APPENDIX C TO TIB VOLUME TWO, NO. 3, OCTOBER 1990

NEW TAXATION REGIME FOR LIFE INSURERS

1.0 INTRODUCTION

The Income Tax Amendment Act (No.2) 1990, ("the Amendment Act"), provides for a new taxation regime for persons in the business of providing life insurance.

The new tax regime for life insurance is the outcome of a lengthy process of consultation between Government and affected parties that was spearheaded by the Consultative (Brash) Committee on Superannuation, Life Insurance and Related Areas. The legislation largely embodies the recommendations relating to life insurance contained in the second report of that Committee.

The new legislation takes effect from the income year commencing 1 April 1990. It repeals the existing section 204 of the Income Tax Act 1976 ("the Act"), and replaces it with a new regime (sections 204 to 205F) that provides for a much more comprehensive base for both income and expenditure.

In the past, a company to which the old section 204 applied was assessable only on the investment income relating to life insurance policies issued in New Zealand, and could claim deductions only in respect of expenses relating to that investment revenue. Premium income was not taxable, and outgoings relating to premiums were not deductible for tax purposes. Under the new taxation regime, life insurance companies resident in New Zealand will be subject to tax on their worldwide underwriting income as well as their investment income. Life insurers will now be able to claim deductions for all their expenditure incurred in earning that income.

Under the new provisions, nonresident life insurers will be able to elect to be deemed resident in respect of their New Zealand business. This means that they will be treated as if they were resident for tax purposes. It will have various effects, for instance they will be eligible for the inter company dividend exemption, but would also be liable for foreign dividend withholding tax which will arise from New Zealand funds invested in overseas equities. Alternatively they may remain nonresident and be taxed under the new regime on underwriting and investment income from life insurance policies offered or entered into in New Zealand.

There are also transitional provisions (section 206) which provide for the separation out of superannuation assets and liabilities from the life fund to a registered superannuation scheme.

2.0 DEFINITION OF A LIFE INSURER

The new taxation regime applies to life insurers. A "life insurer" is defined for the purposes of sections 204 to 206 as "any person who carries on the business of providing life insurance".

A definition of "life insurance" has been inserted into section 2 of the Act, and means :

> "Insurance (including reinsurance and the provision of annuities) where and to the extent that a person provides to another person for consideration, benefits contingent upon the death or survival of a human being or beings."

Two items are specifically excluded from the definition of life insurance :

(a) Medical or accident insurance where the only benefits provided which are contingent on death or survival are contingent on death from a specified cause (for example contraction of a terminal illness), or where such benefits are included as an incidental element to the provision of medical or accident insurance; and

(b) Superannuation funds where the only benefits provided to beneficiaries are the return in a lump sum form of contributions and the allocation of investment earnings; that is, superannuation funds without any life insurance provided by the trustees of the fund

For the purposes of sections 204 to 205F, where a person in the business of providing life insurance provides annuities, this activity will also be treated as part of the business of providing life insurance. However where any other person provides annuities which are not contingent on human life, these will now be treated as "financial arrangements" and will be subject to the provisions of the "accruals rules" contained in sections 64B to 64M of the Act.

3.0 APPLICATION OF THE NEW REGIME

Sections 13(3) and 13(4) of the Amendment Act provide that the new sections 204 to 205F will apply from the income year commencing 1 April 1990, except to the extent where a New Zealand resident life insurer has business outside New Zealand.

For the first year of the new regime, the 1991 income year, where a life insurance company has life policies, reinsurance policies or annuities issued outside New Zealand, then the portion of life insurance underwriting income and other income which relates to those policies will not be subject to taxation in New Zealand. Previously, New Zealand resident life insurance companies have been assessable only on income that relates to policies offered and entered into in New Zealand. This deferral of the new life insurance regime in respect of policies offered or entered into outside New Zealand is designed to give life insurers affected time to adjust themselves to the new regime in respect of their overseas business. Thereafter sections 204 to 205F will apply to the worldwide income of all types of a New Zealand life insurer.

4.0 ASSESSABLE INCOME

Section 204A provides that life insurers will be required to pay tax on two bases :

(a) Life Insurer income (or "ordinary income") determined according to sections 204B to 204Q; and

(b) Policyholder income (where the life insurance company is taxed as a proxy on income that is attributable to policyholders) determined according to sections 205 to 205F.

Whilst tax is payable on both of these income bases, the life insurance company can utilise imputation credits in respect of the tax paid on the life insurer base to offset its liability for tax on policyholder income.

(A) <u>LIFE INSURER INCOME</u>

5.0 CALCULATION OF LIFE INSURER INCOME

In terms of the new section 204B of the Act, the life insurer income for a New Zealand resident life insurer is calculated by calculating all income (other than underwriting income) plus underwriting income (as defined) less expenses. This is given by :

Life Insurer Income or Loss = i + u - e

<u>Other Income</u> (i) This item consists of the total of all amounts of assessable income under the general provisions of the Act derived from the life insurance business (but not taking into account deductions or allowances available), other than :

- premiums,
- claims in respect of reinsurance,
- underwriting income (as defined), and
- policyholder income (as defined in Section 205)

<u>Underwriting Income</u> (u) This is made up of three components:

- Mortality profit, calculated as per section 204F
- Premium loading, calculated as per section 204G
- Discontinuance profit, calculated as per section 204H

<u>Expenses</u> (e) These are all expenses or losses deductible, or allowances available under the general provisions of the Act other than:

- reinsurance premiums, and
- claims and amounts credited to actuarial reserves.

Where an item of expenditure or loss is included in item "e" as defined in section 204B no deduction will be available under any other section of the Act (section 204J). This is to prevent the possibility of claiming a deduction for the same expenditure more than once.

Tax is levied on the assessable income at the rate applicable to resident companies, currently at a rate of 33 cents per dollar.

6.0 OTHER INCOME

6.1 PROFIT OR LOSS ON THE DISPOSAL OF PROPERTY

The rules applicable to life insurance companies regarding the profit or loss on the disposal of property are contained in the new section 204C. Section 204C provides that the assessable income of a life insurer will include profits or gains derived by, or losses incurred by a life insurer on the sale or other disposal of any property. The rules are somewhat complex reflecting the changing historical modifications to life insurance and superannuation.

It should be noted that the legislation provides that the gains or losses on sale or other disposal of any "property" are taken into account. This has a wider compass than "investments",the term used in the old tax regime. "Property" is a very comprehensive term and includes, amongst other things, buildings used principally as premises by the life insurer. These were previously likely to be excluded from the term "investments". However in effect, the new legislation provides for the same treatment afforded by the old regime in respect of most property purchased before the 1991 income year, for the period until the commencement of the 1991 income year.

The gains and losses on the sale or other disposal of any property other than financial arrangements (to which the "accruals rules" contained in sections 64B to 64M of the Act apply) or any other property where the cost is taken into consideration in calculating assessable income (other than by depreciation) in an income year, will be calculated as follows:

(a) Where the property was acquired on or before the last day of the 1983 income year the gains or losses are calculated on the difference between:

- Consideration received (or receivable) from the sale or other disposal of the property; and
- The "specified base cost for 1983 income year property" which means the greater of :

  (i) Cost price; or
  (ii) The market value of the property on the last day of the 1983 income year.

(b) In any other case, the gains or losses are calculated on the difference between :

- Consideration received (or receivable) from the sale or other disposal of the property; and
- Cost price.

(c) Notwithstanding the above two calculation methods, where the property consists of land and buildings acquired before the 1990 income year, which if sold before the 1990 income year would have been a capital item not subject to the previous section 204 (in other words, land and buildings which were not included in the term "investments" used in the old regime), the gains or losses on sale or other disposal of the property are calculated on the difference between:

- Consideration received or receivable on sale; and
- Market value on the last day of the 1990 income year.

Although there are various particular provisions for determining the gain or loss on sale or other disposal of any property, section 204C(4) confirms that when calculating whether there is any depreciation recovered on the sale or other disposal of an asset, this is based on the book value of the asset which is the cost price less any accumulated depreciation.

6.2 DISTRIBUTION OF PROPERTY TO POLICYHOLDERS (Section 204D)

Where a life insurer sells or disposes of any property (other than financial arrangements which have an equivalent provision at section 64J) for inadequate consideration to a policyholder, sections 91 and 197 of the Act will apply as if the property were trading stock, and as if the policyholders were shareholders. This has the effect that the disposition of the property will be treated as the sale of the property by the life insurer at market value, and this amount will be taken into account in computing the gains or losses on sale of the property.

6.3 CERTAIN PROPERTY NOT TRADING STOCK (Section 204K)

Where the property of a life insurer consists of property which:

- Would have been subject to the 'accruals rules' (contained in sections 64B to 64M of the Act) but for the application of paragraphs (a), (b) and (d) of Section 64M of the Act, in general terms a financial arrangement acquired before the relevant implementation date for the "accruals rules"; or

- Is an excepted financial arrangement (as defined in section 64B of the Act) for example shares and some other near equity instruments, leases and short term trade credits,

then that property (except for the provisions of section 204D discussed above), cannot be treated as trading stock. Therefore the life insurer will not be able to account for the change in value of these items until it is realised by sale or other disposal.

This provision is intended to make it clear that all financial securities and equities are subject to taxation under section 204C (see item 6.0 above) and not under the other provisions of the Act. The section does explicitly state that any expenditure or loss incurred in acquiring that property will be treated as capital and therefore not deductible. However, this will not prevent the life insurer from taking the costs of acquisition of that property into account for the purposes of Section 204C.

6.4 ADJUSTMENT FOR SUPERANNUATION POLICIES IN RESPECT OF PROPERTY ACQUIRED BEFORE 1 APRIL 1988 (Section 204E)

For the period before 1 April 1988, income relating to superannuation policies was exempt from taxation. Therefore an adjustment is required to exclude the portion of the gains or losses on sale of assets which relates to superannuation policies issued by a life insurer before 1 April 1988. The adjustment is made by way of an apportionment of the gains or losses on sale or other disposal of assets owned as at 1 April 1988 as follows :

$$\frac{a}{b} \times c$$

where:

a is the amount of the liabilities of the life insurer on the last day of the income year that last ended before 1 April1988 which related to:

- Superannuation policies contained in the Life Fund; and
- Specified mortgage repayment insurance policies contained in the Fund; and
- Annuities contained in that Fund

b is the total liabilities of the life insurer as at that date; and

c relates only to property owned as at 1 April 1988 which was sold or otherwise disposed of during the current income year, and is the total of two items:

(1) Where the property is a financial arrangement, the base price adjustment (as set out at section 64F) which would have been calculated if the property had matured on 1 April 1988; plus

(2) For all other property, the aggregate of the differences between:

- Market value of the property as at 1April 1988; and
- either (i) The "specified base cost of 1983 year property" (as discussed earlier), if the property was acquired in the 1983 income year or earlier; or
  (ii) Cost price or acquisition value.

As noted above, this adjustment ensures that equivalent treatment to the old life insurance regime is applied to all gains and losses arising before superannuation income became taxable.

Therefore gains and losses on land and buildings which were not included in the term "investments" under the old regime are not taxed until the 1991 income year, and so are not subject to the apportionment outlined above.

It should be noted that the ratio a/b above will remain constant over time because it is as at a specific date. Item "c" of the formula will decrease over time as the assets owned as at 1 April 1988 are progressively realised.

7.0 UNDERWRITING INCOME

7.1 MORTALITY PROFIT

Mortality profit, (as calculated under section 204F) represents the profit that arises when the deaths experience of the life insurer is more favourable than expected.

Mortality Profits arise in general terms because when a life insurer sets its premiums and the level of insurance cover it can afford to offer, the calculations are done on the basis of existing mortality tables. With improved health care and greater life expectancy it is likely that the number of deaths, and therefore the payout of claims, is likely to be less than originally anticipated by the life insurer. As a consequence, the life insurer derives an underwriting profit.

For taxation purposes the Mortality Profit will be calculated only in respect of those policies which were in existence at the beginning of the income year in accordance with the following formula for each life insured under each life insurance policy :

$$\text{Mortality Profit} = (q \times (s0 - v0)) - (s1 - v0)$$

where:

q is the probability as at the beginning of the income year of a claim becoming payable on the death of the life insured in the income year

s0 is the claim payable contingent on death of the life insured as at the beginning of the income year

v0 is the amount of the actuarial reserves in respect of that life insured at the beginning of the income year. The basis for calculating the reserves is discussed at item 8.0 below.

s1
- if death of the life insured has occurred either during the income year, or during a previous income year (after the 1991 in come year) and the amount of the claim payable has not been included in this item in calculating the mortality profit in any previous income year, then S1 is the amount of the claim payable;
- otherwise S1 is the same as v0

A Mortality profit for each life insured may never be less than zero unless the person whose life was insured died during that income year, or in a previous income year (after the 1991 income year) and the claim was not taken into account in calculating that previous income year's Mortality Profit. In other words, a Mortality Loss may not occur unless the death of the life insured has occurred. Where there is more than one life insured under a single policy, the life insurer has the option of using as item "q" in the above formula, a common factor for each of the lives insured under the policy provided that it is a reasonable approximation of the average probability of a claim becoming payable on death of the lives covered under that policy. Where necessary the factor must be weighted to take account of the differing claims payable and actuarial reserves held in respect of the different lives insured.

Where a life insurer commences the business of providing life insurance partway through an income year then the Mortality Profit formula will apply to each life insured under each policy taken out during the year instead of just those in existence at the beginning of the year. Also, the Mortality Profit formula is modified so that items “q” and “s0” are calculated as at the date on which the policy is entered into, instead of the beginning of the income year, and item “v0” refers to the end of the income year instead of the beginning.

Where a policy provides for an annuity payable on death, a claim is deemed to be payable on death, and a Mortality Profit is calculated on the basis that the amount of the claim is the net present value of the annuity. The net present value is calculated using the same assumptions as were used by the life insurer in calculating its actuarial reserves. These assumptions are discussed at item 8.0 below.

7.2 PREMIUM LOADING (Section 204G)

A Premium Loading is a portion of the premium charged by the life insurer which relates to the risk spreading service that is offered by the life insurer. The calculation of Premium Loading for taxation purposes is set out at section 204G and provides that the Premium Loading will be calculated for each life insured under each policy which was in existence at the beginning of the income year as follows:

- To the extent to which the benefits under the policy are an annuity which was in the course of payment during the income year, The calculation is:

  Premium Loading = 0.01 x q x v0

- In all other cases the calculation would be:

  Premium Loading = 0.2 x q x (s0 - v0)

where in either formula -

q is the probability of a claim being payable due to the death of the life insured during the income year as determined at the beginning of that year.

s0 is the claim payable contingent on death of the life insured, or if there is nothing payable contingent on death, the amount payable contingent on the survival of the life insured to a specified date or age, determined as at the beginning of the income year.

v0 is the amount of the actuarial reserves in respect of that life insured at the beginning of the income year.

The Premium Loading may never be less than zero for any life insured under any policy.

The factors of 0.01 and 0.2 were determined with reference to published Tables of Mortality, reinsurance premium rates and life office temporary insurance rates. They are by necessity an approximation, and were determined by the Consultative Committee following discussions with representatives of the life offices.

Where there is more than one life insured under a single policy, the life insurer has the option of using as item “q” in the above formula, a common factor for each of the lives insured under the policy provided that it is a reasonable approximation of the average probability of a claim becoming payable on death of the lives covered under that policy. Where necessary the factor must be weighted to take account of the differing claims payable and actuarial reserves held in respect of the different lives insured.

Where a life insurer commences the business of providing life insurance partway through an income year then the Premium Loading formula will apply to each life insured under each policy taken out during the year instead of just those in existence at the beginning of the year. Also, the Premium Loading formula is modified so that items “q” and “s0” are calculated as at the date on which the policy is entered into, instead of the beginning of the income year, and item “v0” refers to the end of the income year instead of the beginning.

Where a policy provides for the payment of an annuity, then a claim is deemed to be payable on death, which means that the Premium Loading is required to be calculated. If the annuity is actually payable contingent on death of the life insured, the Premium Loading is calculated on the basis that the amount of the claim is the net present value of the annuity determined as at the beginning of the income year. If the annuity is contingent on survival of the life insured to a particular date or age, the claim is deemed to be the net present value determined as at that date. In either case, the net present value is calculated using the same assumptions as were used by the life insurer in calculating its actuarial reserves.

7.3 DISCONTINUANCE PROFIT (Section 204H)

A Discontinuance Profit calculation arises where the liability of the life insurer has terminated under the policy for any reason other than the death of the life insured or survival by the life insured to an age or date specified in the policy. Generally a life insurer will be required to pay out less than the expected liability under the policy where the policy has been discontinued.

In practice most discontinuances will be the result of the policy lapsing and being cancelled, or the life insured cashing in the policy and receiving its surrender value which if surrendered early in the policy's intended term, will often be less than the total premiums paid to date.

The Discontinuance Profit, which may never be less than zero for any policy, is calculated in accordance with the formulae set out at section 204H in respect of all policies which terminate in whole or in part as follows:

- Where the policy is in existence at the beginning of the year and either the policy terminates (wholly or partly) during the year or a claim is paid out for a reason other than death or survival of the life insured to a specified date or age :

  Discontinuance Profit = va - vb - sv ; or

- Where the policy was not in existence at the beginning of the income year and the policy terminates for any reason other than the death or survival of the life insured to a specified date or age :

  Discontinuance Profit = p - sv

where in either formula:

va is the amount of the actuarial reserves in respect of that life insured immediately prior to the time of termination but calculated using the same assumptions as are used to calculate the actuarial reserves at the beginning of the income year.

vb is the amount in the actuarial reserves in respect of that policy determined immediately after the time of termination or the time when the claim became payable having regard to the termination or claim and using the same assumptions as above.

sv is the amount (including a nil amount) payable on termination of the policy, or the claim as appropriate.

p is the total of all premiums paid in regard to that policy before it was terminated.

8.0 ACTUARIAL RESERVES (Section 204I)

Broadly speaking, an actuarial reserve is an amount set aside by the life insurer to meet its future liabilities. An actuarial reserve is calculated using mortality tables, expected rates of return, and other assumptions, and the person who makes the calculations is required to be professionally qualified as an actuary.

The calculation of the actuarial reserves must satisfy the criteria set out at section 204I, and in particular the assumptions made by the actuary making the calculations must be:

- Based on the same principles as those used in the actuarial advice by the life office's actuary in making recommendations on the level of surplus available for distribution to shareholders, policyholders, or allotment to other objects of a superannuation scheme; and

- In conformity with generally acceptable commercial practice; and

- Likely to produce a reasonable estimation of the future experience of the life insurer and has regard to its past experience.

In addition, an actuarial reserve may never be less than zero for any policy, and in total they may not be less than the aggregate of surrender values for the policies.

The actuarial reserves at the end of an income year are the same as those at the beginning of the next income year, and hence there is scope for the assumptions used in calculating the actuarial reserves to change over time. However the assumptions used must always satisfy the requirements outlined above. In the first year of the regime, the 1991 income year, the assumptions and bases of calculation used in calculating the reserves at the end of the year must be the same as those used in calculating the reserves at the beginning of the year.

The actuary responsible for the calculation of the reserves is required to furnish a declaration to the Commissioner with the life insurer's return of income which:

- States the interest rates, mortality tables and other assumptions and other bases of calculation used in the calculations.
- Declares that the assumptions and bases of calculation meet the requirements of section 204I.

The Commissioner has the power to seek advice from any actuary regarding the interest, mortality and other assumptions used for calculating the actuarial reserves. In addition, the Commissioner may use different bases of calculation from those used by the life insurer regardless of whether this advice has been obtained.

9.0 NONRESIDENT LIFE INSURERS THAT ISSUE POLICIES IN NEW ZEALAND (Section 204L)

In effect, nonresident life insurers are taxed on their New Zealand life insurance business under the new regime in exactly the same manner as a New Zealand resident life insurer. However the scope of the regime is limited to the business of the nonresident to the extent to which the business relates to life insurance policies which were offered or entered into in New Zealand. For the purposes of section 242 of the Act, this business income is deemed to be derived from New Zealand by section 204L.
This occurs regardless of whether the policy was executed in New Zealand and regardless of whether the life insurer has an agent or fixed establishment in New Zealand. In other words, the effect is that the New Zealand tax is levied based on the policy itself having been offered or entered into in New Zealand being the source of the income, not the presence of the life insurer in New Zealand.

Therefore as with a New Zealand resident life insurer, but subject to the above comments, the Life Insurer Income base for the taxation of a nonresident life insurer is given by the formula provided at section 204L as follows:

Life Insurer Income (or Loss) = i + u - e

Other Income (i): This item consists of the total of all amounts of assessable income under the general provisions of the Act derived from the life insurance business (but not taking into account deductions or allowances available) to the extent that business relates to policies offered or entered into in New Zealand, other than :

- premiums,
- claims in respect of reinsurance,
- underwriting income (as defined), and
- policyholder income (as defined in Section 205)

Underwriting Income (u): This is made up of the same three components as for a New Zealand resident life insurer namely:

(a) Mortality profit, calculated as per section 204F
(b) Premium loading, calculated as per section 204G
(c) Discontinuance profit, calculated as per section 204H

In each case the calculation is made only in respect of policies offered or entered into in New Zealand.

Expenses (e): These are all expenses, losses and allowances deductible under the general provisions of the Act which were incurred in gaining or producing the income included in items "i" and "u" above, other than:

- reinsurance premiums, and
- claims and amounts credited to actuarial reserves.

Tax is levied on the assessable income at the rate applicable to the non-resident entity. For nonresident companies this is currently at a rate of 38 cents per dollar.

To the extent that a nonresident life insurer derives income from New Zealand which is not included in item "i" above, or derives nonresident withholding income which is not included in item "i" above, then this income will be subject to the ordinary provisions of the Act.

This situation may arise for instance where an Australian resident life insurer issues policies in New Zealand. The income relating to the policies offered or entered into in New Zealand will be subject to tax under the Life Office base discussed above. However if that life insurer derives income such as interest from New Zealand relating to policies offered and entered into outside New Zealand, that income will be subject to ordinary tax rules. In this instance NonResident Withholding Tax would be levied on that interest earned.

9.1 NONRESIDENT LIFE INSURERS MAY ELECT TO BE RESIDENT (Section 204M)

In terms of section 204M, a nonresident life insurer may elect to be deemed resident for tax purposes in respect of its life insurance business offered or entered into in New Zealand. As with the calculation of the nonresident life insurer's income, this business is regardless of where the policy was executed or whether the life insurer has an agent or fixed establishment in New Zealand. The election is subject to approval by the Commissioner.

If a nonresident life insurer does elect to become resident, then the election must be made no later than 20 working days prior to the commencement of the income year to which it relates and the election is permanent. In respect of the 1991 income year however, the election is required to be made no later than 30 September 1990.

The effect of an election is threefold. Firstly as from the first day of the income year the business of the life insurer, to the extent that it consists of policies offered or entered into in New Zealand, is deemed to be carried on by a New Zealand resident company. This would mean for example, that the tax is levied on any assessable income at the New Zealand company rate, and also that the life insurer can take advantage of the tax exemption contained in section 63 for intercompany dividends. However as a New Zealand resident company, the life insurer would become liable for foreign dividend withholding tax as set out at section 394ZL of the Act. In addition, distributions made by the life insurer to its Head Office would be dividends for tax purposes and there would be Non Resident Withholding Tax payable on all such distributions.

Secondly, the life insurer is deemed to be an agent of that company, which would mean for instance that the life insurer would still be ultimately liable for the payment of income tax on the income.

Thirdly the life insurer and the company are deemed to be separate persons in respect of that business. This would mean for example, that similar to the provision for nonresident life insurers outlined above, if the life insurer derived income from New Zealand relating to policies which were offered or entered into outside New Zealand then that income would be assessed separately from the income derived by the deemed company in respect of New Zealand life insurance business.

10.0 FULL REINSURANCE (Section 204N)

Where a person who would otherwise be a life insurer, has taken out reinsurance policies which were offered or entered into in New Zealand and which fully relieve or secure the life insurer of all liability within that income year for providing the benefits contingent on death or survival of human beings, then in terms of section 204N, the person is deemed not to carry on the business of life insurance.

For this provision to apply, the person taking out the reinsurance policies must fulfill two criteria. Firstly the reinsurance policies must reinsure all of the life insurance risks relating to that person's life insurance business, and secondly the reinsurance policies must be offered or entered into in New Zealand. In respect of a New Zealand resident this would mean the worldwide life insurance risks would need to be reinsured, and for a nonresident this would mean the reinsurance must cover all risks relating to policies offered or entered into in New Zealand. The fact that the reinsurance policies are offered or entered into in New Zealand means that the reinsurer would be liable for tax in New Zealand on these policies.

The effect of being deemed not to carry on the business of life insurance for tax purposes does not mean that the person is relieved from liability for income tax in that year. What it means is that the income is calculated in terms of the other "ordinary" provisions of the Act. There is specific provision at section 204N to the effect that when calculating the income of the person under the ordinary provisions of the Act, premiums and claims relating to that person's life insurance business or the reinsurance policies are not assessable or deductible as appropriate.

Also, when determining the income from investments, the nature of the life insurance business being carried on will still be taken into account in determining what gains and losses are assessable. In other words, the fact that a business of life insurance is deemed not to be carried on for tax purposes will not preclude the application of the body of case law stemming from the decision in *California Copper Syndicate (Limited and Reduced)* v *Harris* (1904) 5 TC 159, commonly referred to as the "banking and insurance cases" in determining the taxable investment income of that person.

If the reinsurance policy does not fulfil the criteria set out above, then the life insurer is unable to take advantage of the exemption offered, and would be assessable on the life insurance business in terms of sections 204 to 205F of the Act, and the reinsurance premiums would not be deductible expenses, as discussed at item 5.0 above.

11.0 PARTIAL REINSURANCE (Section 204O)

Section 204O of the Act provides that irrespective of any other provisions of sections 204 to 204P, where the life insurer has taken out policies of reinsurance which were offered or entered into in New Zealand, then there are a number of allowances made to take the effects of these policies into account:

- In calculating the Mortality Profit (section 204F) claims payable by the life insurer at the time of death of the life insured are reduced by claims receivable by the life insurer under the reinsurance policies upon the death of the life insured.

- In calculating the Premium Loading (section 204G) the claim payable on either death or survival of the life insured will be reduced by the claim receivable under the reinsurance policy.

- In calculating the Discontinuance Profit (section 204H) the premiums receivable under the policy must be reduced by the premiums payable under the reinsurance policies, and similarly claims payable must be reduced by claims receivable under the reinsurance policies.

- Actuarial reserves (section 204I) may be reduced by an amount that the actuary responsible for actuarial control of the life insurer considers appropriate.

Similar to the provisions for full reinsurance discussed at item 10.0 above, it should be noted that the above provisions only apply if the reinsurance policy is offered or entered into in New Zealand. Also the provisions apply to nonresident life insurers only in respect of their business of life insurance which consists of policies offered or entered into in New Zealand.

12.0 APPLICATION OF THE NEW REGIME TO MUTUAL ASSOCIATIONS AND TRUSTS (Section 204P)

The new life insurance regime applies to any person who carries on the business of life insurance. Section 204P clarifies the scope of the application of the regime. This section provides that to the extent that any person provides to another person for consideration benefits contingent upon the death or survival of a human being then that person is deemed to carry on the business of life insurance, and hence would be subject to the new regime. The provisions of section 199 of the Act (which relate to mutual associations and provide that although assessable profits are deemed to be made for transactions between the association and its members, rebates paid to members are also deductible) will not apply, and the person whose life is insured and the life insurer are deemed to be separate unrelated persons.

However this is not deemed to be the business of providing life insurance if the consideration is natural love and affection, or the benefits provided are either:

(i) Medical or accident insurance where the only benefits contingent on human life are benefits contingent upon death from a specified cause or death from a specified cause as an incidental element to the provision of medical or accident insurance; or

(ii) Provided by a superannuation fund where the only benefits are the return of beneficiaries' contributions together with allocated investment earnings.

The effect of this is that family dealings will not be treated as the business of life insurance, and the implicit definition of life insurance in section 204P has parity with the definition inserted into section 2 as discussed at item 2.0 above.

It is important to note that this provision means in practice that with limited exceptions, the provision of life insurance benefits from one person to another person is deemed to be the business of life insurance. Therefore entities which commonly provide these benefits, for instance superannuation funds which provide lump sums payable upon the death of the contributor are, for income tax purposes, partly carrying on the business of providing life insurance. In order not to be treated as a life insurer, the person would need to enter into a reinsurance policy in New Zealand which fully reinsures the life insurance liability. This would mean that section 204N (discussed at item 10.0 above) would deem that no life insurance business was being carried on.

12.1 SUPERANNUATION SCHEMES (Section 204Q)

There are a number of difficulties in applying the formulae for Underwriting Income (Mortality Profit, Premium Loading and Discontinuance Profit) to superannuation schemes. In order to allow time for these concerns to be addressed, two limited exemptions for certain superannuation schemes from the new life insurance regime have been provided in section 204Q.

However, the section specifically confirms the point discussed at item 12.0 above, that where a trustee of a superannuation scheme provides any life insurance to members or beneficiaries of the scheme that scheme will, subject to the exemptions discussed below, be treated as providing life insurance.

Firstly, an exemption in respect of all superannuation funds other than those to which property is transferred pursuant to an arrangement under Part VI of the Superannuation Schemes Act 1989, is provided for the 1991 income year. This exemption from the regime is for a single income year, the 1991 year. After this date all superannuation funds, other than those which qualify for the second exemption discussed below, will be subject to the new life insurance taxation regime if they are providing life insurance benefits to members or beneficiaries. Briefly, those superannuation funds which do not qualify for this one year exemption are those set up or used for the separation of a life insurer's superannuation business into separate superannuation funds. The reasons for the separation and the mechanics of the transfer are discussed in more detail at item 22.0 below.

The second exemption is a continuing exemption from the regime for a superannuation fund that is a "Qualifying Superannuation Scheme" as defined. In substance, a Qualifying Superannuation Scheme is an employer funded superannuation scheme for the benefit of employees. The definition of "Qualifying Superannuation Scheme" is very specific in order to prevent any tax avoidance opportunity which may be afforded by the exemption, and is provided in section 204Q(4) as a superannuation scheme that, at all times in an income year:

- Either(i) Was set up by an employer or group of employers to provide benefits to, and make contributions to, a superannuation fund only on behalf of employees, former employees and relatives or dependents of employees or former employees; or
  (ii) Was constituted pursuant to any Act relating to the National Provident Fund or the Government Superannuation Fund and in respect of the employer who makes contributions to the fund, provides benefits to employees, former employees and relatives of employees or former employees; and

- Is registered by the Government Actuary under the Superannuation Schemes Act 1989; and

- No trustee is carrying on the business of life insurance under the Life Insurance Act 1908; and

- The only beneficiaries are natural persons; and

- The employer provides significant contributions to the superannuation fund; not just to the cost of its administration; and

- The superannuation fund has not been established or utilised in a manner which has the effect of defeating the intent and application of the new life insurance taxation regime.

In addition, the scheme must apply in writing to the Government Actuary to qualify for this exemption, and the Government Actuary must be satisfied that the scheme satisfies the above requirements. If the Government Actuary is no longer satisfied that a superannuation scheme qualifies for this exemption, then the scheme ceases to be a Qualifying Superannuation Scheme from any date the Government Actuary determines.

If a superannuation scheme qualifies for an exemption from the life insurance regime, it will fall to be taxed according to the "ordinary" provisions of the Act which apply to superannuation schemes. The exemption afforded is not an exemption from income tax, but an exemption from the application of the new life insurance taxation regime.

Similar to the provisions discussed for section 204P at item 12.0 above, in order not to be treated as a life insurer, the superannuation scheme would need to enter into a reinsurance policy in New Zealand which fully reinsures the life insurance liability. This would mean that section 204N (discussed at item 10.0 above) would deem that no life insurance business was being carried on. It is only necessary to reinsure the benefits which are contingent on human life, as if these are reinsured section 204Q will not apply to deem all of the business of the superannuation scheme to be the provision of life insurance.

(B) <u>POLICYHOLDER INCOME</u>

13.0 CALCULATION OF POLICYHOLDER INCOME

The new section 205 defines the policyholder base income (or loss) on which a life insurer is required to pay tax in addition to the life office base discussed at item 5.0 above.

Policyholder income arises from profits attributable to the policyholders. During an income year a life office will distribute some of its income to its actuarial reserves for policyholders and some will be distributed directly in claims to policyholders. Since individual policyholders are not taxed on income which is distributed to them, the policyholder tax must be deducted by the life office before the income is distributed. Therefore the life office pays tax as a proxy for the policyholders.

Net policyholder income is found by adding together claims, increases in actuarial reserves, and subtracting premiums received net of Underwriting Income as calculated in section 204B. As the amount distributed to policyholders is net of tax, it is necessary to gross up this amount by dividing by the after tax rate of income in order to ascertain the pretax figure. Policyholder income is given by:

$$\text{Policyholder Income or Loss} = \frac{(c + (v1 - v0) - (p - u))}{(1 - r)}$$

where :

c is the total of all claims due or payable in that year and all claims incurred in previous years (after 1 April 1990) but not included as such in policyholder income or loss for those years.

v1 is the total of actuarial reserves at the end of the income year

- v0 is the total of actuarial reserves at the beginning of the income year
- p is the total of all premiums due or payable in that year (excluding those payable in previous years)
- u is the Underwriting Income, namely Mortality Profit, Premium Loading and Discontinuance Profit, derived by the life insurer as determined under sections 204 to 204Q
- r is the rate of tax for policyholder income as set out in clause 2A of Part A of the First Schedule to the Act. This rate is currently set at 33 cents per dollar.

The life insurer is liable to pay tax on the income resulting at the same rate as item "r" in the formula above. However the liability for tax on the policyholder base may be substantially reduced or fully offset by utilising imputation credits resulting from the payment of tax on the life insurer income. This is discussed in more detail at item 18.0 below.

13.1 NON-RESIDENT LIFE INSURERS (Section 205A)

As with the calculation of Life Insurer income discussed at item 9.0 above, the calculation of Policyholder Income for a nonresident life insurer is done only in respect of policies offered or entered into in New Zealand. Again, this is irrespective of whether or not the policies were executed in New Zealand, or whether or not the life insurer has an agent or fixed establishment in New Zealand.

The amount of Policyholder Income calculated is deemed to be derived from New Zealand for the purposes of section 242 of the Act by section 205A of the Act.

14.0 PARTIAL REINSURANCE (Section 205B)

Where a life insurer takes out reinsurance policies which were offered or entered into in New Zealand, an adjustment is made in the Policyholder Income calculation for the premiums payable and claims receivable under the reinsurance policies. It should be noted that no adjustment may be made if the reinsurance policies were offered and entered into outside New Zealand.

Where the reinsurance policies qualify, a deduction is made from item "p" of the Policyholder Income formula as follows:

Deduction from item "p" = rp - rc

where:

- rp is total of premiums due and payable for reinsurance due or payable in that income year; and
- rc is the total of claims receivable in respect of reinsurance in that income year;

As with other provisions discussed earlier, for nonresident life insurers the adjustment for reinsurance policies applies only in respect of reinsurance policies relating to the nonresident's business of life insurance which consists of life insurance policies offered or entered into in New Zealand.

15.0 STATUS OF POLICYHOLDER INCOME OR LOSS

As the Policyholder tax is payable as a proxy for the policyholders, there are a number of provisions which ensure that the Policyholder Income or Loss is held only for the benefit of policyholders, and is not available for the use of the life insurer or its owners.

The two income bases for a life insurer discussed at item 4.0 above, being Life Insurer Income and Policyholder Income are completely separate. As discussed earlier, the Life Insurer Income is akin to the "ordinary" income of any taxpayer. Provided the relevant criteria in the rest of the Act, particularly sections 188 and 191 are satisfied, losses from group companies or prior year Life Insurer Losses may be offset against current year Life Insurer Income. Alternatively, Life Insurer Losses may be offset against other group income or carried forward to be offset against future Life Insurer Income.

In contrast, as the provisions outlined below show, Policyholder Income and Losses are effectively quarantined and are not available for offset against any other type of income or loss for any taxpayer.

15.1 POLICYHOLDER LOSSES

Section 205C provides that Policyholder Losses may be carried forward and set off only against future Policyholder Income. This means that a Policyholder Loss is not available for offset against Life Insurer Income. In addition Policyholder losses may be carried forward irrespective of the requirements of section 188(7) of the Act. This has the effect that the 40% continuity of shareholding requirements to enable the carrying forward of losses do not apply in respect of Policyholder Losses.

In addition any losses remaining to be carried forward from the old section 204 are to be treated under the new life insurance taxation regime as if they are Policyholder Losses. The reason for this is that the old life insurance regime also taxed the life insurer as a proxy for the policyholders and hence this treatment is preserved. So any losses remaining to be carried forward at the end of the 1990 income year may not be used as an offset against income from the Life Insurer base.

Sections 205D and 205F confirm specifically that Policyholder Losses cannot be offset against any other form of assessable income, and that no expenditure or loss may be deducted from or offset against Policyholder Income except as specifically authorised in the Act.

15.2 DETERMINATION OF POLICYHOLDER LOSSES

As with other taxpayers, where a life insurer has a policyholder loss for an income year the Commissioner is obliged to make a determination of that loss and give notice of it to the life insurer (Section 205E). However the omission to give a Notice of Determination of Policyholder Loss would not invalidate any assessment or determination of policyholder loss.

16.0 IMPUTATION ASPECTS OF THE NEW LIFE INSURANCE REGIME

Under the old life insurance taxation regime, life insurance companies were taxed as a proxy for the policyholders. Therefore as would be the case for policyholders, the life insurance companies were unable to maintain an Imputation Credit Account ("ICA") as that term is defined in section 394A of the Act. For the same reason, life insurance companies were not eligible for exemption from income tax for intercompany dividends as provided in section 63 of the Act.

As life insurance companies are now to be taxed on two income bases, one being their 'ordinary' income or Life Insurer Income, and the other as a proxy for the policyholders, or Policyholder Income, life insurance companies are now required to maintain an ICA and are eligible for the intercompany dividend exemption. They may therefore pass on the imputation credits in respect of dividends received and may attach imputation credits to dividends paid.

Tax is payable on both of the life insurance company's income bases, however the liability for tax on Policyholder Income may be offset in whole or in part by utilising imputation credits arising in the company's ICA. Imputation credits are offset against the tax liability on Policyholder Income through a Policyholder Credit Account which operates in a similar manner to an ICA. Policyholder Credit Accounts are discussed in more detail at item 18.0 below. Only New Zealand resident companies are eligible for the above treatment, and special provision is made for taxpayers who are not New Zealand resident companies. These are discussed in greater detail at item 18.2 below.

17.0 IMPUTATION CREDIT ACCOUNTS

Section 394B of the Act is amended so that life insurance companies are no longer exempted from the requirement to maintain an ICA. Life insurance companies will be treated no differently in this respect to any other taxpayer. Therefore a life insurance company resident in New Zealand will be required to maintain an ICA.

As with other companies not resident in New Zealand, life insurance companies which are not resident in New Zealand will continue to be unable to maintain an ICA as provided by section 394B(2) of the Act. As noted above, for the purposes of the new life insurance taxation regime these nonresident companies would be an "Other Person" and special provision is made for them to offset credits for the payment of tax on Life Insurer Income against the liability for tax on Policyholder Income. This is discussed at item 18.2.3 below.

The ICA of a New Zealand life insurance company will operate in a similar manner to that of other New Zealand companies. However there are a number of provisions which have been inserted in the legislation governing full imputation as a result of the new life insurance taxation regime.

17.1 CREDITS ARISING TO IMPUTATION CREDIT ACCOUNTS

The new section 394D(1)(a)(ii) provides that no imputation credits will arise from the payment of tax on Policyholder Income by a company carrying on a business of providing life insurance to which section 205 applies, with effect from the 1991 imputation year. This means that the income tax paid as a proxy for the policyholders does not give rise to credits which could be passed on to shareholders of the company.

A transfer from a company's Policyholder Credit Account ("PCA") to its ICA has been provided for in section 394D(1)(l), and this transfer gives rise to a credit in the ICA when the company elects to make the transfer. Transfers to and from the PCA are discussed in more detail at item 17.3 below.

17.3 DEBITS ARISING TO IMPUTATION CREDIT ACCOUNT

A new debit to an ICA in terms of section 394E(1)(aa) has been created for New Zealand resident life insurance companies to reflect transfers to a PCA from the ICA. As discussed at item 18.0 below, transfers to and from the PCA represent credits in the ICA which have been transferred to the PCA to be used as an offset against tax payable on policyholder income. For a New Zealand resident company, a PCA will not in general have any entries generated in its PCA in their own right other than the offset against the tax liability on Policyholder Income, all entries represent transfers to and from the ICA.

There is no compulsion on a New Zealand resident life insurance company to transfer its imputation credits (although there are some deemed transfers these may be transferred back to the ICA after a time period, see item 18.0 below) and use them as an offset against the tax liability on Policyholder Income. They may be retained or distributed attached to dividends if the company wishes. However the liability for tax on Policyholder Income would then be required to be settled by an actual payment of tax rather than an offset, and it is therefore likely that in most cases the credits will be used to offset the tax liability on Policyholder Income.

17.3.1 DEBIT TO APPROXIMATE NON-RESIDENT WITHHOLDING TAX

Another new debit is created for New Zealand resident life insurance companies in terms of section 394E(1)(ab) whenever the company receives a dividend which is exempt from tax to the insurer and in respect of which the company is not required to make a dividend withholding payment deduction. In other words, in respect of most dividends received from New Zealand resident companies.

The debit to the ICA is calculated at section 394E(2A) of the Act as 18% of the lesser of either:

(a) The total of the dividend, plus any imputation credit attached to the dividend, plus any dividend withholding payment credit attached to that dividend; or

(b) $\frac{a}{b} \times c$

where :

a is Policyholder Income or Loss which would have been calculated under sections 205 to 205F only in respect of policies where the holder is not a resident of New Zealand; and

b is Policyholder Income or Loss which was calculated under sections 205 to 205F in respect of all policies; (if this is nil or less than zero, item “b” is deemed to be the same as item “a”); and

c is the aggregate of the dividend plus any imputation credit and dividend withholding payment credit attached to the dividend.

The reason for this adjustment is to account for the non-resident policyholders of the life insurer. A non-resident policyholder would ordinarily be unable to utilise imputation or withholding payment credits attached to dividends received, and would instead have Nonresident Withholding Tax levied on the dividend. Therefore as the life insurer is taxed as a proxy for the policyholders, it is necessary to approximate the treatment of dividends received by the life insurer and distributed to the policyholders through bonuses and actuarial reserves.

Thus the credits attached to dividends are apportioned by the level of policyholder income which relates to non-resident policyholders, and charges Nonresident Withholding Tax on the dividend received. Since the dividend is effectively received net of withholding tax an adjustment is first made to gross up the amount to reflect its pre-tax value, and then the withholding tax is levied. Instead of requiring the company to remit this amount to the Department, and since the adjustment is by necessity an estimate, the life insurer is required to treat the amount as a debit to its ICA, thereby reducing the credits available to be offset against the tax liability on Policyholder Income.

17.3.2 TRANSFER OF CREDIT BALANCE FROM IMPUTATION CREDIT ACCOUNT TO POLICYHOLDER CREDIT ACCOUNT (Section 394FA)

A New Zealand resident life insurance company is able to transfer credits arising in its ICA to its PCA by election. This transfer arises in both accounts on the date of the election. The transfer of credits allows the company the opportunity to offset the credits arising from the payment of tax on Life Insurer Income against the liability for tax on Policyholder Income.

However there are a number of provisions which deem a transfer in certain circumstances, and prohibit a transfer in others. The application of these provisions is designed to ensure that a New Zealand resident company that is a life insurer is not able to utilise imputation credits which arise in its ICA in respect of a future imputation year against a tax liability on Policyholder Income which arose in a prior income year which operates on a different date due to the company having a nonstandard balance date.

Where a company has a nonstandard balance date, there are two deemed transfers from the ICA to the

PCA on the last day of the imputation year. Firstly, by virtue of section 394FA(3)(a), where there are imputation credits arising from the payment of provisional tax before the end of the imputation year and during the accounting year in which the last day of the imputation year falls, and the credit has not been offset by a refund of provisional tax then the company is deemed to have elected that any balance of the provisional tax credits shall be transferred from the ICA to the PCA on the last day of the imputation year (31 March).

Secondly, under section 394FA(3)(b), where the company does not operate a WPA and receives a dividend with withholding payment credits attached these will give rise to credits in the ICA. In a similar manner to the provisional tax credits discussed above, where the credits in the ICA relating to withholding payment credits on dividends are received before the last day of the imputation year during the accounting year in which the last day of the imputation year falls, and have not been offset by a refund of any dividend withholding payment then the company is deemed to have elected that the balance of the withholding payment credits shall be transferred from the ICA to the PCA on the last day of the imputation year.

In addition, by virtue of section 394FA(3)(c), the company is unable to transfer credits from its ICA to its PCA during the period from 31 March until the end of the company's imputation year, if the credits relate to imputation credits or dividend withholding payment credits attached to dividends received.

17.4 DIVIDEND WITHHOLDING PAYMENT ACCOUNTS

Section 394ZT of the Act now allows a New Zealand resident life insurance company to operate a Dividend Withholding Payment Account if it elects to do so. The effect of this is that the life insurer is able to elect to make transfers to its PCA from its WPA. However as dividend withholding payments are refundable if not fully utilised by the person who ultimately receives them, there are provisions to ensure that a life insurer is unable to stream these credits to its shareholders as opposed to its policyholders.

17.4.1 TRANSFERS FROM WITHHOLDING PAYMENTS ACCOUNT TO POLICYHOLDER CREDIT ACCOUNT

Section 394ZW of the Act now provides for a new debit to a company's WPA for transfers from the WPA to the PCA. In addition there is an additional debit for a new penalty, an allocation deficit debit which relates to the rate at which dividend withholding payments were allocated to shareholders as opposed to policyholders.

Briefly, the transfers from the WPA to the PCA are achieved in a similar manner to those from the ICA to the PCA and this is recorded in both accounts on the date of the election. In addition, where credits have arisen to the WPA as a result of dividend withholding payments made by the company before the end of the imputation year and during the accounting year in which that imputation year falls, and these have not been subsequently offset by a refund of a dividend withholding payment, then the company is deemed to have elected to transfer the credit to the PCA on the last day of the imputation year.

However where a credit has arisen to the WPA by virtue of a withholding payment credit attached to a dividend received by the company, the company may not elect to transfer any part of that credit to the PCA during the period from the last day of the imputation year until the end of the company's accounting year in which the last day of the imputation year falls.

17.4.2 ALLOCATION RULES FOR WITHHOLDING PAYMENT CREDITS

As withholding payments are refundable to the person who ultimately receives them, there are provisions inserted into section 394ZY to ensure that life insurers do not stream imputation credits which are not refundable to policyholders, and withholding credits which are refundable to shareholders.

A comparison of two ratios is undertaken :

$$\frac{a}{b} \quad \text{versus} \quad \frac{e - f}{g}$$

where :

- a is the total of all transfers which the company has elected to make from the WPA to the PCA during that imputation year; and
- b is the total of all credits arising in the WPA in that imputation year; and
- e is the total of all transfers from the ICA to the PCA during that imputation year; and
- f is the total of all transfers from the PCA to the ICA during that imputation year; and
- g is the total of all credits to the ICA during that imputation year other than transfers from the PCA to the ICA.

Where the ratio of "a / b" is less than the other ratio, there is a deemed debit to the WPA, called an "Allocation Deficit Debit" for an amount which would be required to be added to item "a" in order to make the two ratios equal. Therefore to avoid this penalty, life insurance companies must ensure that policyholders share in any withholding payment credits allocated in an equivalent proportion to the level of imputation credits allocated to them.

18.0 POLICYHOLDER CREDIT ACCOUNTS

Section 56 of the Amendment Act inserts a new Part XIID into the Act with effect from 1 April 1990. This part of the Act relates to a Policyholder Credit Account ("PCA") which is the mechanism for a life insurer to offset credits resulting from the payment of tax on Life Insurer Income against the liability for tax on Policyholder Income.

A PCA will operate in a similar manner as an Imputation Credit Account ("ICA") which is required to be maintained by most New Zealand resident companies. Briefly, payments of tax on Life Insurer Income will also be recorded as credits in this account. This credit balance in the PCA will be able to be used to offset tax payable on Policyholder Income.

As life insurers which are New Zealand resident companies will now be required to maintain ICAs, there are a number of provisions within Part XIID of the Act to enable transfers between the accounts, and to limit any tax avoidance or deferral opportunities which may arise as a result of the two accounts operating.

18.1 NEW ZEALAND RESIDENT COMPANIES

A New Zealand resident company which is a life insurer, is required by section 394ZZZ to establish and maintain a PCA, and is thus described as a PCA Company. As discussed above, this is a memorandum account similar to the ICA and functions to recognise the tax paid on policyholder's income. PCAs for life insurers that are not New Zealand resident companies are discussed at item 18.2 below.

Each PCA Company is required to record in the PCA the opening balance and debits and credits as they arise. The PCA for a New Zealand resident company will operate on the imputation year (31 March balance date), and the account commences on 1 April 1990 with a nil balance.

As the provisions discussed below demonstrate, to a large extent, a PCA for a New Zealand resident company operates subservient to the ICA and the associated Dividend Withholding Payment Account ("WPA"). It should be noted that the provisions of the Act only allow a PCA Company to utilise a credit balance within the PCA. In other words, the PCA is not able to go into debit and be overdrawn.

Section 394ZZZB provides that credits to the PCA of a New Zealand resident company arise from transfers which the company elects to make from either the ICA in terms of section 394FA of the Act, or from the WPA in terms of section 394ZXA of the Act. In either case the date the credit arises is the date of the election. Similarly, the contra entry within the ICA or WPA occurs at the same time as the entry in the PCA.

A PCA Company may elect to offset the credit balance in its PCA against tax payable on Policyholder Income as provided in section 394ZZZC of the Act. This creates a debit to the PCA and the entry arises in the account on the last day of the company's income year to which the payment of the tax relates. Alternatively, a company may elect to transfer the credit balance in the PCA back to the ICA, with the entry in both accounts arising on the date of the election.

The Commissioner is given the authority by section 394ZZZD of the Act to correct the amount or date of any entry in a PCA if the Commissioner is satisfied that there was an error made or that an entry should not have been recorded. As soon as is possible after the Commissioner determines that an adjustment is required, The Commissioner is required to give notice of this determination to the taxpayer. However omitting to give the notice does not invalidate any determination. The company has the power to object to any determination made by the Commissioner, but otherwise it is required to make the required corrections to the PCA.

18.2 POLICYHOLDER CREDIT ACCOUNTS OF OTHER PERSONS

In terms of section 394ZZZE of the Act, any person carrying on the business of providing life insurance (other than a PCA Company as discussed at item 18.1 above), may elect at any time during an income year to maintain a PCA. The election takes effect from the beginning of that income year, and continues in effect until the beginning of the income year in which the person elects to cease operating a PCA. If a person does elect to maintain a PCA, then notification of this election must be given to the Commissioner within 21 days.

Each PCA Person is required by section 394ZZZF to record in the PCA the opening balance and debits and credits as they arise. The PCA for a New Zealand resident company will operate on the balance date of the person. The account commences with a nil balance.

18.2.1 CREDITS ARISING TO POLICYHOLDER CREDIT ACCOUNT OF OTHER PERSON

Section 394ZZZG provides that credits arise to a person's PCA in the same way as if to the extent that person carries on business in New Zealand, that person were a New Zealand resident company and the PCA were in fact an ICA. However since these persons are unable to maintain an ICA a number of the usual provisions do not apply. For instance the provisions allowing transfers between an ICA and a PCA will not apply as there is in fact no ICA to make transfers from. The date upon which the credits arise to the PCA is the equivalent date as if it were an ICA. In practice it is likely that most credits will arise from the payment of tax on Life Insurer Income, and this will be recorded as at the date the tax was paid.

As a person other than a New Zealand resident company is taxed on dividends received, section 394ZZZG(1)(c) provides that credits will not arise to the PCA for imputation credits or dividend withholding payment credits attached to dividends received. The credits are treated in the same manner as for any other taxpayer and are allowed as a credit against income tax payable on Life Insurer Income in terms of sections 394ZE, 394ZP or 394ZZV as appropriate. The credit obtained by the life insurer is deemed to be paid on the date upon which the dividend is paid.

18.2.2 LIMITATION ON CREDITS FOR NON-RESIDENTS

The credits arising to the PCA for tax paid are limited in the case of a nonresident life insurer by section 394ZZZG(6). This subsection provides that notwithstanding the other provisions outlined above, for a nonresident life insurer credits for income tax paid are only available for income tax paid in respect of an amount included in item "i" (Other Income) of the Life Insurer Income formula for a nonresident life insurer (see item 9.0 above), or tax paid in respect of an amount of nonresident withholding income which was assessed separately by virtue of section 317 of the Act. Consequentially, debits only arise in respect of refunds of tax paid on these items.

The reason for this is that credits are only available in respect of income which is New Zealand sourced, and has had New Zealand income tax paid on it. Therefore, if New Zealand policyholders have received distributions funded from sources outside New Zealand, and hence Policyholder Income is increased, the credits available to offset against this income are still limited to the tax paid on Life Insurer Income in New Zealand, and as a consequence additional tax may be payable on Policyholder Income.

18.2.3 DEBITS ARISING TO POLICYHOLDER CREDIT ACCOUNT OF OTHER PERSON

The PCA person may elect in terms of section 394ZZZH of the Act to offset credits in the PCA against tax payable on Policyholder Income. This is entered in the PCA on the date that the person makes the election.

Similar to the situation for credits discussed above, debits to a person's PCA arise as if to the extent the person carries on the business of life insurance in New Zealand, that person were a New Zealand resident company, and the PCA were an ICA. Again the provisions relating to transfers between the ICA do not apply. Also the provision substituting NonResident Withholding Tax for imputation credits (discussed at item 17.3.1 above) and the continuity of ownership provisions contained at section 394E(1)(g) of the Act do not apply.

18.2.4 ANNUAL RETURN FOR A POLICYHOLDER CREDIT ACCOUNT PERSON

Every PCA Person is required by section 394ZZZI to provide an annual PCA return for each income year. It must state the opening and closing balances of the PCA, the amount and source of credits and debits that have arisen during the year and any further information specified by the Commissioner. This return is required to be furnished at the same time as the annual return of income.

18.2.5 REFUND OF INCOME TAX NOT TO EXCEED CREDIT BALANCE OF POLICYHOLDER CREDIT ACCOUNT

As from the 1991 income year onwards as provided at section 394ZZZJ, where a PCA Person becomes entitled to a refund of income tax the amount paid shall not exceed the credit balance in the PCA at the later of either:

- The end of the last income year; or
- The last day of any period where a person furnishes a PCA return.

Where an income tax refund is not paid to the taxpayer, it will be credited against income tax payable or provisional tax payable in the year in which the refund arose or in a subsequent year.

19.0 TRANSITIONAL PROVISIONS RELATING TO LIFE INSURERS

A number of transitional provisions have been included in the Amendment Act to take account of the fact that the Amendment Act was assented to during the 1991 income year and that a number of the PCA provisions need to have retrospective effect. In addition, for a New Zealand resident life insurance company there are provisions to take account of the problems which result if the company's balance date differs from the 31 March balance date of its PCA and its Branch Equivalent Tax Account.

19.1 RESIDENT LIFE INSURANCE COMPANIES WITH NON-STANDARD BALANCE DATES

Section 65 of the Amendment Act provides the details to enable the new life insurance system to be incorporated into the existing imputation, dividend withholding payment and branch equivalent tax systems for PCA Companies which have a balance date other than 31 March.

If the company has an early balance date, that is it balances on a date from 1 October to 30 March each year, the company is required by section 65(1) of the Amendment Act, to maintain an imputation account for the period from the first day of the income year until 31 March 1990. This is in effect an imputation account for the period from the beginning of the 1991 income year for these companies until the balance date of the imputation year. After this, the imputation account will continue with a 31 March balance date. A New Zealand resident life insurance company may elect on or before 30 September 1990 that it will be a WPA Company with effect from the beginning of the 1991 income year.

In addition, where the company operates an ICA, a WPA or a PCA then no credits arise in any of these accounts before the commencement of the company's 1991 income year.

Similarly, in respect of late balance date (from 1 April to 30 September) companies, the ICA commences from 1 April 1990, but no credits arise in it until the commencement of the company's 1991 income year.

19.2 RESIDENT LIFE INSURANCE COMPANIES WITH BRANCH EQUIVALENT TAX ACCOUNTS

Where a company that is a resident life insurer has a late balance date for the 1990 income year, is a Branch Equivalent Tax Account ("BETA") person and does not elect to cease to be so, then it is deemed by section 66(1) of the Amendment Act to have elected under section 394ZZN to be a BETA company from 1 April 1990. As a BETA person, the life insurer would previously have operated its BETA with a balance date the same as its own. As a BETA company, the BETA operates on a 31 March balance date. Therefore, there are provisions to cover the transition from being a BETA person to a BETA company. Briefly, for standard balance date companies the changeover occurs with no real problems, the closing balance of the person's BETA becomes the opening balance of the company's BETA.

In respect of late balance date companies, a final BETA account as a person is required to be furnished before 30 September 1990 for the period from the first day of the company's accounting year until 31 March 1990. The closing balance of this account becomes the opening balance of the BETA as a BETA company from 1 April 1990 onwards.

Early balance date companies that were BETA persons are subject to the same provisions as late balance date companies unless they elect before 30 September 1990 to be treated as a BETA company from the first day of their 1991 income year, in terms of section 66(3) of the Amendment Act. If the company elects for this to happen, the changeover from BETA person to BETA company occurs on the first day of the company's 1991 income year. The company is required to maintain the BETA for the period to 31 March 1990 and thereafter it reverts to the standard 31 March balance date.

Section 66(4) of the Amendment Act provides that a New Zealand resident life insurance company may not make transfers to its imputation account in respect of amounts arising in its BETA in respect of the 1990 or prior income years. This is designed to prevent back-year income tax payments under the old life insurance taxation regime being used to offset Policyholder Income derived under the new life insurance taxation regime.

20.0 FRINGE BENEFITS TAX ON LOW INTEREST LOANS TO POLICYHOLDERS

Section 32(7) of the Amendment Act inserts a new subsection 9 into section 336N of the Act. This provides that where a policyholder owes a loan to a life insurer, then this is treated as if it were a loan to an employee by an employer. The effect of this provision is that fringe benefits tax will be payable if the interest rate on the loan is less than the prescribed rate of interest prevailing at the time for fringe benefits tax purposes.

21.0 SEPARATION OF SUPERANNUATION BUSINESS OUT OF A LIFE FUND TO A SUPERANNUATION SCHEME

Following submissions made to the Consultative Committee on Superannuation, Life Insurance and Related Areas the Committee decided that provided the service being offered is essentially the same, superannuation offered by a life insurer should be subject to the same tax regime as registered superannuation funds. To facilitate this, the Committee proposed that life insurers should be allowed to transfer assets, without a taxation penalty, to a superannuation fund which would be taxed under the taxation regime applying to superannuation. The provisions enabling this transfer are contained in a new section 206 of the Act and a new Part VI to the Superannuation Schemes Act 1989. All applications for approval of transfers must be made before 1 January 1992.

The emphasis for these transfers is that if the life insurer's superannuation liabilities are to be transferred to another entity, thereby relieving the insurer of liability, then the amount of the liability must be carefully determined, and assets of value equivalent to this liability must be transferred contemporaneously. Therefore the requirements are very strict as to certification from an actuary of the amount of the liability and an independent valuation of the property to be transferred to fund the liability.

In general terms the legislation to effect the transfers provides that no Gift Duty, Stamp Duty or Goods and Services Tax liability arises from the transfer. For income tax purposes, the transfer is still taxable, however the life insurer is deemed to have sold the property at cost price (or book value in some cases) and therefore no assessable income arises. The superannuation fund is deemed to have purchased the property on the same day as it was originally acquired by the life insurer and for the same price. There are provisions to ensure that the property is in effect subject to an unchanged taxation regime for the period to 1 April 1988 when the income of superannuation schemes became taxable.

It is important to note that the enabling provisions do not allow any special exemptions from tax or duty in respect of indirect transfers of property. That is, the transfer of the property must be from a life insurer directly to a registered superannuation scheme and not through an intermediary entity. For instance, the transfer of an interest in a parcel of land may not be achieved by transferring ownership of the land to a company or unit trust and then distributing the shares of the company or units of the trust to the life insurer and the superannuation scheme.

22.0 MECHANISM FOR THE TRANSFER OF SUPERANNUATION ASSETS AND LIABILITIES (Part VI Superannuation Schemes Act 1989)

The new Part VI of the Superannuation Schemes Act 1989 which allows for the transfer of superannuation assets and liabilities is inserted by section 5 of the Superannuation Schemes Amendment Act 1990.

22.1 APPLICATION FOR APPROVAL OF THE TRANSFER

As noted above, Part VI of the Superannuation Schemes Act 1989 provides the framework for the actual transfer of superannuation assets and liabilities to occur. Where a life insurer proposes to transfer property to a superannuation scheme in consideration for the trustee of the scheme assuming superannuation liabilities of the life insurer, the life insurer may apply under section 68 of the Superannuation Schemes Act 1989, to the Government Actuary for approval of the transfer.

An application under section 68 of the Superannuation Schemes Act 1989 must be accompanied by:

- A report from an actuary on behalf of the life insurer which states the assumptions and bases of calculation used in determining the value of the liabilities, together with a statement that these assumptions and bases of calculation are appropriate for determining the liabilities; and

- An independent valuation of the property certified by a person approved by the Government Actuary; and

- A certificate from a solicitor stating that either:

  (i) That the trust deed of the superannuation scheme receiving the assets and liabilities does not contain any of the following provisions:

    - Provisions necessary to ensure consistency with provisions implied or required by the Superannuation Schemes Act 1989; or

    - Provisions giving the trustee power to borrow money for the purposes of the superannuation scheme at the trustee's discretion; or

    - Subject to the Superannuation Schemes Act 1989, provisions giving the trustee the benefit of limited liability; or

    - A provision giving a proportion of the beneficiaries the power to totally or partially wind up the scheme; or

    - A provision giving the trustee the ability to pay scheme management and administration expenses out of the property of the scheme; or

  (ii) A statement that the inclusion of any of the above provisions in the trust deed will not detrimentally affect any beneficiary in any material way.

In terms of section 68(4) of the Superannuation Schemes Act 1989, the property which is transferred to the superannuation scheme must be determined by an actuary who is required to have regard to the actuarial soundness of both the life insurer and the superannuation scheme before and after the proposed transfer. The actuary is also required to consider the terms and conditions determining the liabilities of the life insurer which are to be assumed by the scheme immediately before the proposed transfer and any allocation of assets made by the life insurer in the past against its superannuation liabilities. In addition the assets are required to be valued in a manner or by a person who is acceptable to the Government Actuary for the purposes of the independent valuation.

In other words, an actuary is required to ensure that the transfer is equitable having regard to the previous actions of the life insurer, and it does not impinge on the soundness of either the life insurer or the superannuation scheme. Also the property transferred must have been the subject of an independent valuation which was acceptable to the Government Actuary.

A transfer cannot be made to a trustee of a superannuation scheme which carries on the business of providing life insurance for the purposes of the Income Tax Act 1976 (Section 68(4)). As discussed earlier at item 12.1, where a superannuation scheme provides any benefits contingent on human life, it is treated as carrying on the business of life insurance for tax purposes. The only way to avoid this is to enter into a reinsurance policy in New Zealand which fully reinsures the life insurance risk. This means that for the purposes of the transfer of assets and liabilities, if the superannuation scheme provides benefits contingent on human life it must enter into a full reinsurance policy either before the transfer or contemporaneously with the transfer, so that section 204N of the Income Tax Act 1976 will apply (see item 10.0 above) and that the scheme is not treated as a life insurer.

It is likely in practice that this reinsurance policy will be with the life insurer that transferred the superannuation business to the scheme. If this occurs then the transfer has completely separated the life insurer's business of providing life insurance and only pure superannuation business is carried on by the superannuation scheme. Therefore there is no question that the new life insurance taxation regime could apply to these superannuation schemes unless they commence this business after the transfer, hence they are not included in the exemptions from the life insurance regime discussed at item 12.1 above.

22.2 APPROVAL BY THE GOVERNMENT ACTUARY

If the transfer is given the Government Actuary's approval in terms of section 69 of the Superannuation Schemes Act 1989 then the various tax exemptions are available. However if this approval is either not sought or not obtained the transfer will attract no special tax concessions, and will be subject to the duties and taxes which would otherwise prevail.

If an application has been made, it will be approved by the Government Actuary where the Government Actuary is satisfied that:

- The trust deed of the superannuation scheme incorporates terms and conditions so that the liability of the trustee to the beneficiaries will be the same as those of the life insurer transferring the policy. Alternatively, the Government Actuary may treat the liabilities as being the same where they differ only because the trust deed incorporates one or more of the provisions that the solicitor's statement reports on (see item 22.1 above), and the inclusion of those provisions will not detrimentally affect any beneficiary in any material way; and

- The trustee of the superannuation scheme which will be assuming the liabilities has been advised of the details of the proposed transfer and consents to it; and

- Where the consideration for accepting the assets is the assumption by the superannuation scheme of the liability to provide benefits to any specific beneficiary, then that beneficiary consents to the transfer arrangement (although where the beneficiary is a superannuation scheme, it is only necessary to obtain the consent of the trustee of that scheme); and

- The property to be transferred has been determined and an independent valuation has been obtained by an actuary, and the property and valuation are appropriate for the purposes of the transfer.

Where the Government Actuary does give approval for the transfer, then the Government Actuary may also specify the property to be transferred as part of that arrangement, to ensure that property of an appropriate type, amount or value is transferred.

If the approval of the Government Actuary has been obtained, the property must be transferred from the life insurer to the superannuation scheme within three months of the date of the approval. If the transfer occurs within this time frame it is deemed to be lawful notwithstanding that it may be contrary to the trust deed of the scheme, or that the consent of all members or beneficiaries to the scheme has not been obtained.

Provided that the arrangement is approved by the Government Actuary under section 69 of the Superannuation Schemes Act 1989, and the property is transferred within three months of the Government Actuary's approval, then section 71 of the Superannuation Schemes Act 1989 will apply to exempt the transfer from Stamp Duty and also provides that any Goods and Services Tax chargeable on the transfer is charged at the rate of zero percent. For Income Tax purposes, the new section 206 of the Income Tax Act 1976 is deemed to apply to the transfer. It should be noted that if the approval of the Government Actuary is not sought or obtained, or if the transfer is not effected within three months of the approval being granted, the concessionary provisions will not apply, and the transfer will be subject to ordinary tax provisions.

23.0 INCOME TAX IMPLICATIONS OF TRANSFERS OF SUPERANNUATION ASSETS AND LIABILITIES (Section 206)

The new section 206 provides the Income Tax consequences for property transferred pursuant to an arrangement approved by the Government Actuary. In general terms the provisions of section 206 of the Act serve to ensure that the transfer is tax neutral whilst maintaining the taxation regimes which applied in past years to the gains and losses accruing over that time. The reason for this is to ensure that the selection of the property to be transferred is an arm's length decision, and is not influenced by any tax considerations. The actual treatment afforded by section 206 depends on the type of property transferred.

23.1 FINANCIAL ARRANGEMENTS

The provisions of section 206(3) apply where the property transferred is a financial arrangement (to which the "accruals rules" contained in sections 64B to 64L of the Act apply). Briefly, the sale and purchase of the financial arrangement is deemed to take place on the date of the transfer. The price to be taken into account is, at the option of the life insurer, either:

- The market value of the financial arrangement on the date of the transfer; or

- The "Adjusted Base Price", which means:

(i) Where the life insurer is the issuer (debtor) under the financial arrangement, the Adjusted Base Price is the acquisition price plus all accrued expenditure incurred by the issuer, less all consideration paid by the issuer in relation to the financial arrangement before the date of transfer; and

(ii) Where the life insurer is the holder (creditor) under the financial arrangement, The Adjusted Base Price is the acquisition price of the financial arrangement plus all income accrued to the holder, less all consideration received by the holder in relation to the financial arrangement before the date of the transfer.

Therefore, at the option of the life insurer, the property is either transferred at market value and there are tax implications accordingly, or at 'present value' which would mean that only income accrued up to the date of the transfer is taken into account in the life insurer's tax return when the Base Price Adjustment (as per section 64F) is done for the financial arrangement.

23.2 TRADING STOCKS

Section 206(4) provides that where a life insurer transfers property which is trading stock pursuant to the arrangement then the sale and purchase of that property is deemed to take place on the date of the transfer. The life insurer is deemed to sell the property at the opening value used in the life insurer's return of income for that trading stock. This in effect provides for a direct transfer of the value in the life insurer's accounts into the accounts of the superannuation fund at no tax cost to the life insurer.

23.3 OTHER PROPERTY

In the case of all other property, the transfer is deemed to take place either on the first day of the income year in which the transfer actually takes place (bearing in mind that transfer applications must be made before 1 January 1992; see item 21.0 above), alternatively if an application for approval from the Government Actuary was made before 1 April 1991 or the last day of the life insurer's 1991 income year (whichever is the later), then the transfer is deemed to take place at the beginning of the 1991 income year. This means that all income derived after the effective date of the transfer is to be accounted for by the trustee of the superannuation scheme, and this is specifically confirmed in section 206(2)(b) of the Act.

However for the purposes of calculating the gain or loss on sale or other disposal of any property, the trustee of the superannuation scheme is deemed to have acquired the property on the same date as when the life insurer originally acquired it. The trustee is deemed to have acquired the property at a price equal to the "Specified Base Cost for 1983

Income Year Property" (as discussed at item 6.1 above) if the property was acquired on or before the last day of the 1983 income year.

If the property was acquired after that date then section 206(2)(c) of the Act provides that the trustee is deemed to have acquired the property for a price equal to the total of any of the following items which have not previously been claimed as deductions by the life insurer:

(i) The original purchase price of the property; and
(ii) Any expenditure incurred in purchasing the property; and
(iii) Any expenditure incurred in effecting repairs, alterations, or improvements to the property; and
(iv) Any expenditure incurred in securing or improving the legal rights of the life insurer in relation to the property;

In other words the trustee is deemed to have incurred the same amounts of capital expenditure in acquiring the property as the life insurer incurred itself, and for which the life insurer was unable to claim a deduction. In addition, the trustee of the superannuation scheme is deemed to have been allowed all deductions previously claimed by the life insurer or an associated person of the life insurer for interest in relation to the property, or under sections 126, 127 or 128 of the Act for certain expenditure incurred in relation to farming land, forestry land or aquaculture businesses.

In respect of depreciation, the trustee is deemed by section 206(2)(d) of the Act to have been allowed the same deductions for depreciation as were allowed for the life insurer. Also, for the purposes of calculating the depreciation allowances now available to the trustee of the superannuation scheme, the book value of the property is deemed to be the price at which the trustee of the superannuation scheme is deemed to have acquired the property (as discussed above) less the depreciation previously claimed by the life insurer which is now deemed to have been allowed to the trustee of the superannuation scheme.

As with the gains and losses on the sale or other disposal of property as calculated for Life Insurer Income (refer to item 6.1 above), the taxation regime which applied over the period gains and losses were accruing on property held by a life insurer is maintained in respect of that property transferred to a superannuation scheme pursuant to an approved transfer. Therefore where the property was acquired before 1 April 1988 an equivalent adjustment is made to apportion the accrued gains and losses for the superannuation business which was until that date exempt from tax.

In other words, the same

$$\frac{a}{b} \times c$$

adjustment is made (refer to item 6.1)

The life insurer is deemed at section 206(2)(h) to have sold the property on the same date and for the same price as the trustee of the superannuation fund is deemed to have acquired it. This means in practice that although the transfer is taxable in the hands of the life insurer, no gain should result as the property is transferred at a value equal to the capitalised cost of the property. In addition, the life insurer is deemed not to derive any assessable income from depreciation which would otherwise be recovered on the sale of the property.

Section 206(2)(g) sets out the provisions which will apply if the trustee of the superannuation fund is not taxable on the gains and losses on the sale or other disposal of any property. It is expected that there will be few (if any) superannuation schemes which will fall into this category. If the provisions apply then the trustee of the superannuation scheme is taxable upon sale or other disposal of the property, only on the amount of the gain which accrued before 1 April 1988, and this calculation will be subject to the apportionment for superannuation business as per section 206(2)(f) discussed above.

24.0 TRANSITIONAL PROVISIONS

There are a number of provisions contained in section 206 to ensure that the transfer of property to a superannuation scheme does not have tax impact as regards the property or the superannuation scheme.

Section 206(5) ensures that the transfer of shares from the life insurer to a superannuation scheme will be treated as being held by the same persons for the purposes of determining continuity of shareholding for losses carried forward, determining whether a specified group exists or for the holding of credits in the company's Imputation Credit Account, Withholding Payment Account or Branch Equivalent Tax Account.

Also, there is a provision at section 206(6) to ensure that the superannuation scheme is not subject to section 232B of the Act. The latter section provides for the taxation of gains or losses from investments made before 1 April 1988. As discussed above, there are specific rules in respect of superannuation schemes to which property is transferred pursuant to an approved transfer, and hence the provisions of section 232B are unnecessary.

It is acknowledged that there may be some difficulty in estimating the assessable income derived by the superannuation scheme in the year in which the transfer takes place. However overall the quantum of assessable income to be taken into account is unchanged in respect of the transfer, the question which arises is which entity, the life insurer or the superannuation scheme, is required to account for the income earned on the relevant property. Given that the superannuation scheme is required to estimate its provisional income by section 38(2) of the Amendment Act, the trustee of the scheme may be liable for penalties for underestimating its assessable income. Section 206(7) provides that the life insurer may elect that any overpayment of provisional tax that it may have made can be treated as if it were provisional tax paid by the trustee of the superannuation scheme. This is only effective for determining whether any underestimation penalties will be payable by the trustee of the superannuation scheme.

In other words, the life insurer may effectively transfer provisional tax overpaid by itself to the superannuation scheme so that the superannuation scheme would not be liable for underestimation penalties. It should be noted that this provision only applies if the life insurer has paid as provisional tax in excess of its own actual terminal tax liability, and this section does not give exemption from other penalties. Therefore, there may still be additional tax imposed if payments are made late for instance. The emphasis for this provision is that if the estimated global tax liability, that is for both the superannuation scheme and the life insurer, would not attract underestimation additional tax in terms of section 384 of the Act, then the separation of this estimate between the life insurer and superannuation scheme due to the transfer of property should not in itself attract underestimation penalties.

Also section 206(8) provides that a life insurer or trustee of a superannuation scheme may be given an extension of time beyond usual limits to file a return of income for the year in which an application has been made to the Government Actuary to transfer property from a life insurer to a superannuation scheme. It should be noted that persons who wish to have an extension of time granted are required by section 17 of the Act to make this application in writing to the Commissioner before the due date for the return of income.

25.0 MISCELLANEOUS SUPERANNUATION PROVISIONS

Incorporated amongst the provisions of the Amendment Act are several provisions which have an effect on the taxation of superannuation schemes.

25.1 RATE OF TAXATION

As from 1 April 1990, all superannuation funds in existence are deemed to become Qualifying Trusts for tax purposes. Before this period there were a number of transitional provisions affecting superannuation funds, and in particular there was a provision for superannuation funds which were previously Category 1 Superannuation Schemes to be taxed at a rate of 25 cents from 17 December 1987 onwards. As from 1 April 1990 these superannuation schemes are to be taxed at the standard rate for Qualifying Trusts, namely 33 cents.

It should be noted that this change in tax rate is on a particular day, not on an income year basis. Where a superannuation fund has a balance date other than 31 March, the income earned in the income year spanning 31 March 1990 is apportioned between the days before 31 March 1990 and the days after this date and the appropriate tax rate is applied. This is provided by a formula :

$$\text{Tax Payable} = \frac{a \times b \times c}{365} + \frac{d \times e \times c}{365}$$

where:

a is the number of days in the accounting year before 1 April 1990; and

b is the rate of tax which would have applied to the superannuation fund if the rate had not been changed to 33 cents by the Amendment Act; and

c is the taxable income of the superannuation fund for that year; and

d is the number of days from 31 March until the end of the accounting year; and

e is the rate of tax specified in clause 9A of the First Schedule to the Act (33 cents).

25.2 DEDUCTIBILITY OF EXPENDITURE

In the past, one superannuation scheme was unable to be a member of another superannuation scheme. However section 2 of the Superannuation Schemes Act 1989 has been amended to allow superannuation schemes to be members of other schemes. This is to cater for easier administration of schemes so that there can be a ‘master’ superannuation scheme which administers investments on behalf of a number of other schemes. These other schemes have access to the investments, and thus are able to pay their own beneficiaries, by way of rights to the benefits of the master scheme.

Therefore it is likely that many smaller schemes will derive no income in their own right, all investment income being derived by the master scheme, but the smaller schemes will still incur various administration expenses which in the absence of assessable income will not be deductible. To allow for this contingency, section 228(2C) of the Act has been inserted to provide that where the funds of one superannuation fund are invested in another superannuation fund, and the first superannuation fund incurs expenditure in respect of marketing the scheme or administering the scheme which is not the purchase of assets, or expenditure which is not income in the hands of the recipient then this expenditure may be treated as if it were incurred by the other superannuation scheme.

In other words, the expenditure which may otherwise not be deductible to the member scheme, is allowed as a deduction to the master scheme. For this provision to apply, the member scheme must elect with its return of income that the expenditure should be transferred, and the master scheme is deemed to incur the expenditure at the same time as when it was incurred by the member scheme.

25.3 UNIT TRUST ANTI AVOIDANCE

In order to protect a possible difficulty as between the superannuation tax regime and the regime applying to unit trusts, section 226(10A) has been inserted to provide that where a trust which is a company (a unit trust is a trust which is deemed to be a company for tax purposes) becomes a superannuation fund, the trust shall be deemed to have been wound up on the date it becomes a superannuation fund. The deemed winding up has a number of tax implications, the main effect is that most distributions are deemed to be dividends and may be taxable in the hands of the recipient. This provision is to ensure that if the earnings of a unit trust are sheltered by grouping its income against tax losses of other companies, then the income cannot be distributed free from tax by converting the status of the trust to a superannuation fund.