

Asia Pacific Insurance Tax News

November 2009



Foreword

Welcome to another edition of our Asia Pacific Insurance Tax News.

Insurance is a unique business and unique tax laws are often required to cater to the peculiarities of the insurance business. Yet most lawmakers and tax authorities find the business hard to understand. It has been made more difficult by the rapid and widespread implementation of global regulatory and accounting changes as most Asia Pacific countries attempt to follow global best practice. The result is often new tax regimes being introduced with unintended tax consequences. And even when new tax laws are issued to fix old issues, they either take too long to happen or sometimes end up getting it wrong. It is therefore important that insurers stay abreast of tax changes and actively manage the tax risks and challenges they face.

In this issue of Asia Pacific Insurance Tax News, our specialists from ten Asia Pacific countries will share with you some of these tax changes and challenges. I hope you will find them useful and interesting.

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

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PricewaterhouseCoopers Asia Pacific Insurance Tax News is a periodic publication that offers insights into trends and developments in insurance and taxation.

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Asia Pacific

Transfer pricing risks in the risk business

Transfer pricing has become an increasingly high profile issue in the Asia Pacific region in recent years. The introduction of documentation requirements in China, the release of several transfer pricing guidelines in Singapore, the imminent release of transfer pricing guidelines in Hong Kong and the continued tax audit focus in other high risk jurisdictions such as Australia, India, Japan and Korea, mean that it is an issue which should be high on the list of priorities of all multinational companies, including those in the insurance sector.

Spotlight on insurance

Historically, many tax authorities have put the transfer pricing of insurance companies into the “too difficult” category, or, where they have investigated transfer pricing, have tended to focus on cross-industry generic transactions such as management services and brand royalties. However, recent work undertaken by the Organisation for Economic Co-operation and Development (OECD) in relation to the taxation of insurance branches¹ has put the tax spotlight on the insurance sector. At the very least, it will have provided tax authorities with an education on many of the transfer pricing issues common in an insurance business context.

In addition, a number of other recent developments also have the potential to increase the scrutiny under which

transfer pricing arrangements in the insurance industry may be judged by tax authorities:

- The insurance sector has seen significant recent consolidation, resulting in post-integration restructuring with a strong focus on capital structure and capital management.
- Analysts have increasingly started to focus on insurance groups’ management of their effective tax rate. At the same time there has been an increased focus and scrutiny on transactions involving tax havens in many countries following on from the G20 meetings in early 2009.
- Transfer pricing has become an increasingly sensitive area for tax authorities seeking to protect their tax base in light of falling tax revenues due to poor economic conditions. The focus on perceived “soft” areas, such as transfer pricing, has led to heightened scrutiny of the profit profile of multinational groups and their transfer pricing policies.

It is also key to note the importance of regulatory requirements, which stipulate strict guidelines over business operations, financial supervision and personnel, in determining arm’s length pricing.

In light of above, this article looks at three common insurance business

models used, and provides a high level discussion of the key transfer pricing issues which are relevant to each:

- fronting arrangements;
- branch structures; and
- full local insurance subsidiaries.

Fronting arrangements

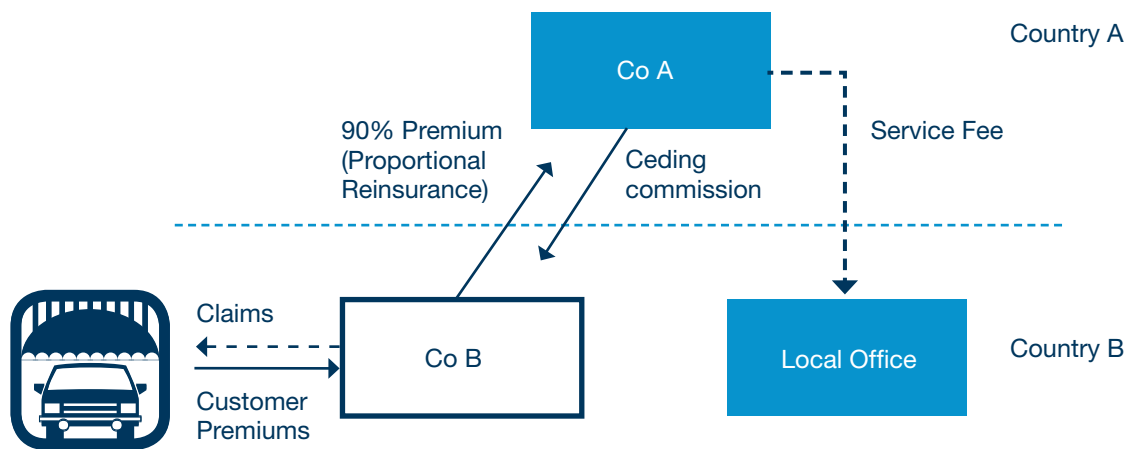
Fronting arrangements are commonly used by international insurance companies as a low risk way to gain exposure to new markets. In a fronting arrangement, an international insurance company (Co A in Figure 1) enters into an agreement with a locally regulated third party insurance firm (Co B in Figure 1). Co B, the local insurance firm, will write the business, and will typically cede a significant portion of the risk to Co A under, for example, a proportional reinsurance treaty.

Co A, the international insurance company, will often set up a local presence in the same jurisdiction as Co B (Local Office) in order to perform the following functions:

- Liaison and monitoring of Co B;
- Gathering information and research on the local insurance market; and
- Local sales and marketing support.

¹ OECD Paper on the Attribution of Profits to Permanent Establishments – Part IV: Insurance – July 17, 2008 (OECD Paper IV)

Figure 1: Typical Fronting Arrangement



Key transfer pricing considerations

The premium and ceding commission payable under the reinsurance treaty are unlikely to be subject to transfer pricing regulations as the transactions are between third parties². The key transactions which will be of interest to the tax authorities in both countries, from a transfer pricing perspective, will relate to the services provided by Local Office to Co A.

In particular, the tax authorities will be interested in the nature of the sales and marketing support services provided by the Local Office. For example, if the Local Office assists in generating sales leads, which it

passes to Co B, the tax authorities may expect the service fee paid to the Local Office to include a sales commission based on, for example, a percentage of the premium income from those customers³.

Consequently Co A will either need to give serious consideration to the benchmarking of an appropriate arm's length sales commission, or have prepared in advance a detailed defense of why a commission-based fee is not required. In each case, this should be documented and retained on file in preparation for any future tax audit, as should the basis for determining the arm's length fee for any other services provided by the Local Office.

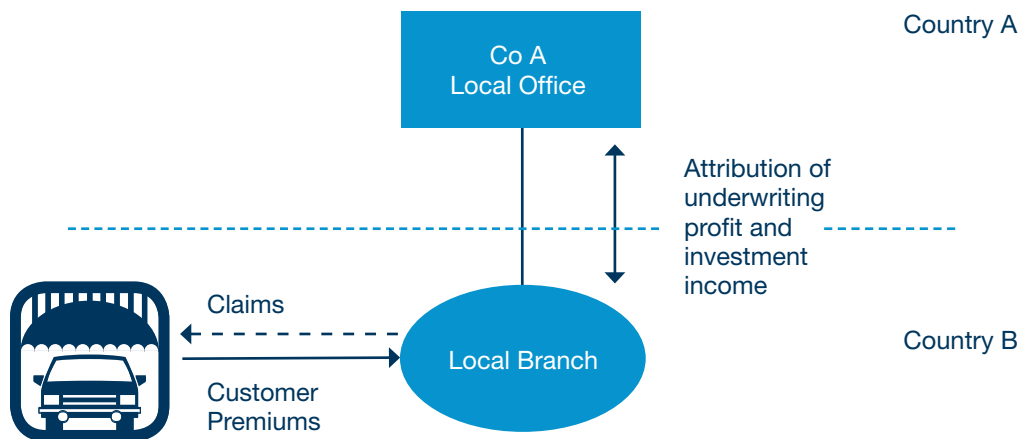
Branch structure

In the next business model (see Figure 2 on the next page), Co A establishes a branch in Country B (Local Branch), which has been granted a license to conduct insurance business from the regulators of Country B. The Local Branch underwrites its own business within limits set by Head Office. Sales, claims management and all other activities related to the Country B business are performed by the Local Branch. However, Head Office underwriting approval is required before any risks can be insured outside of the authorised limits.

² However, this will depend on the definition of "related party" in both Country A and Country B.

³ This article does not discuss issues surrounding the risk that the activities of either Co B or the Local Office may create a Permanent Establishment of Co A. However, these issues should be given careful consideration in the context of the domestic tax laws of Country B and in the interpretation of the relevant double tax convention (if any).

Figure 2: Branch Structure



Key transfer pricing considerations

In our example, for simplicity, we have assumed that there are relatively few dealings between the Local Branch and its Head Office. However, it will be important that an analysis is performed to determine the nature of the underwriting role performed by Head Office so that the dealings between Head Office and the Local Branch can be properly defined. Once such dealings are defined, the profits attributable to those dealings should be determined using general transfer pricing principles⁴.

In addition to determining how the underwriting profit of the business should be attributed, the

functional analysis is also essential in concluding which location is responsible for the acceptance of insurance risk. This is important as, according to OECD Paper IV⁵, this is the location to which the assets that back those risks (and any associated investment income) should be assigned for tax purposes.

The guidance in OECD Paper IV provides a number of methods for allocating investment assets and investment income within an insurance company, which may differ from the regulatory or accounting position in a particular country. Local practice, or the existence of safe harbours under the domestic tax law of Country B, may mean that approaches based on the minimum

regulatory capital, or other methods, are applied for tax purposes. Such a position is consistent with the OECD approach, as long as it does not result in the attribution of more profits to Country B than under the OECD approach⁶. Notwithstanding the existence of safe harbours, companies should be wary of simply taking the position as reported in the branch accounts when reporting the location of investment income for tax purposes as a deviation from the OECD approach may still result in challenges from the tax authorities of the Head Office.

There is still considerable uncertainty as to how the recommendations of Paper IV will be applied. Partly as many Asian countries are not OECD

⁴ By applying the same principles used to determine transfer prices between separate legal entities by analogy (e.g. applying the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Authorities).

⁵ Ibid note 1.

⁶ OECD Paper IV Paragraph 160.

members and/or have not issued firm guidance on whether they will require compliance with OECD Paper IV as part of their domestic tax law. However, as new tax treaties enter into force, which employ the revised wording to Article 7 of the OECD model tax treaty⁷, we can expect to see this becoming an area of closer focus. In addition, OECD Paper IV is often the only guidance available on the specific issues faced by insurance company branches. Therefore, we can expect tax authorities to at least have an awareness of the issues that the paper raises.

Insurance companies operating through a branch structure should

at least consider performing a functional analysis to ensure that they have documented the locations of the people responsible for the acceptance of insurance risk for each of their businesses and that their attribution of the investment income arising from assets supporting those risks, for tax purposes, is consistent with this analysis.

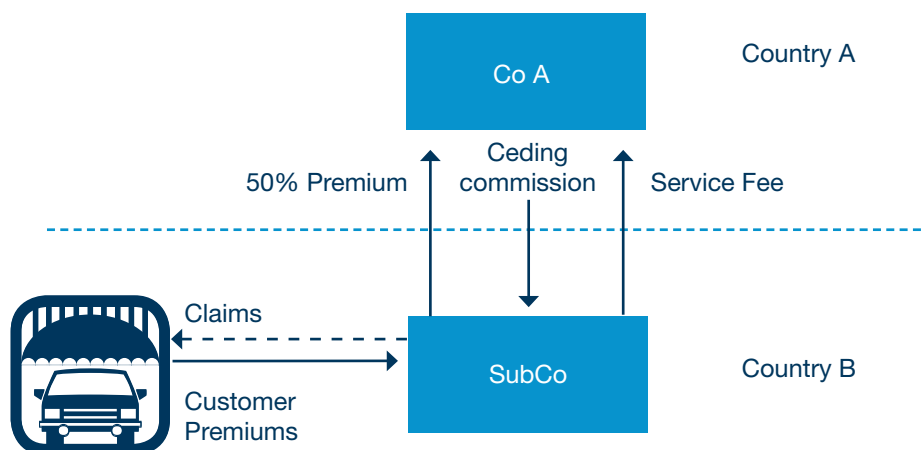
Local insurance subsidiary

For the final business model (see Figure 3 below), instead of operating through a local branch, Co A establishes a locally regulated insurance subsidiary in Country B (SubCo).

SubCo performs all sales and marketing, claims management and underwriting locally on its own account. Typically however, senior management in Co A continues to provide high level management and strategic support services which benefit all Co A's subsidiaries.

In the example shown in Figure 3 below, in order to manage its capital position, SubCo has entered into a proportional reinsurance treaty with Co A for 50% of the risks and premiums of its local Country B book. In exchange for this, SubCo is paid a ceding commission by Co A.

Figure 3: Local Insurance Subsidiary Structure



⁷ The draft wording of the update to Article 7 of the OECD model treaty was issued on July 8, 2008. Specifically the draft also proposes changes to the commentary to Article 7 (Business Profits), Article 10 (Dividends), Article 11 (Interest), Article 12 (Royalties) and Article 13 (Capital Gains), which impact how investment income is attributed to permanent establishments in an insurance context.

Key transfer pricing considerations

The key transfer pricing considerations in this scenario relate to:

- The service fee for the strategic support provided by Co A's senior management; and
- Determination of an arm's length ceding commission.

Service fees

One of the most common areas of challenge for international companies operating in the Asia Pacific region is the deductibility of fees for intra-group management services. Typically these charges are seen as a soft target for tax authorities as they are easily understood, and in many cases, the benefits received by the service recipient may not be easy to demonstrate, even to local management. In addition, because such charges have the effect of reducing SubCo's profits, they can also attract the interest of SubCo's regulators.

In order to ensure the highest likelihood for securing deductibility for such charges, it is particularly important that the arrangements for charging intercompany management services are appropriately documented and that the benefit that each service recipient receives from the services can be evidenced to the local tax authorities in case of an audit.

In addition to specifying the services rendered and benefits received, it is important for head office to formulate the rationale for the selection of the allocation keys used. For example, a charge out of all head office costs based on a simple allocation key, such as gross written premiums, may come under attack as it could be argued that under such a policy, established businesses receive the highest charges whereas developing businesses and markets, which take up a disproportionate share of head office management time and costs, receive lower charges.

Care should also be taken to ensure such services are not duplicative of activities required to be conducted locally. For example, in certain jurisdictions such as Japan, there are regulatory constraints which restrict the ability to outsource insurance related business functions. As a result of this requirement, the tax authorities may deny deductibility for any charges related to such insurance related functions which are performed by related parties overseas.

In other countries, insurers face direct regulator scrutiny of management charges. For example in Korea, the Financial Supervisory Service published the 'Best Practice for Transactions between Local Business Units of Foreign Financial Institutions and their Related Parties' in September 2007; guidelines that include the arm's length principle and internal management procedures applied to transactions between related financial companies.

Related party reinsurance

In our example in Figure 3, we have a proportional reinsurance treaty covering 50% of all risks and premiums. In such a case, the key transfer pricing question is likely to surround the level of the ceding commission, and whether this should include a share of the profits earned by Co A on the business ceded. With other non proportional forms of reinsurance, such as excess of loss reinsurance, it will be level of the premium itself that is required to be at arm's length.

Internal reinsurance transactions are likely to be amongst the most material dealings between related parties in an international insurance group. In addition, many tax authorities make the assumption that insurance companies use intra-group reinsurance as a method of transferring taxable profits offshore.

Without the actuarial expertise to challenge an insurance company's pricing of risks, tax examiners may instead seek to attribute any reinsurance premium income to a permanent establishment of the reinsurer. Other challenges may focus on the "economic substance" of the reinsurance arrangements with the aim of either re-characterising the transactions. Therefore, establishing the commercial and economic rationale for entering into the reinsurance arrangement needs to be carefully thought out before the pricing is considered.

The commercial rationale behind the reinsurance will also have a significant impact on the pricing. For example in Figure 3, the ceding commission that SubCo would be willing to accept in exchange for ceding 50% of its business to Co A would differ depending on whether SubCo was a start-up business looking to use the reinsurance treaty to assist in local market expansion plans or an established local insurer with an existing profitable book of business.

When determining pricing, a common approach taken by insurance companies is to price internal reinsurance using the same pricing models as for external reinsurance. Whilst this analysis may provide a reasonable result, the main weakness of such an approach is that it is often difficult to prove to a tax examiner that such a policy actually does represent an arm's length result. Accordingly, an audit trail should be retained to document each of the assumptions made in the model. Even then, tax examiners in some jurisdictions may require additional support, based either on OECD or local transfer pricing principles.

Sometimes it is possible to find reinsurance arrangements between third parties that can act as comparable transactions. However, it is often difficult to ensure that these are suitably comparable. Consequently, an alternative approach to support the arm's length

nature of the pricing of reinsurance transaction is to benchmark the return on capital earned by comparable independent reinsurance companies, and ensure that the level of the net premium retained by the reinsurer, after payment of any ceding commission (if applicable), results in a return on risk capital which is comparable to the arm's length return demonstrated through the benchmarking analysis.

Early preparation

As outlined above, depending on the business model, there are a wide variety of transfer pricing issues faced by multinational insurance companies. The examples included in this article are deliberately simplified and are not intended to be exhaustive.

As tax authorities all over the region gradually become more sophisticated in their approaches to transfer pricing and more aggressive in their enforcement activities, the need for proper documentation cannot be overstated.

Not only may documentation be needed for compliance purposes in certain countries, but taxpayers that have planned and documented their transfer pricing positions, in advance, stand a much better chance of defending against transfer pricing challenges and adjustments. Advanced preparation and documentation are therefore essential to the management of transfer pricing risk.



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Australia

Risks from ATO activity and opportunities in the tax consolidation regime

In this article, we will deal with two issues: firstly, the risks arising from the current Australian Taxation Office (ATO) activity in the non-life insurance industry and secondly, the opportunities arising from the proposed back-dated changes to the Australian tax consolidation regime.

ATO activity in the non-life insurance industry – more to come

The ATO has been very active in the non-life insurance industry over the last 18 months and it has indicated that 15 further reviews of insurance groups are planned for the 2009/2010 year. So far, both insurance specific issues and non-insurance specific issues have been raised in the ATO reviews.

Transfer pricing, restructuring and tax consolidation

It is convenient to deal with the non-insurance specific issues first. Not surprisingly, at the top of this list is transfer pricing, which of course would include underwriting activities with related overseas parties. In addition, the ATO has also focused on management activities, financing arrangements and even intellectual property such as royalties paid for the use of trademarks.

The other major non-insurance specific focuses have been around corporate restructuring and tax consolidation. For corporate restructuring, the ATO has sought

to understand the commercial rationale for the restructure as well as the taxation outcomes. For tax consolidation, the focus areas included the treatment of insurance assets such as deferred acquisition costs and deferred reinsurance recoveries. Once again, not surprisingly, the ATO was very interested in significant tax advantages arising out of the tax consolidation process.

Outstanding claims liabilities, prudential margins and discounts

Turning to specific insurance issues raised by the ATO in their reviews – the most significant are the application of prudential margins and discount rates to outstanding claims liabilities, but questions have also been raised in relation to indirect settlement costs and liability adequacy testing. While the latter items are technically not in dispute, there have been cases where insurers have failed to make the required tax adjustments to account for the indirect settlement costs component of prudential margins, or have failed to make adjustments around liability adequacy testing.

More controversial are the issues around prudential margins and discount rates. At a recent industry tax conference, the ATO stated that they may accept claims liabilities incorporating a 75% confidence level. Other comments suggested that they would need some convincing to accept this level of confidence, while anything higher

would need substantial justification. Since many in the insurance industry in Australia use substantially higher confidence levels which are aligned with the accounting treatment, this is of considerable concern to the industry.

Similarly, the stated position of the ATO is that the discount rate applied in calculating outstanding claims liabilities should reflect the investment returns of the insurer. Under Australian Accounting Standards, the discount rate applied is the risk free rate. Interestingly, over the last year or two this has probably been substantially higher than the actual investment rate. Of course, the ATO is thinking that the use of the investment rate would result in a higher discount rate, and therefore lower tax deductible claims liabilities.

The tax law provides for the outstanding claims liabilities to be *“the sum of the amounts that ... a company determines, based on proper and reasonable estimates, to be appropriate to set aside and invest in order to meet ... liabilities for outstanding claims”*. In our view, this provision makes the ATO arguments difficult to sustain.

Since the original ATO ruling requiring discounted reserves in 1992, it is interesting to note that the ATO has at various times tried to argue that general insurers should reduce their deductions for outstanding claims liabilities on the basis of using a lower prudential margin. However, history has not helped in their arguments.

For instance, we have seen them challenge an 85% confidence level for Compulsory Third Party claims, only to find that the actual claims experience meant that the original 85% confidence level was not adequate. Also, the last substantial insurance company we are aware of that used a lower than 75% confidence level was HIH Insurance, which subsequently ended up in liquidation.

After so much time spent on these issues, it is our view that if the ATO wishes to insist on its positions in relation to outstanding claims liabilities, then it should approach the Government to codify those positions.

Backdated changes to the Australian tax consolidation regime

Whilst ATO activity in the insurance industry is not good news, the changes proposed around tax

consolidation, which will be backdated to the introduction of the Australian tax consolidation regime in 2002, look like they will provide opportunities for insurers.

Of particular interest are changes and clarifications around the way some items of deferred income will be treated. Although at the time of going to press, these provisions are still being worked on, it does appear likely that they will apply to some aspects of an insurance company's income.

Where applicable, the changes will effectively provide a tax cost or a deduction in relation to the relevant income that was deferred as at the date that an insurance company acquired another insurance company. As these provisions will be backdated to 2002, there appears to be potential for some substantial tax benefits to arise, with the opportunity to be booked directly as a negative tax expense.



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India

Draft new direct taxes code – key implications for the insurance sector

One of the recent developments that had a significant impact on the current Indian income-tax regime was the release of the draft New Direct Taxes Code by the Finance Ministry on August 12, 2009. The draft Direct Taxes Code (DTC) was released along with a discussion paper for public comments and is proposed to be brought into effect from the financial year beginning April 1, 2011.

The aim of the DTC is to simplify the current tax law by replacing the nearly five decade-old Income-tax Act, 1961. Right from the date of release, the DTC has been the subject of much debate and discussion at various industry forums. Representations have also been made to the Government on behalf of industry players (including insurance) by their representative bodies suggesting changes to the provisions of the DTC.

The DTC has proposed significant changes to the taxation of insurance companies, especially for life insurance companies and its policyholders. In this article, we set out the key provisions of the DTC affecting the insurance sector.

Taxable income and tax rates

Under the current tax regime, the taxation of insurance companies is governed by special provisions which operate as a self-contained code. Under the DTC, this special tax treatment will continue with the laying down of separate provisions

for determining the taxable profits of insurance companies.

Currently, income from life insurance business is taxable at the special rate of 12.5%. However, there is an ongoing litigation as to whether income from both Shareholders' account and Policyholders' account represent profits from life insurance business and therefore, whether income from the Shareholders' account is also subject to tax at the special rate of 12.5% as against the general corporate tax rate of 30% prevailing under the current tax regime.

The DTC proposes to accord a "pass-through" status to the Policyholders' account (i.e. such income will be not be taxable in the hands of the life insurance company) and to tax the income from the Shareholders' account at the general corporate tax rate (which will reduce to 25%).

In addition, income derived by insurance companies from a business other than life insurance business would continue to be taxable at the general corporate tax rate.

The DTC proposes to reduce the general corporate tax rate from the existing rate of 30% to 25%.

Minimum alternative tax

Where the normal tax liability of an insurer is lower than the Minimum Alternative Tax (MAT), the insurance company would have to pay the MAT instead.

Currently, MAT is levied on the book profits of the insurance company after making certain prescribed adjustments.

Under the DTC, it is proposed that MAT be computed at 2% of the value of all gross assets of the insurer as at March 31 of the relevant year. This change is expected to significantly impact the tax liabilities of insurance companies, since under the current tax regime, insurance companies typically do not pay either income-tax or MAT during the gestation period due to their huge book losses. However, the shift of base for computation of MAT from book profits to gross assets is tantamount to insurance companies being subject to MAT.

In addition, for life insurance companies, while the Policyholders' account has been accorded "pass-through" status, the DTC does not exclude the assets of the Policyholders' account from the computation of MAT.

The levy of MAT on a gross assets basis could also have a cascading effect for holding entities because while the subsidiaries would pay tax on all their assets, the holding companies' assets would include the value of their stake in the subsidiaries.

Of further concern is the proposal that MAT will be a final tax and that it will not be available as a tax credit in subsequent years. By comparison, the existing law allows a tax credit for MAT and the carry forward of the same for seven subsequent years.

The insurance industry has represented to the Government to make MAT provisions inapplicable to them or alternatively make MAT provisions applicable with certain modifications.

Grandfathering provisions and carry forward of losses

Under the current tax regime, business losses are permitted to be carried forward only for a period of eight years. While the DTC proposes to permit the carry forward of losses indefinitely, the manner in which the said provision has been drafted for insurance companies appears to suggest that losses of insurance companies will only be allowed to be carried forward for one year.

In addition, the DTC does not address the issue of carry forward of losses incurred prior to introduction of DTC.

Taxability of certain life insurance policies – shift from ‘EEE’ regime to ‘EET’ regime

The DTC has proposed significant changes to the taxation of income from certain investment products including income from life insurance policies. It proposes a shift from the

Exempt-Exempt-Exempt (EEE) tax regime to an Exempt-Exempt-Tax (EET) tax regime. Under the current ‘EEE’ regime, the policyholder is not liable for tax at the stage of investment in the policy (i.e. first ‘E’), accumulation / accrual of income on the policy (i.e. second ‘E’) and at the time of receipt of money under the policy (i.e. third ‘E’). The third ‘E’ does not apply in cases where the premium paid for any of the years during the term of such policy exceeds 20% of the actual capital sum assured.

With ‘EET’ regime, the DTC proposes not to levy any taxes at the stage of investment and accrual of income on the policy (i.e. the first two ‘Es’) but instead to tax the amounts received at the receipt stage (including the amounts accumulated / accrued on the policy) other than sums received on death or maturity and where the premium paid during the term of the policy does not exceed 5% of the actual capital sum assured.

The proposed change will have a significant impact on the growth of the life insurance sector. It is particularly negative for insurance policies with significant investment elements such as investment-linked policies where premium paid is likely to exceed 5% of the actual capital sum assured.

Currently, the DTC does not provide for any grandfathering provisions. In their absence, there is uncertainty on how amounts that are received from life insurance policies issued under the ‘EEE’ regime would be taxed under the new ‘EET’ regime.

Summary

The DTC has proposed significant changes in the taxation of the insurance sector especially for life insurance companies and its policyholders. While some of the changes are welcome, others could have a significant adverse impact both for the insurance companies and the policyholders. To this end, strong representation to the Government has been made by the insurance sector. However, it remains to be seen how the representations made by the industry for both life and non-life insurance businesses will be incorporated in the final version of DTC that will be introduced as a new taxation law.



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Indonesia

Life insurers – paying taxes despite the downturn?

In a downturn, you should be making tax losses while in an upturn, you should be paying taxes. This sounds logical enough but it is not the case for life insurance companies in Indonesia, especially for those writing unit-linked business.

Technical reserves

Based on current tax regulations, the treatment of a technical reserve follows the accounting treatment, provided that the technical reserve is calculated by an actuary and approved by the Capital Market Supervisory Board and Financial Institution. This means that the increase of the reserve is deductible and the decrease of the reserve is taxable.

For the past several years, Indonesian life insurance companies writing unit-linked businesses have been enjoying deductions for increases in technical reserves, as a result of increases in the underlying value of the investments in their unit-linked business portfolio. This is so despite the fact that most of those underlying investments are generating typical investment income that is not taxable for corporate tax purposes, as explained further below.

Investment income

In general, investment income is taxable at the life insurance corporate level, except for certain investment income that is subject to final tax, or non-assessable income.

Any final-taxed or non-assessable investment income will be excluded from the corporate income tax calculation.

Most life insurers tend to invest their funds in investment products which produce income that are subject to final tax or are non-assessable income.

The typical final-taxed investment income sources are:

- Interest from time deposits
- Interest from bonds
- Capital gains from shares listed on the Indonesia Stock Exchange

The typical non-assessable investment income amounts are:

- Income from mutual funds
- Any unrealised investment gains / losses (as only realised gains and losses are taxable)

Tax losses

The combined effect of the above two tax treatments (i.e. the deductibility of the technical reserve expense without the relevant investment income being subject to corporate tax) has led to tax loss positions for most life insurance companies that adopt the above choice of products in their investment strategy.

These tax losses are usually accumulated through the years and

most insurers have had difficulty utilising them before they expire at the end of five years.

The aftermath of the 2008 financial crisis

In 2008, the financial crisis caused investment values to decrease significantly and consequently the technical reserves as well. This decrease in technical reserves has significantly altered the tax position of Indonesian life insurance companies.

In a market where investment values are increasing, the corresponding increase in technical reserves consistently lead to increasing deductible expenses. However, in a downturn the opposite happens. The significant decrease in investment values result in corresponding decreases in technical reserves that translate into significant taxable income for corporate tax purposes.

On the other hand, the realised and unrealised losses on most of the investments recorded in most life insurance companies' books are not deductible for corporate tax purposes.

As a result, it is expected that the corporate tax positions of some life insurance companies will look quite different for the 2008 fiscal year. The tax losses that they have been accumulating throughout the earlier years are likely to be significantly decreased or even completely wiped out.

During the annual corporate tax filing process, we have seen several cases of life insurance companies that ended up with huge tax underpayments despite utilising huge brought forward tax losses. Companies that almost never paid annual corporate tax ended up with huge tax bills when they were hit by huge investment losses.

And this is not the end of the bad news. Under the Indonesian tax rules, there is a monthly corporate tax that is payable based on the previous year's annual corporate tax underpayment. With the tax underpayment reported in the 2008 annual corporate tax return, these companies are still being haunted by the obligation to pay the monthly corporate tax in 2009. Although this monthly corporate tax payment is refundable as it serves as a prepaid tax, losing cash flow these days could mean a lot of lost opportunities.

Not all life insurers are badly affected

Not all life insurers are that badly affected. We observed that some life insurance companies are doing fine despite having lost a significant part of their tax losses. We have also observed that there are other companies with a normal tax profile in 2008 as their investment portfolio was not as badly affected by the market downturn.

Even so, this anomaly has attracted some attention from the life insurance players as it may be something that they need to anticipate if another market turmoil should happen.



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Japan

The 2009 Japan Tax Reform – have you reviewed your outbound investment strategy?

In the 2009 Japan Tax Reform, a foreign dividend exemption (or “participation”) rule was introduced, largely replacing the previous taxation and foreign tax credit system for dividends repatriated back to a Japanese parent company from significant non-Japanese investment shareholdings. This new rule is arguably one of the most significant of Japan’s recent tax reforms as it represents a fundamental shift in the taxation of foreign dividends, affecting the structuring of Japanese outbound investments.

The insurance companies that will be most affected by this new rule are likely to be the multinational companies with significant offshore subsidiaries and investments. This article outlines the salient features of this reform and highlights the need for multinational insurance companies to review their outbound investment strategy.

The new tax law applies to foreign dividends received in fiscal years commencing on or after April 1, 2009, subject to certain transitional measures.

Exemption of foreign dividends

Before 2009 Tax Reform

Before the 2009 Tax Reform, a dividend received by a Japanese company from a shareholding investment in a foreign company

was included in taxable income of the Japanese company and subject to normal corporate tax rates, irrespective of the level of shareholding. Double taxation was eliminated or modified through the foreign tax credit (FTC) system.

Under 2009 Tax Reform

Under the 2009 Tax Reform, 95% of a dividend received by a Japanese company from an investment in a foreign company in which it has held at least 25% of the outstanding shares for a continuous period of six months or more ending on the date on which the dividend payment obligation is determined, can be excluded from the company’s taxable income.

The 25% threshold is limited to direct shareholdings in the foreign company, i.e., individual shareholdings of less than 25% should not qualify for the exemption even if the aggregate shareholding held within a wholly-owned group is 25% or more. However, if the foreign company is resident in a country with which Japan has concluded a tax treaty for the avoidance of double taxation, and such a treaty provides for the allowance of an indirect FTC for taxes paid by the foreign company on the profits out of which the dividend is paid; where the company holds a certain percentage of the foreign company’s outstanding shares, that percentage will apply for the purpose of determining the availability of the above exemption to the extent that it is lower than 25%.

FTC system

Before 2009 Tax Reform

Before the 2009 Tax Reform, a dividend received by a Japanese company from a shareholding investment in a foreign company was included in the taxable income of the Japanese company and subject to tax at normal corporate tax rates. However, in order to eliminate double taxation, a FTC was allowed for: (i) foreign taxes paid directly by the company on the dividend (e.g., withholding tax imposed by the country in which the dividend-paying company is located); and (ii) taxes paid by the dividend-paying company on its underlying profits (“1st tier subsidiary”) and, if the 1st tier subsidiary itself received dividends from its subsidiary (“2nd tier subsidiary”), taxes paid on its underlying profits by the 2nd tier subsidiary.

The latter was commonly referred to as the “indirect FTC system” and was available if, in the case of a 1st tier subsidiary, the Japanese company held 25% or more of the total number of shares, amount of investment in capital or voting shares for at least six months prior to the date of determining the dividend payment obligation. In the case of a 2nd tier subsidiary, indirect FTC is available if the Japanese company had an indirect interest of at least 25% in the 2nd tier subsidiary and the 1st tier subsidiary has held 25% or more of the total number of shares or voting capital of the 2nd

tier subsidiary for at least six months prior to the determination date of the dividend-paying obligation from the 2nd tier subsidiary to the 1st tier subsidiary.

Under 2009 Tax Reform

The introduction of the foreign dividend exemption rule eliminated any potential double taxation and thus, the indirect FTC system was repealed, although certain transitional measures applied. In addition, foreign tax directly paid on exempt dividends (e.g., withholding tax) are ineligible for direct FTC claim or deduction from taxable income; where such tax should be added back to taxable income.

Foreign tax paid directly on foreign dividends received from shareholdings of less than 25% remains eligible for a direct FTC claim as the dividends remain taxable.

Anti-tax haven or controlled foreign corporation rules

Before 2009 Tax Reform

In general, before the 2009 Tax Reform, when calculating the undistributed income of a controlled foreign corporation (CFC) to be included in the taxable income of a Japanese shareholder: (i) a dividend received by the CFC is included in undistributed income; and (ii) a dividend paid by the CFC to a shareholder that is subject to tax

on the dividend at a rate greater than 25% may be deducted from undistributed income.

If a Japanese company received a dividend from a foreign company where the dividend was paid from earnings that had previously been taxed to the Japanese company under the CFC rules (“previously taxed earnings”), double taxation may be eliminated through the allowance of a deduction for previously taxed dividends, provided such earnings had been included in the Japanese company’s taxable income within the previous ten years up to the end of the fiscal year preceding the year in which the dividend was received. However, the Japanese company was still entitled to claim a FTC for direct and indirect taxes paid in respect of the dividend, with an adjustment for any FTC claimed at the time the earnings were taxed under the CFC rules.

Under 2009 Tax Reform

Under the 2009 Tax Reform, when calculating the undistributed income of a CFC, a dividend paid by the CFC is no longer deductible. However, a dividend received by the CFC from a company in respect of which it has held a shareholding of at least 25% of the company’s outstanding shares for a continuous period of six months or more ending on the date on which the dividend is declared, can be deducted from undistributed income. There is no distinction between a dividend received by a

CFC from another company in the same country (domestic dividend) or from a different country (foreign dividend). Thus, the exclusion from the undistributed income of the CFC applies to both domestic and foreign dividends received by the CFC.

If a Japanese company receives a dividend from a foreign company where the dividend is paid from previously taxed earnings and 95% of the dividend is exempt under the foreign dividend exemption rule, a deduction for previously taxed dividends is not available. However, a deduction for the remaining 5% portion is allowed to the extent of the previously taxed earnings so that the full tax exemption can be achieved.

Expected impact on Japanese-based multinational insurance groups

1. With the introduction of the new foreign dividend exemption rule, we expect the Japanese Tax Authorities to increase their scrutiny of other international tax areas, such as transfer pricing and the application of the CFC or anti-tax haven rules, as they may anticipate tax planning to take advantage of the new exemption rule.
2. A Japanese insurer that has a branch in a foreign country is generally subject to Japanese corporate tax on profits of the foreign branch with FTC relief

being available for foreign taxes paid. Since Japanese tax rates are generally higher than that of other countries, the new dividend exemption rule may make it more tax-efficient to conduct the foreign business through a subsidiary rather than directly through a branch. Any such review of the business legal form would have to be made bearing in mind not just the likely future tax savings but also the wider commercial costs and operational matters, including the use of tax losses (if any) and the impact on economic and solvency capital of the group.

3. Whether the combined impact of the foreign dividend exemption rule, repeal of the indirect FTC system and the disallowance of a direct FTC claim will increase or decrease a Japanese company's overall global tax liability on foreign dividends and its effective tax rate will vary from company to company depending upon their particular circumstances. Companies should prepare simulations to assess the combined impact of the new rules, transitional rules and related tax reform in foreign countries, and, if necessary, reconsider their policies for the repatriation of profits from foreign subsidiaries. In some cases, it may be necessary for a company to undertake a reorganisation of its foreign subsidiaries in order to maximise its tax position under the new rules.



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Malaysia

Takaful – its development and the ensuing tax issues

The birth of *takaful* is not recent. The concept of *takaful* has been practiced as far back as the Ottoman Empire although it is only in the last few decades that *takaful* has gained prominence. One of the driving factors is the growth of Islamic finance and demand for Shariah compliant business solutions as the economies of the Muslim countries prosper.

Malaysia has long been and continues to be a proponent of Islamic finance. Today, there are eight *takaful* and three *retakaful* operators in Malaysia with plans to issue two new licences with 70% foreign participation. The Malaysian *takaful* market has doubled in asset size over the last five years and the penetration rate is expected to reach 20% by 2010.

Whilst conventional insurance and *takaful* share the same objective, i.e. to provide coverage to policyholders in the event of unforeseen contingencies, the mechanics to arrive at that same aim are different. This has created quite a headache when conventional tax rules and principles are applied to the taxation of *takaful*.

In this article, we will highlight the differences between conventional insurance and *takaful*. We will then proceed to discuss some of the tax issues faced by *takaful* operators in Malaysia.

Concept of *takaful*

Conventional insurance has many elements, activities and procedures that are considered as unethical and unlawful by the majority of Islamic scholars. They include elements such as uncertainty, ambiguity or deception (*gharar*) in contract, gambling (*maisir*) or a consequence created by the presence of uncertainty and excessive interest (*riba*).

Takaful is an alternative to conventional insurance whereby a group of participants agree to jointly guarantee each other against a defined loss. The aim of *takaful* is to spread the risks and losses among a large number of participants. *Takaful* reinforces the idea of shared responsibilities, joint indemnity, common interest and solidarity. The presence of moral value and ethics whereby business is conducted openly in accordance with utmost good faith, honesty, full disclosure, truthfulness and fairness in all dealings is another feature that forms the basis of the *takaful* framework.

Takaful models

Theoretically, *takaful* is perceived as cooperative insurance, where members contribute a certain sum of money to a common pool. The purpose of this system is not profits but to uphold the principle of “bear ye one another’s burden.”

The role of this practice indicates that the policyholders are in fact the managers of the fund and the ones in ultimate control. However, the commercialisation of *takaful* has produced several types of Islamic insurance, each reflecting a different experience, environment and perhaps a different school of thought.

The most widely used business models are *Mudarabah* (profit sharing) and *Wakalah* (agency) and *Wakalah Waqaf* (public foundation). There are also combinations of these three models in practice. Irrespective of the models used, they generally contain the following elements:

- Cooperative risk-sharing for protection amongst participants;
- Clear segregation of roles for participants and operators;
- Incorporates *Tabarru’* or *Waqaf* concept to eliminate *Gharar*;
- Avoids *Riba* and *Maisir*;
- All transactional aspects, i.e. investment, etc., are in compliance with Shariah Law; and
- There must be Shariah Advisory Council as advisors.

Mudharabah model

The process flow of a simple *takaful* product under the *Mudharabah* model is as illustrated below:

In a *Mudharabah* model, the *takaful* operator acts as a *Mudharib* (entrepreneur) and the participant as *Rab-ul-Mal* (capital provider). The *takaful* operator manages the operations of the fund in return for a share of the surplus. This surplus is derived from the operations of

the *takaful* fund (Risk Fund in below diagram) and/or the investment returns. This surplus is shared in the pre-agreed proportion between the operator and participants of the fund. Any loss or deficit arising from meeting the liabilities of the *takaful* fund are to be borne solely by the participants as the providers of the capital on the condition that the operator is absolved from any misconduct and negligence actions, and in that case the *Mudharib* is not entitled to receive any compensation for his efforts.

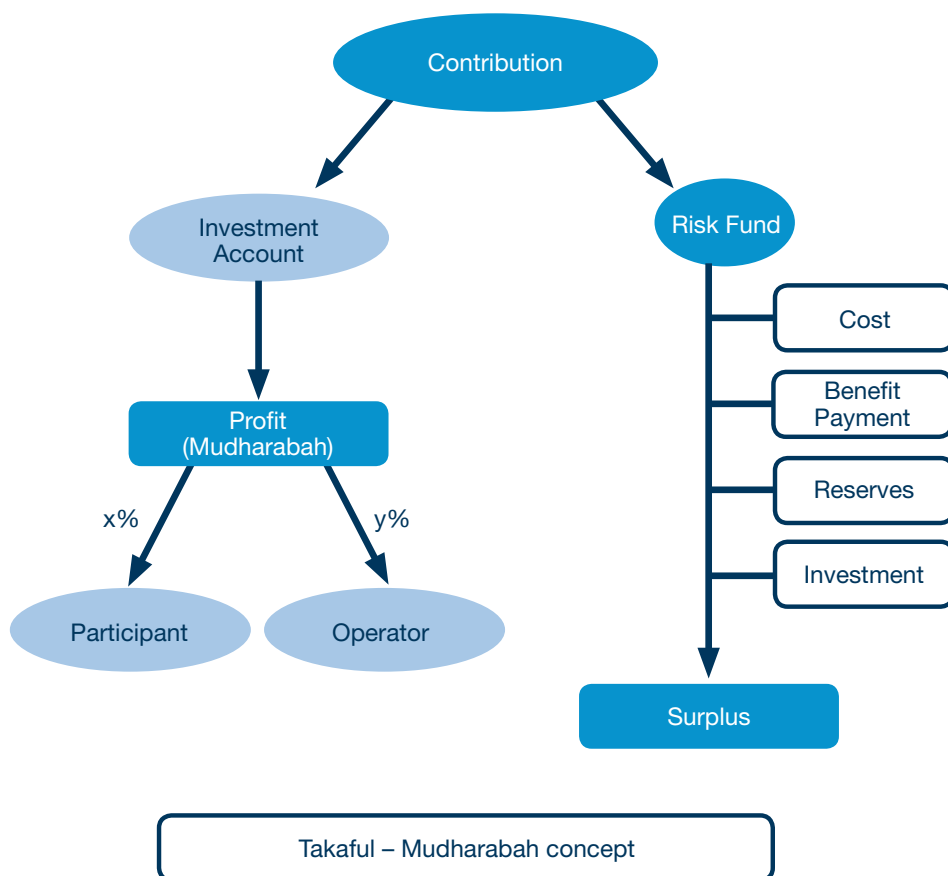
Wakalah model

In a *Wakalah* model, the *takaful* operator acts as the agent on behalf of the participants. The operator is paid a pre-agreed management fee termed as *Wakalah* fee which is usually a percentage of the contributions paid by the participants for the services rendered in respect of underwriting, management and investment of the fund. This is normally deducted upfront from the contributions.

In underwriting, the *takaful* operator acts as an agent on behalf of the participants to manage the *takaful* fund. Any liabilities for risks underwritten are borne by the fund and any surplus arising from it belongs exclusively to the participants. The operator is not liable for any deficit of the fund. In some *Wakalah* models, the operator does not share in the underwriting surplus. As for the management of the investment activities of the fund, the operator is also paid a *Wakalah* fee or performance fee based on an agreed percentage.

Differences between conventional insurance and *takaful*

From the above process flow it can be seen that the contributions made in a *takaful* are earmarked for certain purposes. The main feature of *takaful* which is absent in conventional insurance is that *takaful* incorporates the concept of donation (*tabarru'*).



We summarise the following key differences between conventional insurance and *takaful*:

- **Buying and selling (bilateral) contract vs contract of *tabarru'* (unilateral)**

Conventional insurance involves a contract of exchange (sale and purchase) between insurer and insured. The insurer sells and policyholder buys the insurance policy in return for insurance coverage as opposed to a unilateral undertaking of contribution from individual participants.

- **Guarantee given by insurer vs participants guaranteeing each other**

Under conventional insurance, in return for the payment of a premium, the insurer will guarantee the insured with compensation in the event of a misfortune. In *takaful*, the participants will agree to guarantee each other in the event a misfortune befalls one of them.

- **Insurance is risk transfer whereas *takaful* is risk sharing**

In conventional insurance, the insured is transferring the risks of misfortune to the insurer whilst in *takaful*, the risks of the insured are shared amongst all participants.

- **Claims paid from insurer's fund vs claims paid from *tabarru'* fund**

In conventional insurance, claims made by the insured are paid out of the insurer's fund whereas the claims in *takaful* are paid out of the *tabarru'* fund.

- **Risk taker vs fund manager**

The conventional insurer will manage the premium collected to earn maximum profits from underwriting and as such bears any risk of loss. In *takaful*, the insurer or *takaful* operator is merely the manager of the contributions made by the participants.

- **Profit motive, maximising returns to shareholders vs community well-being**

The conventional insurer manages its business to maximise profits to its shareholders whereas in *takaful*, the focus is on optimising operations for affordable risk protection to participants as well as fair profits for the operator.

- **Shariah compliant vs non-shariah compliant**

Investments made by *takaful* operators must comply with Shariah principles.

- **Premiums belong to the insurer vs contributions belong to the *takaful* fund (participants)**

In conventional insurance, premiums paid are for the insurer to discharge its duty to provide cover for policyholders and any surpluses from underwriting belong to the insurer. In *takaful*, contributions paid are partly invested and a portion is credited as *tabarru'* which is used for mutual assistance. Any surpluses from underwriting and profits from investment will be returned to the participants and in some cases, profits from investment are shared with the *takaful* operator.

- **Discretionary distribution vs predetermined distribution**

In conventional insurance, the profits and/or bonus units to be returned to policyholders are determined by the management and Board of Directors of the insurer. The *takaful* contract specifies in advance how and when profits/surplus and/or bonus units will be distributed.

New tax legislation

In the past, the lack of understanding of the differences between conventional insurance and *takaful* had posed difficulties for the taxation of *takaful* operators in Malaysia.

Previously *takaful* operators were taxed in the same manner as conventional insurers whereas the concept of *takaful* clearly differs in some respects. In recognising such differences, the tax legislation has since been amended to address those issues and to ensure that the industry does not suffer any tax impediments compared to its conventional counterpart. However, some ambiguities still remain under the new legislation and there is a need for further clarification.

Capital allowance claim

The change in tax legislation did not address the issue of capital allowance (CA) claim for *takaful* operators. Similar to the tax provision for conventional insurance, the tax legislation for *takaful* does not provide a claim for CA to be made under the Shareholders' Fund. However, unlike conventional insurance, *takaful* operators will own fixed assets employed in their business of managing the *takaful* funds as opposed to the *takaful* funds owning the assets. Therefore, the tax legislation as it stands puts the *takaful* operators in a disadvantageous position as they are taxed on the income they receive from managing the *takaful* funds but are not able to claim any CA on the fixed assets that they own and use to generate that income.

Notwithstanding the legislation, the current practice adopted by most of the *takaful* operators with regards to CA under the Shareholders' Fund is to allocate the CA between the Family Fund and General Fund based on gross contributions.

Definition of profits distributed / credited

The tax legislation was also amended with regards to the tax treatment of the participants' share of profits in a *takaful* scheme. Previously, as there was no provision in the tax legislation to address this item, all the income of the *takaful* funds including the portion of profit share due to participants ended up being taxed under the *takaful* operators' business. The tax legislation was amended to allow the proportion of profits distributed and credited to the participants out of the Family and General *takaful* Funds to be given a tax deduction. However, in the absence of a clear definition of what constitutes "amount distributed or credited", different *takaful* operators may end up applying different interpretations and tax treatments with regards to the deduction claimed. The different treatments taken give rise to different tax implications and potentially put the *takaful* operators in an uncertain situation in the event that their tax computation is audited by the tax authorities.

Withholding tax on profits distributed to participants

A tax deduction is given in arriving at the *takaful* operator's adjusted income. Correspondingly, the tax legislation requires the *takaful* operator to deduct tax from the distributions made to the participants and the rate of tax applicable depends on the profile of the respective participants.

This requirement to monitor distributions and deduct the relevant withholding tax is difficult to comply with. A distribution of profits to participants could take place every month, and in the case of the General Fund, the distribution could be upon maturity of each policy. Considering the volume of the policies written, the frequency of distribution of profits is likely to be very high in any particular year. As such, compliance with the new withholding tax provision for *takaful* distributions will pose an administrative challenge to the *takaful* operator. Any failure to comply with this withholding tax requirement could subject the *takaful* operator to penalties.

Timing of deduction of profits distributed

The amount to be distributed or credited to participants out of the *takaful* funds which will be determined by the actuary at the end of the financial year may not be immediately disbursed and the eventual amount distributed may also differ. This raises the question of the timing of deduction and remittance of the withholding tax to the tax authorities. The amount to be subjected to withholding tax is another area which needs further clarification from the tax authorities.



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Taking up with relevant authorities

As outlined above, there remain significant tax issues faced by the *takaful* industry in Malaysia. These issues have been taken up with the relevant authorities on a consolidated basis by the Malaysian Takaful Association.

Malaysia is positioning itself to be a significant world player in *takaful* and having clear taxation rules will no doubt help spearhead the development of its *takaful* industry.

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New Zealand

Introduction of new life insurance taxation regime

The Taxation (International Taxation, Life Insurance and Remedial Matters) Act 2009 received royal assent in New Zealand on October 6, 2009. The Act includes a completely new framework for the taxation of life insurance in New Zealand. The changes will apply to all life insurers for new business written by them on or after July 1, 2010.

The new rules will have a significant impact on life insurers. For example, life insurers who write term risk policies will incur substantially more income tax than that payable under the current regime. They will need to develop an effective strategy to deal with the additional tax cost to their businesses. Life insurers will also need to carefully manage implementation issues associated with the new regime to ensure that tax on both transitional and new business is reported correctly.

The need for change

New Zealand's existing life insurance taxation regime was introduced in 1990. It taxes life insurers on two distinct bases – a life office base to tax all profits; and a policyholder base to tax investment income attributable to policyholders. A policyholder memorandum account is then used to prevent the double taxation of policyholder income. Generally speaking, life insurance proceeds are received tax free in the hands of policyholders on the basis that tax is paid at the policyholder base level by the life insurer.

The New Zealand life insurance market in 1990 consisted primarily of policies with both risk and savings elements. The existing regime was designed around these products. Since then there has been a substantial shift towards term risk life insurance products, to the extent that they now comprise well over 50% of the New Zealand life insurance market. By comparison, term risk products comprised less than 10% of the market in 1990.

Under the current taxation regime, underwriting income for tax purposes comprised of mortality profit, premium loading and discontinuance profit. These concepts are all prescribed by formula. However, they are inappropriate for term risk policies as:

- pure risk policies generally operate at substantially higher profit margins than the premium loading allocated under current legislation;
- discontinuance profit is generally negligible for term risk business; and
- mortality profit is assumed to zero out over time for term risk policies.

The government has introduced the new life insurance taxation regime to ensure that the level of tax imposed on term risk policies commensurate with the underlying accounting and economic profit.

New life insurance taxation regime

The new life insurance taxation regime will apply to all new business written by insurers from July 1, 2010. Elective transitional measures are in place for business written before July 1, 2010.

The new taxation regime continues to tax life insurers on two separate bases – a shareholder base to tax income attributable to company shareholders; and a policyholder base to tax investment income attributable to policyholders. However, unlike the existing regime, these two bases are vertically separate. A policyholder memorandum account is therefore not required to eliminate double taxation.

The method of calculating underwriting income for tax purposes also changes. For term risk policies, it is now calculated as the risk portion of insurance premiums and reinsurance claims (expected to be close to 100%) less the risk portion of insurance claims and reinsurance premiums (also expected to be close to 100%). This will result in a significant increase in the tax liability for life insurers, especially those specialising in term risk products.

The vertical separation of the shareholder and policyholder bases means that investment income is now required to be split between that attributable to shareholders and

that attributable to policyholders. This split is to be done using an actuarially determined methodology.

The new life insurance taxation regime also provides life insurers with concessionary tax rules for investment income attributable to policyholders. This income is now able to be taxed in the same manner as the investment income of a portfolio investment entity (i.e. no tax on gains from the sale of certain Australasian investments).

In summary, the taxable income generated by the shareholder and policyholder bases includes the following amounts, as shown in Table 1.

Transition

There are a number of concessionary transitional rules that are designed to assist life insurers with their entry into the new life insurance taxation regime. In particular, the tax treatment of various life insurance policies entered into before July 1, 2010 will be grandfathered and taxed in the same concessionary manner as arises under the existing regime, as shown in Table 2.

Table 1

Shareholder Tax Base	Policyholder Tax Base
Premium income (risk portion only)	Investment income (policyholder portion only)
Investment income (shareholder portion only)	
Fee and commission income	
Reinsurance claims (risk portion only)	
Transitional policy income	
Income from other sources	
Less	Less
Claims (risk portion only)	Investment expenses (policyholder portion only)
Reinsurance premiums (risk portion only)	
Plus/minus movements in risk reserves	
Investment expenses (shareholder portion only)	

Table 2

Policy type	Grandfathering period
Single premium policies	Duration of the policy
Fixed level premium policies	Longer of 5 years or duration of the policy
Yearly renewable term risk policies	5 years

Life insurers can opt out of the transitional rules for a class of policies, although such an election is irrevocable. The transitional rules are also revoked when the insurance cover for a policy breaches the greater of:

- 10% of the previous year's insurance cover; and
- the percentage change in the consumer price index for the previous income year.

Key impact

Life insurers will need to make substantial changes to current accounting, tax, and actuarial reporting systems to ensure that their taxable income is reported in accordance with the new life insurance taxation regime. The impact of a significant increase in the level of taxation on term risk business is also likely to have a flow on effect to product pricing, commission structures, and potentially shareholder returns. Given the tight timeframes, life insurers will need to respond quickly to ensure they successfully manage the accompanying business risks and opportunities.



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Singapore

Tax developments insurers should be aware of

Over the last few years, we have seen a number of tax changes to the Singapore insurance scene. This includes the introduction of a new taxation framework for life insurers made necessary by the adoption of the Risk-Based Capital (RBC) framework by the insurance industry in 2005. It also includes the introduction of various tax incentives aimed at promoting the growth of Singapore as a regional insurance hub with capability and capacity to write various types of specialised risks. While these changes are effective much earlier on, it is not unusual for the actual legislative amendments to be made some years later. 2009 must have been a catch-up year as we saw in this year, the release of a series of new and updated subsidiary income tax legislations. We will in this article set out some of these new legislative amendments.

We will also highlight in this article some other topical changes during the year that is of relevance to the insurance industry. The first is an enhancement to the Financial Sector Incentive – Headquarters Services Award announced in January this year. Next up are a couple of interesting proposed legislative changes contained in the Income Tax (Amendment) Bill 2009. One of them deals with withholding tax and the other deals with transfer pricing.

Updates to existing insurance tax incentive regulations

In 2009, the following tax regulations, which set out the rules for various insurance tax incentives, were amended.

- Income Tax (Concessionary Rate of Tax for Approved Offshore General Insurers) Regulations
- Income Tax (Concessionary Rate of Tax for Approved Offshore Composite Insurers) Regulations
- Income Tax (Concessionary Rate of Tax for Approved Offshore Life Insurers) Regulations

These regulations were amended to include provisions for two incentive schemes that were announced much earlier, i.e. the tax exemption scheme for “approved captive insurers” and the tax exemption scheme for “approved specialised insurers”. The requirement for an insurer to apply for a particular tax concession within three months of commencement of its business was also removed. There are no material consequences arising from these changes as they were more or less in line with what had already been announced earlier on.

A welcomed change was tucked away in Regulation 8 of the Income Tax (Concessionary Rate of Tax for Approved Offshore Composite Insurers) Regulations. Previously, the regulation provided that, for tax

purposes, a composite insurer or reinsurer must allocate common expenses, capital allowances and deductible donations between its life and non-life businesses and between its different classes of incentive businesses using the ratio of gross premiums of the respective businesses. This is the requirement notwithstanding the fact that the insurer may have used some other suitable and perhaps more appropriate allocation basis for accounting purposes. The regulation has now been amended to provide that the Inland Revenue Authority of Singapore (IRAS) may allow alternative methods of apportionment. This should give composite insurers and reinsurers more flexibility in the way common expenses are allocated. It would have been even better if this same flexibility was incorporated in the regulations applicable to insurers and reinsurers that do not have a composite license.

Updates to life insurance tax regulations

In 2009, the following tax regulations were issued for life insurers:

- Income Tax (Adjustment on Change of Basis of Computing Taxable Surplus of Life Insurers) Regulations 2009
- Income Tax (Concessionary Rate of Tax for Income of Life Insurers Apportioned to Policyholders) Regulations 2009

The above two new regulations, which took effect from the year of assessment 2006, seek to codify the transitional adjustments needed to transition from the previous taxation regime to the RBC taxation regime for life insurers. It also seeks to update the existing Section 43(9) regulations that deal with the allocation of participating fund surpluses between Shareholders and Policyholders. It is interesting to note that, with the amendment, captive life insurers are no longer subject to the Section 43(9) apportionment.

New tax regulation on broking incentive

The following new regulation was also issued in 2009 for insurance brokers:

- Income Tax (Concessionary Rate of Tax for Approved Insurance Brokers) Regulations 2009

This new regulation, which is deemed to have taken effect from April 1, 2008, sets out the provisions for the “approved insurance brokers” incentive scheme which was first announced by the Finance Minister in February 2008. This incentive scheme grants a 10% tax rate to qualifying income derived by an approved insurance and reinsurance broker from insurance broking services and insurance advisory services rendered to non-Singapore based clients.

Enhancement to the Financial Sector Incentive – Headquarters Services

Under the Financial Sector Incentive – Headquarters Services Award (FSI-HQ) scheme, insurance groups who base their head office or regional offices in Singapore typically apply for and, if approved, enjoy a 10% concessionary tax rate on their income derived from the provision of qualifying headquarters services to their qualifying network companies.

Enhancements to the FSI-HQ scheme was first announced by the Finance Minister in the January 2009 Budget. Since then, the Monetary Authority of Singapore (MAS) has released a circular setting out more details of this enhancement. We highlight below two key enhancements.

The first enhancement deals with the extension of the FSI-HQ scheme to Singapore-based associated companies and offices. Currently, the 10% incentive tax rate only covers income derived from the provision of qualifying headquarters services to qualifying overseas offices. From January 22, 2009, Singapore-based associated companies and offices can now qualify as network companies (also referred to as “Local Network Companies or LNCs”) throughout the FSI-HQ company’s award tenure.

The inclusion of the LNCs is subject to MAS’ approval, and there is a pre-qualifying condition that the total annual revenue of these LNCs does not exceed 10% of the insurance group’s annual total revenue globally as presented in the consolidated financial statements of the ultimate parent company of the group. Given the relative size of the Singapore insurance operations to the global operations of most foreign-based multinational insurance groups, it is our view that almost all current holders of the FSI-HQ award should be able to meet this pre-qualifying condition.

The other enhancement is the introduction of a withholding tax exemption for interest on qualifying loans paid by a FSI-HQ company to a non-resident qualifying person. There are qualifying conditions to be met for a loan to be regarded as a “qualifying loan”. They include requirements for the loan to be denominated in a non-Singapore currency, that the loan must (broadly speaking) be from outside Singapore and that the funds from the loan must be used only for the FSI-HQ company’s qualifying services. The application for approval to enjoy this incentive must be made to the MAS.

Proposed change – withholding tax on management services

Currently, under Singapore domestic law, payments for technical and management services performed by non-residents are subject to withholding tax at the prevailing corporate tax rate of 17%.

In a press statement issued in 1977 to address the scope and interpretation of the withholding tax provisions, the Ministry of Finance (MOF) had clarified that services performed offshore and charged at arm's length are not caught under the withholding tax system. However, in the case of management service fees paid to related parties, there was an additional condition. The fees for services rendered must be charged on a cost reimbursement basis, with no profit mark-up.

The incongruence of this requirement with the accepted transfer pricing rules has been highlighted repeatedly to the authorities over the years but to no avail. Multinational insurance companies, particularly those whose head offices are outside Singapore, compelled by home country transfer pricing rules to transact at arm's length often face difficulties in meeting this cost reimbursement condition, and, if no treaty relief is available, they will be subject to withholding tax on their gross income.

It is therefore a welcomed change that the MOF is finally proposing to remove the cost reimbursement requirement in the Income Tax (Amendment) Bill 2009. The Amendment Bill was read into Parliament for the first time on September 14, 2009 and is expected to eventually pass before the end of 2009.

The Income Tax (Amendment) Bill 2009, if passed in its present form, will also codify the rules laid out in the above-mentioned MOF 1977 press statement.

Proposed new transfer pricing provision

A new transfer pricing provision has also been included in the same Income Tax (Amendment) Bill 2009. Framed broadly along the lines of Article 9 of the OECD Model Tax Convention, it grants the IRAS the authority to make transfer pricing adjustments to related party transactions that are not concluded at arm's length.

The new provision defines related party by reference to control – a person is considered to be related to another person if: he controls that other person; if he is controlled by that other person; or if they are under the control of a common person. In all cases, control includes direct and indirect control. In addition, the new provision will apply to a person who carries on business through a

permanent establishment (PE), as if the person and the PE were two separate and distinct persons.

The IRAS has in the recent past issued a series of circulars setting out, among other things, their view on the arm's length principle, the transfer pricing documentation requirements and how they apply in the context of related party loans and services. The enactment of specific legislation is a natural extension to those circulars and signals their intention to step up transfer pricing reviews and audits. These developments in turn indicate the IRAS' aim to make transfer pricing a cornerstone of Singapore's international tax policy.

Insurance companies typically operate across borders and many have set up shared service hubs or centres of excellence to achieve efficiencies. Such business models would lead to significant cross border related party transactions. In view of the increased focus on transfer pricing, insurance companies should review their existing intercompany arrangements and ensure the relevance of their transfer pricing policy and documentation in light of their business model. This is to ensure that their policy is able to withstand scrutiny from the IRAS. Otherwise, any tax adjustment would potentially negate the tax benefits for insurers, especially those who have chosen to base their operations in Singapore to enjoy the various tax incentives.



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Taiwan

Current tax developments – some favourable, some not so

There have been a number of tax developments affecting insurance companies in Taiwan. Some are favourable while others are not.

One recent update that has caused quite a stir in Taiwan's insurance industry is the government's decision to tax investment-linked insurance policyholders. Despite strong opposition from local industry players, the government is adamant that the tax will be imposed.

On the other hand, developments in the general tax environment offered some favorable tax treatments for insurance companies, including the reduction of the corporate income tax rate and the extension of the loss carry-forward period. Other "sweeteners" include the revision of Assessment Rules of Profit-Seeking Enterprise Income tax which now offers more relaxed tax deduction rules on certain expenses and the long-awaited release of the Guideline for Determination of Taiwan-Sourced Income.

This article highlights some of these salient changes in the tax environment.

Income from investment-linked insurance policy no longer free from tax

Effective from January 1, 2010, policyholders will be taxed by income category on investment proceeds accrued in the distinctive investment account of their investment-linked insurance policy (ILP).

Whilst the tax exemption benefit remains for proceeds attributable to the life insurance portion, policyholders will now have to include certain proceeds accrued in the distinctive investment account of their ILPs into their tax returns.

Typically, investment income earned in the distinctive investment account would include capital gains from securities transactions, interests and dividends; and these can be derived both onshore and offshore.

Under the new ILP taxation rules, certain income such as deposit interest income and dividends from Taiwan companies should be reported by the policyholders for their personal taxation purposes. On the other hand, under the Income Tax Act, capital gains from Taiwan securities transactions are tax free in the hands of individual policyholders. As for offshore income, they should be included in the alternative minimum tax (AMT) calculation effective from January 1, 2010.

The Ministry of Finance (MOF) believes that this new tax policy will have only a minor impact on policyholders as proceeds from ILP are relatively small. In addition, interest income would only be taxed if the amounts exceed the NTD270,000 exemption threshold.

For the insurers, however, this tax policy will mean increased compliance and administrative burden. The insurers will have to ensure that they have the systems and administrative capability to

produce yearly reports to inform the ILP policyholders of their individual share of the types of investment income accrued in their distinctive investment account. Such information will need to be of sufficient detail for the policyholder to accord each component the correct treatment for his own personal tax purposes. In addition, if a resident policyholder were to convert to a non-resident status, the insurer may need to withhold additional tax accordingly and remit the relevant tax to the Tax Authorities.

In addition to the above income tax assessment, it has also been proposed that payouts from the distinctive investment account of a "non-qualified" ILP will be subject to gift tax or estate tax upon maturity or termination of the ILP if the beneficiary of the ILP is not the policy holder. This proposal is currently being reviewed.

It may be a little early to assess the impact of the above tax policy on the ILP market in Taiwan. However, some believe that the tax levy will discourage consumer savings and impede the growth of Taiwan's insurance industry.

Potential tax savings based on new interpretation of Taiwan-sourced income

For years, the National Tax Administration (NTA) has deemed fees paid for services rendered to foreign service providers but utilised

within Taiwan as Taiwan-sourced income. Such fees were then subject to withholding tax regardless of where the services were rendered.

In general, the broad view taken by the NTA had made it more expensive for multinational companies to transact with Taiwan companies. Finally on September 3, 2009, the Ministry Of Finance released the Guideline for Determination of Taiwan-Sourced Income under Article 8 of the Income Tax Act (the Guideline). This Guideline sets out a new interpretation for determining whether an income is Taiwan-sourced or not.

Highlights of the Guideline are as follow:

1. The location where the services are rendered is determinant of Taiwan-sourced service income, not where the services are utilised. Service fees paid for services rendered completely offshore are not deemed as Taiwan-sourced income. However, where the services are partly rendered in Taiwan or are rendered with local involvement and assistance, the income shall be deemed as Taiwan-sourced.
2. Business profits should be segregated into onshore and offshore portions based on relative contributions. Only the onshore business profits will be regarded as Taiwan-sourced income.

3. Income comprising various income types shall be classified into appropriate categories (i.e. royalties, service fees or rental, etc.) based on their income nature and taxed accordingly.
4. Taiwan-sourced income paid to foreign companies will be subject to withholding tax. However for certain types of income (e.g. remuneration for services rendered, rentals, business profits, awards or grants from participating in skill contests, games, or lotteries and other incomes), the foreign company may appoint a tax agent in Taiwan to file a return, claim a tax deduction for any related expenses incurred and apply for a tax refund within five years from the date of payment. The foreign company may opt to file the application for each withholding tax payment or for the aggregated income derived in each taxable year.

Reduced corporate income tax rate to 20%

Taiwan's corporate income tax rate will be reduced from 25% to 20% for fiscal year beginning 2010 and onwards. Additionally, the exemption threshold for corporate income tax will be raised from NTD50,000 to NTD120,000. For companies with year-ends other than December 31, the 20% reduced income tax rate will first apply in the fiscal year where the period begins in 2010. For example, for a company with fiscal year ending June 30, the first taxable period

where the 20% income tax rate would apply is from July 1, 2010 to June 30, 2011.

The reduction of tax rate to 20% will reduce the tax burdens of Taiwan's insurance companies.

Loss carry-forward period extended to 10 years

To increase the competitiveness of Taiwan companies, the tax loss carry forward period has been extended from five years to 10 years, with all other conditions remaining unchanged.

The extension applies to losses incurred before January 23, 2009 but not yet utilised. For example, for companies with June 30 year-ends, unutilised losses incurred during the taxable period from July 1, 2003 to June 30, 2004 and onwards can now be carried forward for 10 years.

Insurance companies in tax loss positions may need to re-look into their deferred tax calculations.

Regional allocated costs now tax deductible

Currently, the Taiwan branch of a foreign company is allowed to claim a tax deduction for general and administrative expenses allocated by its direct head office.

In addition to the above, a tax deduction is now permissible on general and administrative expenses allocated by its regional head office. The methodologies

available for allocating the general and administrative expenses and the documentation requirement to support the regional head office claim remain the same as those for direct head office allocated expenses.

Hence, foreign insurance companies with regional head offices (commonly in Hong Kong or Singapore) may now consider allocating reasonable amounts of regional head office expenses to their Taiwan branches. Apart from the direct potential tax savings for the Taiwan branch, the regional head office may now be able to recover part of its regional expenses incurred in relation to the Taiwan branch and these tax-deductible regional office expenses are also free from withholding tax.



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Thailand

The various challenges facing insurance companies

Although Thailand has emerged relatively unscathed from the financial crisis, the Thai insurance industry is still facing imminent changes. On the cards are proposals for the implementation of a Risk-Based Capital framework and the adoption of International Financial Reporting Standards in 2011. Due to the dynamic development of these regulatory requirements and accounting standards, the Office of Insurance Commission of Thailand has been issuing many new requirements for insurance companies to comply with.

However, as far as tax treatments are concerned, only those provisions under the Thai Revenue Code are relevant and we are seeing increasing mis-alignment between regulatory requirements and tax treatments. It is crucial that management understands the tax risk areas and challenges that they are facing so that effective decisions could be made.

Policy liabilities – tax reserves not aligned with actuarial reserves

Under Thai tax laws, there are upper limits placed on the deductibility of policy liabilities.

For non-life insurance businesses, the amount of unearned premium reserves deductible in any year is limited to 40% of net premiums written in the accounting period.

For life insurance businesses, the reserve for policyholder liabilities is

allowable as a deductible expense provided it does not exceed 65% of net premiums received in the accounting period.

The above tax rule imposes a heavy burden and presents challenges to insurance companies, especially life insurance companies. Due to the differences between the actuarial reserves and the deductible tax reserves as well as the recording requirements of claim expenses, regular reconciliations between both reserves are always required.

In addition, life insurance companies face the ambiguous classification of riders attached to life insurance policies. The issue is whether the rider should be regarded separately as a non-life policy and be subject to the 40% reserve limit, or as a part of the life insurance policy and be subject to the 65% limit instead.

Indirect taxes

Generally speaking, life insurance is a business that is subject to Special Business Tax (SBT) at the rate of 2.75%, of which the tax base comprises of interest, fee and consideration for services. Non-life insurance, by contrast, is subject to Value Added Tax (VAT) at the current tax rate of 7%, of which the tax base is the premiums collected. This may sound simple; however, in practice there are many indirect tax issues that insurance companies should be aware of since it is not always the case that a life insurance company will be subject only to SBT and a non-life insurance company subject to VAT.

The Personal Accident policy dilemma

As both life and non-life insurance companies in Thailand can issue a Personal Accident policy, there used to be a debate as to whether this product should be subject to SBT or VAT. The Thai Revenue Department finally settled the argument by issuing a tax ruling stating that a Personal Accident policy is an SBT product regardless of whether it is issued by a life insurance company or non-life insurance company.

This interpretation then raised further questions for non-life insurance companies on how the tax base should be calculated. Since non-life insurance companies are more familiar with using premiums as the tax base when calculating VAT, there arose a question as to whether they can apply the same concept and regard the premium from a Personal Accident policy as the base for SBT. Alternatively, as a premium is not included in the SBT tax base for life insurance, would this mean that the non-life insurance company needs to capture the portion of the interest derived from investing the Personal Accident policy's premium and regard that as a SBT tax base? If that is the case, which approach would be appropriate to calculate such tax base, as in practice, the investment portfolios normally consist of a mixture of interest incomes from many products. Up to now, no regulation or guideline has been issued to clarify the situation.

Gains on sale of debt instruments by life insurers

Another challenge that has been the subject of much discussion is whether the gain from the sale of debt instruments of life insurance companies should be subject to SBT. There are two possible distinct interpretations of this issue, which are:

1. No SBT – as SBT should be levied on the category of business (i.e., SBT should be imposed only on the tax base as specified for life insurance business, i.e., interest, fees and consideration for services); or
2. Pay SBT – as SBT should be levied on the type of transaction (i.e., the gain from selling debt instruments is subject to SBT as a transaction/business conducted in a similar manner to that of a banking business).

If the latter interpretation were to be applied, a further question would be whether insurance companies should apply its normal SBT rate for life insurance business of 2.75% or can it also enjoy the reduced SBT rate of 0.011% granted to certain banking transactions. With regards to this question, the Thai Revenue Department appears reluctant to clarify the position and has so far remained silent on the matter.

Life insurers can also be subject to VAT

Though life insurance is a SBT business, it does not mean that VAT will not be applied to life insurance companies. In fact, life insurance companies should be aware that they can also be subjected to VAT if they were to engage in a transaction that falls under the VAT regime.

Managing challenges

Unless there is a change to the corporate tax rules, the difference between book and tax treatment of various items will continue to be a massive accounting and administrative burden for insurers. In addition, the indirect tax rules applicable to insurers are complex. Insurers must therefore stay focused and be aware of the tax challenges they face. Not only should insurers prepare for the approaching storm of regulatory and accounting changes, they should also ensure that they have the systems and accounting capability to produce the necessary information for tax reporting purposes.



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