formulas: individual result may never be negative

[Repealed]

Section EY 41: repealed, on 1 July 2010, by section 190(1) of the Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009 (2009 No 34).

EY42 How policyholder income is calculated

[Repealed]

Section EY 42: repealed, on 1 July 2010, by section 190(1) of the Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009 (2009 No 34).

EY43 Policyholder income formula

[Repealed]

Section EY 43: repealed, on 1 July 2010, by section 190(1) of the Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009 (2009 No 34).

EY43B Policyholder income formula: FDR adjustment

[Repealed]

Section EY 43B: repealed, on 1 July 2010, by section 190(1) of the Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009 (2009 No 34).

EY43C Policyholder income formula: PILF adjustment

[Repealed]

Section EY 43C: repealed, on 1 July 2010, by section 190(1) of the Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009 (2009 No 34).

EY44 Policyholder income formula: when partial reinsurance

exists

[Repealed]

Section EY 44: repealed, on 1 July 2010, by section 190(1) of the Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009 (2009 No 34).

EY45 Policyholder income formula: when life insurance

business transferred

[Repealed]

Section EY 45: repealed, on 1 July 2010, by section 190(1) of the Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009 (2009 No 34).

EY46 Income from disposal of property

[Repealed]

Section EY 46: repealed, on 1 July 2010, by section 190(1) of the Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009 (2009 No 34).

EY47 Deductions for disposal of property

[Repealed]

Section EY 47: repealed, on 1 July 2010, by section 190(1) of the Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009 (2009 No 34).

Non-resident life insurers

EY48 Non-resident life insurers with life insurance policies in New Zealand

When this section applies

(1) This section applies when a life insurer not resident in New Zealand offers or is offered or enters into life insurance policies in New Zealand.

Income having source in New Zealand

(2) The life insurer's income from the business of providing life insurance, as determined under this section, is income that has a source in New Zealand.

Shareholder base and policyholder base

(3) The life insurer's income and deductions are apportioned between their policyholder base or shareholder base under the provisions of this subpart to the extent to which the income or deductions relate to—

(a) life insurance policies that the life insurer, as insurer, offered or was offered or entered into in New Zealand:

(b) life reinsurance policies held by the life insurer that relate exclusively to life insurance policies described in paragraph (a).

Other income

(4) The life insurer's income from the business of providing life insurance, other than under the provisions of this subpart, is determined only in relation to the life insurer's New Zealand business.

Defined in this Act: business, discontinuance profit formula, income, life insurance, life insurance policy, life insurer, life reinsurance policy, mortality profit formula, New Zealand, New Zealand business, non-resident, offered or was offered or entered into, policyholder income formula, premium loading formula, resident in New Zealand, source in New Zealand

Compare: 2004 No 35 s EY 47

Section EY 48(2) heading: substituted, on 21 December 2010, by section 60(1) of the Taxation (GST and Remedial Matters) Act 2010 (2010 No 130).

Section EY 48(2): amended, on 21 December 2010, by section 60(2) of the Taxation (GST and Remedial Matters) Act 2010 (2010 No 130).

Section EY 48(3) heading: substituted, on 1 July 2010, by section 193(1) of the Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009 (2009 No 34).

Section EY 48(3): substituted, on 1 July 2010, by section 193(1) of the Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009 (2009 No 34).

Section EY 48(4): amended, on 1 July 2010, by section 193(2) of the Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009 (2009 No 34).

Section EY 48 list of defined terms **derived from New Zealand**: repealed, on 21 December 2010, by section 60(3)(a) of the Taxation (GST and Remedial Matters) Act 2010 (2010 No 130).

Section EY 48 list of defined terms **source in New Zealand**: inserted, on 21 December 2010, by section 60(3)(b) of the Taxation (GST and Remedial Matters) Act 2010 (2010 No 130).

EY49 Non-resident life insurer becoming resident

Non-resident life insurer may apply

(1) A life insurer not resident in New Zealand may apply to be treated for its New Zealand business as resident in New Zealand on and after the first day of a particular income year.

Application

(2) The life insurer applies by—

- (a) completing a written application specifying the particular income year; and
- (b) giving the application to the Commissioner not less than 20 working days before the start of the particular income year.

Commissioner may grant

(3) The Commissioner may grant the application.

Company resident in New Zealand

(4) If the application is granted, the life insurer's New Zealand business is treated, on and after the first day of the particular income year, as being carried on by a company resident in New Zealand in which the life insurer holds all the issued shares.

Life insurer agent for company

(5) The life insurer is treated as carrying on its New Zealand business as agent for the company and is liable, as agent for the company, to pay amounts payable to the Commissioner and to provide returns of income and other information required by the Commissioner.

Company and life insurer separate persons

(6) The life insurer and the company are treated as being separate persons in relation to the life insurer's New Zealand business.

Defined in this Act: agent, amount, Commissioner, company, income year, life insurer, New Zealand business, non-resident, pay, resident in New Zealand, return of income, share, working day

Compare: 2004 No 35 s EY 48

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