Taxation of Life Insurance Companies

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Section 1 : Basis of Assessment

1.1) The total salary earned during a year is the basis of assessment for tax in the case of salaried persons. It is the profit or gain from business in the case of businessmen. Income from other sources like dividend and interest income on investments is common for both. While there will generally be a clear line of demarcation between the incomes pertaining to successive years in the case of salaried persons, it will never be so in the case of businessmen. To assess or define the profit and gain from business is not therefore an easy task. More so, in the case of business organisations, whether trading or manufacturing or banking or insurance. In the case of insurance organisations, especially life insurance, the complexities get compounded because of the very long-term nature, sometimes spanning decades, of its transactions.

1.2) There will be a minimum of two funds in the case of a life insurance company, the. shareholders' fund and the policyholders' fund. The latter may be sub-divided further, based on the classification of policyholders. Unlike in the case of other industries, the shareholders' fund does not play any active role in running the business, except during the formative years, and hence can remain invested. The taxable income of a life insurance company is therefore the sum of,

- Investment income, net of expenses if any, from the shareholders' fund and
- Profits and gains from the life insurance business.

1.3) There are two methods of assessing the taxable income (profits and gains) of a life insurance business.

- In the first method, the taxable income is defined as (Income Minus Expenses) or **Net Income**. Here, "Income" means investment income and not all expenses may be allowed as deduction from this income.
- In the second method, the taxable income (profit and gains) is defined as (Income Minus Outgo Minus Increase in Liability). It is necessary to define the three terms, Income, Outgo and Liability.
  - Income is the sum of Premium Income, Investment income and any other Miscellaneous income.
  - Outgo is the sum of all Payments made to policy holders (like maturity claim, death claim, surrenders, … etc.) and Management Expenses, like commission to agents, salary to employees, establishment charges, … etc.
  - A life insurance company incurs a liability (i.e. liability to the policyholders) whenever a new policy is issued and an additional liability when a renewal premium is received. This liability is to be estimated by special techniques, known as actuarial techniques, using appropriate discount and probability factors. The difference between the total liability as at the end and beginning of a financial year is known as the increase in liability during the year.

The value of (Income Minus Outgo Minus Increase in Liability) determined by the second method is technically known as the Valuation Surplus.

In either method, the losses, if any, incurred in earlier years have to be carried forward.

1.4) The entire Valuation Surplus cannot however be termed as taxable profit and gain from business since a substantial portion of this surplus gets allocated back to the policyholders in the form of bonus. Only the balance valuation surplus can therefore be treated as taxable profit and gain. Let us call this balance surplus as **Net Surplus**. It would be seen later that, after the opening of the insurance sector, the surplus that gets allotted back to policyholders, is negligible in the case of private insurance companies.

1.5) What should then be the basis of assessment, Net Income or Net Surplus ?

1.6) In the case of a new company with reasonable growth rate, while the Net Income will be negative during the first, say 15 years, the Valuation Surplus may become positive from the fourth or fifth year onwards. So, if the Net Income is taken as a measure of profit and gain,, while the shareholders will be receiving their share of valuation surplus, the Company will continue to stay outside the tax net for many years. But, the position will gradually get reversed as the company matures. After about 20 years, the net income will begin exceeding the net surplus. New companies which actively lobby for the net income to be taken as the basis of assessment for tax purposes, will quietly start lobbying for the net surplus basis once they grow in size. What then should be the basis of assessment ? A look at the history of taxation of life insurance companies may provide the answer.

Section 2 : History of Taxation of Life Insurance Companies

2.1) Before 1918, a life insurance company was being assessed on "Profits", just like any other trading company. The procedure for determining the profit was evolved departmentally, keeping in

view the special features of life insurance business. The Income Tax Acts, 1918 and 1922 gave statutory recognition to these procedures. Till 1939, taxation of life insurance companies was governed by the Income Tax Act, 1922 and Rules 25 and 35 made under that Act. Under this system, the profit was taken as the average annual valuation surplus as disclosed in the last preceding valuation, to which certain items of expenditure were added back, to arrive at the average annual gross surplus. The entire surplus was taxed, without taking into consideration the amount of surplus allotted back to the policyholders in the form of bonus. In those days, since the valuation was being conducted once in 3 to 5 years, the "average" surplus per year was taken as the basis for taxation. But now, since the valuation is being conducted each year, the term "average" is redundant.

2.2) In 1934, the Indian Life Offices Association (ILOA) represented to the Government that this basis of taxation was not fair and that the method of taxation introduced in the U.K under the Finance Act, 1923, should be adopted also in India. Under this system, the life insurance companies in the U.K were assessed for Tax, from 1923 onwards, on the basis of the higher of

- Investment income LESS Expenses of Management and
- Valuation Surplus LESS that portion of the surplus paid to or reserved for or expended on behalf of policyholders.

That is, on the basis of higher of Net Income and Net Surplus.

2.3) This formula for assessing the profit and gain of a life insurance company is a very fair one. In the case of mature companies, the first factor will be the higher and the second factor will be the higher in the case of young companies. And, none can escape the tax net. This change was brought about on the basis of the recommendations of the Royal Commission on Income Tax, which examined in 1920 the methods of taxation of life insurance companies.

2.4) In response to the representation of the Indian Life Offices Association (ILOA), the government appointed an Expert Enquiry Committee. The Committee however did not accept the views of the ILOA and the net effect of its recommendations was to maintain the status quo. The Committee perhaps felt that the U.K model cannot be applied under Indian conditions where the Investment Income Less Expenses of Management (i.e. Net Income) was negative in the case of almost all the companies. On the basis of the Committee's recommendations, the Income Tax (Amendment) bill was introduced in the Legislative Assembly in 1938.

2.5) The ILOA objected to these recommendations and pleaded again for the adoption of the British model. It succeeded in getting the Bill referred to the Select Committee, headed by Shri.Bhulabhai J Desai. The Committee, after hearing the arguments put forward by Shri. L.S.Vaidyanathan and Shri. B.K.Shah, the two actuaries who represented the ILOA, recommended the adoption of the British model, with certain modifications to suit the Indian conditions.

2.6) As per the Committee's recommendations, the profit and gain of life insurance business has to be taken as the higher of

- Investment income LESS Expenses of Management and
- Valuation Surplus LESS that portion of the surplus paid to or reserved for or expended on behalf of policyholders.

But,

- A ceiling was placed on the "management expenses" on a quantified basis, as the sum of 85% of the first year premium and 8.5% of the renewal premium and
- Only 50% of that portion of surplus allocated to the policyholders was to be allowed as deduction from the valuation surplus.

2.7) The Committee justly felt that allowing actual expenses of management as deduction would only benefit inefficient companies and penalise efficient ones. The Income Tax (Amendment) Act XI of 1944 raised these provisions for management expenses to 90% and 12% respectively. The companies, almost all of which were being assessed only on net surplus basis, were however only interested in raising the deduction from valuation surplus, from the existing 50% of the amount allocated to the policyholders, to 100%

2.8) The Income Tax Investigation Commission, appointed in 1948, also went through all aspects of taxation of life insurance companies but rejected the demand for raising the deduction from valuation surplus from 50% of the amount allocated to policyholders to 100%. In the premium charged by life insurance companies there is a hidden charge, known as bonus loading. The companies argued that only this bonus loading is being returned to policyholders in the form of bonus and so, is purely in the nature of return of premiums and cannot therefore be construed as profit. The Commission pointed out that only a part of the surplus comes from this bonus loading and the "Actual bonus declared is to be considered partly as a "Return Of Premium" and partly as a Return On Premium". It also felt that "it may not also be right to exclude all considerations of the repercussions of any modifications of the existing practice on Revenue". The main recommendations made by the Commission were,

- The allowance for management expenses be raised to 90% of first year and 15% of renewal premiums
- A suitable formula may be devised by the Central Board of Revenue and the Insurance Department to determine what percentage of that portion of surplus allocated to the policyholders can be allowed as deduction from the valuation surplus.

2.9) The Central Board of Revenue could not however give proper shape to the second recommendation <u>since the insurance</u>

companies were not able to provide sufficient information regarding the bonus loading component of the valuation surplus. Neither of the recommendations was therefore given effect to.

2.10) The Income Tax Amendment Act, 1953, raised the provision for management expenses from 12% to 15% of renewal premium, thus implementing the recommendation of the Commission and raised also the percentage of the portion of surplus allocated to policyholder that can be allowed as deduction from the valuation surplus from the existing 50% to 80%. This amendment was made effective from the assessment year 1951 - 52. These concessions were not only quite significant but also very fair.

2.11) The Taxation Enquiry Commission, appointed in 1953, also examined the taxation of life insurance business, but felt that there was no case for giving any further concessions.

2.12) The life insurance business was nationalised in 1956 and the Life Insurance Corporation of India was set up on 1st September 1956 under an Act of Parliament. The nationalisation did not however lead to any change in the method of assessment of life insurance business.

2.13) The Income Tax Act, 1922, was replaced by the Income Tax Act, 1961 and the new Act came into effect from 1st April 1962. The taxation of insurance business is governed by Sec. 44 of the 1961 Act and the Rules contained in the First Schedule. These provisions were practically the same as those under the previous Act.

2.14) Rule 2(1) of First Schedule defines the profits and gains of life insurance business as the greater of,

- The gross external earnings of the previous year less management expenses of that year and
- The annual average of the surplus disclosed by the actuarial valuation made in accordance with the Insurance Act, 1938, subject to certain adjustments and additions

One of the important adjustments is the deduction of 80% of that portion of the valuation surplus allocated to the policyholders.

2.15) Premiums received from policyholders, Interests and Dividends on any annuity fund and Profits on realisation of investments are not included in income. Similarly, bonuses or other sums paid to or reserved for policyholders, depreciation of and losses on realisation of investments and any expenditure or allowance that is not deductible under sections 30 and 43 of the Act are not included in management expenses. Rule 2 (2) of the First Schedule lays down the maximum limits for allowable management expenses in terms of different percentages of various categories of premiums.

Section 3 : The Post Nationalisation Period

3.1) Though the method of assessment of the profit and gains from life insurance operations remained unchanged for many years, the rate of tax did not. From 28.12% in the assessment year 1950 - 51, it rose gradually to 52.5% in the assessment year 1965 - 66. In addition, a surcharge of 2.5% was imposed in the assessment year 1972 - 73 and the same was raised to 5% in 1973 - 74. The rate of tax in the case of life insurance companies was lower than the corporate rate of tax. The differential however, came down from 12.5% in 1950 - 51 to 2.5% in 1965 - 66.

3.2) With the nationalisation of life insurance, it was natural for one to expect that no further representation would have been made by the industry regarding taxation. It was not to be so. In the year 1966 - 67, the Income Tax Officer, Bombay, ordered reopening of the assessment of the LIC for the assessment year 1961 - 62. LIC filed a writ petition in the Bombay High Court in March 1967 against this order. It however withdrew the petition in April 1972 when CBDT suggested that the matter may be referred to the Attorney General of India for arbitration. It is not however known as to what the final outcome of the arbitration was. Perhaps, the arbitration proceedings never really took off.

3.3) Perhaps disturbed by these developments, LIC felt that the basis of assessment of life insurance should be simplified and made a formal representation in this regard in February, 1974. The representation was referred to the Central Board of Direct Taxes (CBDT). In the meeting of the Consultative Committee of the Ministry of Finance held in December, 1974, Shri. S. Ranganathan, M.P, put forth a simple method for assessing the profits and gains of life insurance business. He suggested that instead of the higher of Net Income and Net Valuation Surplus, the Gross Valuation Surplus should be the only basis for taxation and the tax should be equal to a specified percentage of the Gross Surplus. His suggestion was accepted in principle. But it took two more years to give it a final shape. The change came into effect from 1st April 1977 and the first assessment on this basis was done for the assessment year 1977 - 78.

3.4) Sec. 115B of the Income Tax Act now states,

(1) Where the total income of an assessee includes any profits and gains from life insurance business, the income tax payable shall be the aggregate of --

i) the amount of income tax calculated on the amount of profits and gains of the life insurance business included in the total income, at the rate of twelve and one-half percent, and

ii) the amount of income-tax with which the assessee would have been chargeable had the total income of the assessee been reduced by the amount of profits and gains of the life insurance business

3.5) The tax rate of 12.5%, appears to have been arrived at by a simple process. Since the LIC was allocating 95% of the

valuation surplus to its policyholders, the taxable income was only 100% (Minus) (80% of 95%). That is 24%. The rate of tax then being Fifty two and one-half percent (without taking into account the surcharge of 5%), 52.5% of 24% was 12.6%.

It was also ensured that, as at the time the change was brought about, this 12.5% of the valuation surplus was not less than the tax, at the corporate tax rate, on the "Higher of Net Income and Net Surplus".

3.6) The insurance industry thus got a very fair deal. But, there is still some lingering grievance that, when the corporate tax was reduced in stages from 55% to 35%, no corresponding reduction was made in the rate of taxation of valuation surplus. This grievance, however, cannot stand closer scrutiny. As a life insurance company grows, the rate of growth of net income will be higher than the rate of growth of net surplus. So, if the condition that "X% of the valuation surplus should not be less than the tax, at the corporate tax rate, on the Higher of Net Income and net Surplus" is applied, the value of X% will be found to be significantly higher than 12.5%.

Section 4 : Likely Issues

Issue 1 :

4.1.1) Right from 1934, the Indian Life Offices have been insisting that the entire valuation surplus should not be taxed but only the surplus net of the surplus allocated to policyholders. Rule 2(i) of the First Schedule of the Income Tax, 1961, is clearly based on this principle. In April 1977, when the rate of tax in the case of a life insurance company was fixed as 12.5% of the Gross Valuation Surplus, the rate, viz. 12.5%, was arrived at by using the same principle. It was always implicitly assumed that not less than 80% of the surplus will be allocated back to the policyholders.

4.1.2) The position was actually so till recently. As per the Insurance Act, 1938, the shareholders were not eligible for more than 7.5% of the valuation surplus. As per the L.I.C Act, 1956, not less than 95% of the valuation surplus has to be allocated to the policyholders. No distinction was made between the surpluses emerging from the participating and non-participating policies. Consequently, substantial portion of the surplus emerging from the non-participating portfolio was going to participating policyholders.

4.1.3) As per the amendments to Sec.49 of the Insurance Act, made soon after the opening of the insurance sector, the shareholders are now eligible for a maximum of 10% of the valuation surplus emerging from the participating portfolio and 100% of the surplus emerging from the non participating portfolio. (The LIC Act has however not been amended). Since, in the case of life insurance companies in the private sector, the participating portfolio is quite negligible, the proportion of the total surplus allocated to the policyholders will also be negligible. So, the basis on which the tax rate of 12.5% of the valuation surplus was arrived at (see section 3.5) will no longer be valid.. So, if at any time the taxation of life insurance companies is taken up for review by the Finance Ministry, it is highly probable that separate rates of tax may be prescribed for surpluses emerging from the participating and non participating portfolios. Or, the U.K method of taxation may be adopted.

Issue 2 :

4.2.1) As per Sec. 115B of the Income Tax Act,

(1) Where the total income of an assessee includes any profits and gains from life insurance business, the income tax payable shall be **the aggregate of --**

i) the amount of income tax calculated on the amount of profits and gains (valuation surplus) of the life insurance business included in the total income, at the rate of twelve and one-half percent, and

ii) the amount of income-tax with which the assessee would have been chargeable had the total income of the assessee been reduced by the amount of profits and gains of the life insurance business

4.2.2) The total taxable income in the case of a life insurance company can be taken as the sum of the

- Investment income, net of expenses, in the shareholders' fund and
- Valuation surplus emerging from the policyholders' fund.

The second item is to be taxed at the rate of 12.5% and the first at the rate of corporate tax. However, some experts on taxation feel that the shareholders' fund is an integral part of the life insurance business and so, the net investment income from this fund cannot be taxed at the corporate tax rate, but only at 12.5%. In all probability, the issue may be taken to the court and, it may take a few more years before a clear picture can emerge. It is however my personal view that there is no ambiguity in Sec.115 B of the Income Tax Act and, the net investment income in the shareholders' fund is to be taxed at the corporate rate of tax.

4.2.3) The Shareholders have not to pay any tax on the shareholders' share of surplus, transferred from the policyholders' fund to the shareholders' fund, since the valuation surplus has already suffered tax in the Policyholders' Fund.

Issue 3 :

4.3.1) As per Sec.10(23AAB) of the Income Tax Act, any income from a Pension Fund set up by an insurer on or after 1st August 1996, will not form part of the total income. That is, any valuation surplus arising from a Pension Fund is not taxable. **Whom does this amendment benefit ?** Since Pension Funds are essentially Non-Participating Funds, 100% of the valuation surplus will pass on to the Shareholders' Fund. If this concession were not present, the shareholders would have only received 100% of the valuation surplus, net of tax. There will

absolutely be no benefit to the policyholders.

4.3.2) Earlier, this benefit was applicable only in the case of Trustee Managed pension funds. Such funds are taxed on the basis of Net Income and not on the basis of Net Valuation Surplus like life insurance companies. Since there are no shareholders in the case of Trustee Managed Funds, the entire benefit of this tax concession was being passed on to the members of the Fund.

4.3.3) This issue may, in all probability, come up for review as and when the Pension Fund Regulatory and Development Authority (PFRDA) bill is taken up by the Parliament.

Issue 4 :

4.4.1) As per Section 72 of the Income Tax Act, 1961,

"(1) Where for any assessment year, the net result of the computation under the head "Profits and Gains of business or profession" is a loss to the assessee, not being a loss sustained in speculation business and such loss cannot be or is not wholly set off against income under the head of income in accordance with the provisions of Section 71, so much of the loss as has not been set off or, where he has no other income under any other head, the whole loss shall, subject to other provisions of the Chapter, be carried forward to the following assessment year, and – ………………."

4.4.2) As per First Schedule of the Income Tax Act, at the time of Computation of profits of life insurance business, profit and gains of life insurance business is taken as the surplus or deficit disclosed in the actuarial valuation excluding from it any surplus or deficit included therein which was made in any earlier inter-valuation period.

4.4.3) The above para may appear to preclude carry forward of losses whereas, the earlier para allows such carry forward of losses. One may wonder whether the above two provisions in the Income Tax Act contradict each other. However, it is not so.

4.4.4) In actuarial valuation, the surplus or deficit as at the end of a year is defined as,

(Value of the Fund as at the end of the year – Value of the Liability as at the end of the year). Suppose the values of the Fund and Liability as at the end of Year1 are respectively 90 and 100. So, loss at the end of Year1 will be 10. During Year2, the Fund increases by 70 and the Liability increases by 55.

So, the profit at the end of year2 will be,

[(90 + 70) – (100 + 55)] = 5 ------------------ (A)

Let us now see how an Accountant would have arrived at the profit at the end of Year2. He will define the profit during year 2 as,

(Increase in Fund during Year2 – Increase in Liability during Year2)

= 70 – 55 = 15

So, the profit at the end of Year2 will be equal to,

Profit during Year2 – Loss Carried Forward from Year1

= 15 – 10 = 5 ---------------------------- (B)

4.4.5) The values arrived at under both (A) and (B) are same. When we define the Fund at the end of Year2 as the sum of the Fund at the end of Year1 PLUS Increase in Fund during Year2, the loss as at the end of Year1 automatically gets carried forward.

4.4.6) Now let us see why the First Schedule states that, "at the time of Computation of profits of life insurance business, profit and gains of life insurance business is taken as the surplus or deficit disclosed in the actuarial valuation excluding from it any surplus or deficit included therein which was made in any earlier inter-valuation period". When the profit is carried forward to next year, it would not only get taxed again, but would also result in paying the shareholders' share of the profit twice. But, what about the loss ?

4.4.7) The total profit of a life insurance company will be, the sum of the

- Profit in the shareholders' fund and
- Profits and Gains from the life insurance business

a) If the profit in the share holders' fund is 20 and the profits and gains of life insurance business is 100, the total profit will be 120. It TC is the rate of corporate tax and TS is the rate of tax on the profits and gains of of life insurance business, the total tax payable will be, **$[(20 \times T_C) + (100 \times T_S)]$**

b) Suppose, the profit in the share holders' fund is 70 and the loss in the life insurance business is 40, The total profit will be (70. – 40) = 30. The "net profit" in the shareholders' fund will be taken as 30 and the "profit and gain" from the life insurance business will be taken as NIL. The tax payable will be **$[(30 \times T_C) + (0 \times T_S)]$**.

c) Suppose, the profit in the share holders' fund is 20 and the loss in the life insurance business is 40, The total profit will be (20. – 40) = –20. The "net profit" in the shareholders' fund will be taken as –20 and the "profit and gain" from the life insurance business will be taken as NIL. The tax payable will be **NIL**. The net loss in the shareholders' fund can be carried over to next year, as in the case of any other business or profession.

d) Suppose, the profit in the shareholders' fund is –30 and the profit and gain in the life insurance business is 15. The total profit will be (–30 + 15) = –15. The net profit is –15, and of this, 15 has come from the profits and gains of life insurance business. So, the tax payable will be, **$[(0 \times T_C) + (15 \times T_S)]$**.. The loss of 30 in the shareholders' fund can be carried forward to next year.

4.4.8) The special rate of tax (i.e. T_s or, 12.5% + Surcharge) on profits and gains of the life insurance business is applicable only when there is a profit or gain. If there is a loss in the life insurance business, it goes to reduce the total profit in the shareholders' fund. So, the question of carrying forward the loss in life insurance business will never arise.

4.4.9) Section 72 of the Income Tax Act caters to the Accountants method of arriving at the profit. The First Schedule caters to the Actuary's method of arriving at the profit and the special nature of taxation of a life insurance company.

Issue 5 :

Unit Linked Insurance

4.5.1) Marketing of Unit Linked Products began only after the opening of the insurance sector. The LIC of India could not introduce these products earlier because of the investment restrictions under Sec.27 of the Insurance Act and additional restrictions placed by the finance ministry from time to time. The question is, whether the existing provisions in the Income Tax Act are sufficient for taxation of profits emerging from the linked business. The answer is YES.

4.5.2) The unit linked business is just a variation of the Cash Accumulation Schemes, known to the industry for a long time.

- Unlike under cash accumulation schemes, the charges towards expenses and risk cover are explicit under the linked schemes.
- The investment risk is borne by the shareholders under the former and, by the policyholders under the latter.
- While determining the value of the fund under administration, unrealised gains and losses are taken into account in the case of linked funds whereas, conventional accounting practices are followed in the case of cash accumulation schemes.
- In the case of linked funds, the appropriations made towards expenses and risk cover and the fund management charges are taken to a separate fund called the Non-Unit Fund. Not so, in the case of cash accumulation schemes, since the charges are not explicit.

4.5.3) Every year, the actuary goes through the ritual of valuing each non-unit fund. It is termed a ritual since, on the basis of assumptions made, even a non actuary can say at a glance that the liability will be zero, except under those cases where periodic loyalty additions are promised. In fact, from the actuarial point of view, there is no need to create a non-unit fund, The various charges appropriated from the premiums and the unit fund can as well be taken to the general non-participating fund. If this is done, one will not look at the linked funds as some thing different and strange.

4.5.4) Let us look at the operation of non-unit funds. At the beginning of first year, the value of this fund will be zero. During the year, the appropriations and charges made from the premiums and the unit fund are added to the non-unit fund and expenses and claim payments are deducted from the fund. Let the value of the fund at the end of Year1 be F1. Since the liability at the end of first year will generally be zero, the surplus will be equal to F1 − 0 = F1. After payment of tax, the balance surplus is transferred to shareholders and the value of the fund will again be zero. This process is repeated each year.

It can be seen from the foregoing that the existing provisions in the Income Tax Act are quite sufficient to deal with the linked funds.

Conclusion

The present system of taxation was formulated when there was only one life insurance company in the country, and that too a government owned company. The product structure too was quite simple. Pension portfolio was virtually non existent. Shareholders' share of surplus was just 5%. This tax structure may not be found to be suitable in the coming years and many anomalies may arise. Within the next few years, the Government may have to undertake a thorough review of the taxation of life insurance companies. When that happens, in all probability, the U.K tax structure, which is very comprehensive, may be adopted.