



The Association of Trinidad and Tobago Insurance Companies

Summary of Ernest & Young Tax Regime Proposal

The life insurance taxation system that a jurisdiction adopts may depend heavily on the maturity of the insurance market in that region, with different systems being more appropriate at different stages of market maturity. There are four main types of systems which are used in most jurisdictions: gross income, income minus expense (I minus E), gross roll- up and gross roll up with periodic charge.

The approach inherent in a **gross income system** of taxing life insurance is the separation of investment income between that which is for the benefit of life insurance policyholders and that which is for the benefit of shareholders. The basis for this separation is the presumption that investment income derived within a qualifying fund is for the benefit of policy holders until such stage as it is transferred to shareholders. The gross income of a qualifying fund less allowable expenditure is then used as a basis for applying the concessional tax rate. The first requirement, as with all other systems, is to separate life business from general insurance or other operations of the company. Taxation is then applied to the gross income received from the fund.

Within the Gross Income Regime, policyholder returns are taxed concessionally as they accumulate in the fund. However income that is no longer for the benefit of policyholders is treated by applying the normal corporate tax or by applying an additional tax to the funds. Even though this system is simple and easy to apply, it may result in a delay in tax receipts from shareholder profits. There is no separation of policyholder and shareholder income until an amount is transferred to shareholders in some form and the cost of collecting the policyholder tax is effectively borne by the company and not by the government.

Trinidad and Tobago, Australia, Barbados, Canada, India, Sri Lanka, Sweden and Jamaica all use the Gross Income Regime. The treatment of their life insurance taxation is as follows:

Trinidad and Tobago- The rate is 15% of gross investment income

Australia- Company tax rate of 30% is applied to income from “ordinary” long term business

- A 15% rate is applied to Pooled Superannuation (Pension) Trust and

- Nil rate is applied to income falling under the Segregated Exempt Assets category.

Barbados- 5% on gross investment income

- 5 % on gross direct premium income on new business written in that year
- For resident companies 3% of gross direct premium income for renewal business for the year.

Canada - 15% of investment income in relevant life insurance reserves.

- Federal capital tax prior to 2006:

⇒ 1% on capital of between \$200 million and \$300 million, and

⇒ 1.25% on capital of over \$300 million.

- From June 30 2006 capital over \$1 billion is taxed at 1.25%

- Additional Provincial capital tax a tax of:

⇒ Between 0.3125% and 1.25% depending on taxable capital in Ontario and Quebec.

⇒ In the provinces of Manitoba and Nova Scotia a capital tax of between 0.26% and 0.52% is applied based on taxable capital.

India- The rate is 14.1625% on gross income and 16.995% distributions tax.

Sri Lanka- A 12.5% rate is applied to investment income

Sweden - 15% is applied to pension business

- 27% (30% on 9/10 of the tax base) on all other life insurance business

Jamaica- The rate is 15% of investment income less expenses of management

- 4% on gross direct premium income.

The underlying aim of an **“I minus E” tax regime** is to separate the investment return accruing to policyholders within the fund from the profits arising to shareholders. This allows each element to be taxed separately. In this system shareholder profits can be expressed as premiums plus investment returns minus claims minus expenses ($SP=P+I-C-E$). Policyholders’ return is the difference between the premiums they pay and the claims they receive ($PHR=C-P$). Thus shareholder profits and policyholders’ returns can be stated together as shareholder profit plus policyholder profit is equal to investment returns minus expenses ($SP+PHR=I-E$).

The principal effect of the use of the I minus E basis is to tax the investment income and gains arising from the investment of policyholders' premiums as they accrue, thus ensuring that the fund out of which claims will be paid has borne taxation. This accelerates the collection of tax revenues from policyholders. The cost of collection is lower for the government as the life insurance company collects tax. The principal disadvantage of an I minus E regime, from an administrative and fiscal policy perspective, is its comparative complexity. In addition in calculating the separate elements a potential complexity arises if the notional profits are higher than the I minus E result as, without further adjustment shareholder, profits may be not fully taxed.

The United Kingdom utilizes the I minus E regime. In the United Kingdom a full rate of corporation tax of 28% for 2008/09 onwards, is applied to policyholder investments and Class VII (pension fund management) profits and to the I minus E profit up to a maximum of the Notional Class I profit less any part of the basic life assurance and general annuity business (BLAGAB) franked investment income treated as forming part of it. The lower rate of income tax (20% for 2007/2008 and 2008/2009) are combined to give a policyholder tax rate to apply to the remainder of any I minus E profit; the combination is a weighted average by reference to chargeable gains, rental income and Case VI profits treated as taxable at the basic rate and the balance of the investment income treated as taxable at the savings rate.

The **gross roll-up system** is the separation of shareholder and policyholders return on investment and also matching of the timing of tax on policyholders with the time when they receive the benefit of their returns. The policyholder is subject to tax on the investment return on maturity of the policy while the life assurance company is taxed on its profits arising from running the life assurance business as they accrue. Income tax may either be deducted at source by the company or, if the income on maturity is received gross by the policyholder, the policyholders personally would be required to pay the tax to authorities.

This type of regime encourages long term pension products; it reduces tax avoidance and encourages particular forms of tax efficient savings. However adopting a Gross roll- up system means that the fiscal authority will receive significantly less tax in the short term than under the I minus E basis, since only shareholder profits are taxed as they accrue. In addition, other financial services industries might argue that the life industry was being given an unfair advantage in comparison with other industries in terms of the taxation of a mature policy and taxation as income accrues. Pre January 1, 2001, Ireland used the Pure Gross Roll up system where business was taxed under I minus E at 20%.

A possible variation on a **gross roll-up basis** of taxation that imposes less of a cash flow burden on a government is to impose a **periodic charge on policy values**. A life assurance company would be required to deduct an 'exit tax' on the gain arising from events such as, death, maturity, surrender of assignment of a life policy and a deemed chargeable event after a specific length of time. By imposing an exit charge to particular policies, it is possible to tailor a gross

roll-up regime to ensure that tax on income and gains on certain types of policy is not deferred beyond a certain period.

This type of system holds similar benefits and drawbacks as a pure gross roll-up system. However to offset this would be an increased complexity and cost of enforcing the system which could affect inward investment into Trinidad and Tobago life assurance industry.

A Gross Roll-up with periodic tax is practiced in Ireland. They changed from a Pure Gross Roll up system in 2001. Business from 2001 is taxed under the current corporate tax rate of 12.5%. An exit tax of 20% is applied plus 6% on the gain arising from a chargeable event including a deemed event every 8 years. Exit tax on a personal portfolio of life policies is 46%.

Conclusion/ Recommendations

By assessing the Ernst & Young proposal, the “I minus E” appeared to be the most logical system; insurance companies should pay less taxes in the long run as tax on profits (I less E where I includes both premium and investment income and E includes all expenses, claims and reserves) should be less than tax on I (where I is investment income only). However some key issues need to be addressed as follows;

- Reserving is a key issue, particularly for life insurers:
 - How do we determine adequate level of reserves? Companies may be tempted to increase reserves to reduce profits and hence reduce tax. However, the need for an adequate MCCR will mitigate the temptation. One suggestion is to use the reserving methodology currently being designed by the Central Bank.
 - An explicit reserve for AIDs mortality should no longer be needed. Insurers would be required to justify any mortality adjustments based on their company’s experience.
 - Any compulsory reserves required by law should be tax exempt.
 - A release in reserve should be taxable since this is matched against claims.
 - The new tax system should be introduced with both the opening and closing reserves based on the new reserving methodology, that is, results from previous years need to be adjusted, otherwise tax may increase in the first year due to release of current specific reserves
- Capital Gains
 - Corporations pay tax under certain circumstances, e.g. depending on the classification of the asset, while individuals are not liable for these taxes. As insurance companies

invest on behalf of their policyholders, a case may be made to exempt insurance companies from capital gains tax.

- Failing that, companies should be required to hold deferred tax liabilities (assets) against unrealized gains (losses)
- Other
 - Treatment of reinsurance – Issues with placing reinsurance with captives
 - Contributions to CAT Reserves should continue to be tax exempt
 - The 6% Insurance Premium Tax should be eliminated

Introducing a new taxation system, with no tax on investment income, would level the playing field among financial institutions and would benefit the policyholders as more interest can be credited to their policies.