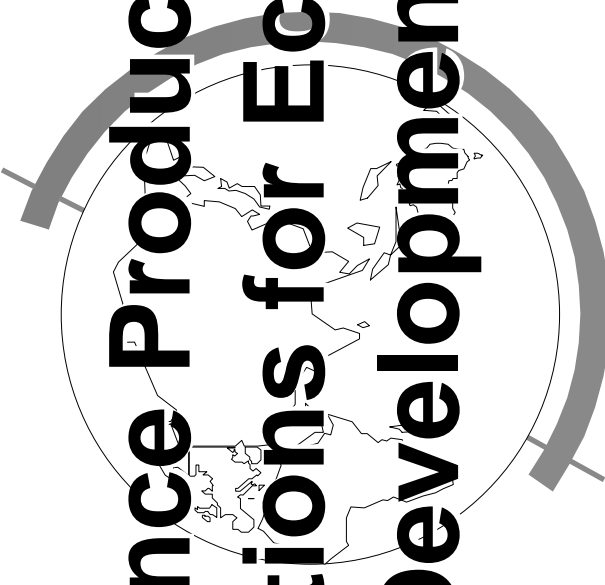


Life Insurance Product Taxation: Implications for Economic Development



**VIII Conference on Insurance Regulation and
Supervision in Latin America**

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Outline of Remarks

- **The Economic and Social Role of Life Insurance**
- **Life Insurance Taxation**
- **Establishing Life Insurance Tax Policy**



The Economic and Social Role of Life Insurance



Why financial intermediaries are essential for modern society

- ☞ Reduce transactions costs in bringing together borrowers and savers
- ☞ Create liquidity
- ☞ Facilitate economies of scale in investment
- ☞ Engage in risk management by ...
 - Pricing risk
 - Engaging in risk transformation
 - Engaging in risk pooling

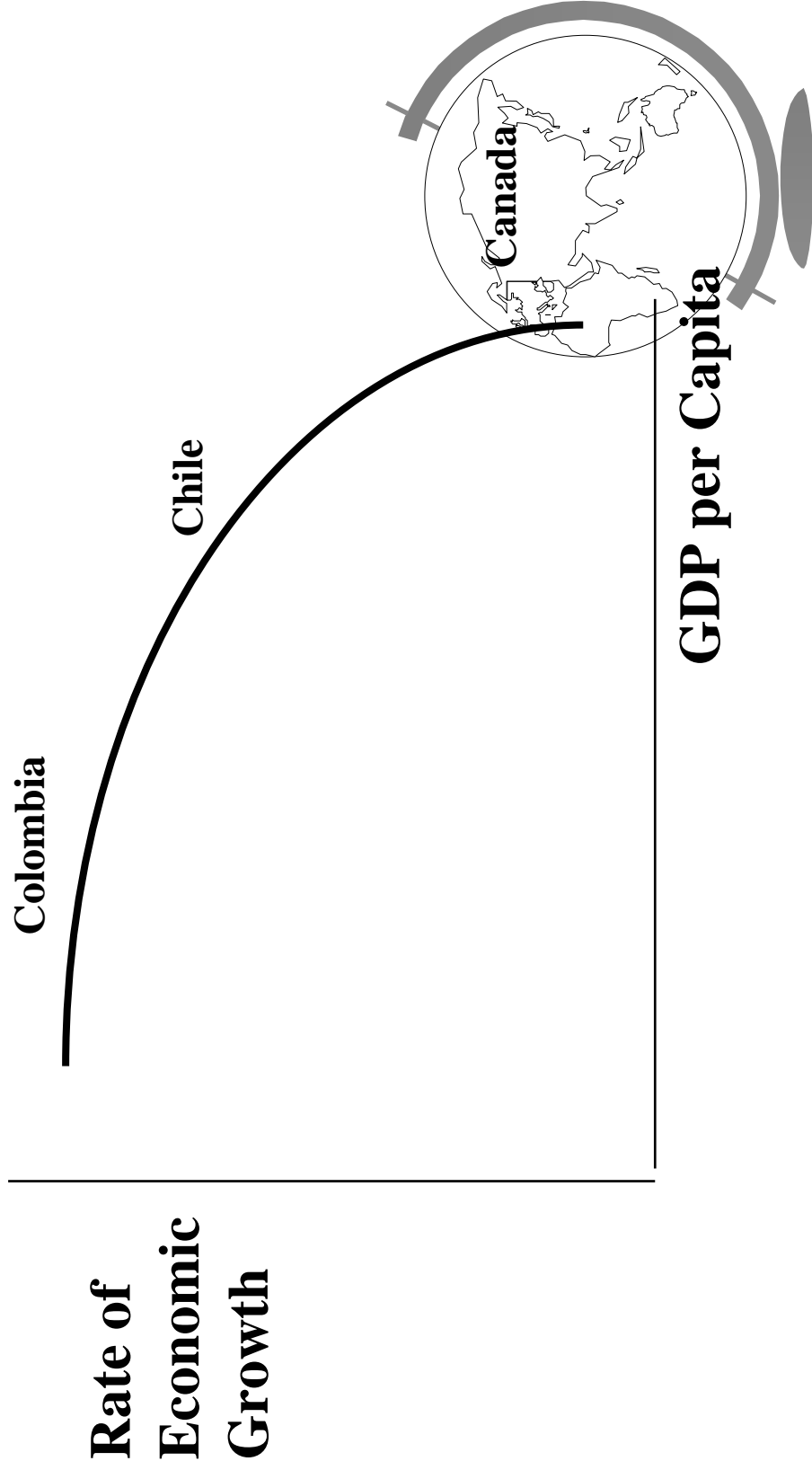


As specialized financial intermediaries, life insurers ...

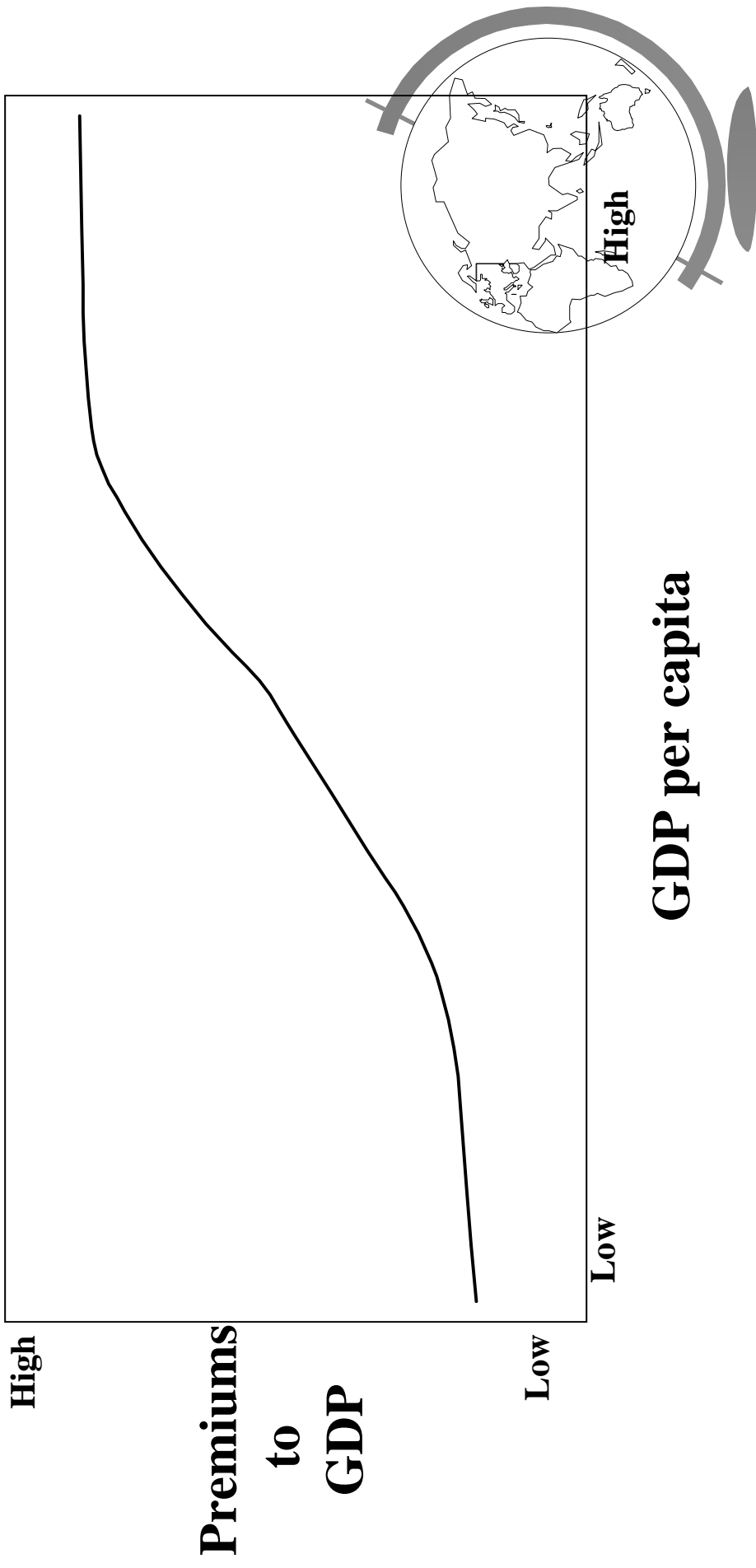
- **Promote financial stability for families and businesses**
- **Substitute partially for government security**
- **Facilitate trade and commerce**
- **Mobilize national savings, especially longer term**
- **Foster more efficient capital allocation**



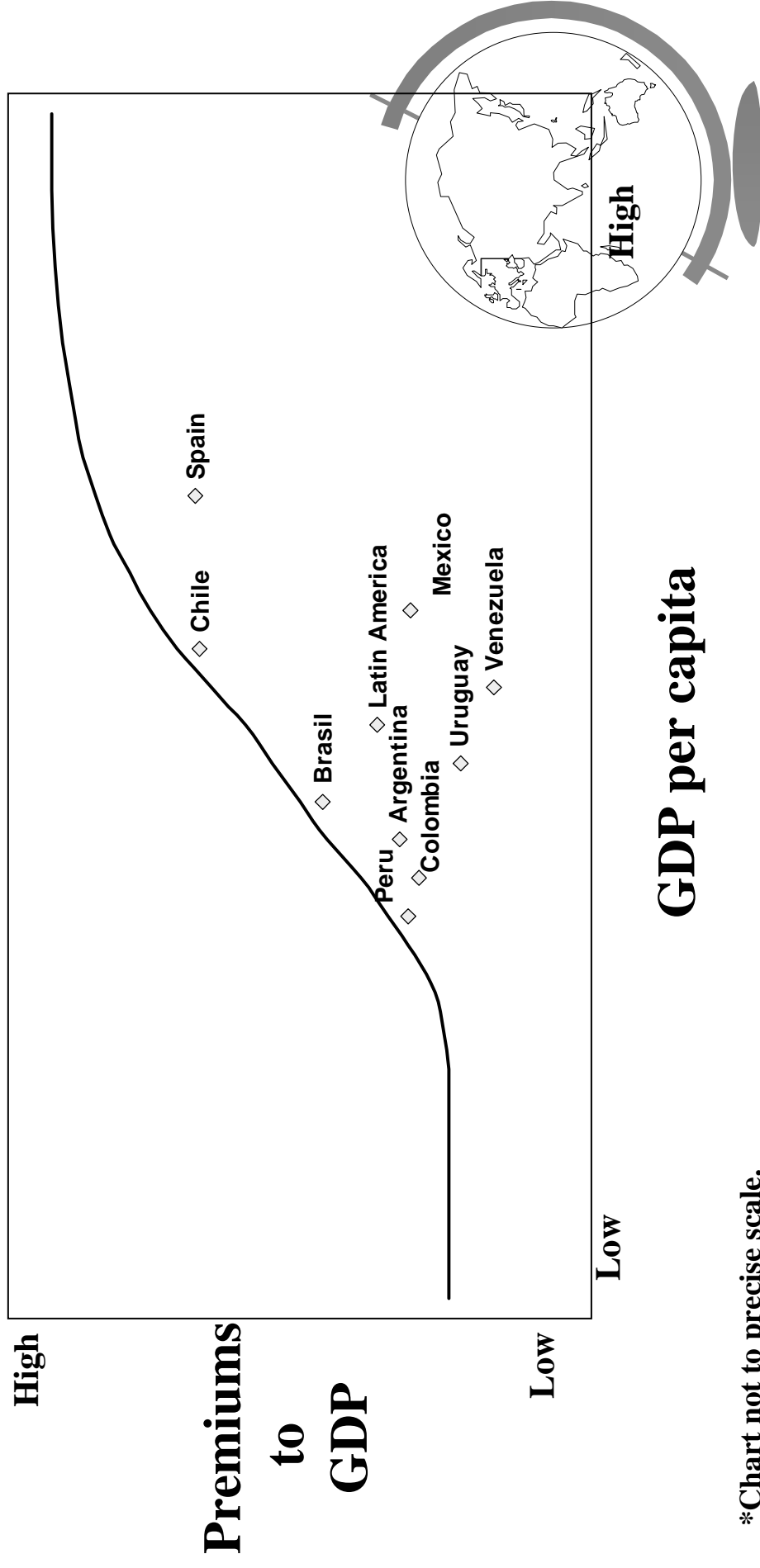
Developing countries should grow faster . . .



Relationship between life insurance and economic development . . .



Taking economic status into account, Latin America life insurance demand might be low* ...



*Chart not to precise scale.



Life Insurance Taxation

Purposes of Taxation

- **To raise revenue**
- **To promote economic goals**
- **To promote social goals**



Desirable Traits of Tax System

- **Simplicity – not complex administratively, low cost of collection, not easily evaded, easy compliance**
- **Equity – each entity should pay its “fair share”**
- **Neutrality – industries, entities, products and services should be taxed equivalently in the interest of promoting national economic efficiency**



Life Insurance Consumer Taxation:

Individuals

- **Premiums**
 - Annuity considerations may be tax deductible (retirement)
 - Life premiums sometime enjoy tax preference but trend is otherwise
- **Benefits**
 - Annuities –
 - Interest credits often tax deferred for non-tax-qualified annuities
 - Payouts usually subject to income taxation to extent not already taxed
 - Life insurance
 - Dividends and interest on cash value often tax free or tax deferred
 - Death benefits usually income-tax free but subject to estate duties



Life Insurance Consumer Taxation:

Employers

- **Premiums**
 - **Payments by employers toward costs of life, health and retirement benefits that benefit employees are ordinarily deductible to business**
 - **Such payments often are not taxable as income to employee, subject to limits**
 - **Payments by employers for benefits that inure to the employer are not ordinarily deductible to business**
- **Benefits**
 - **Life insurance death benefits paid to employees or their families usually are not taxable to them**



Insurance Consumer Taxation:

Value Added Tax (VST/IVA)

- Nature – tax embedded in product price that is paid by final consumers, which is levied against the value added at each stage of the production chain.
- Relies on taxes on outputs with credits for taxed inputs on a transaction-by-transaction basis.
- Can be equitable and neutral and not overly complex for goods and services with *explicit prices* – when what is paid, is the price.
- However, most prices for financial intermediation services, including insurance services, are *implicit prices* – what is paid for the service is *not* the price, so a price must somehow be *implied*.



Life Insurance Consumer Taxation:

Value Added Tax (VST/IVA)

- Premiums for life insurance can contain three components:
 1. Contribution to the insurance pool (i.e., pure financial intermediation)
 2. Charge to reimburse the insurer for administering the pool
 3. Contribution to policy savings (pure financial intermediation).
- Value added in life insurance resides only in the second component, so IVA should apply only to it
- No governments subject life insurance to IVA because of administrative and practical complexity of doing so



Insurance Company Taxation

- **Income Taxation – can be made equitable and neutral but usually not simple**
- **I-E or variations (I-E+U) – combined insurer and insured tax on investment income.**
- **Indirect Taxation – not equitable or neutral but usually simple**
 - **Premium taxation**
 - **Parafiscal taxes such as a tax on premiums, stamp duties, etc., to cover specific activities**



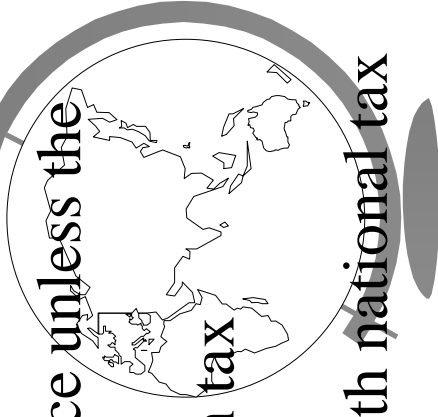


Establishing Sound Tax Policy Toward Life Insurance

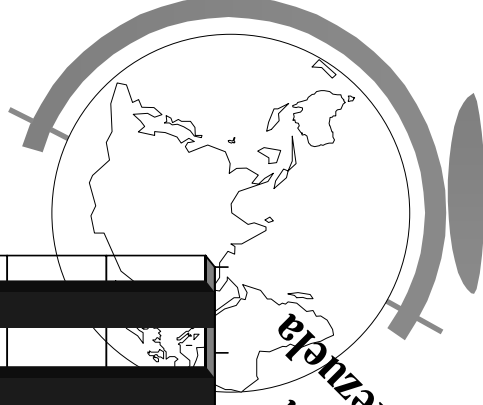
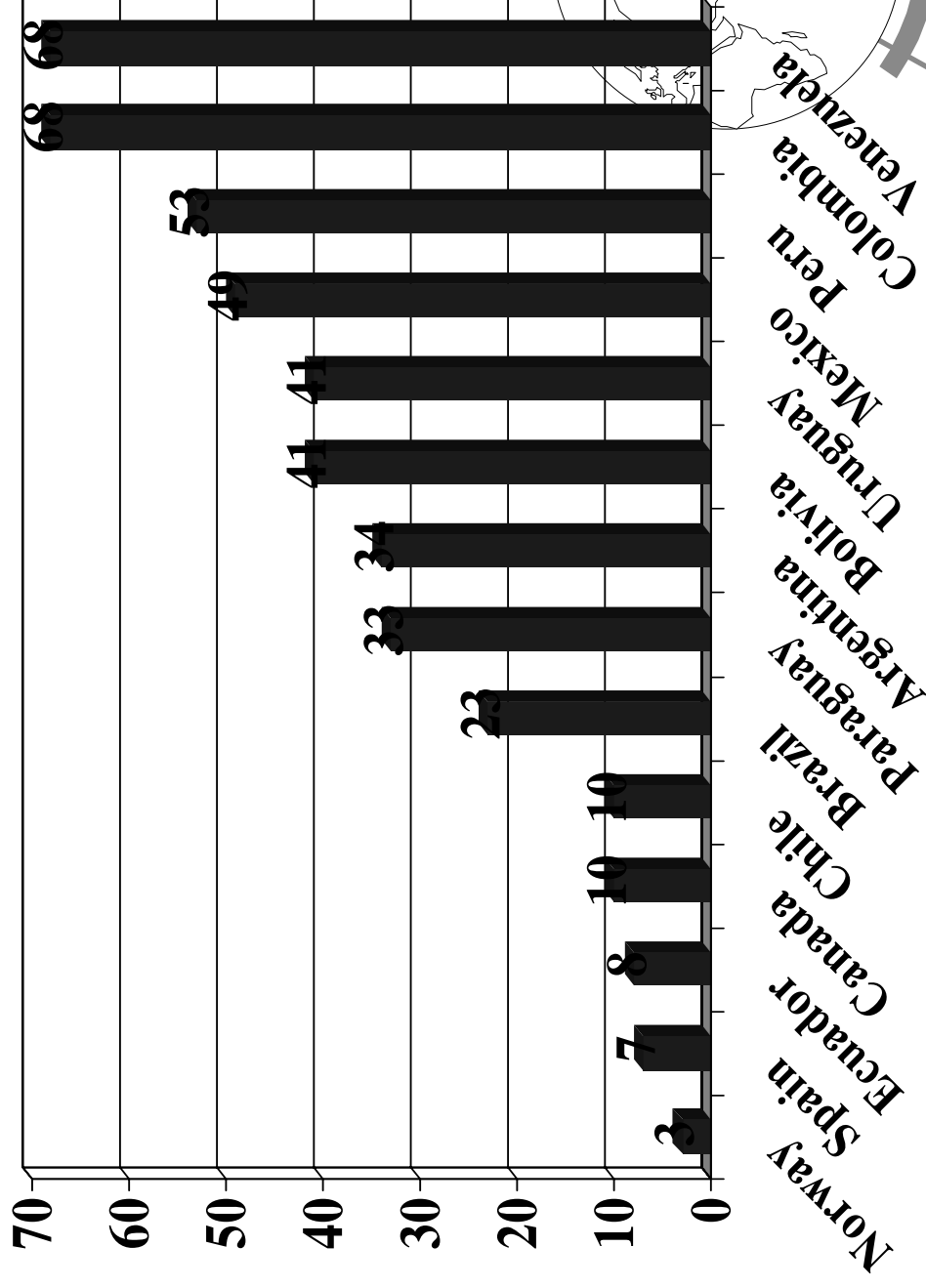
Reasonable Life Insurance Taxation:

The Goal of Simplicity

- ☞ **Aim for *simplicity* by avoiding complicated tax administration and compliance costs by**
 - Minimizing number of taxes levied on life insurance and life insurers
 - Avoiding transactions taxes (e.g., stamp duties) and capital or asset taxes (which are a drag on intermediation)
 - Avoiding sales taxes and other taxation of premiums
 - Not trying to implement VAT on life insurance **unless the OECD countries “get it right”**
 - Relying on established regulatory practices in tax administration to extent feasible
 - Making life insurance taxation compatible with **national tax structure**

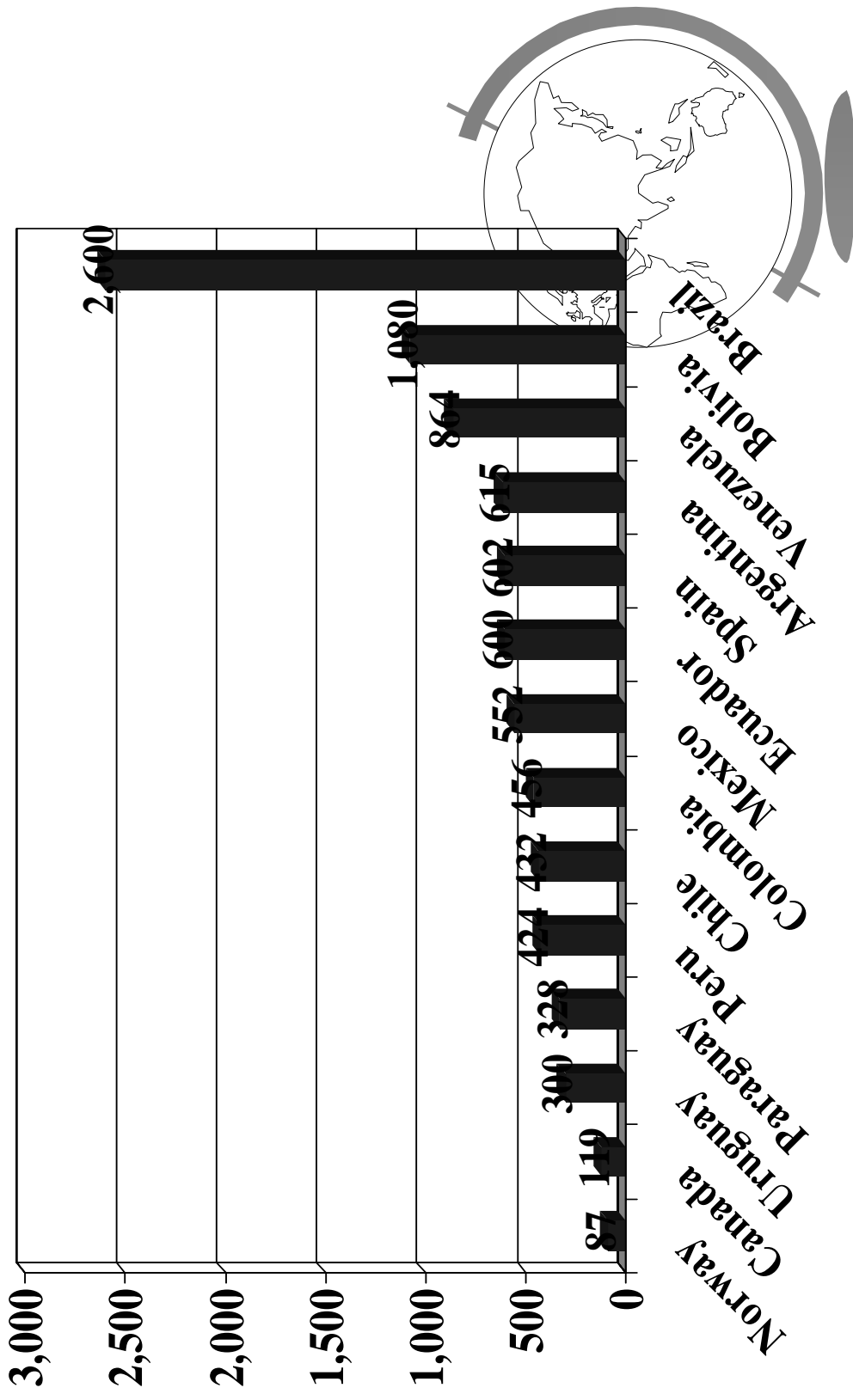


Number of tax payments per year, selected countries



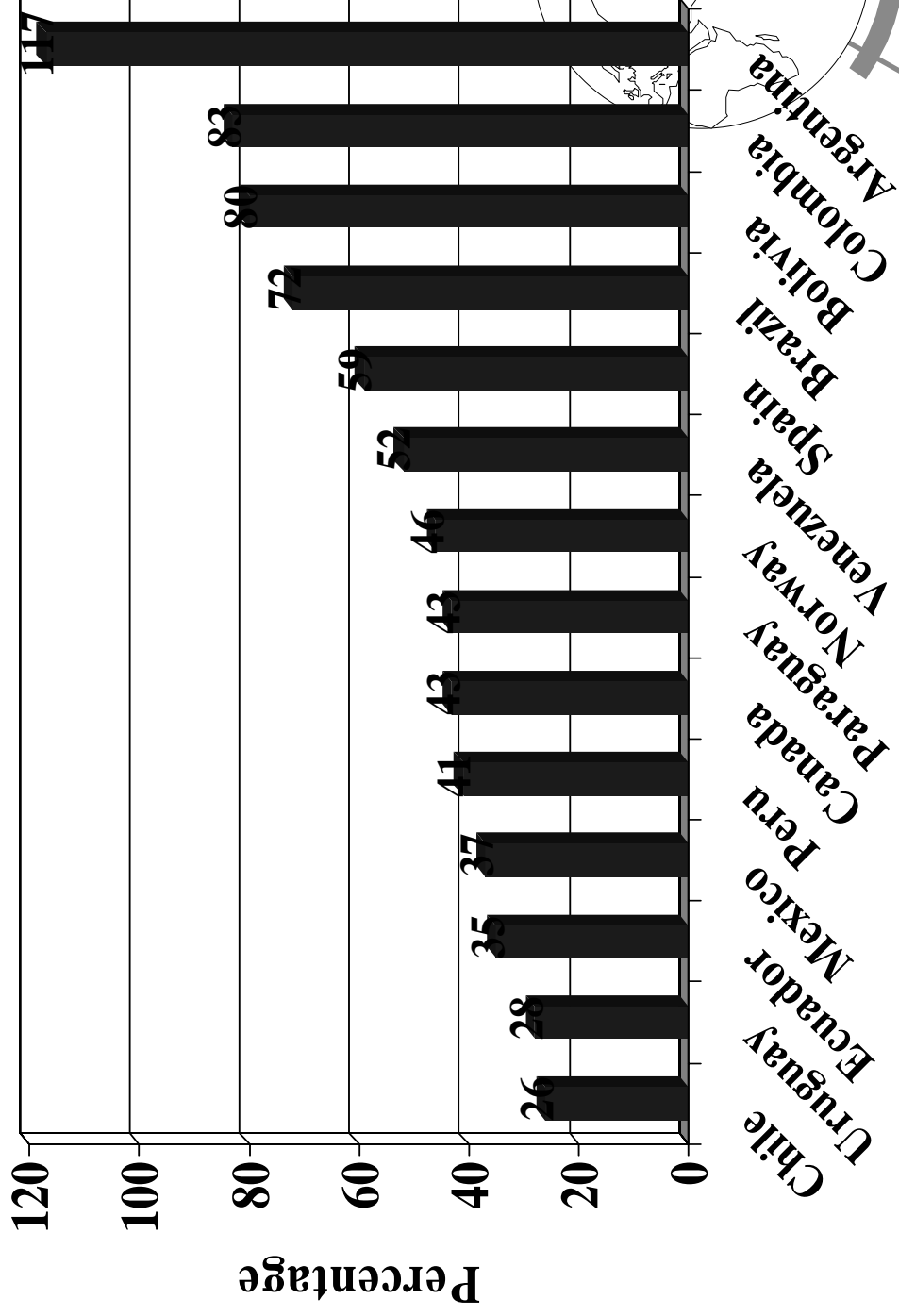
Source: PricewaterhouseCoopers and World Bank Group (2006).

Time to comply: Average hours per year, selected countries



Source: PricewaterhouseCoopers and World Bank Group (2006).

Effective tax rate as percentage of commercial profits

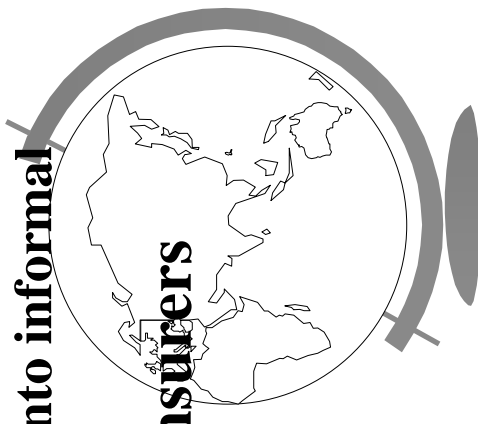


Source: PricewaterhouseCoopers and World Bank Group (2006).

Reasonable Life Insurance Taxation:

The Goal of Equity

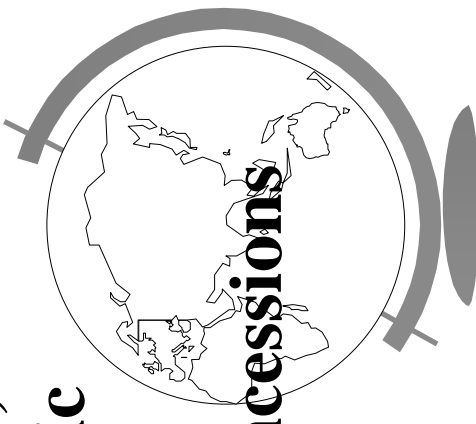
- ☞ Aim for *tax equity* by
 - Ensuring that *total* tax burden on life insurance and life insurers is not excessive
 - Using lowest feasible tax rate and broadest possible tax base
 - ◆ Higher tax rates typically fail to lead to higher revenues in developing countries as they push businesses into informal economy
 - Ensuring that small or unprofitable life insurers shoulder corresponding tax burdens both
 - ◆ for reasons of equity and
 - ◆ to avoid exacerbating solvency problems



Reasonable Life Insurance Taxation:

The Goal of Neutrality

- ☞ Aim for *neutrality* by establishing balance within the national fiscal environment
- ☞ Thus, industries, entities, products and services should be taxed equivalently in the interest of promoting national economic efficiency, *unless* a compelling case can be made for specific concessions.
- ☞ Does a compelling case exist for tax concessions for life insurance?



Possible Rationales for Life Insurance Tax Concessions: I

- ☞ Encourages greater national savings, but
 - Violates neutrality principle unless same concession extended to all financial intermediaries
 - Government tax revenue and thus savings may suffer
 - ◆ But may consider enhanced private savings will be used more efficiently than government savings
 - Not clear that total national savings will increase because people might
 - ◆ Shift from taxable to non-taxable savings
 - ◆ Target savers may save less



Possible Rationales for Life Insurance Tax Concessions: II

- ☞ Life insurance carries positive spillover effects (externalities) for society as a whole and government policy should encourage its purchase
 - Relieves government partially of need to provide generous economic security programs
- ☞ Economic growth is enhanced by having a variety of strong financial intermediaries, and if domestic life insurance industry is underdeveloped, government may wish to hasten the industry's growth via tax concessions



Possible Rationales for Life Insurance Tax Concessions: III

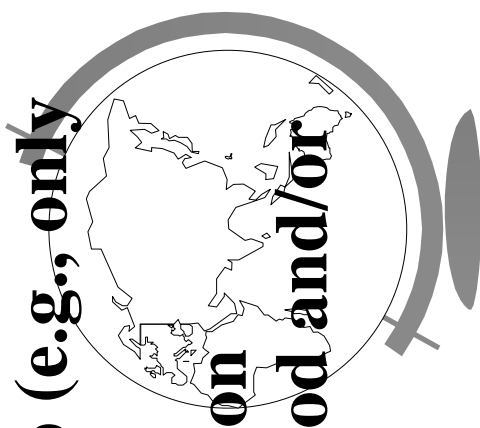
↳ **Economic growth is enhanced by more long-term finance, and contractual savings institutions such as life insurers (and pension funds) can be especially important sources of such finance**



Means of Providing Life Insurance

Taxation Concessions: I

- ☞ **Tax concession (deduction or credit) toward premium payments on qualifying policies**
- ☞ **Tax preference on life insurance and/or annuity cash values**
 - **Deferred taxation on inside buildup (e.g., only on surrender)**
 - **No taxation on inside buildup (e.g., on surrender if held for minimum period and/or on death)**



Means of Providing Life Insurance

Taxation Concessions: II

☞ **Tax preference on life insurance death benefits**

- Neither income nor estate taxation
- No income taxation

☞ **Extend tax concessions to life insurer via advantageous income or other tax system**





“Achieving well-functioning financial markets and institutions, which leverage savings and channel them into productive investments, should be a policy priority for governments....”

**Louis Alberto Moreno, President
Inter-American Development Bank
from remarks delivered in Cartagena, 10 August 2006**