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Editor's say

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I am very pleased to present to you our fifth issue of the PwC's Asia Pacific Insurance Tax News.

The past four issues aimed to keep you informed of the latest tax developments in the insurance industry throughout the region. This year, we focus on a common theme – tax issues surrounding investments of insurance companies across Asia Pacific.

Although investment income probably is the largest income item in the profit and loss accounts of insurance companies apart from premium income, it may not always receive sufficient attention in an insurance company's tax planning agenda. In particular, investment teams of insurers, who generally are not tax specialists, may only look at the before-tax return, rather than after-tax return, when formulating their investment strategy and making investment decisions. Accordingly, we see a lot of tax opportunities, and at the same time significant tax risks, associated with how insurers carry out their investment activities.

In this issue of Asia Pacific Insurance Tax News, our specialists from ten Asia Pacific jurisdictions will share with you some of the topical issues, challenges and opportunities arising from the taxation of investment income of insurance companies in their jurisdictions. I hope you will find these analyses both interesting and useful.

If you would like to discuss further any of the issues raised, please contact the individual authors or contacts listed after each article, our country leaders listed at the back of the publication or your regular contact at PwC. We look forward to receiving your feedback.

Australia

Investment Issues

This article deals with current investment tax issues affecting insurers operating in Australia. It covers:

1. Issues relating to investment income earned from managed funds;
2. Taxation issues and opportunities relating to the taxation of financial arrangements ("TOFA") rules; and
3. Investment issues relating to underwriting.

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Investment Income Earned by Managed Funds

Although only some general insurance companies invest through managed funds, it is very common for life insurers to do so. This has been a result of life insurers restructuring their investments to group them, and in many cases, utilise managed fund structures that are offered to the public by the insurer.

In 2011 the Australian Taxation Office ("ATO") issued a ruling stating that anything received by a general insurance company from a managed fund would be income according to ordinary concepts, and therefore taxable. Subsequent actions by the ATO have demonstrated that they also hold this view in relation to investments of a life insurer. In contrast, insurers have typically treated certain amounts received from managed funds as not being taxable, but rather as reducing the cost base of their investment in the managed fund. Such amounts, commonly referred to as "tax deferred" distributions, arise from differences between the accounting or trust law income of the managed fund, and the taxable net income of the managed fund. A typical example is where the managed fund invests in real estate and there are tax deductions for the cost of the building over time, whereas there is no amortisation for accounting purposes (resulting in an excess of accounting income over taxable income).

In addition, capital gains distributed by managed funds to insurers have typically been treated as being able to be offset against capital losses. While insurers do not often incur capital losses, many insurers actually do have such losses as a result of the way the tax consolidation regime was introduced in the early 2000's. Whereas the insurers' treatment would offset the capital gains distributed against capital losses, so that no tax would actually be payable on that part of the distribution, the view expressed by the Tax Office in its ruling would treat the entire amount as taxable under ordinary principles (as a revenue gain) rather than as a capital gain. Revenue gains cannot be offset by capital losses under the Australian tax rules.

In the authors' view the position taken by the ATO in relation to these distributions represents an extension of the case law precedent. It will be interesting to see how the courts handle this when it is ultimately tested there.

Taxation of Financial Arrangements

The TOFA rules, dealing with the recognition of income from investments, now apply to all insurers with assets exceeding $100 million. It is worth noting that this threshold counts the assets held by certain related parties. For instance, a small Australian branch holding, say, $50 million of assets would need to include the assets of its head office when determining whether it is above the threshold.

TOFA has the potential to reduce investment tax complications considerably, by potentially aligning the taxable income on investments with accounting income. For instance, where an insurer chooses to use the fair value method ("fair value election"), and also chooses to transition its existing investments into the regime ("transitional election"), they would typically not have to make any investment adjustments when preparing their tax return. In our experience, approximately half of the general insurance industry in Australia has made both of these elections. We are only aware of one life insurer that has made the fair value election, although a significant number did make the transitional election.

Some insurers have chosen not to make the irrevocable election to use the fair value method as it results in unrealised gains being taxable and the deeming of all investments as being on revenue account. For life insurance companies, this potentially means losing the CGT concession available to its superannuation business. However, many general insurers saw taxation of unrealised gains (and losses) as mitigated by the negative correlation between investment returns and claims reserves, due to the investment rate applied to discount claims reserves. Some insurers also saw the correlation between accounting profit and tax payments under the fair value method as an improvement in transparency. In some cases, it also helped in passing tax credits to shareholders.

Insurers who have not made any election need to carve out investments from their accounts and treat investments acquired after the TOFA rules first applied as taxable on an accruals basis, with investments acquired before that time being taxable on the old receipts and realisation bases. Some insurers have chosen the fair value method but have not elected to transition their old investments into the regime. In both cases, calculating the tax adjustments required for investment income has multiplied in complexity compared to the situation before the introduction of TOFA. This is due to the practical difficulty of running two separate “books” (for pre and post TOFA investments) and the inability to source either of these directly from the accounting information. In particular, we have seen substantial problems with this where the investment accounting is undertaken outside of Australia, either in-house or by a custodian that has no knowledge of the way the TOFA rules apply.

Underwriting related investments issues

Under Australian IFRS, claims reserves need to be discounted at the risk free investment rate. For tax purposes, however, there is no such specification. Rather, claims reserves are equal to the amount that the company determines is sufficient that, together with investment returns, will provide sufficient funds to pay claims when they are due. The ATO has been trying to force insurers to use the actual investment return rate when discounting. The ATO theory, of course, is that the actual investment return rate should be higher than a risk free rate, and the discounted claims reserves that could be claimed as a tax deduction would thus be lower. However, in the last few years the investment returns have been very poor and it is likely that applying the actual investment return rate would lead to even higher deductible claim reserves!

One final underwriting matter that relates to investments is the application of the OECD guidelines on the allocation of profits to branches. Under those guidelines, the place where the underwriting takes place is likely to be the place where the underwriting profits are to be attributed. Further, the investments which relate to the underwriting are also attributed to that place.

Under Australian domestic tax law, non residents (such as an Australian branch of a foreign company) are taxable only in respect of Australian sourced profits. Further, there is a sound argument that income from non-Australian investments is not Australian sourced, even if the investments relate to business written by an Australian branch. Therefore, the application of the OECD guidelines to an Australian branch is likely to result in not only changes to the allocation of the underwriting profits, but also changes to the place where some investment income is taxable.

Although the OECD discussion paper on the allocation of profits to insurance branches was released some four years ago, and incorporated into the OECD model commentary in 2010, we have not seen any action from the ATO to attempt to implement these guidelines. In fact, Australia is in the middle of revising its transfer pricing rules, and the allocation of profits to branches under the OECD guidelines is one matter being considered as part of these revisions. At the current point of time, a discussion paper has been released by Treasury (to a selected few) dealing with this issue - not just for insurers, but for all taxpayers.

At this stage, we cannot be certain of the outcome of this review. However, we think it is unlikely that the review would not respect the general approach of the OECD guidelines, ie that the underwriting profits and relevant investment income should be recognised in the place where the underwriting takes place. Other aspects of the guidelines, such as recognising transactions between a branch and its head office, and sometimes even applying a mark up to those transactions, is much more controversial in the Australian context.

Whatever the outcome of this review, there is sure to be change.

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China

China Tax management in securities investment – An insurer's perspective

The rapidly growing insurance industry in China provides significant opportunities for foreign insurers. Whilst foreign insurers may find their relative market share in China has remained stagnant over the last 3 years, the overall market has expanded substantially to enable them to achieve strong premium growth in China. Meanwhile, foreign insurers in China have also experienced exponential growth in their assets under management. Effective investment management of insurance proceeds has become one of the major challenges to foreign insurers in China.

The purpose of this article is to look at the emerging China tax issues arising from the recent regulatory changes that would affect foreign insurers' investment of their insurance funds in different securities markets.

Bank deposits and Government bonds

Foreign insurers in China are required to invest a substantial portion of their monies in domestic saving accounts or government bonds in order to reduce risks. However, China has cut interest rates twice since June 2012 and more cuts are expected between now and the end of 2012. The low interest rate environment is not favourable to foreign insurers as they rely on interest income from their investment to bolster profits. The after-tax return on interest income on bank deposits is further eroded by a 25% PRC corporate income tax.

On the other hand, interest income from central government bonds issued by the PRC Ministry of Finance is exempt from corporate income tax. There is, however, uncertainty as to whether this corporate income tax exemption can be extended to provincial government bonds, financial bonds and other quasi-government bonds issued by government institutions such as the People's Bank of China or China Development Bank.

Meanwhile, China also imposes a type of gross receipts tax, known as Business Tax at 5%, on interest income. Interest income derived from bank deposits is currently exempt from Business Tax. Interest income derived from government bonds held to maturity by insurers is also exempt from Business Tax. However, gains on sales of government bonds, financial bonds and other quasi-government bonds are subject to the 5% Business Tax.

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Given the different business tax treatments on interest and capital gains derived from investment in government bonds, uncertainty arises as to whether the accrued interest embedded in the purchase and sale prices of the government bonds should be characterised as interest income free from Business Tax. The alternative is that such accrued interest is deemed as part and parcel of the purchase and sale prices to arrive at the taxable capital gain. Further, complexity may arise where the different insurers adopt different accounting policies to book the embedded accrued interest in bond trading transactions.

In the past, it was seen to be an administrative practice adopted by some PRC local tax authorities not to enforce Business Tax on accrued interest income earned by insurers in China from the trading of government bonds, financial bonds and quasi-government bonds.

Nevertheless, the official position to justify not imposing Business Tax on accrued bond interest has not been well developed. Accordingly, another interpretation taken by some tax officials is that Business Tax exemption on bond interest should only be limited to those bonds that are held to maturity and cannot be extended to accrued interest embedded in sales proceeds of bonds disposed before maturity.

During the last 2 years, extensive tax audit and self-tax-inspection exercises were carried out in the financial services sectors in China. Some financial service groups have reached a compromise with local tax authorities to pay Business Tax retrospectively on accrued bond interest for early settlement of the tax audit or self-inspection exercise.

Foreign insurers that intend to continue adopting a favourable Business Tax position on accrued bond interest should closely monitor future developments on this subject. Hopefully, the PRC tax authorities will issue more guidelines in future to clarify this uncertain Business Tax position.

More Flexibility for Corporate bond investments

In July 2012, China introduced new rules to allow insurers to broaden the scope of investment of their insurance funds into a wide variety of PRC corporate bonds. The expanded scope of permissible investments includes unsecured corporate bonds, convertible bonds (having both debt and equity elements) as well as infrastructure bonds with longer durations. Meanwhile, the upper limit for investment in unsecured corporate bonds was also increased from 20% to 50% of the insurers' total assets. These new rules will not only help insurers in China to improve their investment yields after the lower returns caused by recent interest rate cuts, but will also improve insurers' asset-liability duration mismatch positions which were common in the past.

Unlike government bonds, there is no exemption from PRC Corporate Income Tax or Business Tax on interest income derived from corporate bonds. Accordingly, interest income, trading gain and accrued interest earned by insurers on corporate bonds are subject to both of these taxes.

Public Equities and Mutual Funds

Currently, the China Insurance Regulatory Commission ("CIRC") allows insurers in China to invest part of their insurance proceeds in listed shares and equity mutual funds traded in the domestic stock market up to 20% of the insurer's total assets. Insurers making portfolio investments in China need to consider various key taxation issues, in particular, the taxation of mark-to-market adjustments on the investment portfolio.

Dividend income received by insurers on investment in listed shares is currently exempt from PRC Corporate Income Tax and Business Tax. On the other hand, capital gains on the sale of listed shares by insurers would be subject to 25% Corporate Income Tax and 5% Business Tax. Where the insurers make mark-to-market adjustments on their portfolio investment in Chinese shares, this would be considered as a non-taxable unrealised gain.

In China, insurers may find it tax neutral to select the alternative route to indirectly access the China stock market through investing in equity mutual funds. The existing PRC tax rules do not create an additional layer of taxes for investors to invest in equity mutual funds. Essentially, equity mutual funds are exempt from PRC Corporate Income Tax and Business Tax on dividend income, interest income as well as capital gains derived from their underlying investment portfolio. On the other hand, gain on trading of equity mutual fund units would be subject to PRC Corporate Income Tax in the hands of the investors.

Private Equities

In July 2012, CIRC has also relaxed the restrictions on insurers investing in private equity and private equity funds. The direct investment in private equities together with the investment into private equity funds are allowed to up to 10% of the insurers' total assets. Insurers in China can now participate in a PRC domestic private equity fund as one of the latter's limited partners up to 20% of the latter's assets under management.

In China, private equity funds normally organise themselves as limited partnerships. However, the China partnership income tax rules are still in a state of flux. Generally speaking, a partnership is considered as a flow-through entity for China corporate income tax purposes under the PRC tax circular 159 issued in 2008. That is, the income received by the limited partnership entity (i.e. the fund) should not be taxed but PRC Corporate Income Tax should thereafter be levied on distributions by the fund to the respective corporate partners (including an insurer which was a limited partner). However, Circular 159 does not include details of this tax flow-though treatment. In particular, there is a concern that local tax authorities in different locations in China may try to compete for the tax revenue on the same partnership earnings. In the worst case scenario, an insurer in one city, say Shanghai, that receives a distribution from a private equity fund in another city, say Beijing, may be required to pay tax in Beijing on the fund distribution but such tax paid may not be offset against tax payable in the insurer's home city of Shanghai.

The private equity sector has become aware of the concerns raised by insurers and other investors and has started to lobby with the PRC tax authorities and the relevant regulators to try to resolve this uncertain corporate income tax position.

The QDII program

The Qualified Domestic Institutional Investors ("QDII") program which was launched in 2004 allows qualified PRC domestic institutions, including insurers, to invest in overseas securities (typically bonds and listed stocks) traded in overseas markets within a preset forex quota.

As of August 2012, 27 insurers in China have been granted a QDII license and forex quota to invest in overseas markets. Currently, 3 foreign insurers in China have also secured a QDII license and corresponding forex quota to invest overseas.

Insurers in China with QDII licenses should be aware of the international tax issues in connection with securities investments in overseas markets, especially potential overseas withholding tax on dividend, interest and capital gains that may affect the final returns on their overseas investments. In this connection, insurers in China may also need to engage business agents in the target overseas markets to manage the overseas investment portfolios, thus exposing themselves to the target country's tax net under complicated permanent establishment tax rules. Looking back to China, the PRC tax rules are still largely unclear on how the overseas investment income generated through the QDII scheme should be reported and taxed in China and, if so, whether and how the insurer can claim a credit for foreign taxes paid.

Foreign insurers continue to view China as a very attractive market, although they pose no threat to domestic insurers' market dominance. The level of China business growth remains exceptional for foreign insurers and in part compensates for the disappointing regulatory regime which limits investment channels for insurance funds. Whilst the PRC regulatory environment in relation to insurers' portfolio investment has been eased, the rapid developments in this area requires understanding and careful planning for complex taxation issues to harvest the true potential of the opportunities in this emerging market.

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Hong Kong

Source of bond interest income of companies carrying on non-life insurance business in Hong Kong

Hong Kong is well known for its territorial tax system under which only Hong Kong sourced income derived from a trade or business carried on in Hong Kong is subject to Hong Kong profits tax. For non-life insurance business, the source of bond interest income has recently become a very topical tax issue within the industry. This issue, however, is not generally relevant to life insurance business, as bond interest income (irrespective of its source) is either exempt from tax under the "5% deemed profit" taxation basis or fully taxable (subject to exemption on certain instruments) under the "adjusted surplus" taxation basis for life business.

According to Departmental Interpretation and Practice Notes No. 13 (Revised), interest income earned by persons other than financial institutions or money lenders is generally considered to arise (i.e. to have its source) where the underlying funds are first made available to the borrower. This is commonly known as the "provision of credit" test. Under the provision of credit test, where an issuer issued a bond outside Hong Kong and first received the bond subscription monies outside Hong Kong, the interest income derived from the bond is regarded as having an offshore source and non-taxable. The Inland Revenue Department ("IRD") has also publicly expressed that the above tax position applies even if the bond is acquired by the taxpayer in the secondary market in Hong Kong.

On the above basis, it has been the market practice over past years that companies carrying on non-life insurance business have treated interest income derived from bonds issued outside Hong Kong as offshore sourced and non-taxable. Such tax filing position has generally been accepted by the IRD in the past.

In the past two years, however, it has been noted that some IRD assessors seem to have changed their view and sought to challenge the use of provision of credit test in determining the source of bond interest income of non-life insurance business. Their view seems to rely on the following arguments:-

1. Investment activities should form part and parcel of an insurance business. Where an insurance company carries on its insurance activities in Hong Kong, interest income derived by the insurance company from its bond investment should have the same source as its insurance income (i.e. a Hong Kong source) and be taxable, even though the bonds that it invests in were issued by non-Hong Kong resident issuers outside Hong Kong.

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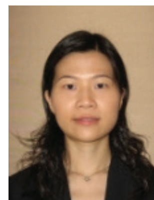

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2. An insurance company is considered as carrying on a business of buying and selling investments, including bonds. Therefore, such bond interest income should form part of the bond trading profits and the source of bond interest income should be determined by reference to the location where the buying and selling activities are conducted.

We are aware that many non-life insurers have received challenges from the IRD on the basis of such arguments.

Whether or not the provision of credit test is the most appropriate test to determine the source of bond interest income of a non-life insurance business is not a straightforward question due to the complexities of the relevant case law. Notwithstanding that, it is worth noting the following observations on the IRD's position.

Firstly, the view that the source of bond interest income of an insurance company should follow where the insurance company carries on its insurance activities appears to mix up the concept of "source of income" with "carrying on a business in Hong Kong". Fundamentally, this view deviates from the territorial source concept of the Hong Kong tax system, which allows a business carried on in Hong Kong to have profits of a non-Hong Kong source.

Secondly, whether an insurance company is engaged in a business of buying and selling of bonds is a question of fact based on the particular facts and circumstances of that company, e.g. the investment strategy of the company, whether the company buys and sells bonds on a daily basis as bond traders normally do, etc. It would be inappropriate to generalize the tax position without taking into account the facts and circumstances of each case. Moreover, even if a business of buying and selling bonds was carried on in Hong Kong, it does not logically follow that the interest earned on bonds acquired as part of that business would have a Hong Kong source. To adopt such a view is, again, to confuse the issue of where a business is carried on with the source of the profit of that business.

Given the lack of legal authority directly on the issue and the current attitude of the IRD, it will be interesting to watch the reaction of the non-life insurance sector to the IRD's challenges and see whether or not the issue will end up being appealed to the courts for resolution.

In the meantime, it is worth analyzing the related tax impact, both historical and future, should the IRD succeed in rejecting the use of provision of credit test in determining the source of bond interest income, and revisiting the existing investment strategy and the way the investment activities are conducted with a view to enhancing the investment return on an after-tax basis.

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India

Investments of insurance companies – Taxation and related issues

Insurance companies operating in India face certain unique challenges on the tax front. These include challenges around the manner of taxation of gains/income arising from investments, which can have a significant impact on the returns to the policyholders, as well as shareholders.

This article provides an overview of some of the key tax issues impacting insurance companies. But before delving into these issues, it is worthwhile reviewing the direct tax regime applicable to insurance companies.

Direct tax regime

The Income-tax Act, 1961 ('the Act'), provides for a separate regime for taxation of profits of any insurance business. Ordinarily, profits earned by a tax payer from any business are recomputed for tax purposes based on specific allowance/disallowances and such profits are taxed at the maximum marginal rate of 30%/40%. Such manner of taxation and these usual provisions are not, however, applicable to insurance companies.

In particular, Life insurance companies are taxed on the surplus/deficit disclosed by the actuarial valuation made in accordance with the Insurance Act, 1938. Non-life insurance companies are taxed on the profit as disclosed in the profit and loss account prepared in accordance with the relevant provisions of the Insurance laws and regulations.

Profits of a life insurance business are taxable at a special tax rate of 12.5%[1], whereas the profits of a non-life insurance business are taxable at the normal rate of tax of 30%[2]/40%[3] as is applicable to other corporate entities.

An insurance company is not permitted to carry out any business other than the insurance business for which it has been granted a license. Accordingly, the entire profits, whether earned in the Shareholders' Account or Policyholders' Account, are treated by the insurance companies as profits from insurance business and offered to tax accordingly after carrying out certain adjustments permitted under the Act.

The key issues from a direct tax perspective with respect to investments of insurance companies are discussed on the next page.

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[1] Certain surcharges apply additionally
[2&3] Certain surcharges apply additionally

Taxation of investment income of Shareholders of a life insurance company

In the case of a life insurance company, the incremental actuarial surplus/deficit is to be considered for computing the taxable profits from a life insurance business.

Insurance companies typically determine these profits by aggregating the results in the Policyholders' Account and the Shareholders' Account and the resultant income after permitted adjustments is offered to tax at a rate of 12.5%[4].

The tax authorities have, in certain cases, treated the Policyholders' surplus as the actuarial surplus representing profit from life insurance business and the Shareholders' income as not forming part of the profit from life insurance business. The contention of the tax authorities is that since the funds in the Shareholders' Account are maintained separately and distinctly from the funds in the Policyholders' Account, the income of the life insurance company from investment of Shareholders' funds is to be treated as income other than from life insurance business. Based on this, the tax officers have treated the income in the Shareholders' Account as 'Income from other sources', or as 'Other business income', taxable at a rate of 30%[5]. Moreover, in some cases, the tax officers have treated the gains/loss on sale of investments in the Shareholders' Account as taxable capital gains/loss.

Thus, there is no uniformity in the stand adopted by the tax authorities with regard to the income earned on investments in the Shareholders' Account.

This is an industry issue and understandably has resulted in significant tax impact for insurance companies for whom the profits on Shareholders' investments are ultimately taxed at a higher tax rate of 30% as compared to a special rate of 12.5% applicable to profits from the life insurance business.

Given that this is an industry issue, protracted litigation on it is likely, although in a recent decision in the case of ICICI Prudential, the Mumbai bench of the Income-tax Appellate Tribunal has taken a view favourable to the tax payer that the income in the Shareholders' Account should be considered as arising out of life insurance business only and, accordingly, be taxed as part of the same business.

Exemption of gains on sale of investments of a non-life insurance company

The taxable profit of a non-life insurance company is taken to be the profit as disclosed in the profit & loss account, subject to certain adjustments.

Prior to 1988, the Act provided for an adjustment to such profit whereby any amount either written-off or reserved in the annual accounts to meet depreciation or loss on the realisation of investment was allowed as deduction, and any sum credited to the annual accounts, due to appreciation or gain on the realisation of investment, was taken as part of taxable income.

To enable the General Insurance Corporation ('GIC') and its subsidiaries (at that time, the insurance sector was not open to the private sector, and only GIC and its subsidiaries were in operation) to play a more active role in capital markets for the benefit of policy holders, the Finance Act, 1988, amended the tax position by deleting the requirement to make these adjustments. As explained in the circular issued by the Tax administrative body (CBDT), this amendment was made to provide for exemption of the profits earned by these companies on the sale of their investments. As a corollary, it was also provided that the losses incurred by such companies on the realisation of the investment would not be allowed as a deduction in computing the profits chargeable to tax.

This adjustment was reintroduced under the Act as a result of which profit for the years ended March 31, 2011 and onwards needs to be adjusted by way of addition or deduction of any gain or loss on realisation of investments, if this amount has not already been credited or debited in the profit and loss account of the respective year.

During the period from 1988 to 2010, insurance companies (including private players who were new entrants with the opening of the insurance sector in 2000) relied on this amendment to the Act and the CBDT circular to treat profit on sale/redemption of investments as exempt from tax. However, the tax authorities at the lower level, in many cases did not accept the stance of the industry and taxed the profit on sale of investments. As a consequence, this issue is now the subject of litigation before higher authorities and the outcome of this could have a significant impact on the post-tax income of non-life insurance companies.

4 Certain surcharges apply additionally
5 Certain surcharges apply additionally

Exemption of dividend income

Under the Act, dividend income earned on shares is exempt from tax. Accordingly, life insurance companies claim exemption for dividend income earned on Policyholders' as well as Shareholders' investments in shares.

In the case of life insurance companies, the tax authorities have not allowed this exemption on the ground that the dividend income earned from these investments is nothing but the income from the normal business of life insurance, and, accordingly, it is required to be reflected as part of business income in the Revenue Account (i.e. Policyholders' Account) prepared in the format prescribed by IRDA. Therefore, the dividend income is treated by the tax authorities as in the nature of business income not entitled to exemption. The tax authorities' contention is also that the Act does not specifically provide for making any adjustment to the actuarial surplus so as to allow exemption for dividend income.

The claim made by the life insurance companies is supported by the interpretation taken by the Courts that only those adjustments which are not specifically prohibited by the specific provisions dealing with computation of profits of insurance companies are allowed to be made.

Similarly, the tax authorities have denied the benefit of exemption to non-life insurance companies.

While the claim of insurance companies is being constantly challenged by the tax authorities, the industry can take some comfort from the fact that higher authorities have ruled in favour of certain tax payers on this issue.

Disallowance of expenditure in relation to exempt income

Under the Act, any expenditure incurred in relation to exempt income is not an allowable deduction. While insurance companies claim exemption for dividend income, they do not typically offer any amount for disallowance. The stand taken by these companies is that no expenditure can be disallowed in their case as the computation methodology provided under the Act overrides other computational provisions relating to business profits and, therefore, any such adjustment dealing with computation of 'Business Profits' is not permitted. The tax authorities at lower level have challenged this stand although, the higher authorities have consistently held in favour of tax payers by accepting the above reasoning provided by them.

While doing so, the tax officers have generally ignored the amount of disallowance computed by the tax payer following a reasonable method (offered on a without prejudice basis) and have computed the amount of disallowance by adopting a methodology specified under the Act. Under the Act, this methodology can be adopted by the tax officer only in circumstances where they are not satisfied, with regard to the accounts of the assessee, of the correctness of the claim of the tax payer. However, tax officers have been adopting this methodology for computing the disallowance apparently without first reaching to a satisfactory conclusion as to the reasonableness of the tax payer's claim.

The methodology specified under the Act for computing the amount of disallowance considers the direct expenditure incurred in relation to exempt income as well as certain indirect expenditure. One of the criteria of the computation methodology is to consider for disallowance an amount equal to 0.5% of the average investments, income from which is exempt. Since insurance companies make a significant amount of investments (income from which could be exempt), this methodology generally results in a huge disallowance for insurance companies which can even exceed the amount claimed for exemption.

In the case of certain tax payers (other than insurance companies) the higher authorities have held that only direct expenditure incurred in relation to exempt income can be considered for the purpose of making a disallowance. Since insurance companies do not generally incur any direct expenditure (such as interest on borrowings) in relation to exempt income, no disallowance is otherwise called for in their case based on the Court decisions.

Huge disallowances by the tax officers, sometimes even exceeding the amount of exemption, has the effect of not only taking away the benefit of exemption, but, over and above that, genuine expenditure of the business is not being allowed as a deduction, thereby resulting in lower returns for the Policyholders and Shareholders.

Before delving into the implications from an indirect tax perspective for life insurance companies, it is worthwhile to review broadly the indirect tax regime applicable to such companies.

Indirect tax regime

Prior to July 1994, only the manufacturing sector was subject to indirect tax, in the form of Central Excise, and the service sector was kept outside the purview of any indirect taxes. In 1994, Parliament imposed service tax for the first time on telephone services, services relating to non-life insurance, and services provided by stockbrokers. After 2002, with the liberalisation of the insurance sector, the government decided to bring life insurance service within the purview of service tax.

Service tax in India is governed by Chapter V of the Finance Act, 1994 and the rules made there under. Service tax is presently levied at the rate of twelve percent of the gross value of the taxable service. Furthermore, there is a levy of

two percent education cess and one percent secondary and higher education cess on the service tax component. Thus the effective rate of service tax comes to 12.36 percent. Presently an inclusive basis of taxation is in place whereby all services are taxable other than those which are specifically excluded or not sought to be covered.

The main income stream of any life insurance company is the premium paid by the policy holders. The composition of the premium varies from plan to plan. Linked and non-linked products are the two types of policies which are sold by life insurance companies. The premium in the case of linked products is composed of the risk portion, the investment portion, and various other allocated expenses which are incurred in relation to management of investments. The non-linked products are composed of pure term plans and endowment plans. In the case of non-linked products with savings schemes, the saving portion of the premium is invested in risk free instruments like government securities.

The investment portion of the premium collected by the life insurance companies has to be invested in the manner specified under the Insurance Law. The Law ensures that the insurer is able to honour the commitment of returning the money of the policyholders. The revenue generated by the insurance companies is composed of the profits, interest, and dividend earned on the investments made.

Service tax implication on investments made by life insurance companies

There is an input tax credit scheme that allows credit of duties and taxes paid on inputs, capital goods and input services to be utilised for payment of duties/taxes so as to avoid a cascading effect of duty/tax. The Scheme specifies that every service provider who provides both taxable and exempt service will have to reverse credit to the extent of exempt service. According to the Service Tax Law, trading in goods is an exempted service and goods include securities. Hence a view can be taken that investment in securities is an exempted service and reversal of credit availed shall be required. Reversal of input credit will result in an increase in the tax cost of the company.

In addition, there are few options for reversal of credit if exempted services are provided. If a wrong option is selected, then the cost of the operation shall further increase. This shall require every insurance company to revisit its method of reversal of credit so as to determine its most tax optimum structure.

The investments of policyholders' funds are in the nature of a regulatory requirement prescribed by the regulatory body. The main intention of any life insurance company behind investments of the policyholders' funds is to earn return for the investors and not trade in securities. In many instances, there are idle funds lying with insurance companies and they are invested in cash funds. Again in this case the intention of the company is to not undertake trading but to invest idle funds. Furthermore, the regulatory body prescribes the norms for investments which the insurance companies are bound to follow. Thus, a view that the insurance companies are providing services in the nature of trading in securities may not be correct per se, in which case the question arises as to whether the reversal of input credit availed will have to be made.

It also needs to be noted that, in the life insurance industry, investment of policyholders' funds is essential for providing the output services and hence, all input services availed in relation to this will qualify as eligible credit not requiring any reversal.

Conclusion

Tax payers are faced with great uncertainty in terms of the direct and indirect tax implications with respect to their investments. Greater certainty on these issues is much needed for the benefit of the Indian insurance industry as a whole.

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Indonesia

Typical investments in Indonesian life insurance companies

Indonesian life insurance companies invest their funds mostly in investment products on which the return is subject to final tax and/or non assessable income.

Typical final-taxed investment income sources are:

- Interest from time deposit
- Interest and realized capital gain from local bonds
- Capital gain from shares listed in IDX

The typical non-assessable investment income source is:

- Income from mutual fund
- Any unrealized gain / loss from investments (including mutual fund) is also treated as non-taxable / non deductible as the Income Tax Law only recognizes realized gains and losses.

Typical non-final investment income sources that are subject to normal corporate income tax are:

- Dividend income
- Interest and realized capital gain from offshore bonds

Investment income is generally recorded in the company's books and is taxable at the life insurance corporate level. However, any final-taxed or non-assessable investment income will be excluded from the corporate income tax calculation.

Investment-driven change in the technical reserve tax treatment

During the past year, the Indonesian life insurance industry has been experiencing significant change in their tax treatment of technical reserves, essentially driven by the tax treatment of investment income.

In the past, life insurance companies, especially ones with unit-linked products, have been enjoying deductibility from the increase in technical reserves resulting from the increase in the value of their unit linked products, despite the fact that most of these assets are generating typical investment income which is not taxable for corporate tax purposes. This treatment has been adopted by most of the market players for many years and has been verified by tax offices during tax audits.

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Now, the tax office is taking the view that technical reserves resulting from final-taxed or non-taxable investment income is not deductible. Technical reserves are only deductible if they are derived from non-final investment income. This view has been made official by the issuance of a Directorate General of Tax (DGT)'s circular confirming this position in December 2011, and which DGT imply to be applicable retroactively. Despite the fact that there is still a dispute over the technical basis of this treatment, at this stage we foresee that the playing field has changed.

How does this change the way insurance companies manage their investments? Should they change?

Below is a comparison of the bottom-line tax impact of the new circular on the tax expense of life insurance companies depending on their investment type. This analysis is under the assumption that the new circular on technical reserves may not be changed soon and this is relevant for those who applied the new circular starting 2011.

	Final		Non-final	
	Commercial	Tax	Commercial	Tax
Investment income	100	–	100	100
Technical reserve	(85)	–	(100)	(100)
Profit before tax	15	–	–	–
Corporate tax	–	–	–	–
Final tax	(15)	(15)	–	–
Profit after tax	–	**(15)**	–	–

In the above illustration, non-final investment would seem to be more beneficial for the company. In the illustration, from a tax perspective, the taxable profit that is subject to corporate tax will always be zero regardless the type of investment income generated. This is because the investment income position will always be offset against the corresponding technical reserve movement. In this situation, no final or corporate tax is due under the non-final investment income, while on the final investment income there is a final tax expense deducted at source.

Apart from the tax consideration, of course, there are many commercial factors that need to be weighed when determining the investment strategy, especially whether the investment return from the non-final investment is as good as the final one, and whether the tax saving is greater than the decrease of the investment return (if the return from the non-final investment is lower than the final one).

Other potential tax saving opportunity

One of the main investment instruments that is held by life insurance companies is local bonds. The investment return is generally subject to 15% final withholding tax. If the bonds investment is placed through a mutual fund, a 5% concessionary final withholding tax rate is applicable up to year 2013. Afterwards, profit distribution from a mutual fund is no longer subject to corporate tax. This creates a tax saving of 10% as compared to the life insurance companies holding the bonds directly.

Again, there is an additional expense to pay the management fee to the mutual fund manager. Companies need to consider whether the tax saving is greater than the additional expense.

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Japan

A general overview of the Japanese tax rules applicable to investments made by insurance companies

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I. Rules and guidance on investments by insurance companies in Japan under the Insurance Business Act

Under the Insurance Business Act, insurance companies licensed by the Financial Services Agency in Japan are subject to investment rules where insurance premiums received from policyholders are invested in the following:

- Acquisition of statutory securities , real estate, monetary claims, short-term bonds, and/or gold bullions
- Loan money (including call loans), and/or loan of securities
- Investment in partnerships and/or anonymous partnerships
- Bank deposits
- Money in trust, monetary claim in trust, securities in trust and/or real estate in trust
- Over-the-counter transactions of securities related derivatives trading(excluding securities forward transactions), securities index futures trading, securities options trading, foreign market futures trading, exchange financial futures trading, financial derivatives trading, forward foreign exchange trading, or similar transactions

Quantitative rules under which insurance companies could not invest in the above assets exceeding certain ratios to the total asset balance were abolished by the reform of the Ordinance for Enforcement of the Insurance Business Act effective on April 18, 2012.

II. Japanese tax rules applicable to investments by insurance companies

A. Securities

1. Classification of and valuation method for securities

The classification and valuation method to be applied to securities under Japanese tax laws are slightly different from those under JGAAP (e.g., Market value method is applied for securities available-for-sale for accounting purposes, while cost method is applied for Japanese tax purposes).

2. Recognition of impairment losses on securities

Impairment losses on securities recognized for accounting purposes are generally not deductible for Japanese tax purposes except for limited special cases:

a. Listed securities (excluding certain controlling shares):

Impairment losses recognized for a security for accounting purposes may be deductible where the value of the security significantly decreased (*).

b. Listed securities of controlling shares and unlisted securities:

Impairment losses recognized for a security for accounting purposes may be deductible where the value of the security significantly decreased (*) due to a significant downturn of the financial position of the company issuing the securities. In this regard, “a significant downturn of the financial positions” refers to situations where:

i. Securities are devalued under provisions of certain legal procedures applied to the stock issuing company; or

ii. The net asset value per share of the stock issuing company at the end of the fiscal year is less than 50% of the net asset value per share at the time of acquisition of the share.

(*)“The value of a security significantly decreased” refers to situations where the fair market value of the security at the end of the fiscal year is less than 50% of the tax book value and the value is not expected to recover in the near future.

3. Foreign exchange method of securities denominated in foreign currency

The foreign exchange method to be applied to securities denominated in foreign currency is as follows:

- Foreign currency - Current exchange rate
- Foreign currency deposits and foreign currency debts /and credits - Current exchange rate (or Historical exchange rate)
- Securities held for trading - Current exchange rate
- Redeemable bonds other than securities held for trading - Historical exchange rate(or Current exchange rate)
- Securities other than the above - Historical exchange rate

4. Foreign exchange method of securities denominated in foreign currency when foreign currency rates fluctuated dramatically ("15% rule")

Under Japanese tax law, a company can apply a special tax rule to the conversion of assets and liabilities denominated in foreign currency when foreign exchange rates fluctuate significantly (approximately 15%). Under the 15% rule, assets and liabilities are to be converted based on the prevailing exchange rate as at the fiscal year end and this rate is thereafter deemed as the historical exchange rate for determining the acquisition cost of those assets and liabilities. If the company applies the 15% rule to any asset or liability denominated in a foreign currency, then all other assets and liabilities which are denominated in the same foreign currency are required to be determined under the 15% rule.

Certain assets and liabilities denominated in foreign currency are not subject to this 15% rule.

5. Dividend exclusion rules

a. Dividends from a Japanese company

Although dividends received from a Japanese company are treated as income for accounting purposes, all or part of the dividends are excluded from taxable income under corporation tax law to avoid double taxation at the level of the dividend paying company and the receiving company if certain conditions are met.

b. Dividends from a foreign company

In general, 95% of a dividend received by a Japanese company from a foreign company can be excluded from the company's taxable income if the company has held at least 25% of the foreign company's outstanding shares for a continuous period of six months or more ending on the date on which the dividend is declared.

6. Realized gain/loss on sale of securities

Capital gain or loss derived from a sale of securities is generally taxable or deductible for Japanese tax purposes. Under the group taxation regime or the consolidated taxation system, however, recognition of such capital gain or loss would be deferred if certain conditions are met.

B. Real Estate

1. Valuation method for real estate

For Japanese tax purposes, the acquisition cost of real estate is not limited to the purchase price (or the total cost of construction), but also transportation costs, fares, insurance, customs duties, installation costs, brokerage fees, legal costs and all other expenses directly incurred in making the fixed assets fit for use.

2. Depreciation method of real estate

For Japanese tax purposes, there are some depreciation methods applied to depreciable fixed assets. For buildings, the straight-line method will apply.

In practice, many companies recognize depreciation expenses for Japanese accounting purposes to be equal to depreciation limits for Japanese tax purposes, so book tax differences are unlikely.

3. Recognition of impairment losses on real estate

Impairment losses on real estate (land and buildings) recognized for accounting purposes are generally not deductible for Japanese tax purposes except for limited special cases (e.g., the fixed assets damaged by natural disaster, the assets unused for a year or more, the assets no longer used for their original purposes, or similar events).

Revaluation gain or loss recognized for accounting purposes could be taxable or deductible for corporation tax purposes where assets are revaluated under provisions of certain legal procedures occurred to the stock issuing company (court's decision of commencement of corporate rehabilitation procedures/corporate reorganization procedures, etc.).

4. Realized gain/loss and disposal of real estate

Capital gain or loss derived from transfer of real estate and disposal of real estate is basically taxable or deductible for Japanese tax purposes. Under the consolidated taxation system, the group taxation regime or, tax-qualified restructuring, however, recognition of such capital gain or loss would be deferred if certain conditions are met.

C. Loans

1. Recognition of valuation gains or losses on loans

Valuation gains or losses on loans are not generally taxable or deductible for Japanese tax purposes except for cases where assets are revalued under the provisions of certain legal procedures occurred to the stock issuing company (court's decision of commencement of corporate rehabilitation procedures/corporate reorganization procedures, etc.).

2. Recognition of bad debt losses on loans

Bad debt losses of loans could be treated as tax deductible expenses in the strictly limited situations.

3. Recognition of bad debt allowances on loans

Effective for fiscal years beginning on or after April 1, 2012, the tax reform abolished tax deductions for bad debt allowances with some transitional measure.

However, the above reform is not applicable to SMEs (small to medium sized enterprises), banks, insurance companies and other similar financial corporations, and therefore bad debt allowances recognized by insurance companies can be deductible to the extent of the deductible amount prescribed under the Japanese tax laws.

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Korea

Tax implications in relation to changes in investment structure

Foreign insurers have expanded their operations and increased their market share in Korea. For such expansion, many multinational insurers with a subsidiary or branch in Korea have been considering, or have already changed, the investment structure of the Korean subsidiary or branch.

Recently, the Korean government has encouraged financial companies to convert their investment structure into the financial holding structure for the purpose of consolidating business portfolio and hence achieving synergy within their group. Major Korean financial companies have established their financial holding companies and key foreign invested financial companies in Korea, such as Citigroup and Standard Chartered, have also established their local holding companies as a result of their competitors' expansion into the local market in 2009 and 2011.

This article outlines tax implications from the changes in investment structure which should be considered by foreign insurance companies. In particular, it summarizes recent tax issues that foreign insurers should take in account when they change their investment structures. Also discussed are tax issues related to the two common means for changing the structure which are often considered by foreign investors, being the establishment of a holding company by initial stock swap for a local structure change, and share transfer between foreign related parties for an overseas structure change.

1. Local structure change – establishment of a holding company by initial stock swap

Most of the financial holding companies in Korea established their holding companies by initial stock swap. An initial stock swap is where the shareholders of the subsidiaries transfer their shares to the newly-established holding company (New Co.) and New Co. issues shares to the former shareholders of those subsidiaries. The establishment of a holding company by initial stock swap is the most preferred option since there is tax relief available in relation to the transaction taxes under the Korean Special Tax Treatment Control Law (STTCL).

As a result, a foreign insurer who has an insurance company operating in Korea and intends to set up a Korean holding company might consider the initial stock swap for the shares of the Korean insurance subsidiary, as some key foreign financial investors have done.

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In general, the Korean tax issues in relation to the establishment of a holding company are as follows;

- **Capital Gain Tax ("CGT")**

There is a Capital Gain Tax (AGT) to be levied on overseas parent companies. A capital gain from the share transfer of a non-resident entity is subject to the withholding tax which is 11% of the gross proceeds received or 22% of the net capital gain.

- **Securities Transaction Tax ("STT")**

A non-listed share transfer is subject to STT at the rate of 0.5% of the actual transfer price.

- **Deemed Acquisition Tax ("DAT")**

Under the Local Tax Law, if a taxpayer becomes a controlling shareholder who owns more than 50% of shares in a company through an acquisition of shares, the controlling shareholder shall be deemed to have acquired his portion of the company's assets which are subject to acquisition tax under the Local Tax Law.

- **Registration Tax, related Local Education Surtax**

If a foreign investor establishes a company in Korea, the investor is required to pay a registration tax of 0.48% including surtax (or 1.44%, where the surviving company is located in a prescribed metropolitan area, the registration tax rate would be levied three times the normal rate) of the nominal value of paid-in-capital upon the incorporation of the new company.

As noted above, the STTCL provides for tax relief for the above tax exposures which would otherwise arise in relation to the establishment of a holding company by way of a stock swap. This relief was previously applicable to foreign, as well as local, shareholders. However, a legislative amendment in 2011 restricted the tax relief to Korean resident shareholders only. Therefore, a foreign insurer who intends to set up a holding company in Korea should estimate its related tax exposures in advance as part of transaction costs.

2. Overseas structure change - share transfer between foreign related parties

A foreign shareholder intending to transfer its own shares in Korean companies to its related party overseas, may do so in one of two ways:

- Korean share sale between foreign related parties
- Korean share free transfer between foreign related parties

The transaction taxes related to the above two options are variable depending on the tax exemption clauses in the applicable tax treaty, the stock value and the amounts of capital gain, etc. There may be tax implications for foreign insurers who intend to change overseas shareholder structure, subject to certain conditions. In particular, such foreign insurers should consider the following tax implications:

2.1 Korean share sale between foreign related parties

- **Capital gain tax ("CGT")**

Generally, any capital gain arising from the transfer of shares in a Korean company between non-resident companies without a Korean permanent establishment ("PE") is subject to the Korean withholding tax, but subject to any exemption available under the relevant tax treaty. Under Korean tax law, the withholding tax rate applicable to such capital gain is the lower of 22% (including 10% resident surtax, hereinafter all rates include 10% resident surtax) of the capital gain or 11% of the sales proceeds. If there is an exemption for capital gain from a transfer of shares under a tax treaty, no Korean withholding tax would be imposed in relation to such a gain.

- **Securities transaction tax ("STT")**

Under the STTA, a transfer of shares in a non-listed Korean company is subject to the STT at the rate of 0.5% of the actual transfer price. However, if the price is below an arm's length price, STT should be adjusted up to 0.5% of the arm's length price.

2.2 Korean share free transfer between foreign related parties

- **Other income tax**

A transfer of shares in a Korean company for no consideration to an overseas related party is treated as other Korean-sourced income of a non-resident. A withholding tax rate of 22% (including surtax) is levied on the income. If there is an exemption for other income from a transfer of shares under a tax treaty, however, the deemed transfer income arising from the transfer of the shares should not be subject to Korean withholding tax.

- **Securities transaction tax ("STT")**

For share transfers within a group but without consideration, the company receiving the shares is not normally subject to Securities transaction tax. However, there has been a case where the Korean tax authorities considered such a share transfer as a share sale and levied STT in connection with the transaction.

Please note that the withholding tax rate for other income is higher than that of the capital gain earned by non-residents under the CITL and tax treaties allowing exemptions on other income from share transfers for no consideration are relatively less common than tax treaties allowing exemptions for capital gain from share sales. However, a share transfer, in general, does not trigger the STT. Accordingly, to minimize the relevant transaction taxes, careful share transfer planning is required taking into account the particular facts of each case.

In addition, a foreign shareholder should be aware of the fact that the tax authority may raise queries in relation to the arm's length price for the transaction. Under the Corporate Income Tax Act ("CITA"), a transfer of shares in a Korean company between related non-resident companies without a Korean PE should be conducted at an arm's length price determined under the Law for Coordination of International Tax Affairs ("LCITA"). Where the arm's length price cannot be determined under the LCITA, the price determined under the Individual Income Tax Act ("IITA") is deemed to be the arm's length price. The deemed arm's length price under the IITA also applies for STT purposes. However, there are some vague areas when it comes to calculating a tax valuation amount under the relevant tax regulations.

3. Conclusion

In addition to the investment structure change plans outlined above, foreign insurers may also consider the following structure change plans;

- Stock acquisition
- Asset acquisition
- Establishment of a holding company by a spin-off

For their international operations, a number of multinational insurers adopt an optimal investment structure in Korea which allows them to enjoy flexible capital movements, favorable tax treatment and simplified financial reporting procedures.

However, it is recommended for foreign insurers to check in advance the acceptability of their planning structure to the competent authorities (especially, the Financial Supervisory Service) and other potential regulatory barriers against their planning structures.

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New Zealand

New Zealand rules for the taxation of investment income

The New Zealand insurance industry is currently facing numerous challenges. These challenges include managing the Christchurch earthquake claims process, increased regulation, increased costs of reinsurance and a low investment returns environment.

In recent years the New Zealand Government has promoted tax simplification to encourage investment. This is evidenced by the various foreign investor-friendly tax regimes that have been introduced over the years such as the Portfolio Investment Entity (PIE) regime and modified Foreign Investment Fund (FIF) regime which was introduced in 2007. The New Zealand Government continues to explore ways to increase the attractiveness of New Zealand's capital markets, but at the same time increase tax revenues to achieve the primary goal of returning to a budget surplus.

This article provides a high level overview of New Zealand's investment tax regimes and specific rules for the taxation of gains and income from investments and specific consideration for insurers. Optimising taxation outcomes for similar investment products will benefit insurers by increasing after tax returns in a low investment income environment.

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Summary of the tax treatment of key investment classes

There is a general presumption under New Zealand taxation law that investments made by insurers are held on revenue account, meaning all gains and losses are treated as taxable and deductible respectively. However, there are certain exceptions to this rule under the PIE and FIF regimes. The table below summarises the New Zealand tax treatment of the most common classes of investments:

Investment	Realised gains/(losses)	Income on distributions
Equities – direct holdings		
• New Zealand	• Taxable/(deductible)	• Dividends taxable with a credit for imputation credits
• Australian ASX listed	• Taxable/(deductible)	• Taxable with no credit for franking credits
• Non Australian ASX listed and all other jurisdictions	• Non taxable/(non-deductible). Subject to 5% fair dividend rate income based on market value	• Non taxable/(non-deductible). Subject to 5% fair dividend rate income based on market value
Bonds and cash – direct holdings		
• New Zealand and overseas bonds and cash investments	• Taxable/(deductible) including any unrealised movements and unrealised FX gains/losses	• Interest income taxable
Indirect investments held in:		
• Managed funds (non PIE)	• Taxable/(deductible)	• Taxable
• Managed funds (PIE)	• Non taxable/(non-deductible) when units are redeemed	• Taxed on PIE attributed income only
Property		
• Direct property investments	• Taxable/(deductible) based on presumption that insurers hold property on revenue account	• Net rental income after expenses is taxable. No tax depreciation for buildings.

Equities

Where insurers invest into New Zealand equities, realised income or losses are treated as taxable or deductible. New Zealand has an imputation system (similar to Australia's franking credit regime) where dividends may be fully imputed with company tax paid on underlying profits, providing a credit against tax to pay at the shareholder level.

Income from direct equity investments of less than 10% in a FIF is generally subject to the Fair Dividend Rate (FDR) method of calculating taxable income. Under this method, investors are taxed on a 5% deemed rate of return based on the market value of their investments.

A number of points to note on FDR:

- New Zealand tax only applies on 5% of the market value of investments – there is no tax on actual dividend income or realised gains.
- Realised losses on investments – there is no deduction available for any realised losses.
- Quick sales – adjustments are made for tax on shares bought and sold within a tax year.
- Australian exclusion – the rules do not apply to certain listed Australian companies and unit trusts.
- No tax upon sale – subject to the 'quick sale' rules, there is no "wash up" calculation when shares are sold. Tax calculated under the FDR method is the only tax payable.

Investments in New Zealand equities and certain Australian equities listed on the Australian Stock Exchange (ASX) are exempt from the FIF rules.

Bonds and cash

Bonds and cash are taxed under New Zealand's financial arrangement rules. Under these rules unrealised gains and losses are treated as either taxable or deductible respectively. This is an important consideration given the volatility of interest rates and foreign exchange rates in recent years. Interest income is also treated as taxable.

Indirect Investments

There are two forms of indirect investment available to insurers in New Zealand. These are standard managed funds and the managed funds that elect to be taxed under New Zealand's PIE regime.

Distributions from standard managed funds, (usually in the form of a unit trust) are treated as taxable or deductible. In addition realised gains/losses from the disposal of units are taxable/deductible on the basis that the investments of insurers are held on revenue account.

The PIE regime is an elective regime and mainly applies to collective investment funds. Under these rules, income derived by the PIE fund is allocated to investors who are taxed at their prescribed investor rate (PIR). For overseas investors this rate is capped at 28%. The main benefit to insurers of investing through a PIE as opposed to a standard managed fund is the certainty of not being subject to tax on any capital gains arising on the disposal of investments held by the PIE; i.e. realised and unrealised gains on New Zealand and certain Australian listed shares are treated as non-taxable. This is a key advantage for insurers as they would otherwise be treated as holding these investments on revenue account, or taxed under the financial arrangement rules on an unrealised or realised basis. This advantage needs to be considered in light of PIE fee structures and uncertainty about whether the investments made by the PIE would match the performance of investments managed directly by an insurer.

Taxation of property

Realised gains on property are generally taxable as in most cases all property held by an insurer would be deemed to be held on revenue account. Under New Zealand's land rules, income derived from the sale of property held for the purposes of resale is also subject to tax. New Zealand has recently removed the deduction allowable for depreciation on buildings other than commercial fit out.

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Singapore

Singapore's investment incentives – the benefits and the challenges

Singapore uses various tax incentives to attract investments and to steer investors towards certain targeted sectors in Singapore. In the investments and fund management space, there are also various tax rules and incentives in place to promote Singapore as a location to raise capital and manage funds. How do these investment rules and incentives affect insurers operating in Singapore?

Where insurance business is incentivised

While the normal corporate tax rate is 17%, Singapore has a whole host of incentives that can offer a reduced tax rate ranging from 0% to 10% on relevant incentivised income. Examples of these incentive schemes are the offshore insurance business scheme, the marine hull and liability scheme, the offshore takaful and retakaful scheme and the offshore specialised risks scheme. When an insurer is enjoying a particular incentive scheme, it is not just the underwriting income derived by the insurer that will enjoy the incentive tax rate. The following specified investment income it may earn from assets supporting the incentivised business will also enjoy the same incentive tax rate:

1. the dividends and interest derived from outside Singapore,
2. interest from Asian Currency Units deposits, and
3. the gains or profits realised from the sale of "offshore investments".

One should, however, note that "offshore investments" is a defined list of investments and does not simply refer to all investments that are held offshore. Gains realised from the sale of investments that are not within the definition of "offshore investments" will not be able to enjoy the incentive tax rate.

Exempt income

Some investment income is exempt for all investors, including a Singapore insurer. They include:

- Singapore dividends paid out by Singapore resident companies that are exempt under Singapore's one-tier taxation system.
- Foreign-sourced dividends received by a Singapore tax resident that have met certain qualifying conditions – the "Section 13(8) exemption". Among the key conditions that must be met are that the foreign dividend must have been subject to tax in the foreign jurisdiction from which the income is received, and that the headline tax rate in that jurisdiction is at least 15% in the year the foreign dividend is received in Singapore.
- Tax-exempt real estate investment trust distributions.

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Investment in real estate investment trusts (REITs)

In Singapore, a REIT would qualify for tax transparency treatment at the REIT level if, among other conditions, it distributes at least 90% of its taxable income to unit holders in the same year in which the income is derived by the trustee. While an insurer who invests in a Singapore REIT would generally be taxable on its REIT investments, it could also potentially derive distributions that are exempt or non-taxable, such as:

- Distributions that are exempt from tax on the basis that the underlying relevant income is a capital gain or otherwise tax-exempt,
- Distributions that are not taxable on the basis that they are a return of capital. In such cases, an insurer should reduce the carrying cost of the investment instead.

Incentives to promote the bond market

As part of the Government's measures to promote the bond market in Singapore, it has made income derived from certain bond issues either exempt or taxable at reduced rates to an investor. For insurers in Singapore, the following tax rates could potentially apply (various conditions and specifications apply) to their investment income derived from bonds purchased in the Singapore market:

- Interest from Singapore Government Securities (SGS) and certain qualifying bonds issued or managed in Singapore between a designated time period of the incentive, termed as qualifying debt securities (QDS) – 10%
- Interest from "qualifying project debt securities" – 0%
- Interest from any QDS (other than SGS) that, among other conditions, are issued during the period 16 Feb 2008 and 31 Dec 2013 and have an original maturity of not less than 10 years – 0%
- Interest from certain qualifying "Islamic debt securities" – 0%

Investment department should capitalise on the tax incentive rates

Navigating what investment income is tax exempt or what is taxable, and at what rate, can be a minefield. However, if the investment manager(s) of an insurer is made aware of the tax concessions that are available, he/she could factor in the tax benefits of different investment assets when making investment decisions for the insurer. These benefits may go a long way in enhancing the investment returns and reducing the effective tax rates of the insurer.

Raising capital that are QDS

Of late, we have also observed some insurers raising Tier 2 capital that qualifies as QDS for tax purposes (various conditions apply). Investors are typically attracted to QDS due to their reduced tax rate, which can be 0% to 10% depending on the investor's attributes. As for the insurer raising the capital, the funding cost is generally low in the current environment. Accordingly, insurers who wish to raise capital could consider issuing QDS that qualify as Tier 2 capital.

Compliance – need to identify and classify properly

For tax return filing purposes, an insurer needs to identify its investments and classify the associated investment income into its appropriate tax income categories. Failure to do so could expose an insurer to unintended tax penalties. However, the multiplicity of possible tax treatments of investment income has made this task a monumental one.

We highlight below some potential pitfalls that insurers could encounter in classifying investment income into the appropriate tax categories:

- Dividends from companies listed on the Singapore Exchange (SGX)

  Many insurers acquire shares of companies listed on SGX and receive dividends. However, not all dividends distributed by SGX-listed companies are Singapore tax exempt dividends. For example, the listed entity could be a foreign company whose dividends do not qualify as exempt "one-tier" dividends.

- Foreign-sourced dividends received by a Singapore tax resident

  As highlighted above, foreign-sourced dividends are tax exempt if they qualify for the Section 13(8) exemption. This exemption, however, comes with two key qualifying conditions: (i) that the income must have been subject to tax in the foreign jurisdiction from which the income is received, and (ii) that the headline tax rate in that jurisdiction is at least 15% in the year the foreign dividend is received in Singapore. Insurers will need to carry out checks and maintain documentation to substantiate that these two conditions are met before classifying the income as tax exempt.

- Interest income from QDS

  The term QDS is not "uniquely tax", in that the same term is also used in the regulatory returns an insurer files with the Monetary Authority of Singapore (MAS). In the regulatory returns, an insurer has to identify investments that are QDS in the prescribed forms lodged with MAS. That classification is based on the QDS definition in the Insurance Regulations. However, the Income Tax Act has a different definition of QDS for the purposes of a reduced tax rate. An insurers should take steps to ensure that it follows the tax definition when applying the reduced tax rate for tax filing purposes.

- Income from perpetual securities

  Of late, it has become rather common for companies to issue perpetual securities (generally preference shares with no dated maturity) that are, for tax purposes, a QDS. Insurers investing in such securities should take care to treat the return from these securities as QDS income (taxable at reduced rate) and not dividend income (potentially exempt).

- Singapore REIT distributions

  As REIT distributions can be exempt, taxable or a return of capital, an insurer investing in a REIT would need to take care to identify and track the amounts appropriately.

Often, the finance department spends a significant amount of time identifying the investment income to the appropriate tax category. If this is a manual process done outside the accounting system, it is time consuming and prone to a certain level of human error. Given the amount of work involved in identifying investment income to the appropriate tax rates, insurers can consider automating the process with some planning in advance. This includes proper coding of the different attributes of the investment income and ensuring that these attributes are captured appropriately. The reports that would be generated off the investment system should also be capable of capturing all the information needed for tax filing purposes. Regular reviews of the tax attributes would then be required to ensure that the system is capable of generating the right reports and information.

Conclusion

In conclusion, Singapore has a raft of incentives that can be used to reduce not only the tax rates applicable to an insurer's underwriting income, but also the tax rates applicable to investment income. Such tax benefits should be optimised as part of any investment department strategy and capital raising exercise. However, as would be expected, the multitude of tax rates also poses challenges in the tax filing process. An insurer should have in place good systems and controls to identify and classify its investment income to properly meet its tax compliance obligations.

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Taiwan

Taxing Capital Gains Derived from Sale of Equities and Bonds

In Taiwan, an insurer may invest their funds in the local and foreign markets, including the recent uplift for investing in Mainland China's stock market. Based on Taiwan Insurance Institute's 2011 statistics, approximately 60% of Taiwanese insurers' local investments comprise domestic equities, bonds and real estate. Investing in the domestic market has certain tax advantages, in contrast to returns from foreign investments which in general are taxed at 17%. In particular, gains from the sale of domestic equities and bonds are exempt from income tax, but are subject to the income basic tax (also known as alternative minimum tax, "AMT") regime. Gains from sale of land are free from income tax and AMT, while gains from sale of buildings are subject to income tax assessment. However the recent amendment of the income tax and the income basic tax in relation to capital gains from securities transaction (the primary aim of which is to tax high-net worth individuals) may require Taiwanese insurers to factor higher tax costs into their returns on investments.

Taiwanese Insurers

Amendments to the Income Tax Act ("ITA") and Income Basic Tax Act ("IBTA") were passed on 25 July 2012 and impose income tax on capital gains derived from disposal of Taiwanese securities and futures; these amendments are effective from 1 January 2013. While the primary target for introducing tax on capital gains is major retail investors and those who frequently trade on the TSE or OTC, the amendments could mean a larger tax bill, increased pressure on profitability and additional compliance measures for the insurance sector.

The salient amendments to the IBTA are summarized as follows:

Prior to 2013[1]	From 2013 onwards[2]
1. Sale of all types of securities (including shares, bonds, futures and options) was included in the AMT regime.	1. Sale of all types of securities are included in the AMT regime.
2. Exemption amount is NT$2 million.	2. Exemption amount is NT$0.5 million.
3. AMT rate is 10%~12%. Applicable tax rate is 10%.	3. AMT rate is 12%~15%. Applicable tax rate is 12%.
	4. 50% of the capital gain can be tax-exempt should the securities be held for more than 3 years.
	5. Capital loss can be deducted from capital gain in the current year and carried forward for 5 years thereafter.

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Following the above amendments to the IBTA, the AMT rate is increased from 10% to 12% and exemption threshold of NT$2 million is reduced to NT$0.5 million. With the potential increased AMT liabilities, insurers are encouraged to evaluate the impact of the above amendments on their investment returns and where necessary, revisit their investment strategy.

Foreign Insurers

In general, capital gains derived from the sale of Taiwanese equities and bonds by foreign institutional investors ("FINIs") without a fixed place of business (such as a Taiwan branch) or business agent in Taiwan are not taxed. The amendments to the ITA and IBTA will not impact these investors (including foreign insurers) as long as they do not have any fixed place of business or business agent in Taiwan.

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[1] Certain surcharges apply additionally
[2] Certain surcharges apply additionally

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