Taxation of Life Insurance Business – Some Issues

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1. Current Income Tax Legislation For Life Insurance Business:

1.1 The taxation of life insurance business in India is currently governed by Section 115 B, Section 44 and the First Schedule of the Income Tax Act, 1961. The texts of these are reproduced herein for ready reference.

"**115-B. Tax on profits and gains of life insurance business** – (1) Where the total income of the 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 per cent; 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.

……"

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

" **THE FIRST SCHEDULE**

INSURANCE BUSINESS

(see Section 44)

A. LIFE INSURANCE BUSINESS

1. Profits of life insurance business to be computed separately.- In the case of a person who carries on or at any time in the previous year carried on life insurance business, the profits and gains from that business shall be computed separately from his profits and gains of any other business.

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

1.2 The Insurance Act, 1938, before it was amended by the IRDA Act, 1999, provided that the actuarial valuation shall be carried out at least once in three years and hence the reference to “the annual average” and ”adjusting the surplus or deficit.

1.3 Section 72 of the Income Tax Act, 1961, is also reproduced herein.

“72. Carry forward and set off of business losses- (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 a 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 income under any other head, the whole loss shall, subject to the other provisions of the Chapter be, carried forward to the following assessment year, and - ………..”

2. Issues that need consideration:

2.1 Treatment of “shareholder fund income”:

2.1.1 As per Section 115 B , the income of an assessee is divided into two parts,viz.

a) “profit and gains of the life insurance business” ; and
b) “total income reduced by the amount of profits and gains of the life insurance business”.

and “(a)” is taxed at 12.5 % and “(b)” is taxed at normal rate of tax applicable to the assessee. The “profit and gains of the life insurance business” is defined in the First Schedule as “..Surplus or deficit disclosed by the actuarial valuation made in accordance with the Insurance act, 1938”. In this context, how the income of the shareholder will be taxed as it does not constitute “profit and gains of the life insurance business”.

2.1.2 Why does this situation arise? This situation arises because, the current tax legislation does not envisage separate "policyholder fund” and “shareholder fund” but only a single fund as is the case with LIC. In this system, the income on share capital gets included in the total income of the life insurer and the shareholders get return only in the form of share of surplus. The income on share capital is not available to them. Whereas the IRDA Regulations require separate “policyholder fund” and “shareholder fund”.

2.1.3 This needs consideration.

3. Carrying forward of losses:

3.1 As per the First Schedule, at the time of “Computation of profits of life insurance business” , “profit and gains of the life insurance business” is taken as “the surplus or deficit disclosed by the actuarial valuation” excluding "from it any surplus or deficit included therein which was made in any earlier inter-valuation period”. This essentially precludes carry forward of losses whereas the tax legislation does allow carry forward of losses in general. Exclusion of retained or carried forward surplus from the taxable surplus is provided for as it has already been taxed, but why exclude “deficit included therein which was made in any earlier inter-valuation period”? The CII, in the initial stages of liberalisation process, had made a submission to the authorities that in life insurance business the losses should be allowed to be carried forward for setting those off against the future surpluses.

3.2 The provision of Section 72, are of general nature and since the special provisions in the legislation always override the general provisions, the provisions of the First Schedule would normally override the provisions of section 72 so far as life insurance business is concerned.

4. Taxation of Linked Business

4.1 In India, till recently, life insurance products were funded on non-linked basis. The linked funding though prevalent in other markets for a long time did not get introduced in India. The tax legislation in India therefore does not provide for taxation of life insurance business funded on linked basis.

4.2 The linked business has two funds, viz. the "Unit Fund", which is a policyholder fund, and "General Fund" , which is a shareholder fund. In India, the current tax legislation provides for taxation of life insurance business on "surplus basis". How will the current tax legislation deal with the linked business. One view held in India is that since the life insurance business in India is taxed on surplus basis, only the surplus of General Fund be taxed. That leaves the "Unit Fund", i.e. policyholder fund without any tax. In the traditional non-linked business, where the products are bundled, the total surplus is taxed.

4.3 Another issue that needs explanation is that the "General Fund" is set up by the life insurers to meet the negative cash-flows in future. The General Fund is therefore calculated for each policy by projecting cash-flows to ensure that all future outgoings can be met without recourse to further finance. If a life insurance company does not envisage any negative cash-flows, the company may have zero General Fund. In this context, there may not be any General Fund surplus at all and the linked business will not be taxed at all.

4.4 It is therefore necessary that the tax legislation addresses this issue. An early step will spare the life insurance industry from possible difficult situation in the future.

5. Conclusion

5.1 The current tax legislation was framed for a particular environment and the legislation does not address the issues that have emerged in the changed situation. Recognising this, the Government of India had constituted an Expert Committee to review the taxation of life insurance business. It is necessary that a view is taken on the recommendations of the Expert Committee as soon as possible so as to spare the liberalised life insurance industry of uncertainty in respect of these issues.