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INVISIBLES: INSURANCE

Establishing life insurance tax policy in developing countries

Study by the UNCTAD secretariat

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CONTENTS

INTRODUCTION

1. The Committee on Invisibles and Financing related to Trade , at its tenth session in December 1982, adopted resolution 21(X) on "life insurance in developing countries". In this resolution, the Committee requested the secretariat "... to prepare studies on the various fiscal and other measures that developing countries of UNCTAD could adopt to make life insurance products ... more competitive with other savings media ....". The Committee advised that tax incentives for insurance companies and policyholders could be examined. This report has been prepared in response to this request. Several experts from developing and developed countries co-operated with the secretariat in its preparation. A special acknowledgement is owed to Messrs. A.E. John Thompson, of Coopers and Lybrand, Toronto, Canada, who prepared a background paper and contributed many useful ideas, and to Mr. Harold Skipper, of Georgia State University, Atlanta (USA). The secretariat is grateful to all of them and recognizes the importance of the opinions, ideas, comments and factual information which they provided; however, it alone is responsible for the final text of this document.

2. Committee resolution 21(X) can be considered as flowing in part from the UNCTAD secretariat's 1982 study, "The promotion of life insurance in developing countries", 1/ which had been requested by the Committee in previous sessions held in 1975 and 1980. The study noted that for life insurance to achieve much importance as an economic security device in a country, certain conditions must point favourably in that direction. These conditions remain of great importance in life insurance development, and the reader is invited to refer to the detailed description contained in the 1982 study. This report presumes conditions are sufficiently favourable within an interested developing country so as to render tax-related considerations of relevance to efforts to promote life insurance.

3. This suggests that this report may be of little relevance at present for some countries, especially some of the least developed countries. On the other hand, life insurance is of great relative importance in several developing countries and many others would like to assist in its promotion, even though its current relative share of the total insurance business may

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1/ TD/B/C.3/177 and Corr.1.

be low. 2/ The tax policy adopted by Government towards life insurance can have an important influence on the extent to which life insurance is successfully integrated into a society.

4. This report discusses reasons why a favourable tax policy towards life insurance promotion may be appropriate. In general, if a Government decides to use tax policy to encourage life insurance development, it might be most appropriate to view such as a part of a total package of social welfare and, in the process, examine other economic endeavours to see if they too are deserving of encouragement via tax policy. Once it is clearly apparent that life insurance can play a positive role in the lives of individuals and families and that it can contribute toward economic development of the country, favourable consideration could be given to fiscal incentives. However, fiscal incentives must be responsive to inflationary pressures and must be molded in light of the country's economy. The intent of this report is not to encourage additional taxation of life insurance but rather to give guidance regarding the possible structure of a reasonable tax policy towards life insurance. The report presumes that all relevant resolutions of the Conference and of the Committee relative to localization of insurance and to local investment of reserves are applied.

5. Not all possible tax measures discussed in this report are equally important. Many of them, not unexpectedly, could be the cause of reduced tax revenues as a result of reduction of tax rates on life insurance. Decisions should therefore be made individually, in light of the country's local conditions and Government priorities, whether the potential position aspects of a favourable tax policy outweigh any possible loss of tax revenue.

2/ Using the ratio of life insurance premiums to total insurance premiums for 1982, life insurance can be considered of great relative importance in: Republic of Korea (with a ratio of 73 per cent), Zimbabwe (64 per cent), India (63 per cent), Chile (53 per cent), Thailand (52 per cent), Panama (46 per cent), Pakistan (39 per cent), the Philippines (39 per cent), and Malaysia (30 per cent). See, Sigma, Swiss Reinsurance Company, April 1984, p. 13.

Vast differences exist among countries even of the same region. Even so, life insurance has a relatively greater share of total insurance business in the Asian developing countries than in the developing countries of Latin America or Africa. In Asia, 44 per cent of total insurance premiums came from life insurance in 1981. In Latin America, the corresponding figure was 20 per cent and in Africa, it was 19 per cent. (See Sigma, Swiss Reinsurance Co., August 1983, p. 5). The African figure must be viewed with caution. Over one-half of the 19 per cent figure is accounted for by Nigeria and Zimbabwe alone. The Latin American and, especially, the Asian figures are not so heavily influenced by the data from one or two countries thus suggesting a more widespread relative importance for life insurance within these two regions.

Chapter I

GENERAL CONSIDERATIONS IN DESIGNING A LIFE INSURANCE TAXATION SYSTEM

6. There are no "absolutes" as regards life insurance taxation, although many commonly-agreed general considerations enter into the design of a system of life insurance taxation. This chapter sets out the more important considerations. From these flow the details of the system, some of which are discussed in the following two chapters.

A. The purposes of taxation

7. Governments impose taxation on individuals and organizations to accomplish various national objectives, the main objective being to raise revenue to cover government expenditures. However, tax policy can serve other objectives. Governments attempt to control aggregate demand through tax policy and thereby, to combat economic instability, unemployment, and inflation. Other factors assumed equal, an increase in taxes depresses total consumer and business spending while a decrease encourages spending.

8. Tax policy can be used to encourage or discourage certain social, political or economic activities. For example, high taxes on cigarettes can discourage the purchase and hence smoking of cigarettes. Low taxes on investment earnings can encourage investments. Objectives can be, and often are, in conflict. Government must then decide how to balance the competing objectives.

B. Establishing government tax policy towards life insurance

9. Life insurance tax policy falls in the area of resolving the conflict of the various competing national objectives. While Governments throughout the world have adopted a wide range of attitudes on this point, relatively few have consciously chosen to impose a greater tax burden on the life insurance industry than that imposed on other industries. Even so, situations exist where tax laws discriminate unfairly against life insurance. This seems rarely to be the result of a deliberate Government policy but arises from a lack of appreciation of the important role life insurance can play and from an unclear understanding of the nature and functioning of life insurance.

10. The rationale for a preferred taxation position for life insurance companies, their policyholders, or both has historically centered around the worthwhile social and economic role that life insurance can play. This role was recognized by the Committee in 1982 in its resolution 21(X) on life insurance when it formally recognized that life insurance and life insurers "... can play an important role in promoting individual economic security and in national development efforts, including the mobilization of personal savings."

11. The UNCTAD secretariat's 1982 life insurance study noted that a strong and efficient life insurance market could be a source of public and private sector financing. It can reduce the financial burden on the state of caring

for the aged and financially dependent. By offering life insurance services locally, foreign exchange can be conserved. The life insurance business can be a source of revenue to Governments through taxation and licensing fees and can generate employment.

12. Life insurance can serve the interests of individuals and families by providing a measure of protection against the adverse financial consequences of premature death. It can be the vehicle through which individuals accumulate savings for emergencies and for retirement. By making available a variety of employee benefit plans, life insurance companies can promote better employee/employer relations and can provide low cost benefits to a broad spectrum of persons. Life insurance can permit more favourable credit terms to borrowers - both individuals and businesses - and can decrease the risk of default. Also, life insurance proceeds can be used to repay home mortgage loans in the event of the death of the family supporter. This can save the home for dependents and thereby enable persons of modest means to own their own dwellings.

13. Other arguments also exist to justify a favourable tax policy. For example, life insurance has many of the characteristics of consumer or producer co-operatives, friendly societies, and fraternal benefit societies. Such organizations are judged socially beneficial in most jurisdictions and, as a result, enjoy either total or partial exemption from taxation or enjoy other special tax privileges. 3/

14. The encouragement of personal savings through life insurance (as well as through other media) can serve as a useful adjunct to governmental anti-inflationary policy since an increase in the savings rate normally means a decrease in the spending rate. This in turn depresses aggregate demand and, thus relieves some inflationary pressures.

15. Additionally, the tax privileges available to the insurance sector can be justified as being appropriate in some countries because of non-tax burdens the sector may be expected to bear. In many countries, regulations require investment in Government bonds or other low yielding assets, the rates of return on which may be artifically depressed. Faced with such investment constraints, life insurers' products cannot be as competitive as otherwise. Thus, a favourable tax policy on life insurance can make up for the "hidden" tax involved in Government borrowing.

16. Counter-arguments also exist. In their development efforts, developing countries must be exceedingly prudent in providing special tax concessions. Even with the acknowledged worthwhile social and economic role that life insurance can play, the need by Government for adequate revenue could be considered even more critical.

17. For many developing countries, life insurance may be considered irrelevant or inappropriate because of ideological, cultural, or religious reasons or because economic security is provided chiefly through the family, tribe or clan. For these countries, as well as for those experiencing high inflation rates, a favourable tax policy for life insurance could be irrelevant or inappropriate. Also, social inequity could exist in granting

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3/ Harold F. Bell, "Comparative Analysis of Taxation Approaches - Life Insurance", International Insurance Seminar Proceedings (1982), Toronto, Canada, pp. 106-107.

tax privileges to life insurance as it benefits the wealthy who can afford to pay large premiums. This can be important, although practical ways exist to cope with this situation, as discussed later. Further, as noted by one author, "... by making provision against the contingencies of life and death, such (wealthy) policyholders are relieving the State of at least some of its social welfare responsibilities therefore enabling it to do more for those who are not in a position to help themselves." 4/

18. Finally, life insurers are increasingly thought of less as co-operative endeavours of self-help and thrift and more as large business concerns which ought to be taxed as any other large businesses. Whether the size of a business should be used as a basis for establishing tax policy or whether the overall good it provides to society should be the basis is a decision each Government must make for itself.

C. Understanding the special nature of the life insurance business

19. No meaningful decisions regarding the taxation of life insurance should be made without understanding its special nature which can render complex otherwise simple tax concepts. Fundamentally, life insurance is a simple proposition. A policyholder pays money - the premium - to a life insurer in return for which the insurer agrees to pay an agreed sum of money if the policyholder dies during the term of the policy and, in some instances, in the event of survival to a stated time.

20. Life insurance is most commonly purchased on a level premium plan; that is, the same premium is charged throughout the contract's duration. Keeping the premium the same from year to year involves the collection during the early years of sums greater than those required to pay current death claims and expenses. These "pre-payments" are accumulated by the insurer and are utilized, along with the earnings from these funds, during later policy years when premiums collected are insufficient to meet the then current death claims and expenses. In this sense, therefore, total insurer premium income is not strictly comparable to total income from other enterprises, whose products involve no element of "pre-payment".

21. The insurer is required to show a liability item (the policy reserve) which corresponds to these funds. 5/ It is deemed fair to permit the policyholder to recoup a portion of this reserve if the policy is voluntarily terminated. This amount is referred to as the policy's cash surrender value and is the savings element within a life insurance policy. Hence, the real reason for having a savings aspect to life insurance is to smooth out premium payments over a long period of years.

22. Since premiums and reserves are calculated on assumed future experience, the actual experience and profits under the policies will emerge only after many years. Year to year experience can be a poor indicator of actual operating gain. The actual gain will be revealed from the combination of the extent to which: (1) actual investment income exceeds that assumed in deriving policy reserves; (2) actual mortality experience is more favourable than that assumed; and (3) actual expenses are less than those assumed.

4/ Ibid.

5/ The terms "actuarial reserves" and "mathematical reserves" are also used to describe policy reserves.

23. To a greater degree than most, a country's life insurance industry is usually homogeneous and often well organized for consultation. To promote understanding of this complex industry, two-way dialogue on a recurring basis should be considered essential. The industry will be the vehicle through which the system functions and, because of the complex nature of the industry, it usually performs many of the functions which the tax authorities would normally perform for other industries.

D. Criteria for a life insurance tax system

24. Any proposed system of life insurance taxation should be tested against certain standard criteria. Of course, for many Governments, the most important criterion may be that the system develop an acceptable amount of revenue. Other criteria are also important and are discussed below.

1. Compatibility with the general tax structure

25. An appropriate tax system for life insurance cannot be designed in isolation from the structure of the existing tax system. For example, if at a particular stage of a country's development, the Government relies heavily on transactional types of taxation (e.g., sales or excise taxes) rather than on income taxes, it would probably be inappropriate to attempt to install a sophisticated income tax system for the insurance industry. Even with a particular type of tax, the rules must be suitably chosen. For example, if sales taxes generally apply only to tangible goods, it could be deemed inappropriate to apply a type of turnover tax to the life insurance industry exclusively.

26. Life insurance tax rules should also be co-ordinated with the form of corporate taxation followed in the country. These can vary from separate taxation of the corporate income with full taxation of dividends to shareholders, to a completely integrated system under which full credit for corporate tax is given to shareholders, with a variety of compromises in between. However, once the unique issues in the life insurance industry are considered and resolved, the appropriate form of co-ordination would usually be apparent.

27. The general approach to using incentives or disincentives in the tax system should be consistent with the Government's general attempt to direct economic or social behaviour through the tax system and by other means such as expenditure programmes, grants, discretionary undertakings to private industry, and direct intervention in the economy through Government operations. Also, where more than one taxing authority exists within a country (e.g., with a federal system of Government), there needs to be close coordination to avoid unfair double taxation.

2. Compatibility with the insurance regulatory structure

28. The overriding purpose of an insurance regulatory system is to ensure the solvency of insurance companies and thereby to protect the public from unsound operators. The main purpose of an insurance taxation system is to raise revenue for the Government. Herein lies the potential for intra-Governmental conflict. The insurance industries of most developing countries are subject to rather extensive insurance regulatory rules, although the quality and extent of the actual supervision is often more theoretical than real. Regulation typically requires pricing, reserving, and investment conservatism. Therefore, insurers must behave in a correspondingly

conservative manner. The designers of a life insurance taxation system must be sensitive to these regulatorily imposed requirements, use them as appropriate, and try to avoid measures which inadvertently or unfairly penalize life insurers which must function in such a conservative environment.

29. A country's insurance legislation and regulation provide a reference point and framework for tax planning. Tax designers should, therefore, make conscious, well-informed decisions before imposing their own, different requirements on life insurers. Also, both taxation and regulatory authorities must be sensitive to the fact that a taxation system is capable of inadvertently encouraging life insurers to attempt to avoid some statutory requirements to save taxes. With these facts in mind, developing countries would be well-advised to ensure that an adequate and clearly defined system of insurance legislation and regulation is set up before embarking on any extensive revision of the life insurance taxation system. 6/

3. Structural viability

30. A life insurance taxation system must be structually viable for the country. This criterion has two parts: (1) administrative feasibility and simplicity and (2) revenue reliability. Ideally the tax system would not involve complex administration by the tax authorities. It should be easily understood and explained by the authorities and should not appear as bewilderingly complex to taxpayers. Compliance by the taxpayer should be facilitated and tax avoidance possibilities minimized. In other words, the system should be simple and its functioning transparent.

31. An important aspect of tax revenue generation is the reliability of the revenue stream. Although difficult to realize in practice, revenues should not fluctuate greatly from year to year and, for purposes of permitting longer-term Government planning, they should be fairly predictable.

4. Balance within the fiscal environment

32. The designers of a life insurance taxation system must deal with several difficult issues which relate to establishing a balance within the fiscal environment of the country. While no clear-cut, universally acceptable standards exist in the areas discussed below, many Governments have determined that, in the absence of compelling national policy objectives to the contrary, the concept of economic neutrality ought to be the national position. The concept of economic (or tax) neutrality holds that the tax policy of the country should not be the cause of one product, service, or type of provider having an economic advantage over another in the marketplace. Even if this concept is adopted, difficulties remain in its practical implementation, as discussed below.

(a) Life insurance versus other savings media

33. If a national policy objective is to promote savings among the population, life insurance is one of the ways of achieving this objective and a favourable tax policy related thereto could emerge. Other savings media (e.g., banks, building societies, retirement plans) also will be considered as means of accomplishing this objective. Government must decide whether it should adopt a position of economic neutrality among the various savings

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6/ See UNCTAD "Insurance Legislation and Supervision in Developing Countries", TD/B/393 1972.

institutions. If it does, effective implementation will demand careful monitoring.

(b) Stock versus mutual versus Government insurers

34. In some life insurance markets, stock (shareholder-owned) life insurers predominate. In other markets, mutual life insurers are the dominant force.7/ In still other markets, Government-owned or sponsored life insurers either compete with privately-owned insurers or enjoy a monopoly within the local market.

35. An economically neutral tax system should recognize that there is nothing unfair in subjecting shareholders of stock life insurers to the same tax exposure as shareholders of other, non-insurance corporations. Except for this recognition, however, a strong argument can be made that a tax system should tax all life insurance companies equitably.

36. In a recently published survey of the taxation systems of 11 major developed market-economy countries, it was found that only France accorded limited special tax concessions to mutuals and not to stock insurers. The other countries (Australia, Belgium, Canada, Germany, Federal Republic of, Italy, Japan, Netherlands, Switzerland, United Kingdom and United States) essentially taxed stocks and mutuals in the same manner, except for the element of dividends to stockholders. 8/

37. There also exists in some countries the issue of Government-owned life insurers versus privately-owned. Where privately-owned life insurers are permitted to compete against a Government-owned life insurer, care usually is taken to ensure that the Government-owned insurer competes on the same basis as its privately-owned counterparts. If this is a country's policy, it logically should extend also to the approaches adopted in taxing the competing entities.

(c) Domestic insurers versus foreign insurers

38. The issue of how to tax foreign-domiciled life insurers which conduct business within a developing country might be closely linked to the country's general policy regarding foreign insurer operations within the country. Of course, a country's taxation system can be the vehicle through which foreign insurers are discouraged from entering a particular market, or the tax system can perform the opposite function. From a pure tax standpoint, there is no

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7/ A mutual life insurer is typically a corporation organized as a non-profit entity and owned by its policyholders. For purposes of this report, all life insurance companies that are owned or controlled by or are run for the exclusive benefit of their policyholders are considered as mutual life insurers. Thus, co-operative life insurers, fraternal benefit societies, voluntary benefit associations, and other such insurers are herein considered as falling within the mutual life insurer category, even though this is not always technically correct.

8/ See International Comparison of Insurance Taxation (Toronto, Canada: Coopers & Lybrand, 1984), pp. 10-13 (hereafter referred to as C & L Tax Study).

inherent reason for taxing the local business of foreign insurers any differently from that of local insurers. 9/ From a national policy standpoint, however, a Government may deem some discriminatory tax treatment to be in the national interest. This is a decision to be made by each Government in light of its national goals and constraints (such as any non-discrimination clauses in existing tax treaties). 10/

(d) Participating versus non-participating insurance

39. Life insurance policies are generally classified as to whether they are participating (with bonus) or non-participating (no bonus). 11/ Participating policies provide that part of the surplus funds generated by the policies will be distributed among the policies in the form of dividends (bonuses). A non-participating policy is one in which the insurer does not distribute to policyholders any part of such surplus funds. Usually, premiums for participating policies are higher than those of non-participating policies. Thus, a portion of the surplus funds generated by participating policies is derived from a deliberately conservative pricing structure.

40. The concept of tax neutrality would accommodate the two classes of life insurance through an appropriate recognition of policy dividends under participating policies. This recognition would apply both to the taxation of the insurance company as well as to that of the policyholder. This complex, technical issue is addressed in more detail in the following chapter.

5. Social sensitivity, tax evolution and conflict minimization

41. Any life insurance taxation system must evolve in a manner consistent with a country's religions, customs, and political realities. Additionally, the tax system should be socially equitable. This is usually interpreted to mean that the taxation burden, ideally, should fall less heavily on those in society least able to pay.

42. It is common to find that a developing country's insurance tax structure was originally patterned after its former metropolitan power. Over time, it may have been altered, often to suit some immediate fiscal need by Government. Changes are often frequent and, at times, have resulted in

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9/ Some practical definitional hurdles must be overcome and some potential areas for abuse carefully considered. For example, some method would be essential for determining the investment income applicable to the local business of a foreign company.

10/ In fact, many developed countries grant fiscal incentives only when their life insurance contract is locally underwritten, thus insuring a full contribution of life insurance in economic development. A similar system is increasingly being adopted in developing countries.

11/ This traditional distinction increasingly is being blurred as life insurers have begun to offer "new money" non-participating products which permit the pass-through to policyholders of investment and mortality experience.

conflicting, unco-ordinated policies. 12/ This creates an environment of uncertainty for life insurers.

43. Because of the long-term nature of the business, it is desirable that tax changes are not made abruptly or drastically. Since returns only emerge over a long period of time, it is unrealistic to expect life insurance companies to establish operations if they may be subject to unexpected and far-reaching tax changes. At the same time, it is reasonable to expect that the taxation of the life insurance industry would evolve gradually over time, in tune with a changing economic, political and social environment.

44. Finally, as important as any one of these criteria is the appropriate balance among the criteria. Conflicts will inevitably emerge. The adverse effects from these conflicts should be minimized. For example, achieving an appropriate degree of social sensitivity will often conflict with administrative simplicity. The most obvious example is an income tax. It is difficult to administer and yet has the least harmful economic effects and is the best measure of ability to pay. Only occasionlly is there a happy coincidence between desired economic and social objectives on the one hand and administrative ease on the other.

45. The balance among the criteria will vary as a country progresses. In the early stages of development, revenue yield and administrative feasibility will be of prime importance. As a country matures and the economy and society become more sensitive to fiscal measures, the tax rules can be designed to reflect more criteria. Eventually there is a limit to the viable precision of tax rules. As industrialized countries are discovering, detailed tax rules designed to carry out a multitude of objectives can become incomprehensible and counter-productive.

12/ Isagani de Castro, "The Importance of Taxation in Planning the Integration of Life Insurance in a Developing Country", paper presented at the 4th Third World Insurance Congress, Casablanca, Morocco, May 1984.

Chapter II

APPROACHES TO LIFE INSURANCE COMPANY TAXATION

46. After consideration has been given and decisions taken on the wide range of important issues presented in the preceding chapter, the practical problem of implementation must be faced. Little homogeneity exists internationally concerning the details of how life insurance companies are taxed. However, while the details differ, the fact of taxation - in some form - is almost universal. This is unlikely to change, even if a Government decides to accord life insurers especially favourable taxation in an effort to assist in its promotion. Recognizing, therefore, that Governments are accustomed to life insurer-related tax revenues and will likely continue to tax life insurers in some way, it becomes necessary to consider the various approaches which can accomplish the Government's goal of generating a reasonable tax revenue stream while, at the same time, minimizing any excessively depressing effects that a tax on life insurers could have on the public's acceptance of life insurance.

47. This chapter is intended to assist Governments in molding such a life insurer taxation system. It presents a far from exhaustive treatise of the subject owing to the many complex, technical details which enter into the issue. It is intended, however, to serve as a point of departure for further, individual Government study of the issue.

48. As a practical matter, some Governments decide what they believe to be a reasonable tax burden for a given industry then work backward to estimate the set of tax rates and bases that generates the approximate level of desired tax revenue. It is noted that this approach is potentially dangerous unless the country already has a firm history of life insurer-related tax revenues from which to draw reasonable inferences and unless the country has some reasonable idea of the resulting impact on life insurance promotional efforts.

49. Four broad approaches to life insurer taxation are discussed below. The narrative of each approach presents summary information as to: (1) the appropriate tax base and commonly found deductions, (2) reasonable tax rates which could be applied, and (3) an evaluation of the particular approach. An effort has been made to evaluate each approach using as general criteria ease of administration and equity.

A. Premium income as a basis for taxation

50. A tax on an insurer's premium income is a form of transaction or turnover tax. Insurance premiums are one of the few intangible commodities which are often subject to such tax, even in the absence of a similar tax on other financial institutions. In some jurisdictions, premium taxes are regarded as a quasi-substitute for income tax or as a sort of minimum tax on a business operation. Indeed their existence may to some extent reflect the difficulty in establishing a figure for an insurer's total profit, which logically would be the base for taxation. Also, in some countries, it was introduced originally to discourage foreign insurers from operating. [13]

13/ *Ibid.*, p. 13.

1. The tax base and deductions

51. Under the typical premium tax structure, the tax base - i.e., the amount to which the tax rate is applied - is the simple total of the life insurer's premium revenue, with minor alterations. The revenue figure usually includes income from the insurer's accident and sickness business but not revenue from any life reinsurance. Taxation of the premium income from life reinsurance would be tantamount to double-taxation as the original premium would already have been subjected to taxation.

52. Some countries exclude from premium revenue all receipts from life insurers' annuity business as well as contributions to qualified retirement programmes. Other countries tax one or both at a lower rate. To maintain taxation equity between participating and non-participating insurance, life insurers are usually permitted to deduct from their total premium income all policy dividends paid to participating policyholders.

53. The tax is typically assessed on the premium income derived from domestic business only; that is, from policyholders resident in the country. The domicile of the life insurer is not the controlling element. In other words, the tax is assessed on the local business of all life insurers, irrespective of whether the life insurer is a local insurer or a branch or an agency of a foreign insurer.

2. The tax rate

54. In the previously mentioned survey (see para. 36), five of the 11 developed countries have no premium taxes. For the six others, the tax rates range from 2 per cent to 3 per cent, although France assesses a rate of 5.15 per cent. 14/ It is common throughout the world to tax life insurance premiums at a rate lower than property and liability insurance premiums and to tax health insurance premiums at a rate no higher, and often lower, than life insurance. 15/ A survey of premium taxes assessed by several African countries revealed that many countries have no premium taxation. For those countries having a tax, 16/ rates commonly were in the 1-5 per cent range, although rates of 10 per cent (as of 1980), 16 per cent (1984), and 18 per cent (1984) were found. 18/

55. The premium tax approach has a degree of acceptance internationally. It is generally recognized that anything beyond a low rate is harmful and could violate the principle of economic neutrality among financial institutions.

14/ C & L Tax Study.

15/ See "International Comparison of Insurance Taxes", Sigma, Swiss Reinsurance Company, October/November 1978.

16/ Benin, Burkina Faso, Cameroon, Central African Republic, Congo, Egypt, Gabon, Ivory Coast, Morocco, Senegal, Togo, Tunisia, Zaire.

17/ Private survey provided to the UNCTAD secretariat by Munich Reinsurance Company.

This is understandable as the tax results in a direct and corresponding increase in the cost of the service to the public. This can effect greatly the desirability of the service.

56. Also, as mentioned earlier, some persons consider the premium tax as a surrogate for income taxation of the insurer. Since the typical expected profit margin within a life insurance product is less than 5 per cent, a 3 per cent premium tax can be considered as being roughly equivalent to an income tax of 60 percent. 18/

3. Evaluation of premium income as a taxation basis

57. The use of premium income as the basis for taxation is probably the simplest approach to taxation of life insurance companies. It is easy to administer by both the insurer and the tax authorities. In fact, the insurer does most of the work. Verification is not difficult and, since it is a tax at the source, it avoids burdening policyholders with tax paperwork. It should provide Government with a predictable and stable source of revenue.

58. On the other hand, its simplicity is the source of potentially great inequity. The premium tax is a regressive tax. It falls with relatively greater severity on lower income policyholders because it absorbs a greater proportion of a low income person's available savings as compared to a higher income person. The premium tax has other unpleasant attributes as well. It is a direct tax on personal savings. It applies to both the savings and protection elements of insurance premiums. Also, importantly, it falls most heavily on older policyholders since they pay higher life insurance premiums, even though the life insurance coverage amount may be identical. To distinguish among these elements would be extremely complicated, although certain types of contracts (such as annuities) which are primarily of a savings nature are often totally exempted from premium tax. 19/ As a result, the premium tax can constitute severe taxation which is rarely applicable to savings through other financial institutions such as banks and trust companies. This problem warrants continuing consideration and a recognition that, other factors being equal, the higher a premium tax, the less attractive become cash value policies and the more it penalizes older citizens.

59. Finally, the simplicity and ease of application of a tax on premium income can be the source of enormous temptation by authorities. It becomes a seemingly simple matter to raise the tax rate whenever the Government treasury needs additional revenue.

18/ This analogy is useful in giving some idea of the level of the tax burden. The 60 percent figure assumes the tax is not passed on to the policyholder, an unrealistic assumption. To the extent the tax is passed to the policyholder the effective tax rate would be lower. If the entire tax were passed, the effective rate would be 37.5 per cent (3% divided by 8%). The 5 per cent profit figure given here would be high for many life insurers.

19/ Another approach followed in certain countries (e.g., Greece) is to subject to premium tax only policies of a stated, relatively short duration (e.g., less than 10 years), on the theory that policies of longer duration have larger savings elements.

60. In recognition of these problems and inequities, many developed countries (e.g., Australia, Germany Federal Republic of, Netherlands, Switzerland and United Kingdom) as well as developing countries (e.g., Ethiopia, Ghana, India, Kenya, Nigeria, Pakistan, Sri Lanka and most countries in Latin America) assess no premium tax. Even so, because of its ease of administration and its revenue raising capability, and in spite of its many disadvantages, a premium tax at a modest rate could be viewed as a suitable element in the tax system of developing countries which have highly undeveloped accounting and tax structures. Even then, much thought should be given before its adoption. In general, tax rates in excess of 3 per cent should be considered as excessive. Such high rates will certainly discourage the purchase of life insurance, unless signficiant tax concessions are given through other means. However, providing premium tax relief, for example, does not eliminate the regressive aspect of the premium tax and to an extent is illogical.

B. Investment income as a basis for taxation

61. This and the immediately following section present variations of investment income as a possible basis for life insurance company taxation. The two approaches differ in their conceptual underpinning and in the details as to how they function. This section discusses taxation based on the investment pool concept.

62. In general, tax systems levy taxes on the investment earnings of citizens. These earnings may be actually paid out to the taxpayer, or they may be held by the institution and re-invested on behalf of the taxpayer. With some exceptions, it is fair to say that irrespective of whether these earnings are paid out or re-invested, they are considered as taxable income to the investor.

63. The above logic suggests that interest earned by life insurers on behalf of their policyholders ought also to be considered as taxable income to the policyholders. Since, for the average life insurer, 80-90 per cent of its assets are claimed by policy reserves and since these reserves are measures of the insurer's obligations to its policyholders, earnings from these assets could be properly viewed as belonging to the policyholders. 20/ In other words, this approach considers the operation of a life insurer as simply an investment pool operated for the benefit of policyholders.

64. However, any attempt to allocate this income among individual policyholders and to tax them on it seems doomed to failure because of administrative complexities and policyholder misunderstanding. Taxation at the corporate level can serve as a substitute for individual policyholder taxation, although very few countries actually use this approach by itself as a substitute for corporate profits tax. The United Kingdom is perhaps the foremost exception. It uses a variation of this approach as the basis for corporate taxation, as discussed below.

20/ Technically, one would argue that only that interest credited to policy reserves and through other policy benefits, such as dividends, should be taxable to policyholders. Also, worth acknowledging is the legal point that while policyholders, as a group and not individually, have a "claim" against the life insurer through policy reserves, title to the assets backing these reserves actually rests with the life insurer. These technical points do not invalidate the essence of the argument.

65. Some years ago, Canada levied a tax on investment income as a substitute for taxing the income in the hands of the policyholders. This was in addition to a corporate tax on profit but was deductible by the company in arriving at the overall corporate profit. Canada abandoned the system in 1978 in favour of one which includes income from all sources (the so-called total income approach). The Philippines levies taxes on total income and, in addition, has a special type of tax on investment income. Interest derived from fixed income investments is subjected to separate taxation, even if overall financial results produce a loss. No deduction is allowed against the corporate profits tax for the taxes paid on interest income.

1. The tax base and deductions

66. If one subscribes to a taxation system based on the investment pool concept, the tax base logically should be the earnings from those assets, perhaps with certain deductions. Investment income would be the sum of interest earnings, dividends and net rental income. Capital gains and losses could be included in the summation only as they were realized with the possible exception of bonds, where income treatment may be more appropriate and discounts or premiums could be amortized.

67. For a tax on investment income to be sound theoretically, it would permit certain deductions from the tax base. Each country must decide for itself the extent to which it might wish to permit the following deductions - recognizing that the price for more deductions is an administratively more complex system. The possible deductions discussed below include :

(a) Expenses associated with the investment function;
(b) Total expenses;
(c) Dividends received from domestic corporations;
(d) Earnings from priority investments; and
(e) Earnings from "socially desirable" life products.

68. In deriving taxable income, most experts agree that a deduction should be permitted for expenses directly associated with the generation of the income. Thus, a deduction from investment income for expenses associated with the investment function within the insurer is logical.

69. If no corporate profits tax for life insurers exists and, therefore, insurer acquisition and operational expenses cannot be netted against total income, consideration might be given to permitting a deduction of a portion of these expenses from investment income. The justification for this approach could be that such expenses are viewed as having been incurred in the production of the investment income, for without expenditures for business acquisition, etc., there would be nothing to invest. Permitting a deduction for total expenses has the drawback that it can distort actual insurer profit flow. This can result when an insurer is expanding rapidly or, conversely, when it has decreased new business writing significantly. Expenses of writing new business form a major part of total expenses and, in some cases, can exceed total investment income if a company is growing rapidly. "The effect of expansion is thus to postpone the emergence of taxable income (as defined in this process); yet insurers in this position could not be said to be trading unprofitably if, while expanding, they were able to provide increased benefits to policyholders as well as dividends to stockholders." 21/

21/ Harold F. Bell, op cit., p.110.70.

70. Many countries permit a deduction, in whole or in part, for dividends received from domestic corporations in arriving at taxable income. The theory upon which this treatment is based is that the dividend-paying corporation has already paid taxes on account of the dividends and that the receiving corporation should not be required to include such amounts in its taxable income base since to do so would result in double taxation. 22/ Perhaps a more convincing logic for permitting this deduction is that it serves as an incentive for investment by insurers in domestic corporations. Such a deduction need not be allowed foreign insurers if the intention is to encourage ownership by nationals.

71. Closely related to the preceding category is that of special exemptions (or tax credits) for earnings from investments in certain industries or in Government securities which have been accorded priority in Government development plans. For example, if interest paid on Government bonds were excludable from income for tax purposes, such bonds would be more attractive. Special tax incentives are common in developing countries, although their discussion is beyond the scope of this report. 23/

72. Deductions are also often permitted for earnings attributable to certain "socially desirable" life insurance products. The theory for permitting such deductions is that the products perform some worthwhile societal function and, therefore, their sale should be encouraged through an explicit recognition within the tax system. Qualified retirement plans - both personal and employer-sponsored - are perhaps the most common life insurer products enjoying favourable tax treatment. Health insurance is another example. The earnings on the assets standing behind the reserves for such socially desirable products may be totally excluded from taxable investment income. This can be accomplished by requiring insurers to segregate such assets and earnings from other corporate investments and income. This is desirable as it facilitates verification that the tax benefits are accruing to the relevant products.

2. The tax rate

73. If life insurance companies operated simply as an investment pool for policyholders, the theoretically appropriate tax rate would be that applied to the individual policyholders. However, to determine this rate, or the aggregate of the rates, would require attribution of all of the income among all of the policyholders. As this is not feasible, the practical and arbitrary alternative is to assess the insurer at some relatively low rate based on a perception of the average of policyholder tax rates.

22/ Actually, if the amounts were included as taxable income to the receiving corporation and if its dividend payments to its shareholders were also taxed, this would result in triple taxation.

23/ For more information, see Taxation in Sub-Saharan Africa, Occasional Paper No.8, Part I C.A. Aguirre, P.S. Griffith, M. Yücelik "Tax Policy and Administration in Sub-Saharan Africa" (Washington, D.C.: International Monetary Fund, 1981), pp. 33-36.

74. Any attempt to tax investment income at regular corporate rates could bankrupt an insurer or at least render its products unattractive financially if the investment income tax base approaches gross investment income. 24/ Also, a high tax rate would not normally be justified since life insurers' gross investment income far exceeds actual gross profits realized from the combination of their underwriting and investment operations. In other words, the regular corporate tax rate can be justified if it is applied to a life insurer's equivalent of other corporations' profit but not if applied to investment income with no significant allowances for deductions.

75. The United Kingdom has taxed life insurers' investment income, net of all operating expenses, at a 37.5 per cent tax rate, a rate which has been lower than the general corporate tax rate. (This rate will soon be reduced, in line with a general reduction in corporate tax rates.) This is referred to as the "I minus E" (investment income minus expenses) approach. The effect of permitting a full deduction for expenses is to yield a taxable income base of modest size. Nigeria's tax system is also based on the "I minus E" approach and the Philippines applies a tax rate of 10 per cent on dividend income, 15 per cent on interest from savings accounts, and 20 per cent on interest received from money market funds or certificates of deposit. These taxes are in addition to corporate profits tax, premium taxes and other taxes. 25/

76. To a great extent the actual tax rate would be chosen only after decisions had been made regarding the deductions to be allowed in arriving at taxable investment income. If few deductions are permitted, the tax rate should be low based on the rate otherwise applicable to policyholders. If deductions are deemed to be generous relative to the magnitude of total investment income, the tax rate could be relatively high, more in line with the corporate rate.

3. Evaluation of investment income as a taxation basis.

77. A system of taxation based on investment income would be somewhat more complex than the previously discussed approach. On the other hand, it offers the potential advantage of spreading the tax burden more equitably. Of course, any such system should be fully integrated and consistent with policyholder taxation on cash values.

78. An investment income-based tax system, however, need not be exceedingly complex. A system using simple gross investment income as the base and allowing no deductions would not be much more complex to administer than the premium tax system and could be particularly appropriate for some developing

24/ Of course, this depends on the country's regular corporate tax rate. If it is low, the statement is less valid. Also, this statement should be tempered with the observation that taxing all or almost all of an insurer's gross investment income at regular corporate tax rates would be less detrimental to a life insurer and the marketability of its products if the Government's tax policy toward policyholders was particularly favourable (e.g., permitting deductibility of premiums). However, this involves difficult issues of equity among policyholders.

25/ The example of the Philippines is cited here for information purposes only and not as a system necessarily to be emulated. See Isagani de Castro, op.cit.

countries. Some persons may take exception to a gross investment income-based tax system. For example, it can be argued that a deduction for investment expenses should be permitted. Investment expenses, however, are typically small in relation to gross investment income. As a result, ignoring them does little harm. Moreover, to bar a deduction for total operating expenses could be partially justified if the tax rate were set at a sufficiently low, fair level. Setting a low tax rate represents an implicit allowance for expenses.

79. At a low tax rate, it might appear to some observers that life insurers were receiving especially favourable treatment in not being subjected to regular corporate tax rates. Of course, this would not be the case but there remains scope for misunderstanding and for the possibility of future tax increases which ignore the original justification for having low rates.

80. A tax on gross investment income would produce more stable and predictable tax revenues than one which followed the "I minus E" approach, although the latter approach may be considered more feasible. It should be recognized that the "I minus E" approach treats cash value insurance more harshly than term insurance, a potential drawback to encouraging savings via insurance. A tax on gross investment income has the disadvantage that an insurer which was, in reality, losing money would nonetheless have to pay taxes. It is suggested that if the "I minus E" approach is adopted, it should be considered as a substitute for any other corporate income tax.

C. Excess investment income as a basis for taxation

81. Another approach which builds on investment income is the excess investment income approach. The rationale for this approach is quite different, however, from that of the previous approach. The logic is that since insurers need to earn a certain minimum rate of interest for reserves to accumulate to the necessary level, any return earned in excess of this minimum can be considered as taxable income to the insurer. In other words, those earnings necessary to maintain policy reserves ought not to be included as a part of the tax bill of the company itself.

82. A variation of this approach was used in the United States many years ago but was ultimately abandoned. The 1959 law in the United States under which life insurers were taxed contained an element which incorporated this notion, although it has been abandoned in 1984. Australia utilizes a variation of this method of life insurer taxation to the exclusion of a tax on total corporate income. Australia permits a deduction for a portion of general and administrative expenses in arriving at taxable income.

1. The tax base and deductions

83. The tax base would be the simple sum of all investment income (as described in the preceding section) less allowable deductions. A deduction would be allowed for investment earnings necessary to accumulate policy reserves. 26/

26/ Determining this amount is not easy however. The checkered experience of the United States on this subject provides much insight into the various methods which can be used as well as the many difficulties which can arise in its application. A discussion of these methods is, however, beyond the scope of this report. See, S.S. Huebner and Kenneth Black, Jr., _Life Insurance_ (10th ed.; Englewood Cliffs, New Jersey: Prentice Hall, Inc., 1982), pp. 676-677.

84. In addition to permitting a deduction for earnings needed to maintain policy reserves, it is common to permit a deduction for investment expenses, and income attributable to reserves which are supportive of socially desirable products (see para. 72). Countries also often permit deductions for dividends received from domestic corporations (see para. 70) and for earnings from priority investments (see para. 71).

2. The tax rate

85. The tax rate for this approach would normally be the country's regular corporate tax rate.

3. Evaluation of excess investment income as a taxation basis

86. The excess investment income approach is not without its inequities and problems. It does avoid some of the complexities of the total income approach (see the next section) and can be more equitable than the previous tax systems. Since it relies on the general corporate tax rate, it is less likely to be misunderstood by persons with little insurance knowledge.

87. Although the approach is conceptually well-based, it is sensitive to changing economic conditions, and does not necessarily produce a stable revenue flow. A difficulty with the approach is that it relies on somewhat artificial assumptions which can become out of date especially in an inflationary environment.

D. Total income as a basis for taxation

88. Perhaps the most common approach to life insurer taxation internationally is the total income approach. This is not surprising, as corporations are generally taxed on this basis. It is widely used in developing countries (e.g., most of the French-speaking countries of Africa, the countries of the Association of South-East Asian Nations and most Latin American countries) as well as developed countries (e.g., Belgium, Canada, France, Germany Federal Republic of, Italy, Japan, Netherlands, Switzerland and United States). The details of each country's system can vary significantly but the underlying concept for each system is essentially the same: life insurers should be taxed on their entire corporate income, regardless of source but, at the same time, deductions should be permitted which are not only akin to those accorded other corporations but also in recognition of the special nature of life insurance. It is common to state that an insurer's overall profits are measured by the sum of its investment activities and its gain from insurance operations.

89. The total income approach can be the most equitable of the various bases discussed herein but this very fact can render it also the most complex. Even the most advanced developed countries have not yet satisfactorily resolved many of the complicated issues involved in designing a fair yet not insufferably complex tax system following the total income approach. 27/ Hence, while the following discussion attempts to present the issues simply, some complexity is unavoidable. Also, it is beyond the scope of this report to try to resolve the many contested areas.

27/ See, for example, David Y. Timbrell, "Issues in Taxation of the Life Insurance Industry," International Insurance Seminar Proceedings (1982), pp. 127-128. and, especially, Henry J. Aaron, The Peculiar Problems of Taxing Life Insurance Companies (Washington, D.C.: The Brookings Institution, 1983).

1. The tax base and deductions

90. The tax base is the sum of all sources of corporate income minus allowable deductions. Total corporate income for the year would normally be comprised of: (1) gross premiums received from the company's life insurance, annuity and health insurance operations and (2) investment income net of investment expenses. Deriving a figure for gross premiums received is a straightforward matter. However, a comment related to one aspect of investment income is in order. The way in which the yield on investments is measured has a close relationship to the calculation of the policy reserves and is an important element in estimating the income each year. Since the insurer derives a significant portion of its income from the margin between the interest assumed in its reserves and the investment income actually earned, it can be regarded as a dealer in long term money, in somewhat the same way as a bank is regarded as a dealer in short term money. Thus, gains or losses on investments, which might ordinarily be regarded as capital gains or losses in other businesses, could be regarded as "on account of income". This is particularly relevant in an inflationary environment in relation to debt securities, where gains and losses in market value are a reflection of changing levels of interest rates and form part of the determination of the overall yield. Gains and losses on other investments such as real estate and shares would usually be regarded as capital and included when realized.

91. In the same vein, amortization of discounts or premiums on debt securities would often be taken into income each year. While gains and losses would usually be recorded when realized, a spreading of gains or losses on debt securities over a period of time may also be considered appropriate for accounting purposes and could be considered for tax purposes.

92. To help avoid overstatements of life insurer solvency, there are often adjustments of investments to market value when it is lower. Alternatively, some other arbitrary form of reserve against future market declines may be allowed. Income treatment of gains and losses on investments is common. Reserves against market declines are common, including provision for a write-down to market if it is lower. While the treatment of gains or losses on investments might not be one of the more crucial issues for a developing country, nevertheless, it is wise to strike an approach early, thereby avoiding the need for transitional arrangements if a change were made later. The treatment of gains and losses on investments of other financial institutions would also have to be considered.

93. The key to a workable and fair total-income-based tax system rests in the choice of permitted deductions and in the method by which these deductions are calculated. Here also resides the system's complexities. Measuring the income of a business with no long-term assets or liabilities is an easy matter. It is simply a process of bookkeeping for receipts and expenditures. The difficulties start when costs are incurred for the benefit of future years or revenues are received for obligations to be rendered in the future. As the period of years involved grows longer, the difficulty of matching costs and revenues in any one year becomes greater. This is the core of the problem in life insurance taxation.

94. An analogy between depreciation and policy reserves can be helpful. In the case of depreciable assets, it is a matter of matching costs (by way of depreciation) against resulting revenue (namely sales from the use of the depreciables). In the case of life insurance it is the reverse: determining

the provision for policy reserves so that the revenue (from premiums and investment income) can be appropriately matched annually against the costs (in the form of claims and expenses). However, appropriate matching involves a high degree of professional actuarial judgement.

95. The range of variations found in developed countries for calculating the reserve deduction attests to the view that there is no such thing as a "correct" method. 28/ However, what is common is that an attempt is made to derive a reasonable amount for these reserves which is allowable as a deduction against income.

96. Even though the reserves determined for various regulatory purposes are calculated in a conservative manner (and, hence, are intended to be higher than necessary), the simplest approach to resolving the issue of determining the appropriate level of reserves to be deducted for tax purposes would be for the taxing authorities simply to adopt the supervisory authority's standards. If there were no published standards, the reserve position as reported in the company's financial statement could be used. As the tax authorities developed expertise in this technical area, the tax reserve deduction could be changed. Use of the same standard would simplify the administrative burden on the tax authorities as well as on life insurers. The life insurers would not need to prepare different reserve calculations for the tax and the regulatory authorities. The tax authorities, in turn, could place greater reliance on the accuracy of the computation since the regulatory authorities might be charged with verifying it.

97. The effect of using statutory reserves for tax purposes is to overstate the reserve deduction and, hence, to understate taxable income somewhat. This need not be considered as a major problem if the country is dedicated to the promotion of life insurance. It can be viewed as one aspect of a favourable tax policy.

98. The above discussion relates mainly to long-term life insurance and annuity contracts. In the case of individual or group term insurance, where the time period is much shorter and the savings element much smaller, determination of the reserves is much less of a problem since it is mainly a matter of pro-rating the premium over the term of the coverage.

99. A deduction is allowed for benefits paid out and, perhaps, for benefits incurred, whether paid or not. Often such benefits are included in the broad category of general insurer expenses. Common benefits incurred and paid include death proceeds, matured endowments, annuity benefits, as well as disability and surrender benefits.

100. There is perhaps no country which follows the total income approach to life insurer taxation and which fails to permit a deduction for investment, administrative and acquisition expenses. As a practical matter, investment expenses are usually netted against investment income before the investment income figure is included in the tax base. Permitting a full deduction in the year in which administrative expenses are incurred presents no difficulty. However, acquisition expenses pose a conceptual problem, since they are incurred in one year but serve as a basis for revenues to be produced over several years.

28/ See, generally, ibid.

101. None the less, it appears that virtually all countries that use the total income approach permit acquisition expenses to be written off fully in the year incurred. This is by far the simplest approach and is an explicit recognition that equity must often yield to simplicity. Even so, it must be recognized that an interaction can exist between reserve deductions and expense deductions, with the net result that an insurer can obtain an initial deduction which exceeds the actual acquisition expenses. This can occur when the tax law permits a full deduction for acquisition expenses in the year incurred and also permits a reserve deduction based on statutory reserves. This is because certain reserve methods (e.g., the so-called net level premium method) presume for solvency purposes that acquisition expenses are amortized over the premium-paying period. Accordingly, such methods overstate the reserve and therefore the reserve deduction. A more realistic assessment of the reserves for tax purposes might implicitly acknowledge that acquisition expenses consume all of the first year premium (typically) and, therefore, there would be no first year reserve and, hence, no reserve deduction.

102. In the first situation (using statutory reserves as the tax deduction basis), the insurer would deduct acquisition expenses and the first year reserve. In the second situation (using realistic assumptions), the insurer could still deduct acquisition expenses but not also the full statutory reserve. 29/ This problem does not arise, or at least is rendered less important, when tax authorities utilize their own, realistic reserve assumptions, rather than relying on statutorily-mandated assumptions. Developed countries generally allow immediate deduction of acquisition expenses and many permit deduction for statutory reserves. However, Canada has for some time prescribed the rules for tax reserves, and as from 1984, the United States will be basing its tax reserves on minimum statutory requirements, the effect of which can be to have no first year reserve deduction. France is also revising the manner in which acquisition expenses are reflected in reserve calculations, apparently for tax revenue reasons. As a practical matter, for a developing country, this problem might be ignored safely in the early stages of the total income approach, with reliance being placed initially on regulatory reserves. Also, it should be noted that the problem of reserve deduction affects the incidence of tax over a policy term, not the total quantum of tax.

103. Dividends (bonuses) paid on participating life insurance policies are usually deductible in whole or in part in determining taxable income under a total income tax system. In fact, there is usually a separate accounting of the income attributable to the participating business. If the insurer is a stock company, the shareholders may be entitled only to a small percentage of the profits of the participating business. If the insurer is a mutual, the company is owned by the policyholders, in which case profits of any non-participating business as well as that from the participating business may be distributed to the participating policyholders as policy dividends.

104. To some extent, policy dividends represent a return of excess premium, for premiums on participating policies are usually higher than for corresponding non-participating policies. However, to a further extent, they

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29/ In fact, a case can be made that as an offset to the immediate deduction of acquisition costs, a negative reserve in the first year could be appropriate, since acquisition costs often exceed the first year's premium.

represent distribution of income from the business operation. It would be very difficult to distinguish the two elements. 30/ To allow a full deduction for the policy dividends may reduce the tax base of a life insurer below the comparable corporate tax base of other businesses. Within the industry itself, to do so may give the mutual company an unfair advantage over the stock company.

105. The survey quoted earlier reveals that most countries allow a full deduction for policy dividends. 31/ However, Canada limits the deduction to the amount of the participating income. This tends to place stock and mutual companies on a similar basis. The deduction for policy dividends in Japan is limited to a deemed minimum return of 7 per cent on the insurer surplus, and in the Federal Republic of Germany, to the average investment return on stockholders' equity. Under the new system adopted in the United States in 1984, deductions for policy dividends paid by a mutual company will be limited to reflect a return on net worth, but full deductibility will be allowed stock companies.

106. Tax treatment of loss carryovers can be important. A loss carryover is the carrying forward (or backward) to other tax years of income tax losses from the current year. Since a life insurance business takes a long time to get established, a strong case can be made for having a carryforward period which is longer than for most business enterprises. Thus, for example, rather than a five-year carryforward, it could be entitled to a 10-year or 15-year carryforward. Countries follow a wide variety of practices with respect to carryforward periods for life insurers, varying from as little as five years to an unlimited period. A unique method of effectively providing a long carryforward period for a life insurer is that followed in Canada, where it is not necessary to claim the full amount of the maximum tax actuarial reserves.

107. A carryback of losses is an extra way of providing against unexpected adversity in a long-term business. However, possibly because of revenue considerations, many countries do not permit any carryback with respect to life insurers. The use of loss carryovers obviously complicates tax administration. And, except for the initial period, the typical life insurer - if well run - should not experience great fluctuations in its earnings and only rarely any loss at all - certainly not of the same order of magnitude as that of general insurers. Thus, while the use of loss carryovers is common and is laudable, its importance to well-established life insurance companies may not be too great. It can be important for new insurers.

108. Provision is also commonly made for some deductions of the type discussed earlier. For example, deductions are usually permitted for: (a) dividends received from domestic corporations (see para. 70); (b) earnings from priority investments (see para. 71); and (c) earnings from "socially desirable" life insurer products (see para. 72).

109. Consideration may be given also to a few other deductions. One is for a contingency reserve. Because of the difficulty in measuring annual income in a long-term business, and to help provide a cushion against unforeseen

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30/ For a clear discussion on this important, technical matter see, Henry J. Aaron, op.cit., pp. 23-27.

31/ C & L Tax Study.

catastrophes, permitting a deduction for contingency reserves might be considered. This could be especially appropriate where no deduction is permitted for carrybacks of losses. Certainly, the regulatory authorities favour an extra solvency margin. However, deductions for such additional reserves are rare in tax systems. The Netherlands does allow an equalization reserve of up to 5 per cent of policy reserves to meet catastrophic losses.

110. Premiums paid by a life insurer for reinsurance are universally allowed as a deduction. Occasionally, a distinction is made between licensed and unlicensed reinsurers, with deductions denied to the latter. Naturally, reinsurance benefits and commissions received by the ceding company from the reinsurer are included as income to the ceding company or netted against reinsurance premiums paid.

2. The tax rate

111. Regular corporate tax rates are commonly applied. This not only simplifies tax administration across industry groupings but also minimizes chances of misunderstandings. It is suggested that countries which elect to follow the total income approach to life insurer taxation use the regular corporate rate, making any special concessions through deductions.

3. Evaluation of the total income approach as a taxation basis

112. From the standpoint of equity, there can be little doubt that the total income approach to life insurer taxation represents about as workable an attempt as currently exists. However, it can be complex and many details have to be attended to if the system is to be equitable. Experience has also demonstrated the difficulty in achieving an adequate and stable tax base, especially during periods of high inflation.

113. Effective enforcement and administration of the system could require a number of skilled experts within the Government's taxation department, as well as in industry itself, depending on the details of the system. If this commitment is needed and cannot be made, a developing country would be well-advised to rely on variations of the methods discussed previously or to consider a simpler version of this approach.

E. Taxation of foreign-owned life insurers

114. If a country permits foreign-owned life insurers to conduct business, some special considerations apply, regardless of the tax system applicable in the country, and a few observations are in order. These observations imply no position as to either the desirability or feasibility of permitting non-resident or foreign owned, locally domiciled life insurers to conduct business in the country. Of course, the long-held UNCTAD position regarding maintenance of reserves in the country continues to be applicable, irrespective of the nature of the insurer.

115. In the main, no great taxation issues arise if a locally-domiciled life insurer is owned by foreigners. The local insurer would be subject to the same tax rules as any other life insurer, assuming the country adopted the attitude of economic neutrality in this respect. Perhaps the chief area of potential tax difficulty relates to the various management and technical services performed by the foreign owner (typically a transnational corporation) for its local subsidiary. The difficulty relates to whether the fees assessed the subsidiary by the TNC are reasonable and, indeed, whether

the services were performed at all. This area is highly complex, with many of the difficulties susceptable to resolution through tax treaties between the relevant countries. 32/

116. Where a non-resident insurer is licenced to carry on business in a developing country as a branch office, special rules may be needed to determine the investment income which is attributable to the branch operation. Furthermore, consideration could be given to a form of non-resident branch tax, which would give a treatment roughly comparable to the non-resident tax on dividends paid by a domestic corporation to its foreign parent. Alternatively, an elevated premium tax could be viewed as a surrogate for income taxation of such branch offices.

F. Other forms of life insurer taxation

117. Of course, income taxation is not the only form of taxation to which life insurers may be subjected. For example, it is not uncommon to levy taxation on the property owned by life insurers. This would be on the same rates and bases as those used for other corporate property owners. 33/ Life insurer license fees are perhaps the most pervasive of minor Government taxes. Such fees often serve a variety of functions, even extending to that of being a surrogate in some countries for income or sales taxes.

118. Some jurisdictions levy a capital tax. For example, three of the 11 provinces in Canada levy such a tax. The rate for British Columbia and for Manitoba is 1/5 of 1 per cent on paid-up capital in excess of $Can 1 million and $Can 750,000, respectively. The rate for Saskatchewan is 3/10 of 1 per cent for paid up capital in excess of $Can 10 million. The rationale for such a tax, beyond that of revenue production, is not clear.

119. The countries that are members of the Communauté financière africaine (CFA) impose a minimum business tax on all corporations. It is a function of the previous year's turnover and is available as a credit against profits tax. However, no refund is given if the business tax paid exceeds the profits tax. This tax is generally justified on the grounds that it is a safeguard against underreporting of profits. Even so, the tax has been the object of criticism. 34/

120. Life insurers also may be subject to the usual range of registration duties and stamp taxes on legal transactions or operations. The efficacy of such duties and taxes has also been questioned, especially in light of the

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32/ For a detailed discussion of these and related matters see, generally, the seventh report of the Group of Experts, Tax Treaties between Developed and Developing Countries, (United Nations publication, Sales No. E.78.XVI.1), especially, pp. 41-45.

33/ There are problems with property taxation in developing countries. See, e.g., the report of the expert group, Tax Reform Planning, (ST/ECA/135), United Nations publication, Sales No. E.71.XVI,1. (1971), p.6.

34/ "Tax Policy and Administration in Sub-Saharan African" Loc.cit., p. 30.

administrative effort they require relative to revenue raised. 35/

121. A few countries levy a tax (often a stamp tax or duty) based on sums insured by a life insurer. Tax rates must be exceedingly low because of the large denominations of life insurance policies relative to the premium charged. In the Philippines, for example, the rate is 1.75 pesos per 1,000 pesos insured, or 0.175 per cent. This is in addition to corporate income tax, premium taxes and certain investment taxes. The United Kingdom assessment is 0.05 per cent of the sum insured. Denmark's rates are 0.05 per cent of the sum insured with respect to term life insurance, and 0.3 per cent for cash value life policies. Singapore and Thailand have such a tax at a rate of .01 per cent and .05 per cent respectively. Of these countries, only the Philippines assesses premium taxes. A tax based on sums issued is appealing because of its simplicity. However, relatively few countries utilize it in their taxation system. Moreover, it can easily discourage the purchase of low premium policies (such as term insurance); the very types which lower income persons could possibly afford.

35/ Ibid., p. 31.

Chapter III

APPROACHES TO POLICYHOLDER AND BENEFICIARY TAXATION

122. As was made clear earlier, the manner in which a life insurance company is taxed can have an important influence on the competitiveness of its products and, thus, on the success or failure of efforts to promote life insurance within a country. However, insurer taxation is only one aspect of the taxation issue. The tax treatment of those who buy insurers' products or receive benefits from them can be equally important.

123. This chapter discusses in a general way the various tax approaches which Governments could adopt in respect of policyholders and beneficiaries. The measures to be discussed include tax policy relative to: (a) premium payments; (b) benefits payable during life; and (c) benefits payable on death. As with the previous chapter, the purpose here is not to suggest to Governments additional ways of taxing policyholders and beneficiaries. Rather, an attempt is made to explain the range of reasonable tax policy initiatives available to Governments, recognizing that exposing life insurance benefits to taxation under certain circumstances and, conversely, extending certain tax relief measures to it, can both be judged appropriate.

A. Tax policy relative to premium payments

124. This section is divided into two parts. The first part discusses tax policy related mainly to individually-owned life insurance and annuities. The second part focuses on tax policy relative to employer-provided benefit plans.

1. Life insurance and annuities

125. In recognition of the unique role that life insurance can play in society, many, if not most, countries grant some form of tax relief for premiums paid on qualifying life insurance policies. This can be an effective way of encouraging the purchase of life insurance and is judged to be worthy of consideration by developing countries which do not now provide for such tax relief or which provide exceedingly limited relief.

126. Perhaps the first country to grant an income tax deduction for life insurance premium payments was the United Kingdom. It was introduced in 1799, although removed some years later when the tax on income was abolished. It was re-introduced in 1853 and remained in effect until 14 March 1984. Its recent repeal was said to have been prompted by the Government's desire to introduce tax neutrality among all forms of savings and investments plus a growing Governmental irritation with certain abusive tax avoidance schemes associated with life insurance contracts. 36/

127. Other countries (e.g., India) provide tax relief not only for qualifying life insurance premium payments but for contributions to certain other forms of savings and retirement plans. Thus, to grant tax relief on life insurance premiums does not necessarily suggest denying similar deductions for other socially worthwhile financial undertakings.

36/ "LAPR Killed after 131 Years", The Post Magazine and Insurance Monitor, 22 March 1984, p. 684. It should be noted that the repeal applies only to policies issued or altered after 14 March 1984.

128. Numerous approaches exist to granting tax concessions but all have common features. First, each approach provides that only certain policies can qualify for relief. The definition of qualifying policies may be exceedingly narrow or quite broad, depending upon the overall objective in granting such relief. For example, both Canada and United States follow a narrow approach and grant no general tax relief on life insurance premium payments but each does provide that payments for certain types of annuities can qualify as tax deductible under individually-established retirement plans. Most other countries follow a broad approach, granting general tax relief for all but certain categories of policies. For example, Kenya provides tax relief for payments for all but annuity contracts. Most other African countries also provide broad-based tax relief. 37/ India's broad-based approach permits a deduction for payments on all life insurance policies except that no deduction is permitted for premium payments within a single year which exceed 10 per cent of the sum insured. This exception does not apply to payments for deferred annuities, which also qualify for deduction.

129. The second common feature is that each approach defines eligibility according to the life insured under the policy for which relief is sought. All countries granting some relief naturally provide relief to the policyholder and, in some manner, to his or her spouse. Some countries (e.g., Australia, India, Ivory Coast and Senegal) also provide relief for premium payments made for insurance on a child's life.

130. The third common feature is that all systems have some type of limitation as to the maximum amount of premiums paid which can be taken as a tax deduction. In most countries, the usual procedure is to state the ceiling as a percentage of salary and a fixed amount. For example, the United Kingdom provided that deductible premiums could not exceed £1,500 or one-sixth of the taxpayer's total tax-year income, whichever was the greater. Senegal provides for deductibility of premiums up to 5 per cent of the taxpayer's annual revenue but with a maximum ceiling of 100,000 CFA francs plus CFAF 20,000 for each child.

131. As to the procedure for implementing the system, one approach is to have taxpayers show the qualifying amount of the premium as a deduction on their income tax returns. With a progressive tax system, this means that the higher the income of the policyholder, the greater relatively is the tax benefit from owning life insurance. This is tempered in most countries by having fairly modest overall ceilings. Another approach is to permit a direct credit against income tax owed. This latter approach can be considered as being of relatively lesser benefit to high income earners.

132. Still another procedure is to allow policyholders to gain tax relief by taking a deduction directly from the premium remitted to the life insurer. The insurer then obtains reimbursement from the Government by taking a credit through its corporate tax return. This was the procedure adopted in 1979 in the U.K. For such a system to be viable, however, it is necessary to use the same implicit tax rate for everyone. The United Kingdom permitted a credit against the premium of 15 per cent, one-half the basic income tax rate. Such an approach tends to benefit lower income persons relatively more than upper income taxpayers. This procedure has the further obvious advantage of minimizing the administrative burden on taxpayers as well as on tax authorities.

37/ See Private Survey by Munich Reinsurance Company, op.cit.

2. Employee benefit plans

133. The tax policy adopted by Government relative to life insurer funded employee benefit plans can have a major impact on the demand by employers for such coverages. 38/ The wisdom of a favourable tax policy with respect to these plans is widely recognized in both developing and developed countries.

134. The almost universal approach is to permit the employer to deduct payments for such plans, as a legitimate business expense, for purposes of determining its taxable income. Also, and of great importance, payments made by employers on behalf of employees are not commonly considered as taxable income to the employees. Certain conditions, however, may have to be met if the payments are not to be considered as taxable income to employees, and limits may be placed on the exempted amount of coverage. These are intended to minimize the chances that higher paid employees receive a disproportionately large share of the benefits.

135. As stated in the secretariat's 1982 life insurance study, "... particular encouragement to the marketing of group insurance is advisable. These plans are an efficient and low-cost means of providing basic life insurance to many persons. "39/ The report went on to point out the reasons why Governments might want to take a special interest in such plans. These reasons still hold. The success or failure of efforts to promote such plans will be determined in large measure by the tax posture adopted by Governments toward the plans.

B. Tax policy relative to benefits payable during life

136. Life insurance benefits are typically associated with the death of the insured. However, in many countries, the so-called "living benefits" paid by life insurers exceed those payable upon death. This section discusses possible tax policy approaches which can be adopted by Governments with respect to life insurance benefits payable during life.

1. Policy dividends

137. As stated earlier, life insurance policy dividends represent in part a return to the policyholder of a deliberate premium overcharge. Logically, therefore, the mere return to policyholders of monies they had previously provided the insurer should not give rise to a taxable event. On the other hand, a portion of policy dividends is composed of insurers' favourable investment experience. Arguably, this portion should be taxable although any attempt to do so on a fair basis would prove exceedingly difficult. This has been explicitly or implicitly recognized by both developing and developed countries. Few, if any countries tax policy dividends as income to policyholders.

38/ For purposes of this report, life insurer funded employee benefit plans include group life insurance, group health insurance and employer-provided retirement or savings plans. Group health insurance can include group disability income coverage, group accident coverage, group hospitalization insurance and group medical expense coverage.

39/ TD/B/C.3/177 and Corr. 1, para. 104.

138. Moreover, any attempt to tax the investment income element of policy dividends at this time would be not only administratively difficult and time-consuming but also of so little value in terms of revenue generation as to be a money losing proposition for Governments of developing countries. The usual treatment of not taxing policy dividends represents a minor tax concession to life insurance promotion and can well be continued.

2. Policy cash values

139. As discussed previously, a case can be made that interest credited to policy cash values should be taxed as income to policyholders. Indeed, it might be argued that this is necessary to achieve tax neutrality in the treatment of the various forms of savings. However, only two countries - Canada and the United States - seem to have adopted measures to tax policyholders on the "inside interest build-up" in cash value life insurance policies and then, only on policies with high cash values relative to the death benefit. This is evidence of administrative difficulty and an implicit recognition of the social value of the savings inherent in some forms of life insurance.

140. Rather than attempt to tax policyholders on interest earnings within a policy, the usual approach is to adopt a measure of gain which is administratively simple and which minimizes policyholder confusion and displeasure. It involves taxing a policyholder only on surrender of the policy and then only to the extent that the benefits received (the cash surrender value plus the sum of all dividends received) exceed the sum of the premiums paid under the policy. This difference, if positive, would be subject to income tax. If the difference is negative, no taxable event is deemed to have occurred (and hence, no loss is usually permitted to be shown against income).

141. This net gain approach overstates the cost basis (total premiums paid) since, to be conceptually correct, only that portion of the premium which represents policy savings should constitute the basis. The charge for the mortality risk should not form a part of the basis. Since the basis is overstated, the taxable income is understated. Also, by postponing tax payment until policy surrender, the policyholder is deferring taxation; an obvious advantage, especially during periods of high inflation. If tax relief has been granted on premium payments, the cost basis would be reduced accordingly.

142. Even with these two problems, however, it is suggested that no attempt be made at present by most developing countries to tax the annual interest credited to policy cash values. The administrative complexities and resultant compliance costs would likely far outweigh tax revenue generated. If a country is interested in levying some tax on such earnings, it is suggested that the preceding approach be adopted as being a reasonable compromise between fairness and simplicity, or alternatively, a tax based on the investment pool concept, could be levied on the insurer.

143. There also exists other possible tax rules related to cash values. For example, some countries tax a person's wealth. This tax is levied annually on a person's adjusted net worth (i.e., assets minus liabilities), except that special allowances are permitted, in recognition of the fact that certain assets are essential for an individual's livelihood (e.g., agricultural produce, farm animals, one's home, etc.). It is common to exclude cash values

from such tax, with certain minor exceptions. This is because of the social benefit of life insurance. However, when a policy is terminated by surrender or death, any monies received normally lose their distinction as life insurance proceeds and are subject to the tax thereafter.

144. Another common tax is the gift tax. This tax is levied on the transfer of property by gift during the donor's life, subject, however, to a certain minimum amount which can be given free of tax. A life insurance policy is sometimes donated by one person to another. For example, a policy taken out on the life of a minor son by his father might be given to the child when he reaches adulthood. The measure of the value of a gift of a life insurance policy is usually the net cash value (gross cash value minus policy loans). This amount is usually subject to gift tax, although the normal allowances are available as offsets.

145. Finally, the cash value of a life insurance policy which is owned by someone other than the insured can be subject to estate taxation if the policyowner dies prior to the insured (e.g., a father owns a policy on his daughter's life and the father dies). In such cases, the tax basis of the policy for purposes of calculating the estate duty is usually the policy's net cash value.

146. Even if a country has a wealth tax, a gift tax and an estate tax, the total tax revenue generated by applying these taxes to life insurance cash values is miniscule. They are mentioned here for the sake of completeness, not because of their importance as revenue sources.

3. Matured endowments

147. Endowment insurance pays a stated sum of money (the maturity value) to the policyholder (or other person designated by the policyholder) if the insured survives a stated time period or on earlier death. Much of this insurance is sold in developing countries, although it is far less popular in most developed countries.

148. When an endowment policy matures because the insured survived the policy period, a portion of the proceeds may be subjected to income tax in many countries. Consistent with the policy of tax neutrality, it is suggested that developing countries consider taxing matured endowments in the same manner as they tax the gain on any other maturing investments (e.g., certificates of deposit or matured bonds) assuming, of course, that benefits have not been formerly subjected to taxation.

149. In general, taxation of endowment policies involves the same considerations as in the cash value discussion above and should be subjected to the same tax rules. This suggests that the appropriate tax policy upon maturity is the net gain approach whereby the sum subjected to tax is any positive difference between: (a) the maturity proceeds plus all dividends received in the past and (b) the sum of all (after-tax) premiums paid in the past.

4. Annuities

150. Annuities are of little importance in most developing countries, in terms of their proportion of life insurer total premium income. However, annuities can be an excellent vehicle through which citizens can save money although

their use in a highly inflationary environment should be discouraged unless investments backing the annuity reserves are sensitive to inflation and unless the products are appropriately designed. 40/ They also can give rise to large sums available for long-term investment. Government's tax policy relative to annuities can have a particularly important influence on their attractiveness to prospective purchasers. For purposes of tax policy analysis, issues can be divided into those that arise during the accumulation phase of an annuity, on the one hand, and those that arise during the liquidation phase, on the other. The accumulation phase is that time period during which currently or previously contributed funds are accumulating interest and before payments commence to annuitants from the insurer.

151. The issues which arise during the accumulation phase are: (a) whether any tax relief should be granted on payments made into the annuity and (b) whether interest credited to annuity cash values should be subject to current taxation. These two issues are related to each other as well as to the earlier discussions on tax relief on premiums and taxation of policy cash values. If Government's policy is to encourage private savings via tax policy, the granting of tax relief on annuity payments and the deferral of current income taxation on the annuity's interest build-up can be meaningful measures for accomplishing such encouragement. Because annuities during their accumulation phase are closely akin to other long-term private savings media, a policy of tax neutrality would suggest that the tax approach adopted for other retirement savings plans and for annuities should be compatible.

152. As mentioned earlier, many countries grant tax relief for payments into annuities. Those that do not grant tax relief for payments usually do not tax the annual interest credited to annuity cash values. Rather, they subject the cash value to tax only at time of liquidation or if a withdrawal of cash value is made prior to commencement of the liquidation phase.

153. The issues related to the liquidation phase of annuities are less varied than those of the accumulation phase. When the life insurer begins to pay to the annuitant the periodic annuity payment (typically monthly or quarterly), each payment can be considered as being composed of part principal and part interest. If the interest accretions have escaped taxation during the accumulation phase, a case can be made that each annuity payment should be subject to tax to the extent that it represents past, untaxed interest earnings. Moreover, if tax relief has been granted for premium payments during the accumulation phase, a further argument can be made that the portion of each annuity payment that represents principle should also be subject to tax. Of course, the converse applies also in each case.

154. Taxing annuity payments to the extent that the annuity has been the object of special tax concessions during the accumulation phase is common practice in most countries. This approach is logical if it maintains tax neutrality among the various retirement funding vehicles although a country may, as a matter of policy, want to avoid burdening retirees with such

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40/ The issue of general life insurance product design - not just that of annuities - is a highly important, often overlooked area. It does life insurance purchasers little good if the benefits associated with a favourable tax policy (or, for that matter, favourable experience associated with investment, expense and mortality results) are not or cannot be passed on to policyholders through appropriately designed products.

taxation. Developing countries could derive much benefit from encouraging more use of annuities provided investments are inflation-sensitive and the products well-designed. It is suggested, therefore, that where conditions are appropriate, consideration be given both to granting tax relief on contributions to annuities and to avoiding attempts to tax yearly interest accretions during the annuity accumulation phase, instead relying only on a tax on any gain on withdrawal.

155. The comments on wealth taxes, gift taxes and estate taxes made in paragraphs 143-146 apply equally well to annuity cash values.

5. Employee benefit plans

156. As discussed above (see paras. 133-135), it is common practice to encourage the purchase by employers of various benefit packages for their employees. A favourable tax system regarding such plans is universally acknowledged as an effective means of helping to accomplish the goal. Favourable tax treatment extends not just to employers but also to employees. Thus, life or health insurance benefits received by employees or their dependents through employer-provided group life or group health insurance are sometimes not subject to income tax, although disability income benefits may enjoy only partial exemption.

157. Benefits received by employees from employer-funded retirement plans are usually subject to income tax upon receipt but only to the extent of each payment. This tax treatment presumes that contributions by the employer toward the retirement plan were taken as tax deductions and the contributions to employees were not taxed. This balanced approach to retirement benefit taxation is judged fair, although special concessions might be afforded retirees.

G. Tax policy relative to benefits payable on death

158. The average policyholder purchases life insurance because of a recognition that his or her death would cause financial hardship to dependents and he or she wishes to minimize this hardship. The purchase and retention of a life insurance policy, therefore, often relies on the noblest of human motivations.

159. It seems often to be the situation that the more life insurance is integrated into a society, the greater is its utility to those in society who need it most. In other words, in the initial stages of life insurance development in a society, middle- and upper-income persons tend to be the main purchasers of life insurance. As life insurance assumes a role of greater importance and achieves more acceptance, more suitable products and marketing techniques are developed for lower income persons, with the result that the characteristics of the average life insurance buyer then shift to be those of lower and middle income persons; typically those who can benefit most from well-designed life insurance policies.

160. In recognition of: (a) the motives behind life insurance purchase, (b) the typically great financial need of surviving dependent individuals, and (c) the sympathy for the bereaved survivors, few countries impose general income tax treatment on death proceeds payable under a life insurance policy. It is recommended, therefore, that life insurance death proceeds be received by the policy beneficiary free of any income tax.

161. However, Governments are not hesitant about subjecting life insurance death proceeds to wealth and estate duties. 41/ The reason is simple and understandable. If an insured had $1,000 in a bank immediately before death and $2,000 in the bank immediately afterward, and the additional $1,000 came from proceeds of a life insurance policy, there really is no essential distinction between the first and the second $1,000, except for the obvious fact that there is now more money. Both a wealth tax and an estate tax would be blind to the sources of the $2,000 bank account. If the total assessable net worth of a deceased after, taking all applicable deductions, is above the stated minimum level in the law, then life insurance death proceeds are appropriately assessed tax.

162. It should be pointed out, however, that there are legitimate ways of avoiding estate duty on life insurance death proceeds. The typical estate tax law provides that all property controlled or owned by the deceased person or payable to or for the benefit of the deceased person's estate is to be included in the gross estate calculation for estate tax purposes. The key to determining whether a life insurance policy insuring the deceased's life is to be included in his or her estate is whether the deceased owned or controlled the policy. If someone else owned the policy and the policy was not payable to or for the benefit of the estate, then the proceeds logically ought not to be included in the gross estate.

41/ A distinction is made between an estate tax and an inheritance tax. An estate tax is levied on the transfer of property because of death. An inheritance tax is levied on a recipient's right to receive property. Some countries have both types of taxes. Others have only one. Life insurance death proceeds up to a certain stated maximum and payable to certain named beneficiaries (e.g., surviving spouse, parents, or children) are often exempted from inheritance taxation.

Chapter IV

LIFE INSURANCE TAXATION MODELS FOR DEVELOPING COUNTRIES

163. The difficulties of designing an appropriate tax system for life insurance companies, policyholders, and beneficiaries are evident from the preceding discussion. Economic neutrality and social equity must give way to some extent to revenue needs and administrative feasibility, especially in developing countries. It is not possible to develop specific recommendations which would be appropriate in every or even most circumstances. However, certain general models or patterns can be suggested for various degrees of development, and these are set out as a guide in Annexes I and II. Annex I provides three possible models for life insurer taxation. Annex II does the same for policyholder and beneficiary taxation. These models should be understood to be illustrative of possible general patterns only. Many other variations exist. Decisions regarding a specific tax system should be undertaken only after careful study by the concerned country.

164. Taxes on premium income and on investment income, based on the investment pool concept (see paras. 61-80), would be the only taxes for Model I. The rates for each tax would, for reasons explained earlier, start and remain low. Implicit in this model is that tax administration must be kept simple. Provision would be made for a limited number of deductions only, so as to retain simplicity. Thus, to spur domestic development and investment, allowance is made for three deductions (domestic dividends, priority investments and small business) against investment income. To try to retain economic neutrality and to promote certain socially desirable life products, allowance is made in both taxes for deductions of policy dividends and for special life products.

165. Model II would be appropriate for a somewhat more advanced tax administration. It is composed of a tax system based on the total income approach, but on a simplified basis. To foster equity and development objectives, deductions are generous but not at all unreasonable. As an important concession to simplicity, the reserve deduction would be based on the calculation submitted by the insurer for insurance supervisory purposes. Policy dividends would be deductible in full under this approach. No premium tax is envisioned, because of its regressive nature, although it must be acknowledged that a tax system based on total income which allows deduction for statutory reserves may be considered as producing insufficient tax revenues. If this is the case, consideration may be given to a very modest premium tax.

166. Model III would represent a move toward more economic neutrality and equity. It, too, would be based on the total income approach. However, it would rely on specific "tax reserves" rather than those used for statutory purposes. Also, it would limit the deductibility of policy dividends in an effort to equalize tax treatment between stock and mutual life insurers. Model III would be appropriate for a country with a fairly advantaged tax administrative arrangement and life insurance industry. It is noted that premium tax in this situation should not be needed and, indeed, could be judged to violate the concept of economic neutrality.

167. The three models shown in Annex II correspond to those of Annex I as far as insurance company taxation is concerned. Just as insurer taxation in Annex I became more complex and more equitable as each successive model is examined, so too do policyholder and beneficiary tax measures become more complex and equitable with each model in Annex II. Thus Model I provides generous tax concessions in an effort to promote life insurance. Tax relief would be granted on payments for both life policies and annuities and any gains during lifetime would be subject to favourable tax treatment.

168. Model II retains some of the advantages of Model I but would presume that tax administration was at such a level as to permit the taxation of net gains on policy surrender as well as taxation of the interest portion of each annuity payment during the liquidation phase. Model III would track Model II except that tax relief for premiums paid by individuals would be abolished in recognition of the economic neutrality concept. The country may want to consider further, making a distinction in taxation of the inside interest buildup on policies that are primarily investment oriented and those that are primarily death protection oriented; with the former being subjected to special tax rules.

169. It is questionable whether further specific tax incentives, beyond those discussed in this report, are needed in relation to insurance company taxation. Provided the rules for computing the income and deductions are designed along the lines discussed, subjecting the remaining tax base to reasonable tax rates should not be too onerous. Furthermore, taxes can be kept low to the extent that there are tax incentives in the developing country's general tax system for investment in domestic companies or for other domestic purposes and these are fully available to a life insurance corporation.

ANNEX I

Three models for life insurance company taxation in developing countries

	Model I		Model II	Model III
General approach to Taxation	Tax on premium and investment income ("pool"concept)		Tax on total corporate income	Tax on total corporate income
Starting base	Gross premiums	Gross investment income	Total corporate income	Total corporate income
Allowable deductions				
General expenses	--	no	yes	yes
Investment expenses	--	no	yes	yes
Change in policy reserves	--	--	yes-statutory	yes-tax reserves
Reserve interest	--	no	--	--
Domestic dividends received	--	yes	yes	yes
Priority inv. earnings	--	yes	yes	yes
Policy dividends paid	yes	--	yes-fully	yes-limited
Special product exemption	yes	yes	yes	yes
Loss carryovers	--	--	yes	yes
Benefit payments	no	no	yes	yes
Tax rate	1-2%	2-5%	Regular corp. rate	Regular corp. rate

NOTE: Dashes (--) denotes "not applicable".

ANNEX II

Three models for policyholder and beneficiary taxation in developing countries

	Model I	Model II	Model III
General approach to insurer taxation (Annex I)	Tax on premium and investment income ("pool"concept)	Tax on total corporate income	Tax on total corporate income
Tax deduction for premiums			
Individuals	Yes	Yes	No
Employers	Yes	Yes	Yes
Taxable Lifetime Gains			
Policy dividends taxed?	No	No	No
Net gains on surrender taxed?	No	No	Yes
"Inside" interest taxed?	No	No	No
Annuity payments taxed?	No	Yes	Yes
Employer-provided benefits taxed?	No	No	No
Death proceeds subject to income tax	No	No	No