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Tax regime and litigation issues

Life Insurance

29 November 2013

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Outline

Company taxation

- Governing tax provisions
- Issues in litigation
- Other tax issues
- Impact of on going litigation

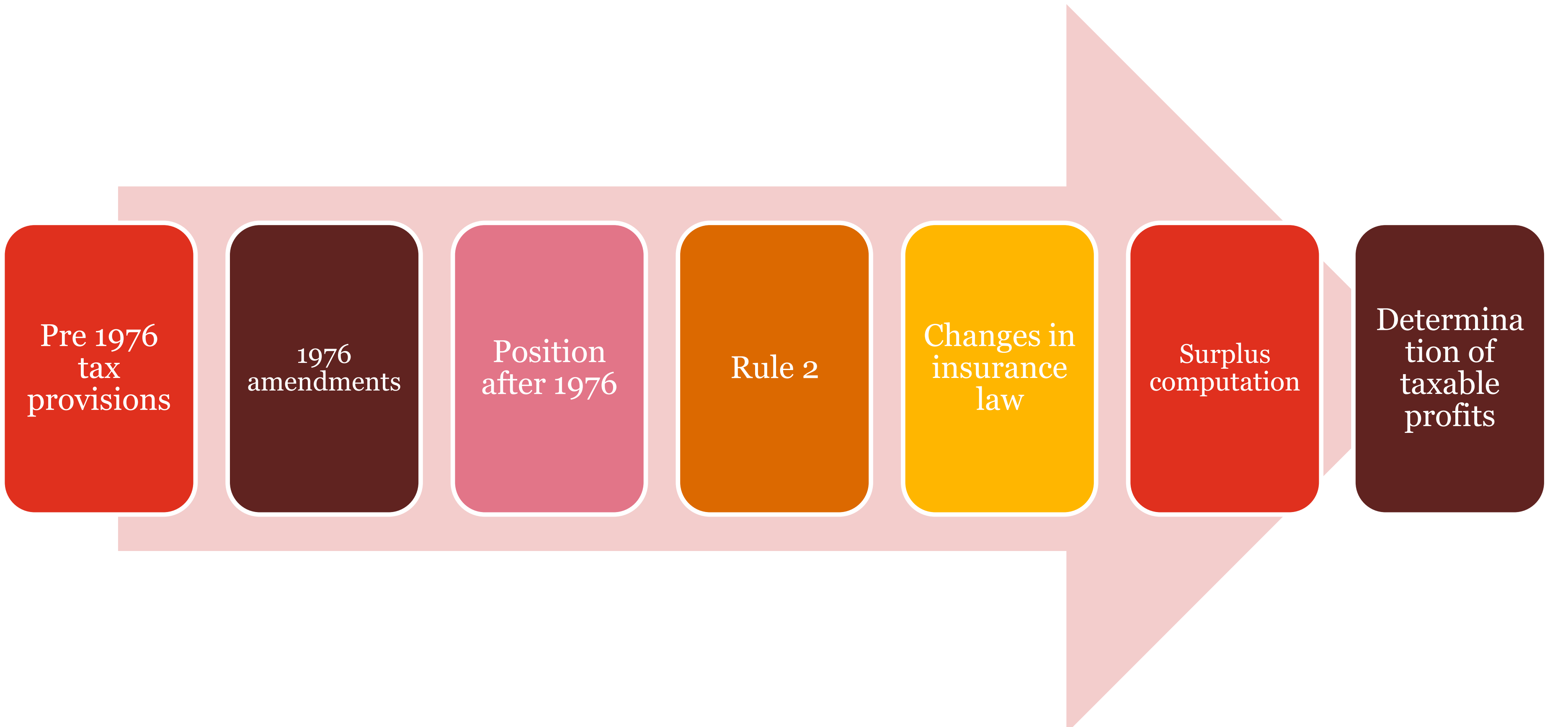
Policyholders' taxation

International tax regime

Company taxation

1

Governing tax provisions



1976 amendments

- Substantial amendments made with a view to simplify tax regime
  - Only actuarial surplus as the basis of income
  - No adjustments permitted to the surplus
  - Rule 3 deleted
  - Special tax rate of 12.5% provided

Position after 1976

Provisions governing life insurance business

Section 44

- *Notwithstanding anything to the contrary contained in the provisions of this Act relating to the computation of income chargeable under the head "Interest on securities", "Income from house property", "Capital gains" or "Income from other sources", or in section 199 or in sections 28 to 43B, the profits and gains of any business of insurance, including any such business carried on by a mutual insurance company or by a co-operative society, shall be computed in accordance with the rules contained in the First Schedule"*

Section 115B

- *Profits & gains from life insurance business subject to tax @ 12.5%**
- *Profits & gains from other than life insurance business @ 30%**

* Applicable surcharge and education cess additionally levied

Position after 1976

Section 44

- Separate code for taxation
- Basis of taxation different from basis that is generally applicable to other corporate entities
- Provides for taxation of insurance companies and computation of profits thereof
- Overrides other tax provisions relating to business profits/ capital gains/ other income
- Specific provisions dealing with deductions/ disallowances of expenditure applicable to other corporate entities do not apply

Section 115B

- Special rate of 12.5%* for profit from life insurance business
- Other income - normal tax rate

* Applicable surcharge and education cess additionally levied

Position after 1976

Provisions governing life insurance business

Section 44

Rule 2

"The profits and gains of life insurance business shall be taken to be the annual average of the surplus arrived at by adjusting the surplus or deficit disclosed by the actuarial valuation made in accordance with the Insurance Act, 1938 (4 of 1938), in respect of the last inter-valuation period ending before the commencement of the assessment year, so as to exclude from it any surplus or deficit included therein which was made in any earlier inter-valuation period."

Section 115B

Rule 2

- Rule 2 of First Schedule
  - Provides for computational methodology of life insurance profits
  - Plain reading suggests
    - Surplus/ deficit of prior inter-valuation period to be excluded from surplus/ deficit of current inter-valuation period
    - Surplus of current period is excess of Assets over Liabilities
  - Specific provisions dealing with deductions/ disallowances of expenditure applicable to other corporate entities do not apply
- Current difficulties in applying Rule 2
  - Term ‘annual average’ referred to in Rule 2 redundant since actuarial valuation carried out on yearly basis by insurance companies
  - **‘Actuarial valuation’ not defined in the Income-tax Act**
  - **Term ‘included therein’ referred to in Rule 2 - meaning**
  - Only policyholders’ account considered if Form I is adopted as basis for taxation
  - Policyholders’ surplus as per Form I is including transfer of funds from shareholders‘ account

Rule 2 – not happily worded and capable of subjective interpretation

Changes in insurance law

- Indian life insurance sector opened up in year 2000 for private players
- IRDA, a regulatory body constituted under IRDA Act ,1999
  - to provide for governing rules and regulations
- Significant changes brought out/ new regulations introduced under IRDA Act
- New accounting formats introduced - two separate accounts prescribed
  - Policyholders' account (PHA) known as Revenue account (Technical account) and
  - Shareholders' account (SHA) known as Profit & Loss account (Non-Technical account)
- New format of Valuation Balance Sheet (i.e. Form I) introduced - different from old format

Surplus computation…

- Taxable profits from life insurance business to be computed as per S.44 read with Rule 2 of First Schedule
- Whether taxable profits to be determined based on
  - Financial statements or
  - Actuarial valuation report i.e. Actuarial Report & Abstract as per IRDA requirements
- Whether Policyholders' account & Shareholders' account forms part of single life insurance business
- Different approaches followed by life insurance industry

…Surplus computation

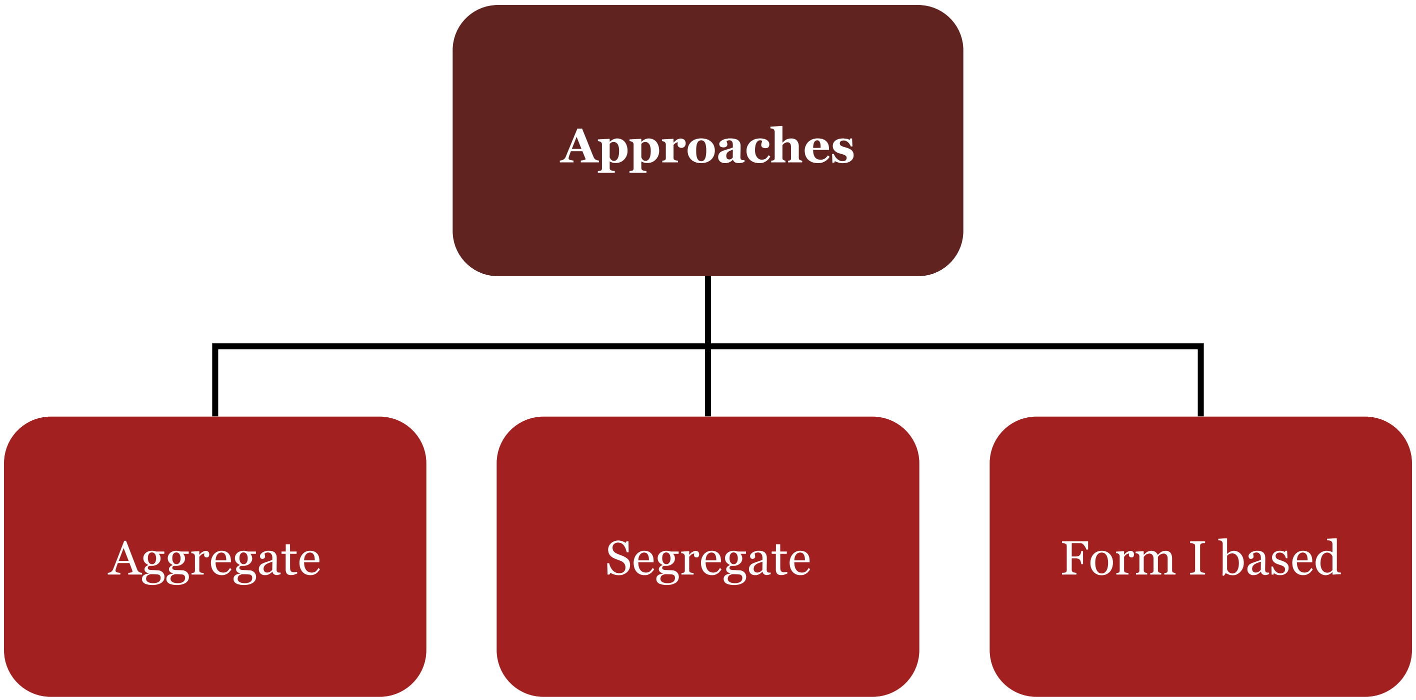
Computation as per Old Form I

- Computation of surplus under old law – based on Valuation Balance Sheet
- Surplus = Balance of Life Insurance Fund less Net Liability as at the valuation date

Computation now

- Based on new Form I
- Surplus = Balance of Funds less Mathematical Reserves as at the valuation date

Determination of taxable profits – Various Approaches…



…Approaches…

- Aggregate Approach (based on financial statements)
  - PHA and SHA are considered part of one single business of life insurance
    - Maintenance of two separate accounts is as per IRDA requirements
  - Aggregate results of both PHA and SHA (after nullifying effect of transfer between accounts) represents the profit of company
    - Thus, taxable surplus / deficit computed to include impact of both the accounts

- Segregate Approach (based on financial statements)
  - PHA and SHA represent two separate businesses
  - Profits of each account to be calculated independent of other
  - Only PHA represents insurance business and should be taxable @ 12.5%*
  - SHA not to be taxed as ‘Income from insurance business’ and should be taxable as ‘Income from other business’ @ 30%*

* Applicable surcharge and education cess additionally levied

...Approaches

- Form I based Approach (based on actuarial valuation report & partially on financial statements)
  - PHA and SHA considered part of one single business of life insurance
  - Surplus reflected in Form I considered as policyholders' surplus
  - Profit/loss in SHA aggregated with Form I surplus to arrive at taxable profits

Valuation Balance Sheet (i.e. Old Form I based computation) – Additional Defense

Issues in litigation

- Several issues sprung during assessments and pending at various levels because of -
  - No clarity in computation of taxable profits as per Rule 2
  - No uniformity in approach adopted by life insurance players
  - No uniformity in approach adopted for assessments in different jurisdictions
- Characterisation of taxable profits
  - PHA profits - considered as Income from life insurance business, taxable @ 12.5%*
  - SHA profits - considered as income from other business/ income from other sources, taxable @ 30%* (corporate tax rate)
- Transfer of funds from SHA to PHA treated as income
- Negative reserves taxed
- Treatment of exempt income - Pension and dividend
- Disallowances of expenses incurred to earn exempt income

* Applicable surcharge and education cess will be additionally levied

Outcome of litigation

- Favourable decision of Mumbai Bench of Income-tax Appellate Tribunal ('Tribunal')
  - *ICICI Prudential Insurance Co. Ltd.* v. *ACIT* [2013] 140 ITD 41 (Mum)
- Major issues decided in favour of the assessee
  - Method of combining results in PHA and SHA accepted
  - As per Rule 2 surplus has to be based on Valuation Balance Sheet
  - Transfer of funds from SHA to PHA considered tax neutral
  - Income in SHA treated as income from life insurance business
  - Adjustment to Form I surplus on account of Negative reserves unjustified
  - Pension income and dividend income eligible for exemption
  - No disallowance attracted under section 14A

Revenue's appeal before High Court – Pending

Other tax issues

- Deductibility of bonus to policyholder
  - Whether allowable post 1976 amendment?
  - Currently claimed as deduction in certain cases
- Exemption for pension [u/s 10(23AAB)]
  - Losses in pension business whether to be added back ?
- Profit on sale of investments
  - Taxable as capital gains or income from life insurance business?

Rule 2 – Need for change

Impact of ongoing litigation

- Several years impacted
- Exposure due to re-opening of past years by Tax Authorities
- Huge tax demands affecting cash flows
- Interest and penalty exposure

Policyholders' taxation

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Policyholders' taxation

Nature of Product	Premiums/Contributions (First E)	Accretions (Second E)	Maturity/Surrender value (Third E)
Life insurance	Section 80C - Allowed up to Rs. 100,000 along with other specified investments	Not taxable	Section 10(10D) • Exempt if received on death • If received other than on death - taxable if premiums payable during policy term exceed 10% of actual capital sum assured or is a Keyman insurance policy
Health insurance	Section 80D - Allowed up to Rs. 15,000. Additional Rs. 15000 allowed for parents (Rs. 20,000 for senior citizens)	No accretions	No maturity/surrender value
Pension/annuity	Section 80CCC – Allowed up to Rs. 100,000 but along with deduction u/s 80C and u/s 80CCD	Not taxable	Section 80CCC – surrender value and pension received taxable provided deduction allowed for premiums paid

International tax regime

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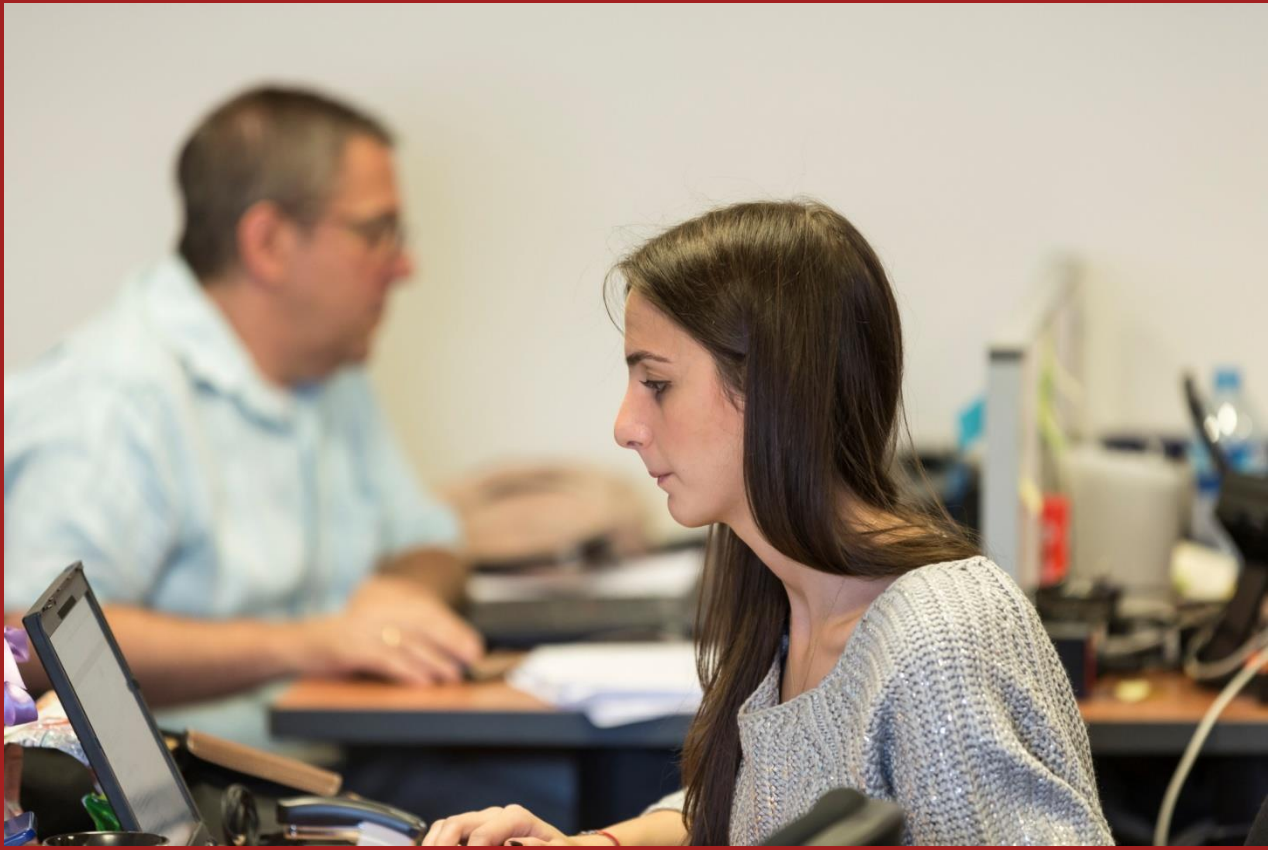

International tax regime

- Link to PwC portal providing updated survey of accounting and taxation rules applicable to both life and non-life insurance business
- Survey covers approx. 42 European and Asian countries

http://www.pwc.com/us/en/insurance/publications/international-comparison-of-insurance-taxation.jhtml

Company taxation

Particulars	Singapore	China	Switzerland	Australia
Source documents for determining taxable income	• Generally audited commercial accounts (i.e. Company's Act Accounts) except for participating fund which is taxable based on the Regulatory Return. • If not prepared, then regulatory return may be used	• Statutory Accounts • Regulatory Return not relevant	• Statutory Accounts • Regulatory Return not relevant	Specific items in Statutory Accounts considered with certain adjustments
Basis of computation/ general approach to Computation of taxable income	• Income allocated to Policyholders' Account of Participating Fund - taxable at 10%. • Overall Profits of Other Funds (i.e. Non-Participating fund, investment linked Fund and Shareholders' Fund) - taxable at normal corporate tax rate of 17%.	Profit as per Statutory Accounts - taxed at Corporate tax rate of 25%	• Profit as per Statutory Accounts taxed • Tax rates vary from 12.09% to 24%.	• Shareholders' Funds – taxed at 30% • Super Annuation Fund – taxed at 15%

Company taxation

Particulars	Singapore	China	Switzerland	Australia
Basis of computation / general approach to Computation of taxable income	• Tax generally calculated on a fund by fund basis • Taxable income in Participating fund is allocated between Policyholders' and Shareholders' based on tax rules.			• Current Pension/Annuity Business – taxed at 0% • Other Business (Participating Fund, Shareholders' Funds) – taxed at 30%
Policyholders' Bonuses	• Taxed in Company's hands • It is part of taxable income of the Company's participating fund.	• Deductible in Company's hands • Net profit before tax is after deducting Policyholders' Bonus. • At least 70% of participation product net gain should be allocated to policyholders of participation product.	• Deductible in Company's hands • Policyholders' income is deductible from corporate income.	Not deductible in Company's hands.

Policyholders' taxation

Particulars	Singapore	China	Switzerland	Australia
Deductibility of premiums	SGD 5,000* or 7% of capital sum insured with an insurance company, whichever is lower. * Combined limit for insurance premium, statutory contribution to Central Provident Fund and/or other approved pension funds	Generally not deductible	Generally, tax deductible depending on canton and life insurance product.	Generally not deductible, except for income protection policies
Interest build-up	Not taxable, but taxed in the hands of life insurance company	Not taxable	Generally, not taxed	Not taxable
Proceeds during lifetime	Tax Exempt, if derived directly by an individual. Different rates may apply in certain specified situations	Not taxable	Not taxed if certain conditions are met	Income protection policies taxable. Others, generally not taxable.
Proceeds on Death	• Tax exempt if derived directly by an individual. • Different rates may apply in certain specified situations	Not taxable	Taxable at special rates	Not taxable

Thank You

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Annexure A

Pre 1976 tax provisions

- Rule 2 of the First Schedule to the Income-tax Act, 1961 reads as under:

  "2. Computation of profits from life insurance business

  (1) The profits and gains of life insurance business shall be taken to be the greater of the following –

  (a) The gross external incomings of the previous year from that business, less the management expenses of that year;

  (b) the annual average of the surplus arrived at by adjusting the surplus or deficit disclosed by the actuarial valuation mad e in accordance with the Insurance Act, 1938 (4 of 1938), in respect of the last-intervaluation period ending before the commencement of the assessment year, so as to exclude from it any surplus or deficit included therein which was made in any earlier inter-valuation period and any expenditure or allowance which is not deductible under the provisions of sections 30 to 43 in computing income chargeable under the head 'profits and gains of business or profession.

  ....

  "3. Deductions – In computing the surplus for the purpose of Rule 2, -

  (a) four-fifths of the amounts paid to or reserved for or expended on behalf of policy-holders shall be allowed as a deduction:......".

Annexure B

Product level tax issues …

Keyman insurance policy

- Meaning of the term ‘Keyman’
- Assignment prior to April 1, 2013
- Double taxation of surrender value
  - Firstly at the time of assignment
  - Secondly at the time of maturity

Employer - employee policies

- Pre-assignment, on assignment and post assignment
  - Deductibility of premiums paid by employer ?
  - Taxability of premium paid by employer in hands of employee?
  - Exemption of amount received by employee on maturity/ death/ surrender ?

…Product level tax issues

ULIPs

- Current law not equipped to deal with taxation of complex products
  - No specific tax treatment
- Actual capital sum assured – death or maturity benefit?
- Maturity proceeds exempt u/s 10(10D)?

Pension Policies

- Amount received on surrender whether taxable – premium partly claimed as deduction u/s 80CCC?
- Exemption of death benefit received?