LIFE INSURANCE INDUSTRY

Submission to the Review of Business Taxation

A Platform for Consultation

16 April 1999

Contents

1 Executive summary

During February 1999 the Review of Business Taxation (the Review) released a discussion paper "A Platform for Consultation" and requested feedback from the business community. The purpose of this submission is to present the response of a group of members of the life insurance industry to the Discussion Paper.

The signatories to this submission represent the majority of the life insurance industry in response to *A Platform for Consultation*.

1.1 Support for reform principles

The signatories to this submission support the policy settings underpinning tax reform and have developed this submission within this framework. Our interpretation of these policy settings as they relate to life companies are as follows:

- transparency, auditability and simplicity
- consistent product treatment
- competitive neutrality
- enhanced international competitiveness
- improve efficiency and administration.

We are committed to assisting the Review achieve its objectives. The principal concern driving our proposals is the need to achieve competitive neutrality and reasonable transition to the new system of taxation with prospective application.

1.2 The life insurance industry

The signatories to this submission manage over 23% of the Australian funds management industry, of which life insurance is a substantial component. As a collective group, the companies making this submission manage funds on behalf of approximately 4.6 million policyholders.

Funds managed for policyholders and shareholders by the life companies making this submission.

Life company	Total company Australian assets under management $billion[1]	Total Australian life office assets $billion[2]	Australian policyholders million	Australian shareholders million
AMP	53.7	24	1.7	1.0

[1] ASSIRT Market share report, December 1998
[2] Source Rice Kachor Research June 1998

Colonial Mutual	25.8	10.8	1.3	0.4
GIO	9.8	3.6	0.3	0.1
National Mutual	21.9	9.2	1.1	0.5
Royal Sun Alliance	0.7	0.6	0.2	n/a
	111.9	48.2	4.6	2.0

Our submission is made on behalf of these policyholders and shareholders. We want to ensure that they are not disadvantaged by the new tax system proposed by the Review.

1.3 Focus of our submission

We support the Investment & Financial Services Association (IFSA). We have not repeated its submission, but have sought to develop and expand on the issues of most concern to our customers and shareholders to address anomalies and present workable solutions.

We agree that future life insurance business should be taxed as follows:

- *shareholders* - earnings derived from their interests in the business to be taxed at the corporate rate
- *policyholders* - to be taxed on the same basis and at the same rate as the appropriate investment-type benchmark.

For both existing and future business there must be horizontal equity between savings vehicles and competitive neutrality between providers of savings products. It is essential that changes do not unfairly treat existing policyholders. Central to an equitable, efficient and neutral outcome is the need to determine an appropriate benchmark for life insurance policyholders.

In reaching this position it should be acknowledged that we have accepted the majority of the tax reform proposals and that our concerns are limited to only those matters which do not meet the tax reform policy settings. These matters are:

- equitable taxation of life company superannuation
- equitable transition arrangements
- symmetry and equity in taxation of management fees.

1.4 Benchmarks for investments and entities

Benchmarks are clearly critical so that any proposed tax changes do not create further distortions. The issue which needs to be addressed for life insurance is neutrality. There are two strands of neutrality identified in *A Strong Foundation*:

- *type of investment* neutrality – business tax arrangements should avoid differentially taxing the same type of investment
- *entity* neutrality – business tax arrangements should avoid differentially taxing either the type of entity, or entity financial alternatives, or the type of income distribution from entities.

The Review should ensure that the tax arrangements being proposed are such that an investor in a saving vehicle is taxed on the same basis, regardless of the type of entity offering the saving product.

For ordinary life insurance saving policies, we generally accept that the investment benchmark for these products is a unit trust. For allocated and life annuities, the investment benchmark is a pension offered by a superannuation fund, and a bank account for term annuities.

Superannuation investments should be benchmarked against a directly invested superannuation fund.

Comparison of tax benchmarks

Main product categories	Investor (individual/ corporate)	Appropriate tax benchmark
Ordinary business	I	Unit Trust/Bank Account
Individual superannuation	I	DIY fund/RSA
Corporate superannuation	C	PST/Direct Superannuation Fund
Annuities		
Allocated/Fixed Term	I	Superannuation fund/Bank account
Lifetime	I	None

These benchmarks are generally accepted by the Review. However, we have a major issue on the benchmarking of entities, specifically, there is a major ramification for superannuation.

Superannuation should be taxed on the same basis, regardless of the type of entity offering the superannuation product.

We consider the non neutrality relative to the direct share investor has nothing to do with entity taxation/neutrality. It would exist purely because of the deliberate measures to tax superannuation investments more lightly than direct investments. That is, this particular non neutrality is in respect of the type of investment, not the entity of investment, and is a deliberate means of (partly) overcoming the bias against saving inherent in an income tax system.

Disadvantages for Life Insurance Superannuation Investors

We set out below what gives rise to the relative policyholder disadvantages for superannuation investors in a life company under the proposed tax reforms:

Tax reform proposal	Life co superannuation investor	PST/unit trust investor	Superannuation fund direct investment	Industry funds
Tax rate for superannuation achieved by refund arrangements	Yes	No (taxed directly at 15%)	No (taxed directly at 15%)	No (taxed directly at 15%)
Taxation of unrealised gains	Yes	No	No	No
Retrospective tax on in-force long term contracts	Yes	No	No	No
Tax preferred income	No	Yes?	Yes	Yes

This analysis is predicated on the understanding that PSTs will be taxed as present. If this is not the case, the disadvantage for PST investors are the same as for policyholders.

Disadvantages for Life Insurance Ordinary Savings Investors

The relative disadvantages for non-superannuation policyholders are also illustrated:

Tax reform proposal	Life co investor	CIV, as defined	Direct investment	Non CIV trust
Flow through	No	Yes	Yes	No
Tax preferred income	No	Yes?	Yes	No
Taxation of unrealised gains	Yes	No	No	No
Retrospective tax on in-force long term contracts	Yes	No	No	No

There are also inequities arising from changing the tax treatment of management fees without relief for investors.

We acknowledge the need for simplicity in taxation arrangements but believe that this aim has lead to a significant and potentially damaging lack of investment neutrality. Unless the nature of the interests held by policyholders is acknowledged (being that direct savings are not a business) life insurance policyholders will be unfairly disadvantaged relative to investors in essentially equivalent vehicles.

1.5 The role of the life insurance industry

The life insurance industry provides a vehicle for long term investment and retirement savings. It provides protection to individuals and corporates through its stability, strength and regulatory framework. If the benchmarking is not correct and life company policyholders suffer inequity relative to investors using alternative vehicles this would force restructure and remove unique benefits of the industry. Life companies would become providers of insurance risk protection and annuity business only.

Of immediate concern is the fact there has been press speculation[3] about the possible effects of tax reform on life insurance policyholders. Uncertainty can directly and unnecessarily affect investor confidence without leading to better investment solutions. Due to uncertainty with the tax reform proposals we are unable to address our policyholders' concerns.

1.6 Business Tax Reform proposals

There are three significant tax reform issues which create the anomalies we are seeking to address. These are set out below together with workable, equitable solutions. The solutions are consistent with those proposed by IFSA. The issues are:

- equitable taxation of life company superannuation;
- equitable transition arrangements; and
- symmetry and equity in taxation of management fees.

[3] For example, a recent *Personal Investment* article includes the following quote:
'all of [the life insurance bond] system will go because they propose to tax life bonds at 36%. It won't matter how long you hold it for"

1.6.1 Equitable taxation of life company superannuation

The proposed taxation of life company superannuation disadvantages policyholders relative to investors in equivalent products - due to the taxation of unrealised gains, the taxation of income on reserves at the corporate rate and cashflow delays in the superannuation refund mechanism, life company superannuation policyholders will be unfairly and inequitably treated relative to all other superannuation products (PSTs, industry funds, unit trusts and direct investments). This will:

- disadvantage the retirement savings of millions of Australians with investments in life company superannuation
- significantly reduce the attractiveness of capital guaranteed products
- have flow on effects for investment in infrastructure.

Solution: Competitively neutral taxation of superannuation using either a virtual PST structure taxed as a PST or an RSA structure.

1.6.2 Equitable transition arrangements

There are three matters under this heading:

- changes to the taxation basis for long term life insurance contracts;
- start date; and
- annuity capital gains tax cost base.

1.6.2.1 Changes to the taxation of long term life insurance contracts is inequitable if it has retrospective effect[4]. It is a cost largely borne by policyholders.

New products can be designed to deal with this in the future, but policyholders have committed to long term contracts priced and sold under existing tax arrangements (including tax exempt status for annuities, 15% for superannuation and certain treatment of management fees). The proposed fundamental changes to the tax system will substantially impact returns to policyholders. The products will become non-competitively neutral with comparable products because policyholders will bear a substantial part of this burden. This will result in:

- reduced return on long term savings.

[4] For the purpose of this submission *retrospective effect* is defined as amendments to the tax law which will affect expenditure already committed and arrangements which can not be changed

– a disincentive to enter into long term savings contracts because an effectively retrospective charge will mean that investors will be concerned that government may *change the rules* again in future.

Solution: Elimination of retrospectivity for in-force life insurance policies through grandfathering /transition.

1.6.2.2 The start date will have a significant effect on life insurance companies:

- for life companies with early substituted accounting periods, the effective start date for policyholders will be as early as 1 January 2000 which would result in competitive non-neutrality
- the start date does not allow adequate time for implementation.

Assuming a common start date, companies will have inadequate time to prepare by 1 July in any case. They will be required to implement substantial changes to, for example, products, systems, new policyholder distribution mechanisms and training. This will inevitably result in a significant increased cost which comes from forced implementation. Without the certainty of legislation, particularly with the number of options in the proposals, organisations need to plan around uncertainty because of the limited time between approval of the legislation and the start date.

Solution: A common or phased start date for all taxpayers, being the later of 1 July 2001, or the first 1 July after Royal Assent of the relevant legislation.

1.6.2.3 Changes to the taxation of profit made on annuity business will mean that the sale of assets used to back annuities will now be subject to full tax

As this business was previously exempt, those gains should only be taxable on increase in value after the date of change. Without relief, the capital gains tax base for annuities could include gains made prior to the start date.

Solution: Eliminate effective retrospectivity by adjusting cost base.

1.6.3 Symmetry and equity in taxation of management fees

There is a lack of symmetry and competitive neutrality in the proposed taxation of policyholder management fees on future products – some management fees will be taxable to the life company but not deductible to the policyholder. Investors in other products will receive a deduction for fees thereby making equivalent life company products uncompetitive.

Solution: Further clarity should be provided on the deductibility of certain fees paid by policyholders (eg fees on annual premiums) and life companies should be allowed a reasonable period to review products consistent with our view on a deferred start date.

1.7 Other matters

In addition, this submission expands on comments made by IFSA and makes additional comments on:

- some technical life insurance specific matters
- other corporate tax matters raised by the Review.

We look forward to working with the Review to achieve workable, equitable outcomes.

02 Introduction

On behalf of the Australian life insurance industry, we commend the Government for establishing the Ralph Committee to oversee a review of business taxation. The Review's discussion paper *A Platform for Consultation* is broad reaching in its coverage of business tax, and we support the objective of the Review, that being to make recommendations about the fundamental redesign of business tax arrangements. We also support the objective for a more stable, simple and more efficient business tax system. Such a system can lead to improved competitiveness, greater productivity, higher domestic product and importantly, higher levels of national saving.

The Government is also proposing major changes to the taxation of life insurance products and the tax paid by life office policyholders. The signatories hereto want to ensure that the proposed entity tax regime does not adversely affect policyholders, nor competitively disadvantage life insurance companies in offering financial services.

This submission is in two parts. First, the submission deals with the entity tax framework and how it applies to insurance companies and our policyholders. Second, the issue of taxing the investment in a business is dealt with.

We acknowledge that the Government and the Review is proposing to move our hybrid business tax system towards a more comprehensive income tax base, rather than moving towards a more expenditure tax base. Nevertheless, as an industry, we encourage the Review to reinforce the place for long term saving as a goal of tax reform. We are concerned that some aspects of the proposals do not support savings and will actually create disincentives to enter long term savings arrangements.

2.1 The role of the life insurance industry

The life insurance industry provides a vehicle for long term investment and retirement savings. It provides protection to individuals and corporates through its stability, strength and regulatory framework.

The present taxation of ordinary policies has enabled life offices to offer relatively simple ‘tax paid’ policies. Going forward, the proposals are likely to lead to far more complex products and ones which will not be attractive to policyholders.

For superannuation fund trustees life insurers materially reduce the costs of superannuation investment via economies of scale and other services. Life insurers offer services to smaller superannuation funds that reduce their record keeping and other administrative costs, together with funds management and risk protection. Often these services are provided via a single, tax paid product, significantly simplifying otherwise complex and costly arrangements. If life insurance companies are unable to offer superannuation, this would lead to substantially increased compliance costs for government (ATO and APRA) and for small superannuation funds as they would be required to separately meet compliance obligations. There would be a misallocation of resources through increased administration and compliance costs and less well informed investment decisions

If these unique attributes of life insurance savings are ignored, such that life company policyholders suffer inequity relative to investors using alternative vehicles, this would force a restructure of the industry. Life companies would become providers of insurance risk protection and annuity business only. Specific implications of the proposals would be:

- the ability to protect savings against a fall in capital values using cost-effective capital guarantees, would no longer be competitive. This is particularly important as investors approach retirement, are more likely to use these products. Currently, over $37 billion of Australia’s retirement savings are already invested in capital guaranteed products;
- life office investment represents a significant proportion of the $9.3 billion invested by Australia in its infrastructure in the last two years. Total infrastructure deals, including foreign investment, are $21.7 billion in this period. A reduction in the investments managed by life offices would significantly reduce Australian investment;
- the capital markets would be significantly disrupted generally with the reinvestment of $123 billion in life company superannuation funds under management due to transfers and reinvesting of portfolios;
- there would be a need to provide full Australian CGT, revenue and stamp duty relief and seek foreign relief for substantial foreign holdings;
- there would be a significant non-value added cost of transferring policyholders to non-tax disadvantaged structures. For investment linked policyholders and deferred annuity

policyholders, there would be no added benefits, and for capital guaranteed policyholders, benefits currently provided by the capital guarantees would reduce; and

- many life company agents will need to requalify to sell non-life products.

3 Taxation of life companies

We are supportive of the general policy settings for life company/policyholder taxation. Going forward the policy will tax:

- income on shareholder capital at the corporate rate;
- profit from underwriting and annuity business; and
- policyholders at their marginal rates on benefits paid on investment contracts.

The proposals, however, contain various anomalies that will have significant impacts on our policyholders and shareholders and could prevent the objective of the Review being met. The purpose of this submission is to address these anomalies and suggest potential solutions for your consideration. Our discussion is under the following headings:

- benchmark for investments and entities;
- taxation of superannuation;
- transitional arrangements;
- policyholder taxation on existing life insurance business; and
- other life insurance matters

3.1 Benchmarks for investments and entities

Benchmarks are critical so that any proposed tax changes do not create distortions. The issue which needs to be addressed for life insurance is neutrality. There are two strands of neutrality identified in *A Strong Foundation*:

- *type of investment* neutrality – business tax arrangements should avoid differentially taxing the same type of investment

- *entity* neutrality – business tax arrangements should avoid differentially taxing either the same type of entity, or entity financial alternatives, or the same type of income distribution from entities.

The Review should ensure that the tax arrangements being proposed are such that an investor in a saving vehicle is taxed on the same basis, regardless of the type of entity offering the saving product.

For ordinary life insurance saving policies, we generally accept that the investment benchmark for these products is a unit trust. For allocated and life annuities, the investment benchmark is a pension offered by a superannuation fund, and a bank account for term annuities.

Superannuation investments should be benchmarked against a directly invested superannuation fund.

Comparison of tax benchmarks

Main product categories	Investor (individual/ corporate)	Appropriate tax benchmark
Ordinary business	I	Unit Trust/Bank Account
Individual superannuation	I	DIY fund/RSA
Corporate superannuation	C	PST/Direct Superannuation fund
Annuities		
Allocated/Fixed Term	I	Superannuation fund/Bank account
Lifetime	I	None

These benchmarks are generally accepted by the Review. However, we have a major issue on the benchmarking of entities. Specifically, there is a major ramification for superannuation.

3.1.1 Superannuation entity benchmark

Superannuation investments by members should be taxed on the same basis, regardless of the type of entity offering the superannuation product.

This result would be achieved, if all entities identified by the Review were to be taxed under the entity tax regime. However, superannuation funds (industry funds and non life master trusts, and directly invested superannuation funds) while defined as entities, have been left outside the entity tax regime.

In addition, there is an option to maintain the taxation of PST's as it currently stands, implying that PST's would also be outside the entity tax regime. On the other hand, life insurance companies are to be taxed under the entity tax regime. By including some providers under the entity tax and excluding others, it results in entity non-neutrality.

The debate about the taxation of superannuation business conducted through life insurers seems, at times, to confuse the two strands of investment neutrality. It has been argued that not applying entity taxation to life insurers' superannuation business would introduce a tax non-neutrality between life insurers and, say, individual's investing directly in a public company.

That is not the case. The non neutrality relative to the direct share investor has nothing to do with entity taxation/neutrality. It would exist purely because of the deliberate measures to tax superannuation investments more lightly than direct investments. That is, this particular non neutrality is in respect of the type of investment, not the entity of investment, and is a deliberate means of (partly) overcoming the bias against saving inherent in an income tax system.

While the Review attempts to maintain entity neutrality by proposing an efficient refund mechanism for those superannuation providers captured by the entity tax regime, the system is not effective.

Although explained more fully at 3.2.1 below, it does not achieve the desired result because the imputation refund mechanism does not restore the effective tax of superannuation offered by a life company to the same basis as the tax on superannuation directly invested by a superannuation fund.

If superannuation business conducted through life insurers is subject to entity taxation, life insurers would face a substantial timing disadvantage because tax would be payable at the company tax rate many months in advance of when the superannuation fund receives the rebate. Even if this timing disadvantage and taxing unrealised gains could be fully overcome, the problem of having a 30-36% headline tax rate would remain.

Hence, life insurance companies would be placed in an uncompetitive position against other superannuation providers which contradicts the objectives of the Review. In effect, life insurance superannuation should be benchmarked for taxation purposes against its competitors (such as industry funds, master trusts and PSTs) which are outside the entity tax regime.

We set out below what gives rise to the relative policyholder disadvantages for superannuation investors in a life company under the proposed tax reforms:

Comparison of proposed taxation of superannuation through different savings vehicles

Tax reform proposal	Life co superannuation investor	PST/unit trust investor	Superannuation fund direct investment	Industry funds
Tax rate for superannuation achieved by refund arrangements	Yes	No (taxed directly at 15%)	No (taxed directly at 15%)	No (taxed directly at 15%)
Taxation of unrealised gains	Yes	No	No	No
Retrospective tax on in-force long term contracts	Yes	No	No	No
Tax preferred income	No	Yes?	Yes	Yes

This analysis is predicated on the understanding that PSTs will be taxed as present. If this is not the case, the disadvantage for PSTs are the same as for policyholders.

The relative disadvantages for non-superannuation policyholders are also illustrated:

Comparison of proposed taxation of non-superannuation through different savings vehicles

Tax reform proposal	Life co investor	CIV, as defined	Direct investment	Non CIV trust
Flow through	No	Yes	Yes	No
Tax preferred income	No	Yes	Yes	No
Taxation of unrealised gains	Yes	No	No	No
Retrospective tax on in-force long term contracts	Yes	No	No	No

There are also inequities arising from changing the tax treatment of management fees without the opportunity to review our product structures.

We acknowledge the need for simplicity in taxation arrangements but believe that this aim has lead to a significant and potentially damaging lack of investment neutrality. Unless the nature of the interests held by policyholders is acknowledged (being that of direct savings are not a business) life insurance policyholders will be unfairly disadvantaged relative to investors in essentially equivalent vehicles.

3.2 Taxation of superannuation

3.2.1 Taxation of superannuation investment income

The Review has proposed an immediate refund mechanism to bring life insurance superannuation policyholder taxation from the entity rate to the superannuation rate. This has been proposed with the intent of ensuring competitive neutrality with other superannuation vehicles, such as PSTs. We agree that competitive neutrality must be achieved, but this option does not achieve this for the following reasons:

- It has the unintended effect of taxing unrealised gains as they are credited to policyholders by way of bonuses. Bonuses are credited to policyholder balances, not distributed in cash. The amounts credited can include unrealised gains. No other products require the payment of tax on unrealised gains. This will suppress investment returns to policyholders while investors in equivalent products, for example PSTs, bear no such charge
- The refund is delayed until a policy matures, is surrendered or an annual bonus assigned. However, for investment linked business, this could be up to 15 years later, which makes our product uncompetitive. While it has been suggested that we could re-design our products to assign income on a more regular basis, it would not be reasonable to expect life companies to do this when there are other options available to fix the problem. The reasons for the delay in the refund is that tax is paid every 3 months but the refund is obtained only when bonuses are assigned to policyholders, which is generally annually and/or at the end of the contract.
- The delay in refund plus the need for more liquid assets to pay the tax degrades the return to the superannuation fund.
- For capital guaranteed business, a proportion of investment earnings will not be distributed to enable a stable release of income over time. The refund mechanism does not allow for this and so reserves would be taxed at the corporate rate. Many superannuation funds, mainly industry funds, also provide smoothing as part of guaranteeing income, but will not suffer this effect.
- The refund does not cater for tax preferences or indexation of capital gains.

The immediate refund mechanism is not efficient in restoring the effective tax on superannuation offered by a life insurance company to the same basis as directly invested superannuation.

If not addressed, the consequences will be:

- investment in life company superannuation business will become uncompetitive, superannuation customers will either choose not to invest with life companies, or life companies will fundamentally restructure their business;
- transfer of $123 billion in Australian life company superannuation, representing the interests of over 5 million individuals, out of life companies. This would require life companies to write to each trustee, issue new documentation, transfer interests from one system to another and for the policyholder to suffer the costs of tax on gains and stamp duty which crystallise on disposal;
- employers who have organised superannuation through life insurance policies will incur additional administration burden at the same time as they are dealing with GST and the effects of tax reform on their own businesses;
- superannuation members will be effectively denied a high yielding capital guaranteed product due to the inefficiencies of the imputation refund mechanism proposed by the Review. These benefits cannot be replicated in a PST because it does not have the necessary capital to provide guarantees equivalent to those provided by life companies;
- while limited, largely income only guarantees are provided by industry funds using member capital, these should not be equated with the stronger, regulated capital guarantees provided by life companies. A capital guarantee is an important safeguard for retirees with no ability to earn income, other than through the welfare system. It is also an important alternative to cash, which although guaranteed, does not provide the income levels which may be needed for retirees to be self sufficient;
- funds will be moved from a prudentially regulated environment to an environment regulated by full disclosure only; and
- life insurance companies have been central to investing large amounts of superannuation funds into infrastructure projects. If superannuation is no longer offered by life companies, there will be a shift to investment linked products and a consequential change in investment strategy from maximising returns in the long-term to a more short-term form. This is because investment linked consensus evaluated based on unit price and competitiveness would be reduced if reserves were held to support long-term investments, eg in infrastructure. This will significantly reduce the level of infrastructure investment currently invested by life companies.

Analysis provided by a major life company indicates that an average wage earner with superannuation retirement savings investing through a life insurance policy will lose almost 14% of their final retirement benefit, due to tax reform compared to an industry fund or PST.

In addition, the real-time tax credit system will be complicated to administer and complex for policyholders to understand. We note the complexity of administering the superannuation surcharge as an example of a policy decision with unintended, non-value added administrative costs. Recently announced changes by the government, in an attempt to streamline the operation of the superannuation surcharge, illustrate that more than two and a half years after its announcement, a hastily put together piece of legislation continues to cause major problems. Our solution seeks only to address the administrative burden and unintended taxation effects, while preserving the intent of the policy.

Our preferred solution is to tax life company policyholder superannuation funds as a PST (a virtual PST) or a Retirement Savings Account structure. Both alternatives are proposed and elaborated upon in the IFSA submission with which we concur. We also refer you to the Institute of Actuaries submission in which comment is made on these proposals. In developing the proposals, the industry was cognisant of the need to maintain competitive neutrality and promote transparency while ensuring the tax system going forward is transparent and non manipulative.

3.2.2 Taxation of deferred annuities

Although a superannuation product, we have separated our comment on deferred annuities because the issues, consequences and proposed solutions differ from the proposals for other superannuation business.

Application of entity tax to deferred annuities will result in policyholder returns being taxed at the entity rate of 36%, compared to 15% in other vehicles. The consequence of this is that:

- existing deferred annuities will need to be transferred to an alternative vehicle
- all future business will need to be accepted by a vehicle other than a life company.

This has the effect of removing life companies from the deferred annuity market. We believe that we provide an important alternative for this business which should continue to be offered in the interests of competition. However, our primary concern is to protect the interests of existing policyholders who currently hold life insurance policies and for whom it is unreasonable to force change. In addition, those in capital guaranteed products would lose that benefit. Some older deferred annuities have a reversionary annuitant facility and some deferred annuities can continue past the age of 65.

We have set out above an analysis of administrative costs of transferring superannuation business and anticipate further proportional sunk costs from transferring deferred annuity business. This is a non-competitive impost on our policyholders and shareholders.

Our proposed solution is to extend the virtual PST or RSA structure to include deferred annuities thereby achieving competitive neutrality.

3.3 Transitional arrangements

This section covers:

- committed contractual arrangements
- start date
- annuity capital gains tax cost base.

3.3.1 In force long term contracts

One of the key issues impacting policyholders of life companies relates to committed contractual arrangements that life companies have made on long term inforce business. Life companies have written contracts (eg endowment and whole of life and other capital guaranteed products) which were priced and sold based on certain assumptions surrounding the current taxation treatment of life companies and policyholders. The key assumptions related to the exemption of annuity business, the 15% rate applying to superannuation business, the tax treatment of management fees and the taxation of ordinary business.

The proposed changes to the taxation of life companies and their policyholders is a change to the foundation of the tax system applying to these entities and their customers. The changes will have significant impacts upon returns that those customers will receive on those contracts. These impacts flow directly from the proposed changes referred to above.

The proposed changes to the tax law will also impact upon returns to shareholders of life companies. As stated above, we essentially agree with the policy settings of the proposed reform. However, the present tax system for life insurance companies has been in existence for many years (with changes to provide for the taxation of superannuation business), such that companies had little choice but to write business within the framework of that system. It is submitted that such companies and policyholders have a legitimate expectation that the system would continue to apply to committed contractual arrangements.

It has also been suggested that change is required on the basis that the current system for taxing life companies is not correct. The demutualisation of three of the largest mutual insurance companies occurred during the last four years. As mutuals, all assets including all free capital were owned by members. It was appropriate that income earned on these assets was taxed at the member tax rate (15% for superannuation and a proxy trustee rate for individuals). We accept that now that the largest companies have demutualised, amendments to the taxation law should follow. However, there should be put in place reasonable transitional arrangements to move to the new system.

We also consider that, viewed as a tax-paid product, the system for taxing ordinary business (that is income - expenses, or I - E) produces a result that appropriately taxes the interests of policyholders and shareholders (albeit at the incorrect rate in respect of superannuation). Appendix A demonstrates this clearly, whether the product is a participating one (where profits are shared between policyholders and shareholders) or investment linked style products where there are specific fees charged. At times, the rate of tax has been as much as 6% in excess of the general company tax rate.

Without reasonable transitional arrangements, we believe the change to the law would be retrospective. Retrospectivity, in our view, arises where the taxation law changes such that the taxation treatment afforded to expenditure or the taxation attributes of contractual arrangements committed to cannot be changed. Life companies are committed to long term contracts and cannot unilaterally change the terms of those contracts. Without the opportunity to review the design of those products and how fees are charged, our customers and shareholders would be disadvantaged compared to investors in comparable products The increased tax would be reflected in returns paid to our customers and shareholders.

As contractual arrangements have been committed to, it is not unlike committing to expenditure on plant and equipment pursuant to which any change to depreciation arrangements would not change the arrangements relating to assets already on hand. Even if it was possible to reorganise our business or to transfer customers to new products, there would be significant costs and our investment philosophy would need to change such that there would be realisation of major assets in order to provide the proper asset backing in a new environment.

It is our view that proper transitional arrangements need to be put in place to allow a smooth transition to the new taxation system. As we have stated, we support the new system and on a go forward basis there will be appropriate taxation of shareholder profit and subject to comments in this submission, policyholder returns.

The transitional arrangements can be put in the form of indefinite grandfathering (ie for the life of all relevant contracts) or alternatively that a period be set that reasonably recognises the long term nature of the contract.

There are two options that we would like to put forward as potential solutions to committed contractual arrangements.

Option 1 Old company/new company

The *old company/new company* removes all retrospective application of the proposals. It can be summarised as follows:

- life companies would close existing statutory funds. The existing arrangements would apply to all income and expenditure items arising in those statutory funds. New statutory funds would be created to write new business. Capital transferred from the old statutory funds to new statutory funds to support capital guarantees and business growth would attract taxation under the new arrangements.

- any transaction between the closed statutory funds and new statutory funds/shareholder fund would be a taxable event.

- the virtual PST/RSA model would be a feature of the new statutory funds. Superannuation in the old statutory funds would continue under the current arrangements.

- grandfathering in this fashion would be consistent with the grandfathering provided to policyholders. Policyholders would be entitled to enter into new contracts in the new statutory funds but would be subject to the revised rules for policyholders as determined.

This form of grandfathering would require a continuation of systems to deal with the old taxation law but this would run down as products ran their course. It would be necessary to discuss further with Treasury details surrounding the allocation of expenses between the old and new statutory funds and rules about changes or additions to existing policies.

Option 2 Adoption of the new tax system with adjustments to provide transitional relief

As an alternative to the old and new company approach, it would be possible to adopt the new methodology of taxing life companies and make appropriate adjustments that are transparent and auditable to the calculation of the life company's taxable income.

This form of transition is quite flexible. The adjustments to taxable income can be made on the basis of particular classes of product or based on the components of taxable income for each product, as appropriate. We would welcome the opportunity to discuss and develop this with you.

3.3.2 Start date

Life companies have a concern about the proposed start date of 1 July 2000 because of the fact that many have substituted accounting periods. For some, the effective start date will be as soon as 1 January 2000.

The consequences of not having a common start date are as follows:

- 31 December balancing life company policyholders and shareholders will suffer additional tax compared to 30 June balancing life companies. This produces unfairness and inequity;
- logistically, early balancing companies have less time to prepare and implement the substantial changes to, for example, products, systems, new policyholder distribution mechanisms and training. Removing 50% or more of the available time to prepare for this major change places life companies at a significant competitive disadvantage with less time to prepare and the inevitable increased cost which comes from forced implementation. It is also counter to the precedents of the introduction of the taxation on superannuation business in 1988 and the recently proposed provision for the introduction of GST;
- it is very important that all the changes affecting the basis on which new policies are to be taxed occur on the same start date across all life companies otherwise some companies will be issuing contacts subject to the new policyholder tax base while others will be operating under the old tax base.

In addition to the need for a common start date, we submit that a delay in the start date should be considered. The changes to life company taxation will require substantial systems development, redevelopment of some products, education of the distribution force and education of customers. Quick change will lead to uncertainty and confusion and is likely to increase costs. This issue is made worse by industry focus on the following:

– Year 2000
– GST, which also has a 1 July 2000 start date
– CLERP
– Managed Investments Act
– Member choice.

Essentially, there is not enough time to deal with the existing level of change, which is largely government imposed. The impact relatively disadvantages the financial sector, which is critical to the workings of the Australian economy. Also, rapid implementation can lead to additional cost as it is necessarily separate from normal organisational strategic and operational planning processes.

Life companies propose a common start date for all taxpayers, being the later of:

- 1 July 2001, or
- the first 1 July after Royal Assent of the relevant legislation.

Without this time, which is not unreasonable, the outcomes for shareholders and customers will be increased cost, without added value assuming that these changes can be effected in the time allowed.

3.3.3 Annuity capital gains tax base

As a consequence of moving from tax exempt to taxable status, capital gains tax will be incurred on investments backing annuity products. However, we believe that it is an unintended oversight that no relief has been provided for unrealised gains as at the start date. To provide such relief is consistent with the measure introduced with the taxation of superannuation in 1988.

3.4 Policyholder taxation of existing life insurance business

Life companies support option 1, that the taxation arrangements for existing life insurance products should remain tax paid. This preserves the existing arrangements, apart from management fees, and is appropriate for long term contracts which have been entered into under the existing tax regime. The option for policyholders to choose to go to the new taxation basis, without changing contract, should not be made available to avoid excessive administrative complexity.

3.5 Other life insurance matters

In this section, we deal with the following matters:

- taxation of life insurance policyholder distributions
- section 275 transfers

3.5.1 Taxation of life insurance policyholder distributions for new business

Of the three options for taxing bonuses, we support the option that policyholders be taxed on final distribution to the policyholder. This ensures that policyholders are not taxed on unrealised gains included in bonus distributions prior to termination. It is also more equitable for low income earners than the current position and overcomes problems with trying to match the tax rate applying to ordinary income with the average individual tax rate of policyholders.

However we would like to discuss further the development of a flow through product as outlined in the IFSA submission. It provides flexibility in product planning for policyholders.

3.5.2 Section 275 transfers

It is proposed that section 275 transfers from superannuation funds and ADFs to life companies will no longer be possible. This mechanism is essentially a service currently provided to trustees to remove the administration costs of preparing tax returns. In many cases their only investment is in a life insurance policy and they would not otherwise retain the funds to pay the contribution tax liability. We see no reason why means of streamlining the system should not be considered so that this service can continue to be provided particularly for funds administered by the life company. It is easily audited and is administratively beneficial. We refer to the IFSA submission for further elaboration of this matter.

4 Other taxation matters

In this section, we focus on some of the other aspects of the Reviews proposals (i.e. excluding life insurance issues) in an attempt to make relevant comments on those areas of direct concern to us, our shareholders and our policyholders.

We are also conscious that the IFSA submission deals with many of these issues and we are supportive of their comments. Our submission serves to re-emphasise some points made in that submission and further expand on others.

There are many significant matters which we have not commented upon as we believe that they are consistent with the broad policy settings for tax reform.

Our key issues are set out under the following headings:

- collective investment vehicles (CIVs);
- taxation of entities;
- international taxation considerations;
- consolidation of group companies; and
- taxation of capital gains.

4.1 Collective investment vehicles

The life insurance companies represented by this submission are supportive of the IFSA submission with regard to the proposed tax treatment of CIVs. Therefore, our submission builds on the IFSA submission, by outlining issues that are of particular importance to our policyholders.

We welcome and support the Government's decision (as announced on 22 February 1999) to retain flow-through tax treatment to cash management trusts (CMTs) and other CIVs that meet certain criteria. Against this background, the main issues we wish to raise in our submission are as follows:

- The Government decision to apply flow-through tax treatment to CMTs and CIVs is implemented.
- The taxation of direct investment by an individual investor is the appropriate benchmark.

It is important to ensure that an investor who decides to invest through an intermediary in the form of a CIV is not at a competitive disadvantage from taxation perspective as compared to investing directly. If this occurs, the concept of competitive neutrality is violated.

- The compliance costs for the CIV and the investor are minimised
- The definition of CIV includes all types of entity which perform the same function which would include appropriately defined wholesale trusts.

Appropriate consultation must take place with the industry to ensure that broad agreement can be reached on the scope of the definition of CIVs

- CIVs in the start-up and wind-down phase are not impacted by the CIV definition adopted and their status is recognised in any drafting of the rules
- Codification of the principles of flow-through taxation is achieved.
- Property trusts must be able to qualify as CIVs. The discussion paper argues that only vehicles which do not own active business investments should qualify as CIVs. The passive nature of property trusts is reflected in the structuring of their property holdings such that the ownership of the property is separated from the management and development of the property. The holding of buildings and shopping centres is not an active business. As a consequence, property trusts are in receipt of passive income and should be able to qualify as CIVs.
- It is noted that existing provisions of the Tax Act (Division 6C) already cater for taxing at the entity level those trusts that carry on an active business and that this test should be retained and apply to any active v passive distinction.

4.2 Taxation of entities

If our significant concerns (outlined below) in respect of a “collection at source” system can be addressed, we support the Resident Dividend Withholding Tax (RDWT) option over the Deferred Company Tax (DCT) option for the following reasons:

- DCT has significant disadvantages for non-resident shareholders which will impact foreign investment in Australian companies. Capital is relatively mobile and driven by available yields. Tax inefficiency will have a significant bearing on this; and
- it can represent a significant real cost to the company paying the dividend, penalising companies with foreign income

We do, however, have the following caveats and concerns. Specifically:

- We have strong concerns in respect of the double taxation of foreign earnings of global groups. This is dealt with in the next section.
- RDWT should not apply to distributions between entities. A dividend rebate should continue to be available as is currently provided for.
- under the RDWT option, we are supportive of the calculation and collection options in the Discussion Paper and will work with the Government and the ATO to ensure a smooth implementation of these reforms for our shareholders
- the RDWT system should be applied to all entities from a set date.
- RDWT should not apply to dividends paid to non-resident shareholders sourced from the existing Foreign Dividend Account (or the proposed Foreign Income Account).
- refunds for excess imputation credits and RDWT credits should be available under the RDWT option and should be available to tax exempt Australian resident investors.
- there should be no formal profits first rule for distributions.

There has been a de-facto “profits first” for distributions since the Corporation Law changes from 1 July 1998. At the time that the relevant taxation provisions were being introduced to complement these changes, a strict “profits first” rule was considered and dismissed in favour of the current provisions which give the Commissioner a discretion to deal with legitimate cases where a “profits first” rule is appropriate. An example where the rule would not be appropriate would be a case where a company disposes of a significant business, and as a result, returns excess capital to shareholders.

There is no need for a formal profits first rule, other than to raise revenue, which should not be the objective of true reform.

- we have concerns with the application of the slice rule to redemptions of units by public offer unlisted trusts, this imposes a substantial compliance cost on such trusts. It would be much simpler to treat redemptions as a disposal of the unit
- we welcome the recognition of the double tax that results from an on market share buy back and look forward to the Committee’s proposals to remove this anomaly.

4.3 International taxation considerations

Our overriding concern with the current proposals for taxation of international income is that there will continue to be double tax on profits that are comparably taxed overseas, when such profits are distributed to shareholders. This concern is not addressed in the Discussion Paper.

Against this background we make the following submissions:

4.3.1 Foreign income paid to resident shareholders

One of our major concerns arises in relation to the taxation of foreign income derived by companies which is exempt from tax under section 23AJ (or section 23AH for branch profits) because it has already been fully taxed in another country. However, when this income is distributed to Australian resident shareholders, it is distributed in the form of unfranked dividends. It is therefore taxed in full to Australian resident shareholders, without regard to the taxes already paid in the foreign country.

If Australia wishes to be regarded as a premier regional financial centre in the Asia-Pacific Region, Australian investment in businesses establishing a headquarters in Australia should be encouraged. The same considerations apply to all Australian business wishing to grow globally. As more investment is made offshore, more profits are earned there. The double tax will result in inadequate yields to Australian shareholders, and act as an encouragement for Australian companies to withhold profits, impacting shareholders depending on regular income flows (particularly retirees).

One solution is to allow non refundable franking credits for the foreign underlying tax paid as well as foreign withholding tax (an initiative both supported and welcomed).

We acknowledge the difficulty in resolving this issue of double taxation without a substantial cost to the Australian revenue. However, we believe that this issue should be addressed with some priority if genuine reform is going to take place.

4.3.2 Foreign income paid to non-resident shareholder

A similar issue arises from the distribution of foreign income to non resident shareholders. Where tax has been suffered in a comparably taxed country, DCT or RDWT may also be payable on distribution to shareholders (subject to the application of the extended Foreign Dividend Account rules) and tax is payable again by the shareholders in their home country.

For this reason there is still a double tax problem, notwithstanding the proposed FDA measures. One solution would be to allow streaming of foreign profits to foreign shareholders without payment of Australian tax and without franking account penalties.

Without a solution, multi-national companies will be forced to investigate options to more efficiently service shareholders.

4.3.3 Entity tax/Non-resident dividend withholding tax switch

We do not support the option for an entity tax / non-resident dividend withholding tax switch.

We recognise that the proposed switch could assist in partial mitigation of the negative impact that the DCT option would have on Australian share markets but we are concerned that:

– its introduction could impact on Australia's ability to negotiate lower tax rates under Double Tax Agreements (although this impact is mitigated if the option to allow imputation credits for foreign tax credits is chosen). Australia would no longer be in a position to argue that it does not impose withholding tax on dividends paid from taxed profits. This is particularly relevant having regard to the current discussions taking place in relation to the potential renegotiations of the Australia / US Double Tax Agreement.

– other countries may not accept the entity tax / non-resident dividend withholding tax switch. That is, they may regard it as an attempt by Australia to increase its rate of dividend withholding tax.

– the Review needs to address the risk that DCT could be treated as a form of dividend withholding tax by other jurisdictions, in excess of the rate allowed under Australia's double tax agreements. In this regard, the fact that DCT is not offset against a company's mainstream income tax liability distinguishes it from the (now repealed) UK Advance Corporation Tax.

4.3.4 Triangular relief

We are concerned that implementation of the triangular tax relief option could act as an incentive for Australian companies to relocate overseas. We welcome the acknowledgment of this issue. However, we believe that in many cases, it can be overcome by establishing a sensible corporate structure. Furthermore, enactment of this option would act as a substantial incentive for Australian companies to relocate offshore. For example, a company with headquarters in the UK would be able to pass Australian imputation credits to its Australian shareholders. UK resident shareholders would also have the benefit of receiving dividends from a UK resident company, with attaching tax credits. The UK company could then have a competitive advantage over an Australian resident company with similar shareholders and businesses.

For these reasons, we do not support changes to the law to allow tax relief for underlying Australian tax credits to investors in non-resident companies.

4.3.5 FIF measures - jurisdictional exemption

We support an extension of the jurisdictional exemption for certain US FIF's to other jurisdictions.

The proposals to abolish or replace the active business exemption in the Foreign Investment Fund rules are inconsistent with simplicity, fairness and the intention of the FIF provisions.

The FIF rules were recently amended to provide a broad jurisdictional exemption for a number of US FIF's, on the basis that the US tax regime has extensive foreign accruals rules, and so no revenue risk, and significant compliance savings, would result from this change.

It would be appropriate to extend the jurisdictional exemption to countries other than the US, which have a similarly robust tax system. As a starting point, a jurisdictional exemption could be provided for the other countries that are "broad exemption listed" for the purposes of the Controlled Foreign Companies rules.

4.4 Consolidation of group companies

A serious outworking of the consolidation regime relates to rollovers available in comparably taxed jurisdictions (eg on transfer of wholly owned entities within that jurisdiction) will not be recognised as protecting the group from Australian tax. It should be made clear that such relief will be recognised as effective to protect such groups from Australian tax.

Further to the above, the key issues that must be addressed to introduce a successful consolidation regime are:

- we see no reason why life companies, taxed under the entity taxation regime, should be excluded from a consolidated group;
- there is little flexibility in the proposals. Although it is optional to apply the regime, there are penalties for those who do not elect for consolidation. Benchmarking with the US and New Zealand indicates that rules are considered quite complex. In New Zealand, where the system is truly optional, we understand that few companies have elected consolidation. Feedback from the US is that more companies have applied consolidation, but they have complained of increased compliance complexity;
- the system will impose joint and several liability on each member for the group's total tax debts. This creates difficulties when selling companies and for special finance companies;
- consolidation can only occur between 100% group companies. This is an inflexible rule (benchmark is to the US where 80% is required and we note the 90% rule applied for GST). Minority interests, particularly finance shares have not been accommodated;
- there is recognition of the need to deal with employee shares but no specific proposals have been made;
- consolidation is not available unless groups have a single Australian holding company. Some groups do not have this structure and therefore cannot consolidate their companies resulting in penalties outside the consolidation regime;

Where restructure is possible, rollover and other relief (eg stamp duty relief) is necessary to allow restructuring for consolidation;

- the compliance requirements for entry to and exit from groups are quite significant. Depending on the option selected, it would be necessary to value all assets within a company entering a group or alternatively when that company transfers any assets to another group company;
- current tax rules are drafted to apply differently based on the status of specific companies. For instance, treatment of bad debts for banks and finance companies, treatment of assets held by life companies, special treatment for assets held by mining companies, etc. It is unclear as to whether those tax attributes will be retained for the company or for the group and how transactions within the group will be handled. The profile of the asset or item could change depending on where it is transferred within the group. This does not relieve the compliance burden;
- a solution is needed for bringing losses, franking credits and assets into and out of groups. Rules designed to protect the revenue (eg possibility that losses are quarantined within a company or lost altogether) are potentially complex and possibly inequitable.

4.5 Taxation of capital gains

We remain concerned at the sheer complexity of the capital gains tax provisions. The recent re-write of the provisions into simple language has demonstrated that the problem with the provisions was not that they were poorly worded, rather that they were overly complex, whatever form of words is used. The proposed changes to the regime do not address this issue.

We strongly recommend that clear principles be formulated stating what transactions the capital gains tax measures are designed to cover. As currently drafted, the provisions apply in theory to circumstances where no economic gain is involved (for example, on the performance of executory contracts), although in practice the Commissioner may use his general administrative discretion to mitigate the more extreme effects of a literal interpretation of the provisions.

It is submitted that this is inimitable to the principle of the rule of law, and places Australia at a competitive disadvantage to other countries in attracting capital.

Against these overview comments we would make the following submissions:

- the abolition of indexation would adversely affect superannuation funds and superannuation investments. If this option is to apply, all direct and indirect superannuation investments should benefit from a reduction in tax rates on capital gains.

A loss of indexation benefits for superannuation funds does not appear to be offset in any way with a reduction in the tax rate applying i.e. it remains at 15%. Individuals who suffer from a loss in indexation benefits are compensated by a potential reduction in rates.

- we support rollover relief in respect of scrip for scrip mergers or take-overs, but believe that it should also apply to companies (such as life companies) who hold their assets on revenue account.

Much has been said about how scrip for scrip rollover in relation to publicly listed companies will enhance market efficiency and remove tax distortions from acquisition strategies and take-over defence strategies. We fully support these arguments and acknowledge that there will have to be restrictions on when a scrip for scrip roll-over relief is available (e.g. only on dealings in public company shares).

However, it needs to be acknowledged that significant numbers of affected shareholders hold their shares on revenue account (e.g. life insurance companies in relation to non-superannuation assets and general insurance companies) and it would violate the notion of competitive neutrality if scrip for scrip rollover would only apply if the assets were held on capital account.

- We are supportive of the options canvassed in the Discussion Paper to deal with capital losses. Of major importance is a need to allow a carry back of capital losses.

- In relation to the impact of the CGT options on our individual policyholders and shareholders we would make the following points:

  – While we support the proposal to reduce the tax rates on capital gains, we do not believe that the rates proposed adequately compensate for the loss of indexation (particularly for superannuation investments, as noted above).

  – The tax rates remain substantially greater than the tax rates that apply to capital gains derived by individuals in the US and the UK (noting that the UK has an exemption for the first £6,800 of chargeable gains derived in a year).

- In relation to the proposal to provide CGT relief for venture capital investments for non-residents, we do not support this measure, to the extent that it will encourage foreign venture capital investment at the expense of investment by Australian residents. There should be no relative advantage for non-resident investors.

If a measure is needed to encourage venture capital investment, it should be designed to provide similar benefits for resident and non-resident investors.

Appendix A: Taxation of Life Insurance companies: building a more consistent regime for life insurers

Determining the taxable income of a life insurance company

As outlined in their consultation document, the Review considers that the current tax arrangements for life insurance companies are distortive, and lead to inequities in the financial market. Currently, there are different measurements for calculating the taxable income of a life insurance company, based on the class of business from which the income is derived. In addition, there are also different tax rates applying to each class of business.

The Review's life office tax reform proposal is to widen the taxable income base of life insurance companies, and subject this income to the entity tax regime, with tax levied at the corporate rate. The redesigned imputation credit system would result in both policyholders and shareholders paying tax on distributions from the life insurance company at their marginal tax rates.

The Review's overall objective is to achieve a more consistent basis for determining the taxable income of insurance companies, and to levy the same tax rate on taxable income, regardless of the class of business from which it is derived. As a result, the Review considers that the tax arrangements for life insurance companies will be more comparable with other entities conducting similar business in the financial market.

Applying the company rate to taxable income

Superannuation

Extending the company rate of tax to all forms of life insurance income would eliminate the different tax rates applying to different classes of life insurance business. However, as already noted in our submission, the consequence of levying the corporate tax rate on superannuation investment income is that superannuation members would be treated inequitably relative to non life insurance superannuation investors. Essentially, the imputation refund mechanism proposed by the Review is not efficient in restoring the effective tax applying to superannuation members investing in a life insurance contract to the same effective taxation applying to an investors in non life insurance superannuation.

The virtual PST or the RSA proposal put forward by IFSA could provide a robust method of allowing the investment income allocated to superannuation fund members to be efficiently taxed at the superannuation tax rate of 15 per cent, while taxing the income of shareholders at the corporate rate.

Consistent with the Governments proposals, both of these options would ensure the corporate tax rate applies to:

- fees received;
- investment income on assets held outside the policyholder net excluding investment income included in management fees;
- underwriting profit; and
- expenses.

Calculating the taxable income of a life insurer

The Review concludes that the current tax base of life insurers is narrow, which results in inequities between businesses operating in the financial market. A proposed solution to this inequity is to widen the tax base of life insurance companies to include the profits made on underwriting, and management fees embedded in premiums. Currently, management fees are not explicitly included as life office income, though management fees paid from investment income are effectively taxed because total investment income is taxed. Neither are all forms of underwriting profit taxed in the hands of the life office.

The Review puts forward three options for calculating taxable income of a life office company. All three options seek to include management fees as taxable income to the shareholder. However, this is not a straight forward exercise for ordinary business as will be discussed.

Saving and investment business ranges from conventional contracts, such as whole of life and endowment policies, through to investment linked contracts, such as certain life bonds.

Investment linked policies

The current tax treatment for these products in the hands of a life insurer involves the taxation of relevant income *I* and the deductibility of expenses *E*, which is referred to as an *I-E* tax basis. Specifically excluded from the assessable income are premiums and from allowable deductions, claims paid and claims reserving.

The taxable income of a life insurer includes income that is to be assigned to policyholders (this is the trustee principle, where the life insurer pays tax on behalf of the policyholder). Therefore, the transactions that are excluded from the tax base are those between the life insurer and the policyholder, while the transactions included in the tax base involve those with third parties. In simple terms, this means that the underwriting and management fee transactions between the policyholder and the life insurer offset each other.

A simplistic way to look at this issue is to regard policyholders as essentially taxed on I - F with shareholders taxed on F - E, where F is fees charged to the policy owner. Because policyholder and shareholders are combined in the fund, the taxable income of the fund reduces algebraically to I - E (I - F + F - E = I - E). This is valid for ordinary and superannuation but for the latter it is recognised that the shareholder fees have been taxed at the wrong rate. It does not hold for pure risk business.

Conventional policies

There are no explicit management fees for conventional business.

Conventional business is participating business, that is, the policyholder and shareholder participate in the profits derived from the business on a percentage split (often 80 per cent policyholder and 20 per cent shareholder). The shareholders do not charge a specific management fee - rather they become entitled to their proportion of the resulting profit after the expenses of the fund have been met (which includes other items such as tax). Because there is no specific fee, and any implicit fee has no effect on the shareholders profit emerging, there is no point in taxing fees explicitly.

This means that the treatment of management fees is not an issue for conventional business, and because the interests of policyholders and shareholders are combined, the I - E base for tax is an appropriate one. However, the I - E tax base assumes that the shareholder and policyholder interests are combined and the same tax rate is applied to both interested parties.

Taxable profit

If management fees are to be included as an extra item in the tax base of the life office, the total taxable profits would become F + I - E. If F is to be deductible to the policyholder, implying the policyholder's share of the taxable income is I-F, then the shareholder's share must be (F+I-E) - (I-F) = F + F - E. Therefore, management fees would be included in the shareholder tax base twice.

The Review's proposals solve this problem partially by excluding from I the fees on investment return. In addition the Review suggests deductibility of fees incurred on a regular basis such as annual management fees, though there are problems with the manner of this deduction as discussed below. However, we contend that premium based fees are incorrectly treated, as policyholders would not be able to claim a deduction for these.

To resolve the asymmetry between policyholders and shareholders, policyholders then would require a deduction for premium based fees or the second inclusion of fees in the life company tax calculation should be eliminated. If not, policyholders would be treated inequitably relative to investors in competing products, such as unit trust.

It is worth noting that if extra tax were payable by the life office on F, the tax would fall predominantly on policyholders for participating business, because of the way (post-tax) profits are shared for this type of business.

Manner of deductibility of fees to policyholders

In terms of delivering management fee deductions, whether for premium based fees or recurring annual fees debited to policies, this could be provided for through an individual's tax return or internally within the life office. The Review has proposed the first of these two mechanisms for recurring annual fees.

We see two difficulties with allowing these deductions through an individual's tax return. Firstly, in the case of recurring annual fees, policyholders would be claiming a deduction each year when in fact the assessable income to which they relate may only arise on termination of the policy. Secondly the total taxable bonus or investment income which the policyholder would be required to enter in their tax return would be greater than the overall return on the policy, to the extent of the management fees separately deducted. The second problem is compounded by the first issue, leading to policy owner confusion.

A preferable, more simple, approach would be to deliver policyholders a deduction internally within the life office by simply reducing the taxable bonuses or investment income assigned by the amount of the relevant management fee. This means the total life company income tax basis reduces to I - E, with this split I - F to policyholders and F - E to shareholders. The taxable bonus assigned to the policyholder would be I - F, with relevant franking credits attached.

Life companies believe that the double taxation of management fees should be dealt with within the life company, rather than through individual tax returns. The taxable bonus assigned to the policyholder would be net of such fees.

Options for taxable income

For risk business, in all three options proposed by the Review to define total taxable income, policy liabilities or actuarial calculations are used to determine profit. These policy liabilities should not be Margin on Service (MoS) policy liabilities (see discussion below), but with adjustments the current termination value determined as part of the solvency standard should be used (refer to Appendix B for more comments).

Our comments on each of the options in the Review's discussion paper are included in Appendix C. In conclusion, we are supportive of Option 1. However, this is subject to being satisfied with the detail of defining the components of the taxable income of a life insurance company.

Transition arrangements for the introduction of an additional tax on the life office

In our submission, we recommend that all the policyholder taxation arrangements for existing ordinary policies continue (ie. that grandfathering of the tax paid basis applies). The analysis above showed that under this structure, the I - E regime was appropriate for total taxable income.

As described above, including the management fees as taxable income will result in additional tax on the life company. If levied in respect of existing contracts, which have been priced based on the tax regime we have had to date, it is reasonable to assume shareholders would seek to recover their position by raising fees wherever possible. In addition, for participating contracts the additional tax impost would automatically largely fall back to policy owners via reduced bonuses, simply as the result of the nature of those contracts.

Existing policy owners would be unable to claim a deduction for any increased fees. This is highly inequitable as deductibility to policy owners of fees is an essential component of the new system.

Whether borne by shareholders or by policy owners, the net result is inequity.

Given the long term nature of life company contracts, we support the introduction of reasonable transitional arrangements, particularly for the inclusion of management fees, derived from existing contracts, as taxable income of life companies.

Appendix B: Valuation of policy liabilities

We do not support the use for taxation purposes of the policy liabilities determined under the Margin on Services method (MoS) for profit reporting purposes.

Apart from the philosophical point that we do not believe it is automatically the case that the basis for determining accounting profits should be identical to that for taxation purposes, as that is not the case anywhere else. MoS policy liabilities have the following features:

- For some types of investment contract the liabilities will include investment income that contains unrealised gains. Hence change in policy liabilities over a year will include unrealised gains allocated to that policy over the year.

- For some contracts, the MoS policy liability can be determined by a projection basis or by an accumulation basis (ie there is a choice). For other contracts a projection basis is required.

- Where a projection basis is adopted (likely to be the majority of cases), MoS spreads the affect of initial acquisitions expenses over the life of the contract. The effect is to allow the impact of these expenses on the profit to emerge year by year - in a unit trust those expenses emerge into profit as they are incurred. MoS increases the profit in the early years of a policy and reduces the profit in later years when compared to a corresponding unit trust.

- MoS policy liabilities include investment earnings credited to policies that are net of any policyholder tax levied on those earnings. Similarly the fact expenses are tax deductible is allowed for in the liability calculation. In Option 1, the policy liability needs to be redetermined without including the tax deductibility of expenses, and the calculation needs to allow for the fact the interest credited to policies is after tax, and may include unrealised gains.

- MoS contains some technical provisions relating to capitalising losses on new business written on unprofitable terms. It also allows these losses to be reversed later if experience improves. Those provisions can lead to a decrease in profit (if losses are capitalised) or an increase in profit (if losses are reversed) quite independently of any taxable activities.

- For some contracts (such as yearly renewable term business) it is possible for the MOS policy liability to be negative.

For these reasons we do not advocate the use of MoS policy liabilities. However we do believe that the Current Termination Value (CTV) of policies as calculated for statutory purposes as part of the Solvency Requirement is a suitable starting point. The CTV is determined as part of the prescribed basis for solvency in the Life Insurance Actuarial Standard AS2.01 and is subject to audit.

The CTV will still need adjustment to remove the effect of unrealised gains and to recognise it allows for deduction of policyholder tax on credited investment income, but this can be achieved. Further adjustments may be needed for participating insurers.

Appendix C: Three options proposed for determining taxable income of a life office

Option 1

This formula accidentally double counts certain management fees. Fees deducted from policies are counted twice - once specifically and once because the policy liability will decrease. We note the Review does not intend to double count items.

The change in policy liabilities is the item most likely to be subject to variation and can introduce *noise* into the profit calculation from one year to the next by virtue of the methods used to determine policy liability. Different methods will produce different profit numbers on a year by year basis, although they will give the same total result over the life of the business.

The policy liabilities used need to ensure that:

- they do not include unrealised gains in their investment income;
- expense assumptions used to produce the liabilities do not allow for the tax deductibility of expenses (which is not the case with MoS liabilities presently calculated); and
- allow for the fact interest income credited to a policy is net of policyholder tax.

Provided an acceptable technical basis is adopted for determining both the policy liability and the 'investment-income allocated to products' (which has to be deducted from the change in policy liability), this basis has common applicability to all type of business. We would like to discuss these crucial technical issues further with the Review.

Option 2

Unlike Option 1, this item requires specific identification and calculation of fees embedded in premium. This item is not presently determined for bundled products. This may change if life insurers are able to disclose the capital component of their premiums (this is required under new accounting standards 'where possible').

However, such a calculation is not mandatory for bundled products, and if determined will either be done by actuarial calculations or by a specified formula. The latter has an arbitrary element to it, the former involves calculations similar to that required under Option 1.

In addition, there is a wide variety of different types of explicit management fees on the wide variety of life insurance contracts in existence. Identifying and determining those fees will not be as straightforward as it first may appear.

New Zealand uses an arbitrary formula to determine underwriting profit for bundled business only. That formula resulted from an agreement between industry and Government. Life companies are not convinced of the need to tax discontinuance profits as distinct from mortality profits.

Option 3

Life companies agree with the advantages and disadvantages identified by the Review in respect of this option and in particular, note it has a difficulty with products that bundle investment and risk.

Life company view

Life companies have a preference for Option 1 based on the analysis to date. However, we believe further technical discussions with the Review are necessary - in particular ensuring the basis for determining all the elements in the formula produces the result we believe is intended.