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THE TAXATION OF LIFE INSURANCE POLICIES IN OECD COUNTRIES: IMPLICATIONS FOR TAX POLICYAND PLANNING

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INTRODUCTION

This study provides an overview of current tax policy regarding life insurance products within the OECD countries.[1] The study's purpose is to provide some insight into how best to structure life insurance product taxation.[2]

Scope of the study

The study explores tax policy as it relates to the ownership of life insurance products sold by life insurers. Other products and services sold by life insurers, such as accident insurance, health insurance, administrative services, guaranteed investment contracts and the like are not covered here. Although the study's focus is the taxation of the life insurance buyer, some attention is accorded life insurer taxation.

This latter point deserves brief comment. We should not divorce consumer taxation from supplier taxation. Tax concessions extended to either the consumer or the supplier can have similar economic effects. By extending tax concessions to consumers for the purchase of a specific product, government is effectively lowering the product's price. Depending on the product's demand and supply elasticities, government theoretically could achieve the same price-reducing result by extending a tax concession to the supplier. Consistent with this logic, government should also recognize that the desired beneficial effects of a tax concession extended to the consumer can be negated by an increase in the supplier's tax burden.

Consequently, governments should not consider life insurance product taxation in isolation from life insurance company taxation. For purposes of this study, however, it will be assumed that the effective tax burden of life insurers within emerging economies is similar to that of other businesses of equivalent profitability. By invoking this assumption – which, in any event, is a desirable trait of a tax system – the study may more rationally emphasize product (consumer) tax issues.

Study overview

Following this introduction, the first section provides an overview of the economic and social role of life insurance. Any tax concessions accorded life insurance should be justified because of a perceived special economic or social role. The following section presents a discussion of the principles of taxation. Life insurance product taxation should be consistent with these principles. The tax treatment accorded life insurance products among selected OECD countries is presented in the third section, followed by a set of considerations in establishing life insurance tax policy and the elements of such a policy. Three possible taxation models are then discussed. The study ends with a summary and conclusions section.

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[1] I acknowledge with appreciation the research assistance of Matthew O. Hughes and Ralitsa P. Kostadinova.

[2] This study is an updated version of Harold D. Skipper, Jr., "The Taxation of Life Insurance Products in OECD Countries," in *Policy Issues in Insurance: Investment, Taxation, and Solvency* (Paris: OECD, 1996).

I. THE ECONOMIC AND SOCIAL ROLE OF LIFE INSURANCE

Life insurance is important worldwide. It is found in the most economically advanced economies and the least developed. Generally, the more economically developed a country, the greater the role of life insurance as an economic security device. The question arises as to why life insurance is so pervasive and why government policy makers might want to encourage its purchase. Tax incentives can be justified if *society* derives benefits from incented *individuals* purchasing more insurance; i.e., if positive spillover effects (externalities) result from the incentive. We examine whether such spillover effects exist.[3]

Life insurance provides at least three categories of services important to economies. We discuss each below.

A. Can substitute for government security programs

Life insurance can serve as a substitute for government security programs. An OECD study highlighted this important point:

> The fact that so many life insurance policies are purchased undoubtedly relieves pressure on the social welfare systems in many states. To that extent, life insurance is an advantage in the context of public finance, and, as a result, is generally viewed with favor by governments. A number of governments acknowledge this in tangible form by granting tax relief to policyholders. At this point, tax incentives for life insurance contributions are widespread among OECD member countries.[4]

A study by Swiss Reinsurance Company reinforces the view that privately purchased life insurance can substitute for government-provided benefits and vice versa. For a group of 10 OECD countries, the study found a significant negative relationship between social expenditures and life insurance premiums. The researchers attributed the high growth in life insurance premiums, in part, "... to the growing financial difficulties of the social old-age pension systems. . . . Life insurers thus take an increasingly important role in relieving the burden of social pension schemes."[5]

B. Mobilizes savings

The general financial services literature emphasizes the important role of savings in economic development. Countries that save more tend to grow faster. Savings can be either financial or non-financial. Non-financial savings take the form of real assets such as land, jewelry, buildings, etc. Financial savings are held in financial assets such as savings accounts, bonds, shares, and life insurance policies. Generally, the more economically developed a country, the greater the proportion of its total wealth in financial savings. This result is not unexpected and is consistent with the view that financial development and overall economic development move in tandem.

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3 This section draws from Kenneth Black, Jr. and Harold D. Skipper, Jr., *Life and Health Insurance*. 13th ed. (Englewood Cliffs, NJ: Prentice-Hall, Inc., 2000), Chap. 3; R. Levine "Foreign Banks, Financial Development, and Economic Growth," in *International Financial Markets*, Claude E. Barfield, ed. (Washington, D.C.: The AEI Press, 1996); and Harold D. Skipper, Jr., "Risk Management and Insurance in Economic Development," in *International Risk and Insurance: An Environmental-Managerial Approach* (Boston: Irwin McGraw-Hill, 1998).

4 Organization for Economic Cooperation and Development, *Consumers and Life Insurance (*Paris: OECD, 1987).

5 Swiss Reinsurance Company, "A Comparison of Social and Private Insurance, 1970-1985, in Ten Countries," *Sigma*. Zurich, 1987.

Life insurers offer the same advantages as other financial intermediaries in channeling savings into domestic investment. Financial intermediation of all types decouples the savings and investment functions. By doing so, investment is no longer confined to the sector in which the saving takes place. Funds can flow to the most productive sectors in an economy, which, in turn, implies the possibility of larger productivity gains. Insurers enhance financial system efficiency in three ways.

1. As financial intermediaries, insurers reduce transaction costs associated with bringing together savers and borrowers. Thus, thousands of individuals each pay relatively small life insurance premiums, part of which typically represents savings. The insurers then invest these amassed funds as loans and other investments. In performing this intermediation function, direct lending and investing by individual policyholders, which would be time consuming and costly, is avoided.
2. Insurers create liquidity. They borrow short term and lend long term. "Borrowing" for insurers means that they use funds entrusted to them by their policyholders to make long-term loans and other investments. Life insurers stand ready to provide policyholders with instant liquidity if an insured event occurs. Additionally, they stand ready to provide policyholders with the savings accumulated within their policies. The creation of liquidity allows policyholders to have immediate access to loss payments and savings while borrowers need not repay their loans immediately. If all individuals instead undertook direct lending, they likely would find unacceptable the proportion of their personal wealth held in long-term, illiquid assets. Insurers and other financial intermediaries thereby reduce the illiquidity inherent in direct lending.
3. Insurers facilitate economies of scale in investment. Some investment projects are quite large, especially in relation to available financial capital in many emerging markets. They require correspondingly large amounts of financing. Such large projects often enjoy economies of scale, promote specialization, and stimulate technological innovations and therefore can be particularly important to economic development. By amassing large sums from thousands of smaller premium payers, insurers can often meet the financing needs of such large projects, thereby helping the national economy by enlarging the set of feasible investment projects and encouraging economic efficiency.

The more developed (complete) a country's financial system, the greater the reliance on markets and the less the reliance on intermediaries. Financial markets are more developed in developed market-economy countries and, therefore, are of greater importance in such countries than in emerging countries. Even so, financial intermediaries are more likely to be providers of investment funds to the typical business than are financial markets. Only firms of a certain minimum size can easily tap into securities markets. Because of this fact and because financial markets are more complete in developed countries, one would expect financial intermediaries, such as insurers, to play a relatively greater role in investment finance in emerging markets than in developed market-economy countries.

A well-developed financial system will have a myriad of financial institutions and instruments. The greater the variety, other things being equal, the more efficient the system and the greater its contribution to economic development. Contractual savings institutions, such as life insurers and private pension funds, can be especially important financial intermediaries. Their longer-term liabilities and stable cash flows are ideal sources of long-term finance for government and business.

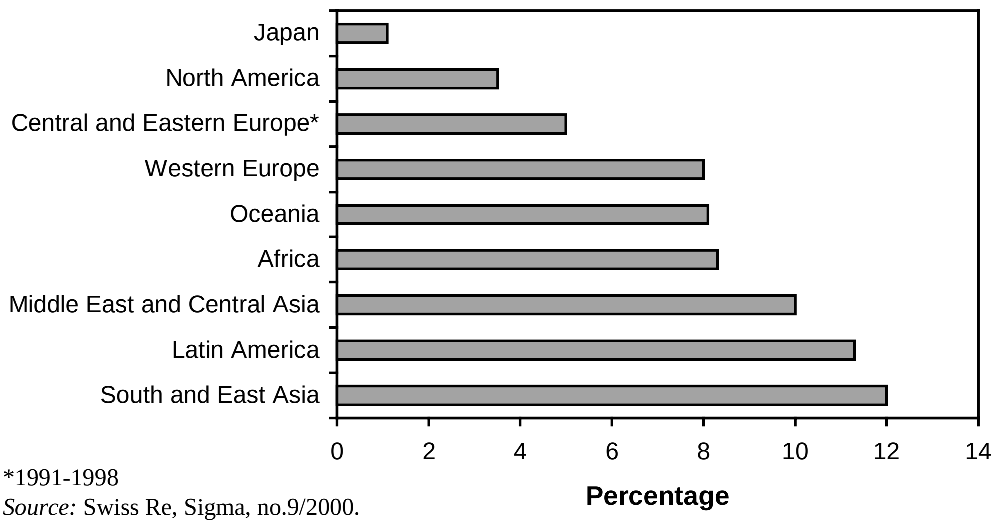
C. Fosters a more efficient capital allocation

Insurers gather substantial information to conduct their evaluations of firms, projects, and managers in their roles as lenders and investors. Although individual savers and investors may not have the time, resources, or ability to undertake this information gathering and processing, insurers have an advantage in this regard and are better at allocating financial capital. Insurers will choose to provide funds to the most attractive firms, projects, and managers.

Because insurers have a continuing interest in the firms, projects, and managers to whom they provide financial capital, they monitor managers and entrepreneurs to reduce the chances that they engage in unacceptable risk-increasing behavior. Insurers thus encourage managers and entrepreneurs to act in the best interests of their various stakeholders. By doing so, insurers tangibly signal the market's approval of promising, well-managed firms and foster a more efficient allocation of a country's scarce financial capital.

Life insurance premium growth was particularly strong for many countries during the 1990s. Figure 1 shows the average annual real growth rates of life insurance premium income by region for the period 1989 through 1998. Growth rates during 1999 were generally greater than the Figure 1 averages for most countries in North and South America and in Europe and below the longer term averages for most Asian and African countries. These high growth rates have resulted in life insurance representing an increasing share of personal sector financial assets in many countries.

Figure 1: Real Annual Life Insurance Premium Growth Rates by Region, 1989-1998



*1991-1998

Source: Swiss Re, Sigma, no.9/2000.

II. THE PRINCIPLES AND EFFECTS OF TAX POLICY

This section presents an overview of taxation principles through discussions of the general purposes of taxation, desirable traits of tax policy, and system of taxation.[6] The section ends with a brief discussion of tax policy's impact on national savings.

A. General purposes of taxation

Three general purposes of a tax system can be identified:

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

That taxation is intended *to raise revenue* for government needs little explanation. Government requires revenue to provide the services demanded of it by its citizens. Taxation is the most important and universal means of obtaining this needed revenue.

Governments often design tax systems also *to promote economic goals*, although this purpose is usually subservient to the revenue-raising objective. The economic goals may be national, or they may relate to some specific industry or even to individual economic activity. Certain industries may enjoy tax concessions because government wants to stimulate productive activity of those industries. For example, some governments have provided significant tax concessions to stimulate research and development by businesses.

Many developing countries impose high tariffs – a type of excise tax – on imported manufactured goods. This is another example of government believing it is promoting economic goals, even if the actual effects may be to hinder development. The intended goal may be to discourage the outflow of foreign exchange reserves or to shelter a domestic industry from the fullness of foreign competition. Of course, such tariffs also raise revenue for the government.

Policy makers also design tax systems *to promote social goals*. Many such examples can be found in virtually every tax system. These social goals may relate either to discouraging or to encouraging certain social behavior. Thus, the typically heavy taxation imposed on tobacco and alcohol products reflects not only a desire to raise revenue from the sale of such products but also an attempt by government to discourage their use or to impose a social levy for the perceived societal harm (negative externalities). On the other hand, governments may permit tax deductions and credits for certain activities in an attempt to encourage those activities. Tax rates, deductions, exemptions, and credits are the tax-related tools that government policy makers use to craft a tax system to promote specific economic and social goals.

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[6] This section draws from Harold D. Skipper, Jr. "State Taxation of Insurance Companies: Time for a Change," *Journal of Insurance Regulation*, Vol. 6 (Dec. 1987), pp. 122-128.

B. Desirable traits of tax policy

An ideal tax policy is one that possesses these traits:

- Equity
- Neutrality
- Simplicity

1. Equity

The concept of *equity* in taxation (also referred to as *vertical equity*) poses theoretical and practical difficulties for tax-system designers. The intent is that each taxpayer should contribute his, her, or its fair share in taxes. The difficult part is determining the "fair share." Most countries judge this fair share as related to ability to pay taxes; those with greater ability should pay more taxes. Net income is widely used as a proxy for ability to pay.

2. Neutrality

> A tax system or provision ideally should possess *economic neutrality* (also referred to *horizontal equity*). This concept means that economically equivalent entities, products, and services should be taxed equivalently. In the absence of overriding economic or social goals to be served by the tax system, the system should not influence economic decisions of individuals, businesses, or other taxpaying entities.

Thus, lacking the existence of some market failure, the tax system should avoid benefiting one industry compared with any other; within a single industry (e.g., financial services), should accord no advantage to one set of competitors relative to others; and, within a given firm, should not influence the firm's choice of production factors or product outputs. The principle underlying the economic neutrality concept is that overall national welfare is enhanced if market forces, not the tax system, drive individual and business decision making.

3. Simplicity

> A tax system can be considered *simple* if it is not complex administratively, its costs of collection are low, it is not easily evaded, and taxpayers can comply with the law without undue expenditure of time and money. Implicit within this trait is that the tax system is appropriate for the country's level of development and the sophistication of its administrative apparatus. This goal often conflicts with the goals of equity and neutrality. How these conflicts are resolved depends on the economic circumstances and conditions of the country at the time the tax system is implemented. A tax system not attuned to its environment is an invitation to avoidance and inefficiency.

C. Systems of taxation

Many tax systems have evolved over time. The common ones are highlighted below. The focus is on the various bases for applying the tax; tax exemptions, deductions and credits; and tax rates. Together these items define a system of taxation.

1. Tax bases

A tax system must begin with the tax base, from which deductions or exemptions may be allowed to derive taxable income. The broader the tax base, the better. No completely satisfactory scheme exists for classifying tax bases but, for presentation purposes, three categories may be used:

- Income
- Consumption
- Wealth

> *Income* is the most widely used tax base internationally. Many policy makers consider net income to be the best measure of ability to pay and so the most equitable means of taxing both individuals and businesses. Significant deductions and other tax concessions are typically provided to derive net taxable income (see below).
>
> Payroll taxes, such as those to finance social insurance schemes, are a type of income tax. Unlike broad-based net-income tax systems, however, payroll taxes apply to earnings from labor only. Interest, rents, dividends, and other income derived from capital are not subject to payroll taxes. Moreover, payroll taxes often apply only to a ceiling income level.

A second important tax base is *consumption*. Consumption taxes may take two forms: where consumers themselves are taxed, as with an expenditure tax, or where the goods or services purchased by consumers are taxed. The latter form is more common, with the expenditure tax evoking much interest. Consequently, further discussion will focus on the taxation of goods and services. Here the subject of taxation is not the income of the taxpaying entity but some measure of the turnover or amount of transactions.

Sales, excise, and value-added taxes are probably the best-known examples of transactions-based taxes. Sales taxes are levied on the consumption expenditures of goods and (sometimes) services. Excise taxes are levied on specific commodities such as gasoline, tobacco, and alcoholic beverages. Value-added taxes are levied at each stage of production.

A consumption tax is an identifiable burden on a financial transaction itself, as contrasted with an income tax levied on a taxpaying entity. Unlike income taxes, most consumption taxes are impersonal and therefore often clash with the equity goal. Consumption taxes can be designed to modify social behavior. Excise taxes are well known in this regard, being the tax-of-choice with respect to consumption of goods that entail negative externalities for society (i.e., society at large pays a price for the individual's consumption of the good). Thus, high taxes on tobacco and alcohol products constitute a type of reimbursement to society for the harm that their use imposes on others.

Consumption taxes also can be designed to modify economic behavior. Thus, import duties and tariffs discourage the purchase of foreign-made goods. The insurance premium tax in most countries is not a tax on consumption. Yet, because the tax is levied on insurers' premium revenues, it can have the same economic effect as a consumption tax.

Lately, some policy makers have advocated an explicit consumption tax on insurance premiums (and other financial services). Such taxation seems inconsistent with the purpose of such a tax. Insurance services are not consumption items. Rather, they constitute the basis for smoothing consumption over time – as with annuities, pensions, and other life insurance savings products – or across different states of nature – as with policies that pay on the insured's death. Thus, as an intermediate financial service whose payoffs are used to purchase fully taxable consumption goods, life insurance premiums theoretically should be exempt from such taxation.[7]

Governments often implement the benefit principle of taxation through a consumption tax. This principle holds that certain recipients of government services should provide the revenue to fund the services. Thus, states levy a tax on fuel, the purpose of which is to help pay for road construction. Those persons who purchase fuel – the beneficiaries of a state's road system – pay the tax.

The third common basis for taxation is *wealth*. Many countries tax a person's wealth, of which property is one element. Estate duties are a type of wealth tax. The objective of such taxes is to minimize great concentrations of wealth, although some countries have eliminated or are in the process of eliminating such taxation.

2. Tax exemptions, deductions, and credits

Tax exemptions, deductions, and credits are the most important mechanisms for modifying a tax system to accomplish social and, to a large extent, economic goals. Their use can be justified on economic grounds if they address a market failure (i.e., when competition fails to achieve an efficient result, the most notable being when society realizes benefits from production or consumption beyond benefits received by the parties directly involved). Without appropriate use of these incentives, a tax system cannot be fine-tuned to target specific behavior.

Thus, if government wants to promote certain activities, it may provide a complete exemption from taxation for those entities that provide the desired services or goods. Qualified educational organizations, charities, and other nonprofit organizations are typical examples of tax-exempt entities – the theory being that their good works benefit society as a whole, not just immediate recipients.

Most tax systems also permit deductions to be taken in deriving taxable income. Many governments have determined it to be socially desirable to encourage individuals to save for their retirement. Tax deductions for savings through qualifying products are the route typically taken to promote this goal.

Tax credits are another mechanism to encourage individuals and businesses to alter their social and economic behavior. Thus, for example, an investment tax credit can encourage capital expansion by businesses. A research and development tax credit can be rationalized on the theory that the additional private research spurred by the credit provides benefits to society broadly, not just to the firms that qualify for the credit.

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[7] The exemption need not apply to policy fees. For discussions about the issues associated with such taxation, see Harry Grubert and James B. Mackie III, "Must Financial Services be Taxed Under a Consumption Tax?" *National Tax Journal* vol. 53 (March 2000); and William Jack, "The Treatment of Financial Services Under a Broad-Based Consumption Tax," *National Tax Journal* vol. 53 (Dec. 2000).

3. Tax rates

The tax rates that government chooses to apply to taxable income determine the tax impact on the taxpaying entity. Other things being equal, the higher the marginal tax rate, the greater the effect that the tax rate itself has on economic behavior, as individuals avoid the highly taxed activity. For this reason economists advocate low marginal tax rates.

D. The impact of tax concessions on national savings

In considering the important economic and social role of life insurance, one may too easily accept the proposition that significant tax concessions are desirable as a means of enhancing national savings. This case may seem facially compelling, but several considerations bear on the issue.

First, neither theoretical nor empirical research has investigated the effects on national savings of life insurance product tax concessions. Related research on Individual Retirement Accounts (IRAs) in the United States and Registered Retirement Savings Plans (RRSPs) in Canada offers ambiguous results.[8] Savers, to some degree, substitute tax-preferred savings for taxable savings; thus not necessarily increasing aggregate national savings but merely changing its allocation.

Second, more general empirical research on the effects of the real interest rate on savings has proven ambiguous. Some studies lend credence to the idea that higher interest rates provoke higher savings rates whereas others have done the opposite.[9]

The ambiguity is associated with opposing substitution and income effects. A higher effective interest rate (for example, because of tax concessions) can be expected to encourage consumers to substitute savings for consumption, as the relative price of consumption is raised. On the other hand, a higher effective interest rate provides savers with greater future income. Other things being the same, this could lead to a reduction in overall savings for target savers. The net effect of these two opposing tendencies is not obvious.

Third, it must be recognized that enhanced national savings can arise from three sources.

1. Individuals and businesses can increase savings, thus leading to enhanced national investment. The preceding discussion touches on this source.

2. Foreigners can be induced to save more within the country. This study does not address this source directly, but notes that foreign capital to establish domestic insurers can be an additional source of national investment. Endogenous theories of economic growth hold that high levels of growth require high levels of national investment, but the theories do not suggest that the savings to finance the investment need be national.

3. Government can increase its net savings. Tax concessions that lead to increased savings, however, can result in lower government savings because of a decrease in tax revenues. In other words, even if tax concessions led to increased individual savings, it is not clear that they would then lead to increased national savings.

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8 For a survey of research on these and other tax-preferred instruments, see B. Douglas Bernheim, "Taxation and Saving" in A. J. Auerback and M. Feldstein, eds., *Handbook of Public Economics* (Amsterdam: North Holland, forthcoming).

9 See Auerback and Feldstein (forthcoming).

Many economists argue that, even if tax concessions do not lead to increased national savings, they could lead to a more efficient allocation of savings. Thus, even if tax concessions failed to increase the overall level of national savings, the resultant shift in savings from the government to the private sector could lead to a more efficient allocation of resources, thus benefiting the national economy.

III. TAX TREATMENT OF LIFE INSURANCE IN OECD COUNTRIES

As financial instruments, life insurance products are subject to national tax policy in all OECD countries. Besides an examination of life insurance product taxation, a brief overview of life insurer taxation is presented.

A. Life insurance product taxation

Perhaps every OECD country provides some tax concession in connection with the purchase, ownership, or execution of life insurance policies. The extent and nature of these concessions vary from being relatively minor and designed to simplify tax administration to being substantial and designed to encourage life insurance purchase or maintenance. This exploration of the tax treatment of life products is structured around life product cash flow components: premiums, living benefits, and death benefits. The information is believed to be current as of 2000.

1. Premiums

Several OECD countries provide tax relief on premiums paid for qualifying life insurance policies as Table 1 shows. Of the OECD countries examined here, at least some relief is provided by 13 countries. Tax concessions more commonly apply to policies whose predominant purpose is to provide living benefits. Concessions are less commonly extended to policies whose purposes are exclusively or predominately to provide death benefits. Also, tax concessions are frequently denied when consumers purchase otherwise qualifying policies from unlicensed insurers. Table 2 shows the 14 OECD countries examined in this paper that make no general provision for premium tax relief.

Table 1. Selected OECD countries providing tax relief on premiums paid for qualifying individual life insurance policies

Country	Comment	Country	Comment
Austria	Up to ATS 40,000	Japan	Up to –50,000
Belgium	If certain conditions are met	Korea	Up to ω500,000
Denmark	If certain conditions are met	Luxembourg	Up to maximum amount
France	Limited tax relief	Portugal	Up to certain amount
Germany	If certain conditions are met	Switzerland	Limited amount
Greece	Certain amount	Turkey	Limited amount
Italy	If certain conditions are met		

Sources: PriceWaterhouseCoopers, *International Comparison of Insurance Taxation* (2000); OECD *Taxing Insurance Companies* (1999); and author.

Table 2. Selected OECD countries providing no tax relief on premiums paid for individual life insurance policies

Australia	Iceland	The Netherlands	Sweden
Canada	Ireland	New Zealand	United Kingdom
Finland	Mexico	Poland	United States
	Norway	Spain	

Sources: PriceWaterhouseCoopers, *International Comparison of Insurance Taxation* (2000); OECD *Taxing Insurance Companies* (1999); and author.

2. Living benefits

In most and perhaps all OECD countries, payments by life insurers for so-called living benefits exceed payouts because of insured deaths. Living benefit payouts or accruals may be classified broadly into three categories. The first category comprises dividends (bonuses) under participating (with profits) contracts. The second category relates to policy cash values and maturity (capital sum) amounts. The third category constitutes payouts under annuity contracts. Each is covered below.

a) Dividends

Life insurance policy dividends, at least in the early years of a policy, represent largely a return to the policyholder of a deliberate premium overcharge. Consequently, the general rule in OECD countries is that dividends paid do not cause current taxable income.[10]

b) Cash values

OECD countries generally do not directly tax interest credited on policy cash values – the so-called inside interest build up, as Table 3 shows. A few countries provide that certain policies with high cash values in relation to the policy's death benefit or with unacceptably short durations may provoke taxation of the inside interest build up. In addition, some countries deny the inside interest build up exemption to policies purchased from unlicensed insurers.

Several countries (see Table 3) tax the inside build up indirectly by taxing that portion of insurers' investment income considered attributable to the taxpayer/policyholder's internal policy interest accruals. This tax is in addition to the regular corporate tax, although it may be taken as a deduction.

One reason for the generally favorable tax treatment of the inside build up relates to the complexity involved in trying to do otherwise. Rather than attempt to tax policyholders on interest earnings within a policy, the usual approach is to adopt a measure of gain that is administratively simple. It involves taxing a policyholder, if at all, only on the maturity or surrender of the policy and then only to the extent that the benefits received (the maturity amount or the cash value plus the sum of all dividends received) exceed the sum of the premiums paid under the policy. This difference, if positive, might be subject to income tax. If the difference is negative, no deduction is usually permitted against income on the theory that the procedure understates taxable income, as discussed earlier. See Table 3.

10 Tax law in the United States provides for taxation of dividends paid in cash if a life insurance policy fails to meet the tax-law definition of life insurance. The great majority of policies meet this definition.

Debate continues whether sound public policy should permit the tax-advantaged inside interest buildup within life insurance policies. Critics claim that this favorable tax treatment is unjustified as it distorts the savings market, making life insurance products artificially more attractive than other savings instruments. They also note that the government loses tax revenues because of this tax favoritism.

Proponents of the status quo point to the socially worthwhile spillover benefits of life insurance, arguing that the current tax treatment encourages families to make provision for their financial security while aiding economic development. They also note that the income may not actually be received by the policyholder unless the policy is surrendered, much as the homeowner does not actually receive his or her home's appreciated value without selling the home. (Tax economists would counter that this value also should be taxed.)

c) Annuities

Payments under annuity contracts are the third category of living benefits. The inside interest build up of annuities during their accumulation period usually receives the same tax treatment as other life insurance products and is the object of similar tax controversy (see above). Most OECD countries tax annuity payouts to some degree. In a few countries – such as France, Italy, and Spain – a prescribed, fixed portion of each payment is subject to tax. In most countries, various mechanisms are prescribed in which the excess of payments received over premiums paid is taxed, usually on some type of prorata basis over the annuity payout period.

Table 3. Income taxation of life insurance values

Country	Taxation of inside interest buildup?	Taxation on gain on surrender?	Death proceeds subject to income taxation?
Australia	Yes	No	No
Austria	No	No, unless policy terminates in less than 10 years	No
Belgium	No	No, with exceptions	No, with exceptions
Canada	Yes, indirectly at 15%	Yes	No
Denmark	Yes, indirectly at 26%	Yes for tax deductible policies, otherwise no	Yes, same as surrender gain
Finland	No	Yes	No
France	No	Yes, for some policies	No, except for large policies
Germany	No	Yes, on deferred interest	No
Greece	Yes, indirectly at 15%	No	No
Ireland	No	Yes	No
Japan	No	Yes, on gain over −500,000 at ½ ordinary rate	No
Korea	No	No	No
Luxembourg	No	Yes, at low rate	No
Netherlands	No, except for certain policies	Yes, on gain in excess of a deduction	Yes, same as surrender gain
New Zealand	Yes, indirectly	No	No
Poland	No	No	No
Portugal	No	Yes, on gain subject to certain relief	No
Spain	No	Yes	No
Switzerland	No	No, if certain conditions met	Yes, at special rates
Turkey	No	Yes, on gain in excess of a deduction	No
United Kingdom	Yes, indirectly	No, with exceptions	No
United States	No, if certain conditions are met	Yes	No, if certain conditions are met

Sources: PriceWaterhouseCoopers, *International Comparison of Insurance Taxation* (2000) and author.

3. Death proceeds

Most OECD countries exempt death proceeds paid under qualifying life insurance policies from income taxation, as Table 3 shows. Germany and the United States tax a portion of death proceeds payable under certain high cash value policies. In Belgium, benefits are taxable on polices for which a tax deduction was taken for premiums paid. The Netherlands provides for income taxation of death proceeds in excess of specified maximums (euro 121,500 and 123,428) provided certain conditions are met. Such taxation is, however, the exception rather than the rule.

A cash value policy's death proceeds can be viewed as comprised partly of the cash value. As the interest component of the cash value typically would not have been taxed during the insured's lifetime, it thereby can escape income taxation completely on the insured's death. This tax treatment may be more favorable than that accorded to other savings media.

Governments commonly levy inheritance taxes or other estate duties, measured on the value of property that a decedent owned, controlled, or transferred. Life insurance death proceeds are subject to estate duties in many OECD countries. In most of these instances, however, provision is made for special circumstances wherein the proceeds are excluded, in whole or in part, from assessment.

B. Life insurance company taxation

The tax treatment at the corporate (supplier) level should not be ignored as it can affect product value. Life insurer taxation typically is of two types: premium taxation and net income taxation.

1. Premium taxation

Several OECD countries levy taxes on insurers' premium revenues. Table 4 shows the countries that do so along with their tax rates. Premium taxes are the most common, but some countries levy stamp duties and other assessments. The insurer is responsible for tax payment in the great majority of countries, although the insured may be responsible when business is placed with an unlicensed insurer. Even with the insurer responsible for payment, such taxation is closely related to policyholder taxation.

Under the typical premium tax structure, the tax base is the simple total of the insurer's premium revenue, with certain alterations. Premiums received from assumed reinsurance are usually excluded from the tax base, as the original insurer that wrote the business would have already been subjected to tax on its direct premiums. Most jurisdictions permit a deduction from the tax base for dividends paid to policyholders. The premium tax base may include premiums received for personal accident and health insurance, but more commonly they are taxed separately, usually at a higher rate. Insurers' investment income is not included in the tax base.

Most countries do not levy premium taxes on annuity considerations paid to insurers. Even those states that tax annuity considerations typically exempt contributions to qualified retirement annuity plans or tax them at a lower rate.

Table 4. Taxation of life insurance companies

Country	Premium taxation?	Basis for net income tax?	Maximum income tax rate?
Australia	Yes, at 10% of first year's premium depending on state and type of policy	Investment income less expenses	30% except pensions at 15%
Austria	Yes, at 4% except 10% for policies of less than 10 years duration	Total income	34%
Belgium	No, except group at 4%	Total income	39%
Canada	Yes, 2-4% depending on province	Total income	43-46% depending on province
Denmark	No	Total income	32%
Finland	No	Total income	29%
France	No	Total income	37.66%
Germany	No	Total income	40%
Greece	No, except 10% for policies less than 10 years duration	Total income	35%
Ireland	Yes, stamp duty of 0.01% of sum assured	Total income	22/24% policyholder/shareholder funds; lower in future
Italy	Yes, 2.5%	Total income	
Japan	No, except limited prefectual taxation	Total income	36.21%
Korea	Yes, 0.5%	Total income	17.6% on first ω100 million, 30.8% on excess
Luxembourg	No	Total income	30%
Mexico	Yes, 3% except no tax on group insurance	Total income	35%
Netherlands	No	Total income	35%
New Zealand	No	Total income	33%
Norway	No	Total income	28%
Poland	No	Total income	30%; lower in future
Portugal	Yes, 0.33%	Total income	32%
Spain	No	Total income	35/25% stock/mutual insurer
Sweden	No	Investment income less expenses	20%
Switzerland	Yes, 5% except single premium at 2.5%	Total income	17-31% depending on canton
Turkey	No	Total income	33%
United Kingdom	No	Investment income minus expenses	23/30% policyholder/shareholder funds
United States	Yes, 1-3% depending on state	Total income	35%

Sources: PriceWaterhouseCoopers, *International Comparison of Insurance Taxation* (2000); OECD *Taxing Insurance Companies* (1999); and author.

2. Income taxation

Governments typically tax life insurers on some variation of net income in OECD countries, in much the same way as other companies are taxed. Table 4 shows the general approaches followed and the maximum marginal tax rates for selected OECD countries. In the past, several countries taxed life insurers on their investment income only, but the trend is toward a tax base composed of total (investment and premium) income. Australia, Sweden, and the United Kingdom follow the so-called I-E (investment income minus expenses) approach.

Determining life insurer profit is a challenge. The challenge arises from the difference in timing between premium payments and claim payments.[11]

The typical tax base for purposes of calculating taxable income is the sum of investment and premium income. The yearly increase in policy reserves, acquisition and administrative expenses, policy dividends paid, and premiums paid on ceded reinsurance usually are deducted from this sum. Other deductions may be permitted and special rules may exist for loss carryovers and (domestic and foreign) branch income.

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11 See *Taxing Insurance Companies*, Paris; OECD, 1999 for an analysis of these and other issues associated with life insurer taxation.

IV. ESTABLISHING TAX POLICY TOWARD LIFE INSURANCE

In establishing its tax policy toward life insurance products, government should ask itself whether special concessions should be extended to them and, if so, what form these concessions should take. This section explores these two issues, drawing on the information presented in the earlier sections.[12]

A. Considerations in establishing life insurance tax policy

In deciding its tax policy toward life insurance products, government should consider thoughtfully the policy's purpose, effect on tax revenues, compatibility with the level of development, compatibility with the insurance regulatory structure, alignment with the desirable traits of tax policy, and compatibility with other countries' tax systems. Each of these is discussed below.

1. Purpose of life insurance tax policy

The purpose of most tax systems is to raise revenue. Tax policy toward life insurers and their products ordinarily shares this purpose. The issue, however, becomes complex because life insurers and their products are complex and governments often view life products as intertwined with their economic security systems and social welfare. If a government extends some tax concessions to life products, it should be clear as to the purposes it seeks to accomplish by doing so (and conduct studies to learn whether the purposes are being accomplished).

Usual rationales for extending tax concessions to life products flow from the belief that life insurance carries meaningful positive externalities (i.e., economic and social benefits for society). These were discussed earlier. These benefits and considerations relate to the role of life insurance both as a savings instrument (and the accompanying role of life insurers as financial intermediaries) and as a financial protection instrument.

Governments use tax policy to encourage national savings. The effectiveness of such policies remains unclear. First, tax concessions for savers will probably result in decreased tax revenues and, therefore, government savings will decrease. Second, consumers often shift from taxable to tax-preferred savings, thus not necessarily increasing total national savings but merely changing its allocation. Third, although tax concessions increase the effective yield on savings, overall savings will not necessarily increase as target savers may save less.

Tax concessions toward life products conceivably could have effects different from those found with other savings media, as most life products combine death protection with savings. If government decides to spur national savings by extending tax concessions to life insurance, it should recognize that such a policy's effects cannot be predicted, except for one observation: preferential tax concessions extended to life insurance products could be expected to cause a reallocation of national savings from non-tax-preferred financial instruments, from non-insurer financial intermediaries to life insurers, and from government to life insurers. Of course, such a policy violates the principle of neutrality. Government may,

[12] This section draws on *Establishing Life Insurance Tax Policy in Developing Countries* (Geneva: UNCTAD, 1985).

nonetheless, decide that potential benefits outweigh neutrality concerns. For example, government may conclude that life insurers' long-term liabilities and stable cash flows are preferred sources of term finance. Government also may prefer private sector savings to public sector savings because of a belief that the private sector uses resources more efficiently.[13] At the same time, government policy makers should be mindful that sectors seeking preferential tax treatment always assert the existence of some positive spillover effects for society from the preference.

Other social benefits of life products flow from their protection function. In this sense, life insurance can substitute partially for government-provided survivor benefits. Government, therefore, may wish to encourage citizens to arrange for their families. Special tax concessions for life insurance purchases could, in effect, lower the price of life insurance and thereby should stimulate sales.[14] No published studies explore the extent to which favorable tax policies encourage life insurance purchases, although countries that have eliminated elements of favorable tax policies have generally witnessed at least a temporary decline in life insurance sales.[15]

Governmental policy makers should be clear about whether any favorable life insurance tax policy is designed to promote savings, protection, or both. If the promotion of savings is the objective, qualifying policies should be heavily savings oriented (*e.g.*, annuities and endowments). If the promotion of death protection is the primary objective, qualifying policies should be predominately protection oriented (*e.g.*, term life products). If they seek the promotion of both protection and savings, policy qualification requirements can be broad.

Taken together, the protection and savings functions of life products have been judged by most countries to offer sufficient economic and social benefit to warrant some tax concession. At the same time, the desirability of maintaining an economically neutral fiscal environment should be emphasized.

2. Effect on tax revenues

Any tax concession extended to life insurance products can be expected to lower tax revenues. In deciding the best mix of tax concessions, government will want to explore carefully which concessions can be expected to achieve their intended purpose at minimal tax loss and administrative complexity (see below).

Government policy makers hardly need reminding that tax concessions mean decreased revenues, which can mean decreased public-sector investment for roads, bridges, public utilities, education, and the like. Such public-sector investment is a necessity for economic success by emerging market-economy countries. Tradeoffs between the desire to promote private-sector investment and the need for public-sector investment should be weighed carefully.

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13 Achievement of this goal would not require violation of the neutrality principle; that is, tax preferences could be extended to all savings products.

14 The extent of the stimulation is a function of the price elasticity of life insurance demand, a little explored subject. Life insurance products could have a relatively elastic demand if substitutes abound or an inelastic demand if substitutes are rare. Cash value life insurance products may exhibit dual demand traits – one type of demand for savings and another for death protection.

15 Italy seems to be an exception to this general statement. See, Tullio Jappelli and Luigi Pistaferri, "Tax Incentives and the Demand for Life Insurance: Evidence from Italy," discussion paper no. 2787, Centre for Economic Policy Research (May 2001). The authors conclude that lowering tax concessions for the purchase of life insurance by high income individuals and raising concessions for low income individuals had no effect on life insurance purchases. This result was attributable to information asymmetries and lack of needed commitment to long-term savings.

3. Compatibility with the level of development

Whatever tax structure is developed, it should be compatible with the country's economic and political circumstances. The administrative systems in some emerging markets may be insufficiently attuned to the many necessary nuances that a more developed market-based economy demands. Opportunities for mistake and fraud abound, and the life insurance tax system must function in such an environment. This means that the system should be crafted to reduce opportunities for error and noncompliance by focusing on direct, simple administrative and compliance mechanisms.

Priorities naturally will differ from one country to another, and life insurance tax policy should align with the country's particular priorities. Thus, for example, if the life market is developing more slowly than a country believes desirable, tax incentives could spur development – even in preference to other financial institutions and products.

An appropriate tax system for life insurance should not be designed in isolation from the structure of the existing tax system. For example, if government relies heavily on consumption taxation (*e.g.*, value added or excise taxes) rather than on income taxes, attempting to develop a sophisticated net income tax system for insurance could be inappropriate.

The approach to using incentives or disincentives in the tax system should be consistent with the government's general attempt to influence economic and social behavior through the tax system and by other means such as expenditure programs, grants, discretionary undertakings to private industry, and direct intervention in the economy through government operations. Policy makers should remember, however, that use of the tax system to influence behavior ordinarily is a second-best approach to more direct approaches.

Tax rules applicable to life insurers also should be coordinated with the form of corporate taxation followed in the country. These can vary from separate taxation of corporate income with full taxation of shareholder dividends, to a completely integrated system under which full credit for corporate tax is given to shareholders, with a variety of compromises between. Once the unique issues in the life insurance industry are resolved, the appropriate form of coordination is usually apparent.

4. Compatibility with the insurance regulatory structure

The overriding purpose of insurance regulation is to minimize insurer insolvencies and by that to protect the public from unsound operators. The main purpose of insurance taxation is to raise revenue for the government. Herein lies the potential for intra-governmental conflict.

Regulation typically requires pricing, reserving, and investment conservation. Therefore, insurers must behave in a correspondingly conservative manner. The designers of a life insurance taxation system must be sensitive to these regulatory requirements, use them as appropriate, and try to avoid measures that inadvertently or unfairly penalize life insurers that must function in such a conservative environment.

A country's insurance legislation and regulation provide a reference point and framework for tax planning. Tax designers should, therefore, make well-informed decisions before imposing their own, different requirements on life insurers and their products. Also, both taxation and regulatory authorities should be sensitive to the fact that a tax system can inadvertently encourage life insurers to attempt to avoid some statutory requirements to save taxes. With these facts in mind, countries would be well advised to ensure that an adequate and clearly defined system of insurance legislation and regulation is set up before embarking on any extensive revision of the life insurance tax system.

5. *Alignment with the desirable traits of tax policy*

As discussed earlier, tax systems should be equitable, neutral, and simple. Life insurance product taxation should be compatible with these traits.

a) Tax equity

Tax equity holds that taxpayers who earn more should pay more in taxes. It is not clear, *a priori*, how individual life product taxation should be crafted to fit with this principle. Certainly, if special tax concessions are extended to life products, they should be fully applicable to lower-income persons.

A tax equity question is whether concessions also should be extended fully to higher-income earners. Upper-income taxpayers have greater opportunities to practice tax arbitrage (and thereby shift from taxable to tax-preferred savings) and, of course, have greater opportunities to take advantage of tax concessions. At the same time, upper-income persons save more than lower-income persons, thus having a greater potentially positive effect on national savings.

If tax equity is a major consideration in deciding upon life product taxation, any tax preference could be weighted in favor of lower-income persons. For example, use of a tax credit rather than a tax deduction carries relatively more benefit for lower- than higher-income persons. Placing an upper limit on the amount of premium or insurance that qualifies for tax concession also can promote equity. On the other hand, system simplicity suffers with each attempt to promote individual equity.

b) Tax neutrality

Tax neutrality is perhaps the most important consideration in establishing tax policy toward life insurance products. The objective of tax neutrality is to establish balance within a country's fiscal environment. This means that tax policy ordinarily should not cause one industry, type of product, or supplier to have an economic advantage over another. Neutrality requires that government raise revenues in ways that interfere as little as possible with the economic choices of consumers and businesses.

- *Financial intermediaries versus other businesses*. To minimize interference with the choices that entrepreneurs, investors, and employees make, government ideally should establish a regime in which the taxation of financial institutions is neither advantaged nor disadvantaged compared with the taxation of non-financial businesses. The tax neutrality trait, of course, is subject to compromise if judged essential to promote social or economic goals or if necessitated by concerns about complexity.
- *Life insurers versus other financial intermediaries*. The above neutrality logic ideally should apply also at the corporate level among financial institutions. Thus, in the absence of compelling social or economic policy reasons, government should provide no tax advantage to life insurers over banks (or *vice versa*). To provide any such advantage is to encourage greater investment and employment within the advantaged sector and thus to distort the financial services market.
- *Life insurance products versus other savings media*. The *a priori* position of neutrality-minded tax planners should be that life insurance products enjoy no special tax concessions not extended also to other savings products and *vice versa*. Sound tax policy holds that a compelling economic or social benefit distinction must be made to justify a difference in tax treatment among such competitor saving instruments. This study takes no position about whether such a compelling distinction exists. This is a decision for each country's policy makers. This study has pointed out that one or more of the following objectives might provide a rationale for tax treatment more favorable for life insurance than for other financial instruments:

- A desire to encourage citizens to arrange for their dependents so as to relieve taxpayers of part of the burden.

- A desire to encourage personal savings via insurance (in preference to other savings media) because:

    - the local life insurance industry is underdeveloped compared with other domestic financial service industries, and it is desired quickly to have a variety of financial intermediaries and instruments to promote economic growth;

    - economic development requires more long-term finance, and contractual savings institutions such as life insurers (and pension funds) can be particularly important sources of such finance because of their typically long-term liabilities;

    - populations accustomed to substantial government-provided economic security may need special encouragement to provide for themselves.

Lacking one of the above or other distinguishing goals, any tax concessions extended to one class of financial products should be extended to all. As noted earlier, most OECD countries apparently believe some distinctions exist.

- *Stock versus mutual insurers*. In some life insurance markets, stock (shareholder-owned) life insurers predominate. Mutual life insurers dominate other markets. In a survey of several countries' tax systems, only Spain accorded special tax concessions to mutuals and not to stock insurers. Other countries essentially tax stocks and mutuals in the same manner, except for the element of dividends to policyholders.

  A strong argument can be made that a tax system should tax all life insurance companies and their products equivalently. Ordinarily, government should not advantage one corporate form over another, so as to avoid rendering products sold by one form less costly than those sold by insurers of a different legal structure.
- *Domestic versus foreign insurers.* The issue of how to tax foreign-domiciled life insurers that conduct business via cross-border sales within a country will be closely linked to the country's general policy regarding foreign insurer operations within the country. Given that tax harmonization does not exist, the principle of *tax territoriality*, adopted by the European Union, probably should apply. Under this principle, cross-border services are subject to the taxes of the country where the service is exercised. No economic reason exists for taxing locally established, foreign-owned insurers any differently from that of locally owned insurers. Indeed, sound economic policy argues for adoption of a national treatment standard as regards insurer taxation; i.e., foreign-owned insurers should be accorded tax treatment no less favorable than that accorded domestically owned insurers.
- *Participating versus nonparticipating insurance.* Life insurance policies are generally classified as participating (with profits) or nonparticipating (without profits).[16] Participating policies provide that part of the surplus funds generated by the policies will be distributed among the policies as dividends (bonuses). With nonparticipating policies, the insurer does not distribute any part of surplus funds to policyholders. Usually, premiums for participating policies are higher than those of nonparticipating policies. Thus, part of the surplus funds generated by participating policies is derived from a deliberately conservative pricing structure.

  The concept of tax neutrality would accommodate the two classes of life insurance through an appropriate recognition of policy dividends under participating policies. This recognition

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[16] This distinction has blurred as life insurers offer nonparticipating products that permit the pass-through to policyholders of investment, expense, and mortality experience.

would apply both to the taxation of the insurance company and to that of the policyholder. This issue is covered more fully later in this study.

c) Tax simplicity

Tax systems should be simple. The goal of simplicity often conflicts with the goals of equity and neutrality.

Life insurers and their products are complex. Because of this complexity, extensive tax rules typically are required. These tax rules become even more complex when one attempts to shape them to satisfy equity and especially neutrality concerns.

Thus, at least a part of the reason that most countries extend tax concessions to the inside interest build up, policy dividends, and other policy values is because of the administrative challenges faced in attempting to derive appropriate taxable income. Much of the analysis in the following area suggests a need to permit the simplicity goal partially to override equity and neutrality goals for some countries.

6. Compatibility with other countries' tax systems

Countries revising their life insurance tax systems might be wise to consider the tax regimes of other countries, including their neighbors and major trading partners – countries that might have already grappled with life insurance taxation issues. Indeed, a premise of this study is that countries can gain insight for developing their own tax regimes by examining the tax regimes of other countries.

This admonition goes beyond one of simply learning from others. As more markets liberalize, the issues of tax differences and convergence assume greater importance, although their discussion is beyond the scope of this paper.[17] Countries revising their tax systems may afford themselves a marketplace advantage by patterning their tax systems closely after those of their major trading partners. Similarly, they should consider other countries' tax systems to avoid placing their own domestic financial intermediaries at a competitive disadvantage.

B. The elements of life insurance product tax policy

With the preceding considerations as background, we can now explore the elements that a country might incorporate into its tax system for life insurance products. This section parallels the earlier tax treatment overview.

1. Tax policy relative to premiums

Many countries grant some form of tax relief for premiums paid on qualifying life insurance, although the trend internationally is away from such concessions, consistent with the neutrality principle. Perhaps the first country to grant an income tax deduction for life insurance premium payments was the United Kingdom. It was introduced in 1799, although removed some years later when the income tax was abolished. It was reintroduced in 1853 and remained in effect until 1984. Its repeal was said to have been prompted by the government's desire to introduce tax neutrality among all forms of savings and

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[17] See Harold D. Skipper, Jr., "The Nature of Government Intervention into Insurance Markets: Taxation" and "Regulatory Harmonization and Mutual Recognition in Insurance" in *International Risk and Insurance* (1998).

investments plus a growing governmental irritation with certain abusive tax avoidance schemes associated with life insurance contracts.[18]

Many approaches exist to granting tax concessions but all have common features. First, each approach defines qualifying policies. The definition may be exceedingly narrow or quite broad, depending upon the overall objective in granting such relief. For example, both Canada and the United States follow a narrow approach. They grant no general tax relief on life insurance premium payments, but each provides that payments by certain classes of individuals can qualify as tax deductible under individually established retirement plans. Several other countries follow a broad approach, granting general tax relief for certain broad categories of policies.

The second common feature is that each approach defines eligibility according to the life insured under the policy. All countries granting relief provide relief to the policyholder and, in some manner, to his or her spouse. A few countries also provide relief for premium payments made for insurance on a child's life. If the objective of tax relief it to promote the protection aspects of life insurance as opposed to the savings aspect, little logic exists for relief for insurance on children. Moreover, if savings promotion is the primary goal, the logic for limiting tax concessions to products sold only by life insurers weakens considerably, if not disappears altogether.

The third common feature is that all systems have some limitation as to the maximum amount of premiums paid for which a tax deduction may be taken. In most countries, the usual procedure is to state the ceiling as a percentage of income or a fixed amount.

As to operational procedures, one approach is to have taxpayers show the qualifying amount as a deduction on their income tax returns. With a progressive tax system, this means that the higher the policyholder's income, the greater is the tax benefit. Having modest ceilings tempers this in most countries. Another approach is to permit a direct credit against income tax owed. This approach is of relatively greater benefit to lower-income earners.

Yet another procedure is to allow policyholders to gain tax relief by taking a deduction directly from the premium remitted to the life insurer. The insurer then obtains reimbursement from the government by taking a credit through its corporate tax return. This was the procedure adopted in 1979 in the United Kingdom. For such a system to be viable, the same implicit tax rate should be used for everyone. The United Kingdom permitted a credit against the premium of one-half the basic income tax rate. Such an approach benefits lower-income persons relatively more than upper-income taxpayers. This procedure has the further advantage of reducing the administrative burden on taxpayers and tax authorities.

The tax policy adopted by government concerning life insurance-funded employee benefit plans can have a major impact on the demand by employers for such coverages. Payments made by employers on behalf of employees are not commonly considered as taxable income to the employees. Certain conditions, however, must be met if the payments are not to be considered as taxable income to employees, and limits may be placed on the exempted amount of coverage. These conditions are intended to minimize the chances that higher paid employees receive a disproportionately large share of the benefits. Employers are permitted to deduct payments for such plans as legitimate business expenses for purposes of determining taxable income.

2. Tax policy relative to living benefits

This section discusses possible tax policy approaches that governments can adopt with respect to life insurance benefits payable during life.

[18] "LAPR Killed after 131 Years," *Post Magazine and Insurance Monitor* (22 March 1984), p. 681.

a) *Policy dividends*

As stated earlier, policy dividends represent in part a return to the policyholder of a deliberate premium overcharge. Logically, therefore, the mere return to policyholders of monies they had previously provided the insurer should not produce a taxable event. On the other hand, a portion of policy dividends may be composed of the insurer's favorable investment experience beyond that already implicit in the dividend scale. Arguably, this portion should be taxable. Moreover, for mutual insurers, some portion of investment income allocated through dividends can be considered an implicit return on the policyholder's ownership interest in the insurer. Conceptually, this portion should be subject to the same tax treatment as that accorded dividends on shares.

Taxing the excess investment income element of policy dividends could be administratively difficult. Also tax revenues generated likely would be small from doing so. The usual treatment of not taxing policy dividends would seem to represent a minor tax concession to life insurance promotion.

b) *Policy cash values*

The tax neutrality principle would have interest credited to policy cash values taxed as any other interest income. However, few countries tax policyholders directly on the inside interest build up. This is evidence of administrative difficulty and perhaps an implicit recognition of the social value of life insurance savings.

As a compromise between simplicity and neutrality, the usual tax approach is to measure gain only on the maturity or surrender of the policy. This net gain approach overstates the cost basis (total premiums paid). To be conceptually correct, only that portion of the premium that represents policy savings should form the tax basis. The charge for the mortality risk should not form a part of the tax basis. As the basis is overstated, the taxable income is understated. Also, by postponing tax payment until policy surrender, the policyholder is deferring taxation – an obvious advantage – especially during periods of high interest rates. If tax relief has been granted on premium payments, the cost basis is usually reduced accordingly.

Even with these problems, it may be wise for some countries to make no attempt presently to tax the annual interest credited to policy cash values. The administrative complexities and resultant compliance costs might outweigh tax revenue generated. The net gain approach can be adopted as a reasonable compromise between neutrality and simplicity. Alternatively, a tax based on the insurer's investment income can be levied on the insurer.

Usually, taxation of endowment policies involves the same considerations as in the cash value discussion above. This suggests that an appropriate tax policy upon maturity is the net gain approach under which the amount subjected to tax is any positive difference between the maturity proceeds plus all dividends received and the sum of all (after-tax) premiums paid.

Other tax rules related to cash values exist. For example, some countries tax a person's wealth. This tax is levied annually on a person's adjusted net worth (*i.e.*, assets minus liabilities), except that special allowances are permitted in recognition that certain assets are essential for an individual's livelihood. Life insurance cash values are often excluded from such taxation, with certain minor exceptions.

Even if a country has a wealth tax and an estate duty, the total tax revenue generated by applying these taxes to life insurance values is often small. They are mentioned here for the sake of completeness, not because of their importance as revenue sources.

c) Annuities

A government's tax policy concerning annuities can have an important influence on their attractiveness to prospective purchasers. For purposes of tax policy analysis, issues can be divided into those that arise during the accumulation phase of an annuity and those that arise during the liquidation phase. The accumulation phase is that period during which contributions are made and before payments commence to annuitants.

The main issues that arise during the accumulation phase are whether tax relief should be granted for contributions to the annuity and whether interest credited to annuity cash values should be taxed currently. If government's policy is to encourage private savings via tax policy, the granting of tax relief on annuity considerations and the deferral of current income taxation on the annuity's inside interest build up might be effective, although note is made of the earlier discussion concerning the opposing substitution and income effects. During their accumulation phase, annuities are closely akin to other long-term, private savings media. A policy of tax neutrality would argue for comparable taxation of annuities and other retirement savings instruments.

Many countries grant tax relief for payments into annuities. Those that do not grant tax relief for payment usually do not tax the annual interest credited to annuity cash values. Rather, they subject the cash value to tax only at time of liquidation or if a cash value withdrawal is made before the liquidation phase.

The tax issues related to the liquidation phase of annuities are less varied than those of the accumulation phase. When the life insurer begins to make periodic annuity payments (typically monthly or quarterly) to the annuitant, each payment is composed of part principal and part interest. If the interest accretions have escaped taxation during the accumulation phase, a case can be made that each annuity payment should be subject to tax to the extent that it represents untaxed interest earnings. Moreover, if tax relief had been granted for premium payments during the accumulation phase, a further argument can be made that the portion of each annuity payment that represents tax-advantaged principal also should be taxed. Of course, the converse applies in each case.

d) Employee benefit plans

The premiums paid by employers for life or health insurance coverage for employees sometimes are not taxed as income to employees. Benefits received by employees from employer-funded retirement plans are usually subject to income tax upon receipt but only to the extent of each payment. This tax treatment presumes that contributions by the employer toward the retirement plan were taken as tax deductions and the contributions were not taxed to employees. This approach to retirement benefit taxation has been considered reasonable by most governments, although it violates the tax neutrality principle.

The tax treatment of individually purchased retirement annuities (and other qualifying savings media) could be coordinated with that of employer-provided retirement benefits, thereby enhancing equity among citizens. For example, in Canada, any citizen with earned income may establish and contribute to an individual, tax-deductible, retirement savings plan. For 2000, the maximum deductible contribution was the lesser of 18 percent of earned income or C$13,500. This maximum sum is deductible only for those who do not participate in an employer-provided, tax-favored retirement plan (or for whom employer contributions or benefits are low). The deduction maximum phases out as employer-funded amounts or benefits increase, eventually being zero for those participating in generous employer-funded plans.

3. Tax policy relative to benefits payable on death

Many, perhaps most, policyholders purchase life insurance because of a recognition that their death could cause financial hardship to dependents, and they wish to minimize this hardship. The purchase and retention of a life insurance policy, therefore, often rely on noble human motivations that probably have positive spillover effects for society.

In recognition of the motives behind life insurance purchases, the typically great financial need of surviving dependent individuals, and sympathy for the bereaved survivors, few countries impose income taxation on death proceeds. Of course, this practice means that any previously untaxed interest on cash values escapes income taxation. This practice can be inconsistent with the neutrality goal but many countries apparently believe that it represents reasonable public policy. In an environment of tax neutrality, death proceeds would be received income-tax free because no special tax concessions would have been extended to life insurance during the insured's life.

Governments do not hesitate to subject life insurance death proceeds to wealth and estate duties.[19] Legitimate ways of avoiding estate duty on life insurance death proceeds should exist.

C. The elements of life insurer tax policy

As noted throughout this study, life insurance *product* taxation should not be viewed in isolation from life *insurer* taxation. This section briefly covers life insurer premium and income taxation.

1. Evaluation of premium taxation

Premium taxation has both desirable and undesirable attributes.[20] A system of taxation based on an insurance company's premium income is a simple approach to taxation. Administration by both insurers and tax authorities is easy. Compliance verification is not particularly difficult. This taxation produces a steady and usually increasing revenue flow to the state.

Insurance companies have been subjected to premium taxation for more than 150 years. This method of taxation arose at a time when governmental tax administration needed great simplicity and ease in administration. As a United Nations' study pointed out, however, "its simplicity is the source of potentially great inequity."[21] Commentators have noted several objectionable aspects of premium taxation:

- It is a direct tax on savings that is applicable only to insurers and not other, competing financial intermediaries

- It is inequitable (regressive) in that it burdens lower-income persons who purchase life insurance relatively more than higher-income persons, as unit costs of insurance are higher for small policies than larger ones and low-income customers purchase small policies

- It discriminates unfairly against higher-premium (and cash-value) forms of life insurance, as its assessment is based on the premium

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[19] Estate and inheritance taxes differ. An estate tax is levied on the transfer of property because of death. An inheritance tax is levied on a recipient's right to receive property. Some countries have both types of taxes. Others have only one. Life insurance death proceeds up to a certain stated maximum and payable to certain named beneficiaries (e.g., surviving spouse, parents, or children) are often exempted from taxation.

[20] This section draws from Harold D. Skipper, Jr., "State Taxation of Insurance Companies: Time for a Change," *Journal of Insurance Regulation*, vol. 6, 1987.

[21] *Establishing Life Insurance Tax Policy in Developing Countries* (Geneva: UNCTAD, 1985), p. 13.

- It discriminates unfairly against those who must pay higher premium rates, such as the elderly and insureds who must pay higher than standard premiums because of health or other difficulties

- It must be paid irrespective of insurer profitability

While premium tax rates of 2.0 or 3.0 percent may seem low, they are applied to a large tax base and few tax concessions are provided. The net result can be a high effective tax burden. Studies have found that the effective tax burden on insurers arising from premium taxation is consistently higher than that on other financial and nonfinancial institutions. With increasing competitiveness within the financial services community, economically neutral tax systems become more critical.

For the above reasons, premium taxation generally should be avoided. As a practical matter, a premium tax at a modest level (*e.g.*, less than 1.0 percent) could be used as a short-term substitute for a broad-based life insurer income tax system. It should be recognized, however, that a premium tax distorts the financial services marketplace and falls short of the goals of equity and neutrality.

2. Evaluation of income taxation

A life insurer tax system based on an insurer's total income probably offers the greatest practical opportunity to address equity and economic neutrality issues meaningfully. Such a tax system, however, can be complex, as the enormous variations in system details among OECD countries attest. For example, in some OECD countries, tax deductible actuarial reserves are calculated using the same assumptions as those laid down for regulatory purposes. In other countries, special tax-prescribed assumptions must be used.

Ideally, a country should tax all corporations, including life insurers, under the same general approach. If some variation of the net income approach is adopted, the system applicable to life insurers could be simplified, at least initially, as relates to reserve and policyholder dividend deductions.

The range of variations found in OECD countries for calculating the reserve deduction attests to the view that there is no perfect method. Although the reserves determined for regulatory purposes are calculated conservatively (and, therefore, are intended to be higher than necessary), the simplest approach would be for the taxing authorities to adopt the supervisory authority's standards. If no published standards exist, the reserve position as reported in the company's financial statement could be used. As tax authorities develop expertise in this technical area, the tax reserve deduction could be changed. Use of the same standard simplifies the administrative burdens on both tax authorities and life insurers. Life insurers would not need to prepare different reserve calculations for tax and regulatory authorities. The tax authorities, in turn, could place greater reliance on the accuracy of the computation since the regulatory authorities might be charged with verifying it.

The effect of using statutory reserves for tax purposes is to overstate the reserve deduction and, hence, to understate taxable income. This need not be considered as a major problem if the country is dedicated to the promotion of life insurance. It can be viewed as one aspect of a favorable tax policy.

Dividends paid on participating life insurance policies are usually deductible in whole or in part in determining taxable income under a total income tax system. In fact, a separate accounting of the income attributable to participating business is usually required in OECD countries. If the insurer is a stock company, the shareholders may be entitled to a small percentage only of the profits from the participating business. If the insurer is a mutual company, policyholders effectively own the company, in which case profits of any nonparticipating business plus those from the participating business may be distributed to the participating policyholders as policy dividends.

As noted earlier, policy dividends represent both a return of excess premiums and a distribution of income. Distinguishing between the two elements is difficult. To allow a full deduction for policy dividends may reduce the tax base of a life insurer below the comparable corporate tax base of other businesses. Within the industry itself, to do so may give mutual companies an unfair advantage over stock companies.

Most countries allow a full deduction for policy dividends. However, Canada limits the deduction to the amount of the participating income. This tends to place stock and mutual companies on a similar basis. The deduction for policy dividends in Japan is limited to a deemed minimum return of 7.0 percent on insurer surplus. Under the United States' system, deductions for policy dividends paid by a mutual company are limited to reflect a return on net worth, but full deductibility is allowed stock companies.

V. LIFE INSURANCE PRODUCT TAXATION MODELS

The preceding sections have made evident the difficulties in designing appropriate, compatible tax systems for life insurance products. Compromises between economic neutrality and social equity, on the one hand, and administrative simplicity, on the other hand, are always made.

It is, of course, impossible to set out specific recommendations appropriate for all economies. However, certain general models may be suggested. Government must first decide on its general approach to life insurance product tax treatment before addressing implementation details.

Three models of life product taxation are presented in Table 5. Model I is the least complex administratively, depending on the method adopted for individual premium tax relief. Model III is the most complex.

The Model I approach might be appealing to an emerging market interested in simplicity and in promoting the purchase of life insurance via the tax system because it believes it carries important spillover effects for society. Under it, premiums paid, to a prescribed maximum, for qualifying death benefit and survivor benefit products could be deducted, in whole or in part, from income or a tax credit taken. Administratively, it might be simpler to follow the past United Kingdom approach of having the policyholder subtract the tax relief directly from the premium remitted to the insurer. For simplicity, all life insurance products could be defined as qualified for tax purposes.

Neither Model II nor Model III permits tax relief for individual death-benefit-product ownership. Model II permits tax relief for premiums paid for savings contracts. Standards would be needed, such as minimum policy duration and maximum contribution limits. Model III permits no special premium-based relief.

All models permit employers to deduct premiums that they pay on behalf of employees for life-insurance-type benefits. Such tax treatment is consistent with the tax treatment of other employer expenses.

Due to the complexity of trying to separate the investment income component of dividends, all three models exclude dividends (bonuses) from policyholder taxable income.

Table 5. Three models for life product taxation

	Model I	Model II	Model III
Income tax relief for premiums			
Deductibility for premiums paid by individuals:			
Under predominately death benefit contracts?	Yes	No	No
Under predominately survivor benefit contracts?	Yes	Yes	No
Deductibility of premiums paid by employers	Yes	Yes	Yes
Taxation of living benefits			
Policy dividends taxed?	No	No	No
Inside interest taxed?	No	No	Yes
Net gain on surrender taxed?	Yes	Yes	-
Net gain on maturity benefits taxed?	Yes	Yes	-
Annuity benefits taxed?	No	Yes	Yes
Employer-provided benefits taxed?	No	No	Yes
Taxation of death benefits			
Subject to income tax?	No	No	Yes, on gain
Subject to estate duties?	Yes	Yes	Yes
National treatment of foreign insurers	No	No	Yes

Note: Dash (-) denotes "not applicable."

In the interest of administrative simplicity, neither Models I nor II attempts to tax the inside interest build up directly. Model III, being more attuned to a sophisticated taxation environment and more concerned with competitor neutrality, calls for a method of taxing interest. Such a model may be too complex administratively to be considered today for many emerging market-economy countries. Models I and II subject any gain on policy surrender or maturity to taxation.

Only Model I extends a tax concession to annuity payouts. This treatment could be justified if government wished to use the tax system to subsidize retirees and for administrative simplicity. Other retirement savings media should be accorded equivalent treatment in the interest of competitor neutrality.

Reasonable levels of employer-provided benefits are not taxed to employees under Models I or II. With its emphasis on tax neutrality, Model III makes no tax distinction between such benefits and any other form of employee compensation.

Regarding the taxation of death benefits, neither Model I nor Model II subjects any portion of death benefits to income taxation. Model III presumes that any previously untaxed gains would be subject to income taxation on death. All three models subject policy proceeds to estate duties in the same way as other financial assets.

Each of the three models presumes that life insurer taxation is based on the concept of economic neutrality and, therefore, insurers are taxed as other corporations, taking into account their special characteristics. If life insurers are subject to an income tax system essentially equivalent to that of other corporations, life insurers should not be subject to a premium tax, unless other financial intermediaries are subjected to an equivalent turnover tax.

With each model, the question arises whether the policies sold to nationals by unlicensed foreign insurers should enjoy the same tax treatment as policies sold by licensed insurers. Lacking tax treaties or other arrangements with neighboring or other governments, emerging markets probably should follow the lead of most EU countries in which tax concessions are more often limited to licensed insurers' products. Models I and II presume such a position. Note that licensed foreign insurers would receive national treatment as regards taxation. Model III presents the liberal market model where one recognizes the desirability of competitor neutrality.

VI. SUMMARY AND CONCLUSIONS

The purpose of this study has been to examine life insurance product taxation in OECD countries and thereby to provide insight for countries as they develop or revise life insurance tax policies. Life insurance plays important economic and social roles for both individuals and societies. Life insurance affords individuals, families, and businesses the opportunity to hedge against the adverse financial consequences of death and to save in a convenient, perhaps quasi-compulsory manner.

As important financial intermediaries, life insurance companies help mobilize national saving to support greater national investment. Enhanced investment is a prerequisite to stronger, long-term economic growth. Additionally, individually purchased life insurance undoubtedly relieves pressure on social welfare systems, thus minimizing taxes.

The financial sector – including the life insurance industry – is believed to have a special role to play in the transformation and development of economies. This is because of the need for a more efficient allocation of savings, for strong stabilization policies and structural reforms, for overall confidence building, and for particularly strong sources of external finance for non-financial businesses.

Because of these beneficial spillover effects, a case can be made for using tax policy to encourage citizens and businesses to purchase life insurance. However, research to date neither supports nor refutes the premise that a favorable life insurance tax policy will be effective from a macroeconomic perspective. The ambiguity on the impact of tax policy on national savings adds little to our confidence that life insurance tax concessions will prove to be a panacea.

Tax provisions applicable to life insurance ideally should be consistent with general tax principles. These principles include the general purposes of taxation (to raise revenue, to promote economic goals, and to promote social goals), the desirable traits of tax policy (equity, neutrality, and simplicity), and the various systems of taxation.

All OECD countries provide some tax concessions in the purchase, maintenance, or execution of life insurance policies. In several countries, tax relief is provided for premiums paid for qualifying life insurance policies. Policies that are primarily survivorship contracts (*e.g.*, endowments and annuities) are more likely to enjoy tax preferences. The trend internationally is away from such tax concessions.

OECD countries generally do not tax life insurance policy dividends nor do they directly tax the inside interest build up under cash value contracts. Rather, any excess of a policy's maturity or cash value (and dividends) over premiums paid is typically taxable, but only at policy maturity or surrender. Death proceeds ordinarily do not incur income tax, but are typically subject to estate duties.

All OECD countries tax life insurers on either their total income or investment income. Life insurers in a minority of OECD countries also are taxed on their premium income. Life insurance product taxation should not be considered in isolation from the taxation of life insurers.

Several considerations should apply as countries establish their life insurance product tax policy. First, policy makers should have a clear view of the purposes they seek to accomplish via any life product tax concessions and of the expected effects on revenues of tax concessions. The importance of life insurance tax policy being compatible with the country's level of development, with the insurance regulatory structure, and with other countries' tax policies is noted. A life insurance product tax system should align with the desirable traits of tax policy. Of the traits of equity, neutrality, and simplicity, the latter two are perhaps key to a successful life product tax system. Neutrality requires that government tax decisions minimize interference with the economic choices of individuals and businesses. Thus, lacking a compelling argument to the contrary, tax policy should not create an economic advantage for one industry, supplier, or type of product compared with all others.

The elements of a possible life product tax system could include a deduction or credit for premiums paid by individuals on qualifying policies. Premiums paid by employers for reasonable levels of life-insurance-funded employee benefits could be deductible to employers and not taxable to employees except in more sophisticated markets.

Living benefits paid under life policies generally could be accorded some tax concessions, as much to avoid the administrative complexities of doing otherwise as to promote life insurance. Thus, neither policy dividends nor the interest credited on policy cash values should be directly taxable. Any gain on policy surrender or maturity might be taxable income. Annuity payments, being composed of part principal and part interest, should invoke taxation on any untaxed interest portion only or, if contributions were deductible, on both portions. Again, however, tax concessions may be called for in the interest of simplicity. Death benefits of life insurance policies whose premiums were not subject to tax relief should not be subject to income taxation but should be subject to any estate duties.

Life insurance company taxation logically should not be separated from life product taxation. Governments ideally should tax insurers and other financial intermediaries equivalently.

Premium taxation is simple administratively for both tax collection authorities and the taxpayer. It produces a typically steady, predictable revenue stream. On the other hand, its application creates substantial inequity among life products and is not competitor neutral given that it must be paid irrespective of profitability. The premium tax approach should be used only if the need for administrative simplicity dominates the goals of equity and neutrality.

The corporate income tax is a logical, if potentially complex, means of taxing life insurers if other corporations are also subject to such taxation. It can be crafted to reduce inequities and to achieve reasonable neutrality. By permitting policy reserve deductions based on statutory reserves and full policy dividend deductions, such a system can be simplified without great sacrifice of either tax revenues or neutrality.

Thus, a complete life insurance tax system would be composed of two parts. The taxation of the insurer itself would be consistent with taxation of other financial intermediaries, with certain concessions to tax simplicity for some markets. Except for concessions to simplicity, life insurance product taxation also would be consistent with the taxation of non-insurance financial instruments, unless government policy makers believe that life products deserved special tax concessions, as discussed earlier.

In crafting the details of the above tax policy, it might be appropriate to accord to the tax systems of other countries. With increasing financial services liberalization and integration, the desirability of having at least minimal tax-system harmonization grows.

A study such as this cannot set out detailed specifications for individual countries' tax systems. Specific advice is necessary. Consideration could be given by intergovernmental or other organizations to preparing model legislation that could be adapted to each country's circumstances.[22]

[22] Thanks are due to Rolf Nebel of Swiss Re for this suggestions.

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