TAXATION PRINCIPLES & PRACTICES

AND

LIFE INSURANCE TAXATION

by

ISAGANI DE CASTRO, F.A.S.P.

TABLE OF CONTENTS

Table of Contents (continued)

INTRODUCTION

This Study was prepared principally for providing notes to students preparing for a course examination in the Actuarial Society of the Philippines. Although this treatise can serve as reference for the study of taxation in general, even by non-actuarial students, its principal focus is on taxation of life insurance to highlight this financial product's unique characteristics as a financial instrument from the tax viewpoint.

Its secondary objective is to document the historical development of taxation of life insurance products and life insurance companies in the Philippines, where changes are believed to have been undertaken without a deliberative study of the counter-productive effects of taxes on life insurance and its important role in the country's socio-economic development.

This Study Note is a compendium of the relevant topics from several reference materials, namely:

1. The National Internal Revenue Code of the Philippines, 1995 Revised Edition, as amended, reprinted in 1996, and edited by Jose N. Nolledo. His annotations from his published 1993 edition were also a source of information.

2. **Law of Basic Taxation in the Philippines**, by Benjamin B. Aban, LL.B., M.A., 1994.

3. A Study by the UNCTAD (UNITED NATIONS CONFERENCE on TRADE and DEVELOPMENT) Secretariat, entitled - **Establishing life insurance tax policy in developing countries**, dated 12 December 1985.

4. **Principles of Taxation**, Part 7 Study Note of the Society of Actuaries, by Mr. Wayne E. Bergquist, F.S.A.

INTRODUCTION

This Study was prepared principally for providing notes to students preparing for a course examination in the Actuarial Society of the Philippines. Although this treatise can serve as reference for the study of taxation in general, even by non-actuarial students, its principal focus is on taxation of life insurance to highlight this financial product's unique characteristics as a financial instrument from the tax viewpoint.

Its secondary objective is to document the historical development of taxation of life insurance products and life insurance companies in the Philippines, where changes are believed to have been undertaken without a deliberative study of the counter-productive effects of taxes on life insurance and its important role in the country's socio-economic development.

This Study Note is a compendium of the relevant topics from several reference materials, namely:

1. **The National Internal Revenue Code of the Philippines**, 1995 Revised Edition, as amended, reprinted in 1996, and edited by Jose N. Nolledo. His annotations from his published 1993 edition were also a source of information.

2. **Law of Basic Taxation in the Philippines**, by Benjamin B. Aban, LL.B., M.A., 1994.

3. A Study by the UNCTAD (UNITED NATIONS CONFERENCE on TRADE and DEVELOPMENT) Secretariat, entitled - **Establishing life insurance tax policy in developing countries**, dated 12 December 1985.

4. **Principles of Taxation**, Part 7 Study Note of the Society of Actuaries, by Mr. Wayne E. Bergquist, F.S.A.

4. A write up of the concepts and methodology of the "**Taxation of Life Insurance Companies Operating in the United States**", by the Financial Controls and Reports Committee of the Society of Actuaries.

5. **The Importance of Taxation in Planning the Integration of Life Insurance in a Developing Economy**, a paper by Mr. Isagani de Castro, read in the 4th Third World Insurance Congress, in Casablanca, Morocco, in May 1984.

When using this Study Note as reference for the study of current tax applications, it is advisable that the most recent version of the National Internal Revenue Code be on hand to get an update on the coverages and rates of taxes.

GENERAL PRINCIPLES OF TAXATION

Taxation Defined

Taxation is defined as the power by which the sovereign raises revenue to defray the necessary expenses of government. Taxation is merely a way of apportioning the cost of government among those who in some measure are privileged to enjoy its benefits and must bear its burdens. The nature of taxes is graphically described by the Supreme Court as: "Taxes are what we pay for civilized society. Without taxes, the Government will be paralyzed for lack of the motive power to activate and operate it. Hence, despite the natural reluctance to surrender part of one's hard-earned income to the taxing authorities, every person who is able to must contribute his share in the running of the Government. The Government for its part is expected to respond in the form of tangible and intangible benefits intended to improve the lives of the people and enhance their moral and material values. This symbiotic relationship is the rationale of taxation and should dispel the erroneous notion that it is an arbitrary method of exaction by those in the seat of power."

The Attributes or Characteristics of Taxes

(a) A tax is a forced charge, imposition or contribution and as such it operates *in invitum*, which means that it is in no way dependent on the will or contractual assent, express or implied, of the person taxed. They are positive acts of government.

(b) It is a pecuniary burden payable in money but the tax is not necessarily confined to those payable in money.

(c) It is levied by the legislative body of the State because the taxing power is peculiarly and exclusively legislative in character. Taxes are obligations created by law.

(d) It is assessed in accordance with some reasonable rule of apportionment which means that conformably with the constitutional mandate on progressivity of a taxing system, taxes must be based on ability to pay.

(e) It is imposed by the State on persons, property, or excises within its jurisdiction.

(f) A tax is levied for a public purpose as taxation in itself involves a burden to provide revenue for public purpose of a general nature.

A tax creates a civil liability on the part of a delinquent taxpayer although the non-payment thereof creates a criminal liability which could be the subject of criminal prosecution under existing laws. In short, in taxation, it is one's civil liability to pay taxes that gives rise to criminal liability, not the other way around, as in criminal cases where criminal liability gives rise to civil liability.

Taxes are personal to the taxpayer. A corporation's tax delinquency cannot for instance, be enforced against its stockholders because not only would this run counter to the principle that taxes are personal, but it would also not be in accord with the rule that a corporation is vested by law with a personality that is separate and distinct from those of the persons composing it as well as from that of any other legal entity to which it may be related. However, stockholders may be held liable for the unpaid taxes of a dissolved corporation if it appears that the corporate assets have passed into their hands.

Purposes of Taxation

Governments impose taxes on goods, individuals and organizations for various objectives. The main objective of taxation is to raise revenue to cover government expenditures. However, taxation can be used by governments for many other purposes to manage the economy of the country. Since an increase or decrease in taxes can influence aggregate consumer and business spending, tax policy can combat economic instability, unemployment, and inflation. It is also used to encourage or discourage certain social, political, or economic activities. For example, high taxes on liquor will raise prices of liquor and therefore decrease liquor consumption. Low taxes on a pioneering industry will encourage investments in that industry. Taxes are also used to provide protection to local industries from foreign importations, through protective tariffs and customs duties. These purposes are sometimes in conflict with each other. Government planners must be able to weigh the importance of the various purposes to achieve the desired balance for the good of the country.

Basic Principles of a Sound Tax System

(1) Fiscal Adequacy - The sources of government revenue must be sufficient to meet governmental expenditures and other public needs. This is essential in order to avoid budgetary deficits and so as to minimize foreign and local borrowings.

(2) Theoretical Justice - A good tax system must be based on the taxpayer's ability to pay. This suggests that the system of taxation must be progressive.

(3) Administrative Feasibility - Taxes should be capable of being effectively enforced. Hence, it must not lay down obstacles to business growth and economic development.

Taxation Distinguished From Police Power

Not all government impositions are classified as taxes. To know which are taxes and which are not, it is necessary to distinguish between taxation and police power. The distinctions lie in the following factors:

(1) Purpose: Police power is exercised to promote public welfare thru regulations. Taxation is levied for the purpose of raising revenue.

(2) Amount of Exaction: In taxation there is no limit; in police power the exaction should only be such as to cover the cost of regulation, issuance of the license, or surveillance.

(3) Benefits Received: In taxation there is no special or direct benefit received by the taxpayer other than the fact that the government only secures to the citizen that general benefit resulting from the protection of his person and property and the welfare of all. As to police power, while no direct benefits are received, a healthy economic standard of society is attained.

(4) Non-impairment of Contracts: In taxation, the taxing act cannot impair the obligation of contracts. This limitation does not apply in the exercise of police power.

(5) Transfer of Property Rights: In taxation, taxes paid become part of the public funds. In police power, no transfer but only restraint on the exercise of property rights exists.

Impositions Distinguished From Taxes

(1) Toll - Toll is a demand of ownership. It is an amount charged for the cost and maintenance of the property used. Tax is a demand of sovereignty for the purpose of raising public revenue.

(2) Penalty - Tax is a civil liability. A person is criminally liable in taxation only because he fails to satisfy his civil obligation to pay taxes. Penalty is a punishment for the commission of a crime.

(3) Compromise or compromise penalty - This is an amount that is collected as a compromise in lieu of criminal prosecution in cases involving tax violations. A compromise penalty cannot be imposed by the Commisioner of Internal Revenue. If a taxpayer refuses to pay the compromise, criminal action is the remedy. It is the court who sentences the taxpayer to pay the compromise penalty as part of the judgement.

(4) Special Assessment - A special assessment is levied only on land unlike a tax which is imposed on persons, property and excises. A special assessment cannot be made a personal liability of the person assessed, and it is based wholly on benefit. It is exceptional both as to time and locality.

(5) License fee - License fee emanates from the police power of the State, while a tax is levied in the exercise of the taxing power. The purpose of the license fee is regulatory. The fee must only be of a sufficient amount to include expenses of issuing the license, the cost of necessary inspection or police surveillance.

(6) Margin fee - This is not a tax but a currency measure designed to stabilize the currency such as the exaction of a fee on the remittance of profits earned in the country imposing it.

(7) Debt - Debts are due to the Government in its corporate capacity, while taxes are due to the Government in its sovereign capacity. A debt is a sum of money due upon contract, express or implied or one which is evidenced by judgement. Taxes are imposts levied by the Government for its support or some special purpose which the Government has recognized.

(8) Other imposts not called taxes but can be classified as such are: subsidy, customs duties and fees, tribute, and regulatory taxes.

Purposes of Income Taxation

In the USA, taxation of income of individuals and corporations became an important source of government revenue as government expenditure started to grow. While such growth in government expenditure was first brought about by World War I, and then followed by World War II, the expanding government services, both at the Federal level and State level, even after the wars made income taxation of individuals and corporations a continuing popular source of government revenue because it is based on the concept of ability to pay. The Philippines until the more recent years, has followed the income tax policies of the USA, with income taxation being the major source of revenue for the national government (Federal Government, in the case of the USA), while Local Governments (the State Governments in the case of the USA) depended mostly on taxes on real property, business and sales taxes.

However, taxation of income of individuals and corporations have become also a source of revenue of the States and Provinces in the USA and Canada, respectively, either by sharing of revenue through some formula or by direct collection by some of the States and Provinces. In the Philippines we are seeing a trend, though still slight, towards greater participation of local governments in the collection of taxes related to income of individuals and corporations. The newly imposed tax on insurance premiums by the municipalities and cities is an example.

Taxation is also used for the social purpose of redistributing income from the higher income group to the lower income group, and this is accomplished through the progressive income tax rate system. While this is a laudable social purpose, there is a limit to accomplishing this purpose and at the same time increasing government revenue as well. It has been the experience in the USA and Canada that at the higher marginal tax rates* very little additional tax is produced because taxpayers spend more time on exploiting all methods of tax avoidance and deferral than on earning more income.

As a consequence, both the USA and Canada have tended to reduce the top marginal tax rates. It has become a favorite agenda of some political parties in the USA to suggest that a flat rate of income tax with limited number of deductions is more efficient than the more complex system of increasing marginal rates with a multitude of special deductions, exemptions, and tax credits. Obviously, the idea to adopt a more efficient tax system through a flat tax rate runs counter to the purpose of income taxation of redistribution of income.

* *(As defined in the USA, marginal tax rates are mathematically developed rates which measures the effect of relatively small changes in each component affecting taxable income. They are used to decide whether to invest in tax-exempt securities, common stocks or fully taxable instruments. Marginal tax rates help maximize the after-tax effect of alternative investment decisions, thus help a company optimize its tax position while complying with the Internal Revenue Code and Regulations.)*

In the Philippines, because of the problem of inefficient tax collection (although for different reasons than those of the USA and Canada), the income taxation for individuals was changed to a system of gross income taxation system where only a few deductions are allowed, but still with increasing tax rates for higher incomes. While the increasing rates are there for the purpose of redistribution of income from high income individuals to low income individuals, it remains to be proven that the adopted income graduations realistically define the target income groups. There are reasons to doubt that the purpose of redistribution of income, so important for a country with highly disparate family incomes as the Philippines, is being attained with the present individual income taxation system.

Definition of Taxable Income

The universal view of the concept of income includes the following categories of income:

1. Normal working income (e.g., employment income, commission income and compensation for general services.).

2. Normal investment income, called passive income in the Philippines, (e.g., interest income, dividend income, rental income, and royalties.).

3. Normal trading income from buying and selling (e.g., the profits of the grocery store).

4. Extraordinary income. This form of income is characterized by infrequent but eventual receipt of income, for example, capital gains and losses realized upon disposition of property used to produce working income, investment income or trading income, and also of property held for personal purposes. Extraordinary income is for most people, risk income and artificial income from the increase in general price levels due to declining purchasing value of currency. If the realization of such gains and losses becomes frequent, such gains and losses will become a normal form of investment income or of trading income. A specific description of how capital gains are taxed follows:

<u>Tax on capital gains</u>: Capital gains from sale of stocks and real property, are extraordinary income. These, and certain passive incomes earned by individuals are subject to tax at rates different, usually lower, than those of compensation income. Reasons for taxing capital gains separately and at lower rates are:

a. A substantial portion of capital gains may not be real gains but inflationary gains. This is the reason used in the USA and Canada for exempting from taxes the gains realized on sale of one's residence. Application of this reason to other sales such as shares of stock may also be justifiable since a large portion of investment income also represents inflationary gains.

b. Capital gains are received infrequently, hence would move a taxpayer to a higher tax bracket in the year he receives the gain.

c. Lower tax rates on capital gains encourages investment of risk capital and therefore benefits the economy. Higher tax rates on capital gains than a foreign country may result in flight of risk capital to that country.

d. To tax capital gains from sale of securities which may have risen as a result of the expected change in value of its future income stream in the form dividends payable, may constitute double taxation. Since the dividends would have attracted little or no taxation in the hands of the holder of the security, it is deemed that it should be taxed similarly when the gains are realized.

5. Windfall gains and losses. These include winnings and losses from sweepstakes and gambling, and casualty losses.

6. Transfer payments. This category includes welfare payments, government assistance payments to the aged, disabled, the unemployed, etc. The non-government items may be gifts and inheritances, and certain prizes, awards and scholarships.

7. Compensation for losses. These include insurance proceeds, workmen's compensation payments, damage settlements (in-court or out-of-court) received from others.

8. Other income consists of fringe benefits received by employees from employers, ranging from Christmas gifts, subsidized parking, free lunches, free housing, to employer-paid insurance benefits.

9. Tax-exempt income includes income specifically exempted, such as interest income from bonds or other IOU's of the government that are classified as tax exempt; those income that if taxed will be subject to double taxation as the dividends received by one corporation from another. Foreign income received by a resident corporation may, under certain circumstances such as when defined in a tax treaty, be excluded from the tax base of the country of residence.

Deductions from Gross Income.

While definitions of income are somehow similar among the countries that tax income, there is no uniformity in the definitions of what can be deducted from income. There are a few that appear to be common such as expenses associated with the production of the income, contributions to recognized charitable, government, or religious organizations, contributions to qualified or registered retirement (savings) plans, taxes paid, losses from theft, fires and storms.

Measurement of Income

In a broad sense income means all wealth which flows into the taxpayer other than as a mere return of capital. It includes the forms of income specifically described as gains and profits including gains derived from the sale or other disposition of capital asets. Income cannot be merely determined by reckoning in cash receipts. Most statutes recognize as income-determining factors other items among which are inventories, accounts receivable, property exhaustion, and accounts payable for expenses incurred.

For income tax purposes income is measured on an annual basis. The tax year is normally the calendar year for individuals, and the fiscal year (a twelve-month period), if this is different from the calendar year, for corporations. Items of income and expenditure need not be in the form of cash. It is sufficient that such items be appraised in terms of money.

Several methods of accounting are accepted under the National Internal Revenue Code of the Philippines (Tax Code) for purposes of measuring the income of the taxpayer. The method adopted by the taxpayer should be the one most suitable to his purpose and must clearly reflect the items of gross income and deductions during the period that it is accounted for. These methods of accounting that are recognized in the Tax Code are:. Cash method and Accrual method. These are methods adopted universally.

Under the cash method, the taxpayer reports items of income and deductions in the year when income is actually received or when deductions are paid. It is the method normally used to determine non-business income. An example where cash basis is applicable is interest income earned by the taxpayer from a bank, but left on deposit with the bank.

Accrual method is normally the method used to determine the business income of corporations and individuals. This method enables the taxpayer to report items of income and deductions which have already accrued although not actually received or paid. It produces a more accurate measurement of income for an accounting period. The accrual method of accounting sometimes differs from the accrual method for tax purposes. In accounting, revenue will be recognized when earned, not when received. For income tax purposes, revenue is generally included in income as earned. For example, an item of revenue which is receivable but not yet due is included in income when it becomes receivable. Revenue received in advance is generally (but not always) spread among the earning periods by the use of a specific statutory reserve.

Deductions are allowed in the year when paid if the method of accounting is cash basis, or in the year when accrued if the method of accounting is accrual basis.

Other accounting methods that are accepted under the Tax Code apply to construction projects where the period of completion of the project is more than a year. This is to allow that income and deductions are more correctly determined and more appropriately allocated to the taxable year. Crop year basis of accounting is accepted for a farmer engaged in producing crops which take more than a year between planting to gathering and disposal of crops. This method enables the farmer to deduct expenses in the year in which the gross income from the crop is realized.

INCOME TAXATION IN THE PHILIPPINES

Taxable Income

Taxable Income is defined as "Gross Income" less the deductions authorized by the National Internal Revenue Code of the Philippines (NIRC) for such types of income.

Under the Income Tax Law, income of individual taxpayers may be classified as follows:

(1) Gross compensation income;

(2) Passive income like royalties, interest on bank deposits, etc.;

(3) Income from profession, trade or business as well as other income not classified as compensation income.

The NIRC defines "Gross Income" as "all incomes from whatever source derived, including (but not limited to) the following items:

(1) Compensation for services, including, fees, commissions, and similar items;
(2) Gross income derived from business;
(3) Gains derived from dealings in property;
(4) Interest;
(5) Rents;
(6) Royalties;
(7) Dividends;
(8) Annuities;
(9) Prizes and winnings;
(10) Pensions; and
(11) Partner's distributive share of the gross income of general professional partnership."

Premiums on the life insurance of an employee, where the employer paying the premium is not a direct or indirect beneficiary is considered compensation to the employee. However, the proceeds of life insurance is excluded from gross income because they partake more of indemnity rather than gain to the recipient; but interest on such insurance proceeds is subject to tax. On the other hand, for estate tax purposes, the proceeds of a life insurance policy would have to be declared as part of the estate of the decedent if the beneficiary designation was not irrevocable. Based on certain conditions, retirement benefits received by an employee or official of a private firm is tax exempt.

Amounts paid specifically either as advance or reimbursement for transportation, representation and other bonafide ordinary and necessary expenses incurred or reasonably expected to be incurred by the employee in the performance of his duties in the business of the employer are not taxable compensation income. However, if the reimbursement exceeds the actual expenses, the excess if not returned to the employer constitute taxable compensation. (Revenue Audit Memo Order No. 1-87, of the Bureau of Internal Revenue defines the rules for these types of expenses.)

Specifically defined in the Code as Exclusions From Gross Income are the following:

(1) Life insurance proceeds paid to the heirs or beneficiaries upon the death of the insured, whether in a single sum or otherwise, but if such amounts are held by the insurer under an agreement to pay interest thereon, the interest payments shall be included in gross income.

(2) The amount received by the insured as a return of premiums paid by him under life insurance, endowment, or annuity contracts, either during the term or at the maturity of the term mentioned in the contract or upon surrender of the contract.

(3) The value of property acquired by gift, bequest, devise, or descent; but the income from such property shall be included in gross income. Gifts are taxed separately under "Donor's (Gift) Tax.

(4) Interest on Government securities issued before the approval of the Code. Government securities issued after the approval of the Code carry specific conditions for exclusion, such as for securities that are already subject to withholding of a final tax.

(5) Amounts received as compensation for injuries or sickness through Accident or Sickness Insurance or under Workmen's Compensation Acts, plus the amount of any damages received whether by suit or agreement on account of such injuries or sickness.

(6) Retirement benefits, pensions, gratuities, etc. received by officials and employees of private firms, (whether individuals or corporate), in accordance with a reasonable private benefit plan maintained by the employer; provided that the retiring official or employee has been in the service of the same employer for at least 10 years and is not less than 50 years of age at the time of his retirement. Other amounts received for the following reasons, are also excluded from taxable income:

(a) separation of the employee or official from employment due to causes beyond his control, such as death, sickness or physical disability.

(b) benefits received from foreign government agencies or other institutions, private or public.

(c) benefits received from SSS and GSIS.

(7) Other exclusions are given in Section 28, nos. (6) and (8) of the NIRC.

Deductions from Gross Income

In the Philippines, the Tax Code allows a taxpayer certain deductions from income which generally fall under, (1) Itemized deductions,(2) Optional standard deduction, (3) Extraordinary deductions, and (4) personal and additional exemptions. Deductions from gross income of individuals, particularly wage earners, are not itemized as they used to be allowed before the gross income taxation system. Instead, deductions are limited under the optional standard deduction provision, if so elected by the individual, equal to 10% of gross income. In addition to these deductions, exemptions of fixed amounts for individuals filing their income tax returns as a married individual, as head of family, or as a single individual, or married individual but legally separated, and without any qualified dependents, are allowed.

Additional exemptions are allowed for taxpayers with dependents, and taxpayers with gross annual compensation income not exceeding a certain amount (P20,000, as of 1996).

The President of the Philippines is empowered by law to adjust personal and additional exemptions once every three years to take into account the movement of consumer prices and subsistence levels.

Before the more recent amendments in the National Internal Revenue Code (NIRC), capital gains from sale of real estate did not enjoy preferential tax rates. The rates as well as the basis have been modified to 5% of gross selling price, or the fair market value of the property at the time of sale not for the same reason as in the USA and Canada as mentioned earlier, but because of the administrative difficulty of verifying the true capital gains realized. To solve this difficulty, government decided to tax the gross proceeds of the sale at a low rate instead of the old system of taxing the capital gains at a higher rate, thus making it consistent with the modified taxation on gross income. It is difficult to quantify the effect of this change. However, what it has achieved is, it has stopped negotiated compromises on the amount of tax payable, thereby minimizing leaks in tax collection from this source. (Taxes on certain other passive incomes are defined under Section 21, (c). of the NIRC.)

Itemized deductions from business income are generally those expenses incurred in the production of income, taxes, losses, bad debts, depreciation, amounts paid to a pension trust, and charitable and other contributions. Extraordinary deductions are allowed to life insurance companies to take into account the long term nature of its business; to trusts and estates, to the extent of the income distributed to the beneficiaries; and to private educational institutions for expenses incurred in expanding the school's facilities.

Simplified Net Income Tax for Self-Employed and Professionals in practice

The self-employed and professionals engaged in the practice of their profession are taxed under a different schedule of rates than the employed. The definition of their taxable income and deductions are also different. Section 21f, defines the income and schedule of rates of tax, the maximum of which is 30%, or 5% less than the maximum 35% for employed individuals.

Tax on General Professional Partnerships

A general professional partnership is formed by persons for the sole purpose of exercising their common profession, where no part of the income is derived from engaging in any trade or business. A general professional partnership, whether registered or not, is exempt from payment of income tax but the partners are individually liable to pay income tax on their shares in the net profits of the partnership. The shares in the profit are taxable even if not actually distributed to the partners.

Taxation of Corporations and Other Legal and Economic Entities

The rate of tax on income of corporations is 35%. Government-owned or controlled corporations are also subject to the same tax rates. Life insurance corporations are also subject to the same rate of tax. However, mutual life insurance companies are subject to a tax of 10% of their gross investment income. This difference in tax basis and rate between a mutual life insurance company and a stock life insurance company is explained under the topic: History of Life Insurance Company Income Taxation in the Philippines.

Corporations organized in a foreign country but is authorized and is engaged in trading or doing business within the Philippines are also subject to the same rate of tax as a corporation organized in the Philippines. Branches of foreign corporations operating in the Philippines, when remitting profits to its head office, are subject to a tax of 15% on the profit remitted. There are exceptions or preferential rates for those located in the Export Processing Zones, and those engaged in petroleum operations.

Organizations that are organized not for profit are not subject to tax. It is important to mention a few such as mutual savings banks, fraternal beneficiary societies operating for the exclusive benefit of the members, and providing for the payment of life, sickness, accident, or other benefits to the members or their dependents. Section 26 of the NIRC lists at least 10 such organizations.

OTHER KINDS OF TAXES IN THE PHILIPPINES

Estate Tax & Donor's Tax

The estate tax is a tax on the privilege to transmit property upon death. It is designed to limit fortunes by taxation and thus prevent undue concentration of wealth in the hands of the few. Estate tax was originally known as inheritance tax which took effect on July 16, 1916. It was a graduated form tax imposed on net inventoried property left by the deceased or decedent. These rates were not imposed on the shares of the heirs. On March 9, 1922 an Act (Act 3031) amended the 1916 Inheritance Tax Law by imposing graduated rates on the shares of beneficiaries or heirs. In the 1939 Tax Code, tax rates were imposed on the net estate and net share of heirs depending on the classes of heirs with mark-up for heirs distantly related to the decedent. The net estate is arrived at by subtracting from the gross estate the authorized deductions. Further amendment was made thru Presidential Decree No. 69. This decree eliminated the inheritance tax and made it unnecessary to know the classes of heirs, and it also increased the tax rates. In 1992 the estate tax rates were simplified and reduced from fifteen schedular rates (3% to 60%) to only five schedular rates (5% to 35%).

The donor's tax is a tax on the donor's privilege to transmit property during his lifetime. The exemption is a lower amount of P50,000 compared to P200,000, but the tax rates are lower.

The details of these taxes are described in Title III, of the NIRC.

Value Added Tax

The Value Added Tax (VAT) is a tax imposed on each sale of goods or services starting from the beginning of the production and distribution process and culminating with the sale to the final customer. In concept it is a tax applied only to the value added by the firm or person (producer or distributor), that is, to the excess of its sales over its purchases of goods from other firms or persons. The VAT is usually collected by tax credit method, whereby each firm or person applies the tax rate to its taxable sales, but is allowed credit for VAT paid on its purchases of goods and services for business use, including the tax paid on purchases of capital equipment under a consumption-type value added tax. As a result, the final customer, or the consumer is the only one who will not be able to claim credit for tax paid.

Under the NIRC the Value Added Tax (VAT) is defined as a business tax levied on certain goods, properties, and services. It is one of the reform measures that government claims will promote efficient and simplified tax administration. It is intended to replace a number of percentage taxes imposed on goods, services and business transactions, including insurance premiums.

Through the VAT the Bureau of Internal Revenue expects to better monitor the collection of tax payments because it will put in place a more effective receipting system for sales transactions. What this means is that the seller of goods or services who is required to apply a VAT (called the output tax) on his selling price and issue a receipt, will also demand a receipt from his suppliers so that he could, in turn, claim credit for the VAT he paid (called input tax) when he reports his business expense. The system provides the Bureau of Internal Revenue a more accurate audit trail.

The government claims that VAT makes "taxation more fair and equitable", and "that everyone shares the burden of taxation proportionally, covering a wider cross-section of businesses, particularly those catering to the higher income groups".

"Section 121. Tax on insurance premium" of "TITLE V. Other Percentage Taxes", of the NIRC, was reclassified under the New VAT Law under a new amended title "Tax on Life Insurance Premium", but the tax rate was retained at 5 %. With this amendment, the VAT rate of 10 % now applies to other premiums, particularly of non-life insurance, except crop insurance.

Other Percentage Taxes

Before the VAT, various percentage taxes were imposed on many business transactions. While the VAT was designed to replace percentage taxes, there are still a number of items or businesses which are subject to percentage tax at various rates, namely, the following:

1. Tax on persons exempt from VAT. Any person or firm who is exempt from the payment of value added tax is subject to pay a percentage tax on gross receipts, equivalent to 2% of his gross quarterly sales. An exempt person or firm is one whose sales or receipts do not exceed the amount prescribed in the regulations by the Secretary of Finance which shall not be less than P100,000 or higher than P500,000, and who is not a VAT registered person or firm.

2. Hotels, motels, and others of similar businesses; caterers carriers and keepers of garages.

3. Dealers in securities and lending investors, on their gross income, at 6%. (A company selling pre-need plans, until the implementation of the Expanded VAT, was subject to a percentage tax of 6%.)

4. Franchises, overseas dispatch, message, or conversation originating from the Philippines.

5. Banks and non-bank financial intermediaries, on their gross receipts, such as interests, commissions and discounts from lending activities, financial leasing, dividends, royalties, rentals of properties, profits from exchange, at rates in accordance with a schedule.

6. Finance companies, on their gross receipts similar to the banks.

7. Life insurance premiums, at 5%.

8. Agents of foreign insurance companies.

9. Amusement taxes, winnings from horse racing.

10. Sale, barter or exchange of shares of stock listed and traded through the local stock exchange or through initial public offering.

<u>Excise Taxes</u>

Excise or privilege taxes are laid upon the manufacture sale or consumption of commodities within the country; upon licenses to pursue certain occupations and upon corporate privileges. Excise taxes may be *specific tax*, that is, imposed and based on weight or volume capacity; and *ad valorem* tax, imposed and based on selling price or other specified value of the goods. This tax is in addition to the value added tax. The taxable base for the value added tax includes the excise tax paid, while the value added tax is excluded in the taxable base of the excise tax.

Documentary Stamp Taxes

A documentary stamp tax is an excise tax. It is a tax on the privilege to enter into a transaction. The non-payment of documentary stamp tax does not render a document void. Failure to affix a stamp on a taxable document renders the document unacceptable as evidence in court, and it cannot be recorded in government offices like the Register of Deeds until the requisite stamps are affixed thereto. A document without the required documentary stamps is inadmissible only until the time that the stamps are affixed. The party who is bound to pay the documentary stamp tax on a document is the one "making, signing, issuing, accepting or transferring the same". In insurance, it is either the insurer or insured who pays the documentary stamp tax. When one party is exempt, it is the other party who pays the tax.

Among the documents that are subject to the payment of documentary stamp tax are insurance policies, policies of annuities and pre-need plans. However, policies of insurance or annuities granted by a fraternal or beneficiary society, order, association or cooperative company, organized and conducted solely by the members, for the exclusive benefit of each member and not for profit, are exempt from the payment of documentary stamp tax. Policies issued by a Philippine company to persons in other countries are exempt from documentary stamp tax.

As of the time this study note was written, the stamp tax on all policies of insurance made or renewed on property, against fire and marine losses; and fidelity bonds, and other insurance policies, is 12.5 % of the premium. On Pre-need plans, the stamp tax is 1.00 per 1,000 of the value or amount of the plan. On policies of annuity the documentary stamp tax is 7.50 per 1,000 of the capital, or 33 1/3 times each 200 of the annual income.

For insurance policies, the stamp tax is affixed upon its issuance even if at that time the premium has not been paid. If the policy is cancelled, there is no refund of the tax. If the life insurance policy is re-issued to replace the old policy, no tax is due if the amount of insurance and the insured life is the same. Any change in the amount and insured life requires the payment of a new documentary stamp tax. Reinsurance contracts are not subject to documentary stamp tax.

Taxes Imposed by Local Governments

The local government units, namely the provinces, municipalities, cities, and barangays were given powers to create sources of revenue through taxation, consistent with the basic policy of local autonomy. The revenues raised accrue exclusively to the local governments. Certain fundamental principles govern the exercise of the taxing powers of the local governments, namely, that taxation shall be uniform in each local government unit; that the taxes and other impositions shall be equitable and based on ability to pay, not be unjust, excessive, oppressive, or confiscatory; not be contrary to law, public policy, national economic policy, or in restraint of trade; and each local government shall try to evolve a progressive system of taxation.

The exercise of the taxing powers of the local government units are limited to a certain extent. It shall not extend to imposing a levy on income tax, "except when levied on banks and other financial institutions", documentary stamp tax, estate tax, excise tax, percentage tax or value-added tax, and a host of many other items as defined in Sec. 133 of the Local Government Code of 1991 (LGC).

Until the approval of the LGC, one of the most important sources revenue of a municipality is the Real Estate Tax. Under the new law, a few others were added, or the rates of tax were increased. The municipality imposes tax on businesses in proportion to their gross sales or receipts, ranging between 37 1/2 % to 50 % of one percent. The tax on banks and other financial institutions, on their gross receipts, or insurance premiums is 50 % of 1 %. Cities may charge up to a rate of 50 % on top of the rate of the municipalities. Before businesses are issued licenses or permits, a clearance from the barangay is required to be obtained for a fee.

Another tax imposed by cities and municipalities is the community tax. Every resident individual or corporation is required to pay community tax based on annual income and value of property owned. A Community Tax Certificate is issued to every person or corporation, which is required to be presented in a number of transactions with the government and for acknowledgement of any document with a notary public.

CRITERIA FOR A LIFE INSURANCE TAX SYSTEM

In a study prepared by the Secretariat of the United Nations Conference on Trade and Development, certain criteria were suggested for establishing a tax policy for life insurance in developing countries. The recommendations are discussed hereunder.

Deciding on an appropriate tax policy for life insurance usually involves resolving conflicts with the various competing national objectives. In most situations where tax laws are found to discriminate unfairly against life insurance, it can be assumed that this is not the result of a deliberate policy but, the lack of appreciation of the important role of life insurance in the country's socio-economic development and poor understanding of the nature and functioning of life insurance.

Although the most important criterion of many governments is for a tax system that develops an acceptable amount of revenue, it is relevant to know what are the other equally important criteria for designing a tax system not necessarily applicable solely to life insurance.

1. Compatibility with the general tax structure. A tax system for life insurance has to be compatible with the structure of the existing tax system. For example, when government relies heavily on transactional types of taxation, such as the sales tax and excise tax, it would be inappropriate to adopt a sophisticated tax system for the insurance industry.

2. Compatibility with the insurance regulatory structure. Conservatism usually prevails in regulating life insurance. The area where conflict exists between the objectives of the tax authority and the insurance regulator is in reserving. More conservative reserving will result in less tax. The insurance tax system must be sensitive to the regulatory requirements by avoiding measures that unfairly or inadvertently penalize insurers which must function under the conservative environment. On the other hand, both the tax authority and the insurance regulator must be sensitive to such provisions of law and taxation that may encourage tax avoidance.

3. Structural viability. The life insurance taxation system must be administratively feasible and simple, and the revenue therefrom must be reliable. The simplicity is for the benefit of both the tax administrator and the taxpayer.. A simple system will minimize the possibilities of tax avoidance. Although difficult to realize in practice revenues should not fluctuate greatly from year to year to provide government with fairly predictable information for long-term planning.

4. Balance within the fiscal environment. The concept of economic (or tax) neutrality should be the position of the national government. This means that the tax policy should not be the cause of one product, service, or type of provider having an economic advantage over another in the marketplace. Difficulties however remain in its practical implementation as in the following examples:

(a) Life insurance versus other savings media. If a national objective is to promote savings a favorable tax policy for life insurance would accomplish this objective. However, other savings media (e.g., banks, retirement plans, etc.) will have to be considered in order to achieve tax neutrality.

(b) Stock vs. mutual vs. government insurers. An economically neutral tax system considers it fair to tax stock life insurers as other non-insurance corporations. A strong argument can also be made that all life insurance companies should be taxed equitably. Most of the developed countries tax stock and mutual life insurance companies in the same manner, except for the element of dividends to stockholders. France, among the developed countries, accord some limited tax concessions to mutual life insurance companies. Where government and privately-owned life insurance companies are permitted to compete with each other on the same basis, it is logical to apply the same tax policy to both.

(c) Domestic insurers vs. foreign insurers. The policy on taxation of foreign domiciled insurers is usually linked with the policy or regulations of allowing a foreign insurer to operate in the country. Where their operation is allowed, the tax policy should be to tax them at no less than what a domestic company is taxed. From the standpoint of the national tax policy, government may find it to be in the national interest to tax foreign companies more, unless there exist a tax treaty between the countries that contain a non-discrimination clause.

(d) Participating vs. non-participating insurance. Under a concept of a tax neutrality the policy dividends are given appropriate recognition. The recognition applies to both the taxation of the insurance company and the policyholder.

5. Social sensitivity, tax evolution and conflict minimization. Taxation of life insurance must be consistent with the customs, religions, and political realities of the country. The tax system must be socially equitable, meaning that the tax burden should fall less heavily on the members of society least able to pay. The changes that have been introduced over time may have been done primarily to suit some immediate fiscal need by government and could result in conflicting and uncoordinated policies which should be reviewed to prevent an environment of uncertainty for life insurers. Life insurance being a long-term business, the changes

should not be abrupt nor drastic, since true returns are not known until much later. Proper balance should be given to the various criteria to minimize conflicts. For example, giving greater weight to social sensitivity can conflict with simplicity in tax administration. The balance among the criteria will change as the country progresses. As a country matures the economy and society become more sensitive to fiscal measures. The tax rules can then be changed to recognize more criteria. It should however be pointed out that a tax system that is adopted to carry out a multitude of objectives can become incomprehensible and counter-productive as some industrialized countries have discovered.

APPROACHES TO LIFE INSURANCE COMPANY TAXATION

The UNCTAD study also put together the several approaches of taxing life insurance companies. The approaches to taxation are based on the sources of income of a life insurance company, namely, premium income, investment income and total income. The study considers as separate approaches the taxation of gross investment income and net investment income.

Premium income as a basis for taxation.

The tax on the insurer's premium income is a form of transaction tax, or turnover tax or sales tax. The insurance premium is one of the few intangible commodities which is often subject to such tax. There is no similar tax on other financial institutitions. It is probably because of the simplicity of administration, from the point of view of both the tax authority and the insurer, that this tax became a popular form of levy. As a source of revenue for the government the tax on premium provides a predictable and stable source.

should not be abrupt nor drastic, since true returns are not known until much later. Proper balance should be given to the various criteria to minimize conflicts. For example, giving greater weight to social sensitivity can conflict with simplicity in tax administration. The balance among the criteria will change as the country progresses. As a country matures the economy and society become more sensitive to fiscal measures. The tax rules can then be changed to recognize more criteria. It should however be pointed out that a tax system that is adopted to carry out a multitude of objectives can become incomprehensible and counter-productive as some industrialized countries have discovered.

APPROACHES TO LIFE INSURANCE COMPANY TAXATION

The UNCTAD study also put together the several approaches of taxing life insurance companies. The approaches to taxation are based on the sources of income of a life insurance company, namely, premium income, investment income and total income. The study considers as separate approaches the taxation of gross investment income and net investment income.

Premium income as a basis for taxation.

The tax on the insurer's premium income is a form of transaction tax, or turnover tax or sales tax. The insurance premium is one of the few intangible commodities which is often subject to such tax. There is no similar tax on other financial institutitions. It is probably because of the simplicity of administration, from the point of view of both the tax authority and the insurer, that this tax became a popular form of levy. As a source of revenue for the government the tax on premium provides a predictable and stable source.

On the other hand, the premium tax is a regressive tax and is the cause of great inequity. The lower income policyholders are taxed more heavily in proportion to their savings than the higher income policyholders. It is a tax on both the savings and protection elements of the premium. Also, the older policyholders are taxed more heavily than younger policyholders because their premium is higher for the same amount of insurance coverage. A high premium tax rate makes cash value life insurance policies less attractive as a savings medium. In recognition of these inequities many developed and developing countries countries in Africa and Latin America assess no premium tax.

The tax rate on premiums is normally kept at a low level. A maximum rate of 2 to 3 percent is common among developed countries, with the exception of France which taxes premiums close to 5 percent. A high premium tax rate is considered harmful and violates the principle of economic neutrality among financial institutions.

Investment Income as a basis of taxation

There are two concepts in this approach of taxing investment income. One is the investment pool concept, which assumes that the life insurance company is managing an investment pool in behalf of the policyholders. This concept is based on the fact that almost 80 to 90 percent of the assets of a life insurance company are policy reserves, hence the earnings from these assets may be viewed as largely, earnings of the policyholders. While it may be argued that the income should be taxed only after it has been distributed to the individual policyholders, it is not done this way because of administrative complexities. "Taxation at the corporate level can serve as a substitute for individual policyholder taxation, although very few countries actually use this approach by itself as a substitute for corporate profits tax. The United Kingdom is perhaps the foremost exception. It uses a variation of this approach as the basis for corporate taxation." Canada used to levy a tax on investment income as a substitute for taxing the income in the hands of the policyholders, in addition to a corporate tax on profit that was

On the other hand, the premium tax is a regressive tax and is the cause of great inequity. The lower income policyholders are taxed more heavily in proportion to their savings than the higher income policyholders. It is a tax on both the savings and protection elements of the premium. Also, the older policyholders are taxed more heavily than younger policyholders because their premium is higher for the same amount of insurance coverage. A high premium tax rate makes cash value life insurance policies less attractive as a savings medium. In recognition of these inequities many developed and developing countries countries in Africa and Latin America assess no premium tax.

The tax rate on premiums is normally kept at a low level. A maximum rate of 2 to 3 percent is common among developed countries, with the exception of France which taxes premiums close to 5 percent. A high premium tax rate is considered harmful and violates the principle of economic neutrality among financial institutions.

Investment Income as a basis of taxation

There are two concepts in this approach of taxing investment income. One is the investment pool concept, which assumes that the life insurance company is managing an investment pool in behalf of the policyholders. This concept is based on the fact that almost 80 to 90 percent of the assets of a life insurance company are policy reserves, hence the earnings from these assets may be viewed as largely, earnings of the policyholders. While it may be argued that the income should be taxed only after it has been distributed to the individual policyholders, it is not done this way because of administrative complexities. "Taxation at the corporate level can serve as a substitute for individual policyholder taxation, although very few countries actually use this approach by itself as a substitute for corporate profits tax. The United Kingdom is perhaps the foremost exception. It uses a variation of this approach as the basis for corporate taxation." Canada used to levy a tax on investment income as a substitute for taxing the income in the hands of the policyholders, in addition to a corporate tax on profit that was determined after deducting the tax on investment income from the overall corporate profit. This was abandoned by Canada in 1978 in favor of one that includes income from all sources.

For corporate income taxation very few countries now use investment income, whether gross or net, as basis. The principal reason for this is to have only one basis of taxation, that is, income from all sources, and for all companies of any kind. Outside of the desireability of having only one form of taxation for all companies, using investment income as basis of taxation of life insurance companies, has justification in countries which recognize that investments is the principal source and the only taxable income of a life company, not the margins from mortality or morbidity. In a situation where the premium is already taxed, taxing investment income becomes even more a logical basis.

Investment income as basis of taxation is appropriate for mutual life insurance companies, and even stock life insurance companies operating in countries that require the distribution of a major proportion of underwriting profits to policyholders.

Investment income is usually the sum of interest earnings, dividends, and rental income. Capital gains and losses are included only as they are realized, unless there are special taxes particularly applicable to these sources of income. There are usually allowed certain deductions from the tax base, such as expenses associated with the investment function. In some countries earnings from certain investments are excluded from the tax base such as those encouraged by government as priority investments. Income from investments of reserves of socially desireable insurance products such as retirement plans and health insurance are also excluded.

Dividends received from domestic corporations are sometimes not included as part of the investment income tax base because taxes have already been paid by the dividend-paying corporation. To tax the receiving corporation for the dividends would constitute double taxation. Another reason for excluding dividends is to encourage life insurers to invest in domestic corporations. This presumes however that dividends received from foreign corporations is included in the investment income tax base.

When investment income and not total income is the basis of corporate taxation, expenses for acquisition and for operations is not usually deductible, although it can be justified that at least part of these expenses are incurred for generating the funds for investments. To allow total expenses as deductions distorts the profit flow of a life insurance company. In a period of expansion, the costs of writing new business can be greater than the investment income hence the company is not liable to pay tax even though the company is not trading unprofitably. On the other hand, not to allow deductions for total expenses from investment income can result in a liability to pay tax even if the company is not showing any profit.

Excess investment income as a basis for taxation

This approach is based on the rationale that since insurers need to earn a certain minimum rate of interest to build up the policy reserves, any return in excess of this minimum can be considered taxable income to the insurer. In other words, investment income necessary to maintain policy reserves is not considered income of the insurer. Life insurers in the USA, Australia, and even the Philippines used to be taxed under a method based on this approach. The important deduction is the amount necessary to accumulate policy reserves, in addition to the lesser deductions such as for investment expenses. The applicable tax rate for this income tax base is the regular income tax rate.

However, the investment income necessary to maintain policy reserves is not the same for all companies, hence a single rate of return applied to all companies, would create inequity that will eventually be transferred to the policyholders.

Tax rate on investment income

When investment income is taxed on the basis of the principle that it is income of policyholders, the appropriate tax rate is theoretically the rate applied to individuals. However, since there is not one income tax rate for all individuals it would be difficult to compute an average of the rates that would be a fair rate to apply to the aggregate investment income. The alternative is to apply a relatively low rate. However, this problem is no longer significant since most countries that tax investment income do not usually consider the taxation as tax on income of individuals, but of insurance companies.

It would be unfair to apply the regular corporate income tax rates to investment income of life insurance companies because the corporate profits realized by a life insurance company is the combined result of their underwriting and investment operations which is usually much less than the investment income with no significant allowances for deductions.

Total income as a basis of taxation

Total income taxation is the most common approach to life insurer taxation, internationally. The details of each system may vary significantly between countries but the underlying concept is the same. One advantage of adopting the total income approach is that it puts life insurance companies under the same system as all other business corporations, thus simplifying the overall income tax regime. However, because of the long-term nature of life insurance, the insurer is allowed special deductions not usually allowed the other businesses in addition to the normal deductions. Thus, while the life insurance business may be taxed under the same system as other businesses, these special deductions make the application of the total income approach to life insurance company income taxation a complex system.

The complexities in life insurance income taxation arise because a life insurance company receives revenues for obligations to be rendered in the future, and incurs costs for the benefit of future years. Matching premium and investment income to benefits paid and costs incurred on an annual basis requires professional actuarial judgement. These involve calculating reserve deductions for reporting taxable income, and there are many variations to doing these. All the methods in use attempt to reconcile various concerns of the insurer, the regulatory authority, and the policyholder, and at the same time satisfy the tax authority of the reasonable amount of reserves to be allowed as deduction against income. Usually, the standards of the regulatory authority are adopted by the tax authority. This simplifies the administrative burden of the insurance company which does not need to compute two different reserves, one for regulatory purposes and another for tax purposes, and the tax authority who would rely on the regulatory authority to verify the accuracy of the reserves.

The effect of using statutory reserves for tax purposes is to overstate the reserve deduction and consequently understate taxable income, at least when measured on a short-term basis. This should not be considered a problem from the taxation point of view as it only defers the emergence of the taxable profit, and serves as incentive to promote the growth of life insurance.

The above discussion relates mainly to long-term life insurance and annuity contracts. For yearly contracts such as group yearly renewable term insurance, health insurance, etc., the determination of reserves is simply pro-rating the premium over the term of the coverage. The deduction for reserves correspond to the income not yet earned for the year.

Deduction of acquisition expenses also present a similar problem as deduction of reserves. These expenses are incurred in the first year that the insurance policy is written in expectation of revenues over several years in the future. Statutory reserve methods however take into account the incidence of expenses. The "full preliminary term" method of valuation, for example, assumes that all of the first year premium is consumed by the acquisition expenses, hence no reserve deduction in the first year. On the other hand, the "net level premium" method assumes that acquisition expenses are amortized over the premium-paying period, hence this method produces a higher reserve deduction in the first year. Adoption of any of these methods however are dictated by solvency, not tax considerations.

Regardless of the reserve method employed, many if not all countries that use the total income approach to income taxation of life insurance companies permit acquisition expenses to be deducted fully in the year incurred. Canada is one country that used to prescribe rules for tax reserves apart from regulatory reserves. The USA and France are among the developed countries that also give consideration to tax revenues when prescribing rules for tax reserve. But for developing countries it is normal to expect that tax revenue considerations are disregarded, and to just adopt the regulatory reserve standards for reserve deductions.

Other Deductibles from Income under a Total Income Tax System

Dividends paid on participating life insurance policies are usually deductible in whole or in part in determining taxable income under a total income tax system. If the insurer is a stock company, the shareholders may be entitled to a limited share of the profits from the participating policies. If the insurer is a mutual the profits from participating and non-participating business are distributed to the participating policyholders as policy dividends.

Policy dividends partly represent a return of excess premium of participating policies and for this reason it should be a deductible from taxable income. However, it is also partly a participation in the income of the business operation, and therefore, to consider deduction of dividends in full would create inequity in tax treatment between stock companies and mutual companies. Most countries allow a full deduction for policy dividends while others allow limited deduction. For example, Canada limits the deduction to the amount of the participating income, thus places stock and mutual companies on similar basis. In Japan, deduction for policy dividends is limited to an imputed minimum return of 7% on the insurer surplus; in Germany, to the average investment return on stockholders equity. In the system implemented in 1984 in the USA, the deductions for policy dividends paid by a mutual company is limited to reflect a return on net worth, but full deductibility is allowed stock companies. In the Philippines policy dividends are not deductible as provided for under Section 31 of the NIRC.

Since life insurance business takes a long time to show profits, losses in the earlier years is an important deduction for a life insurance company that is newly established. These earlier years losses are allowed to be carried forward for a period of time. Countries follow a wide variety of practices with respect to the periods that losses are carried forward, from as short as 5 years, up to an unlimited period. While the use of loss carryovers is common and laudable, an unlimited period is not advisable as it may be rewarding the poorly-run companies.

Another important deduction is for contingency reserves, especially for non-life insurance, to provide a cushion against unforseen catastrophic losses, and in situations where deductions for carryover of losses are not allowed. While the regulatory authorities would certainly favor this extra solvency margin, this allowance is rare in the tax systems. The Netherlands allows an equalization reserve of up to 5% of policy reserves to meet catastrophic losses.

Reinsurance premiums paid by a life insurer to a reinsurer are allowed as a deduction, with some countries making a distinction between licensed and unlicensed reinsurers. Deductions are not allowed for reinsurance premiums paid to unlicensed reinsurers. Commissions and reinsurance recoveries received by the ceding company from the reinsurer are however included as income to the ceding company or netted against the reinsurance premiums paid.

The total income approach as basis of taxation of life insurance companies simplifies tax administration and minimizes misunderstandings across the various industry groupings. On the other hand for the system to be equitable there are a number of complex details that need to be worked out by skilled experts in the taxation department of the government and the industry.

Other forms of life insurer taxation

Many other forms of taxation applied to life insurers are those similarly applied to other business corporations. These vary between countries, but some of the more common forms are license fees, registration fees, tax on property owned, stamp taxes on documents and on capital, etc.

The stamp tax on life insurance policies require special mention due to the rate of tax applied by the tax authority of the Philippine Government, which was the highest among a number of known countries that levy such form of tax. Even at the old rate of 1.75 per thousand of the amount of insurance, before it was increased in 1984 to 2.50 per thousand, it was already the highest when compared to the UK and Thailand at 0.5 per 1,000, Singapore at 0.1 per 1,000 (which was soon revised to S$1 per policy regardless of amount of insurance), and Denmark which has recognized the inequity of levying equal tax rates on term insurance and cash value life insurance, by assessing 0.5 per 1,000 on term insurance and 3.0 per 1,000 on cash value life insurance. A form of tax based on the amount of insurance, if it has to be imposed at all, must be a low rate because it becomes a disincentive to buy the very type of life insurance with low premium, such as term life insurance, that lower income persons could possibly afford.

APPROACHES TO POLICYHOLDER AND BENEFICIARY TAXATION

A tax policy applicable to policyholders and beneficiaries cover premium payments, benefits payable during the lifetime of the insured, and benefits payable upon death of the insured.

Premium payments

To encourage the purchase of life insurance many countries grant some form of tax relief for premiums paid. The first country known to have granted an income tax deduction for life insurance payments was the United Kingdom. It was first introduced in 1799, but removed some years later when the tax on income was abolished. It was re-introduced in 1853 but was repealed in 1984, to effect tax neutrality among all forms of savings and investments and to avoid certain abusive tax avoidance schemes associated with life insurance contracts.

The common features of these tax relief measures are: First, that only certain policies can qualify for tax relief; Second, that rules for eligibility of the life insured is defined; and Third, that the amount of tax relief is limited to a certain amount or percentage of income of the payor.

Generally, insurance premiums paid for retirement plans qualify for tax relief. This applies as well to individually-established retirement plans, as in Canada and the USA. Many African countries qualify the premiums paid on individual life insurance policies. India qualifies premiums paid on all life insurance policies, except that no deduction is permitted for premium payments within a single year which exceed 10 percent of the sum insured. The exception does not apply to payments for deferred annuities which also qualify for deduction.

Eligibility of the life insured generally apply to the policyholder, some to the spouse, and the child or children. The limitations on the amount of premium that qualify for tax relief are usually a percentage of salary and a fixed amount. Some countries allow a separate amount limit for each child insured.

The methods employed for implementing the tax relief system may be any one of the following:

1. The taxpayers are to show in their income tax returns, the qualifying amount as a deduction from income. With a progressive tax system, this method allows a relatively bigger tax benefit from owning life insurance, to higher income earners. To minimize this advantage, modest ceilings for the relief can be set; another way is to permit a direct credit against the income tax owed.

2. The policyholder-taxpayer may also claim the deduction directly from the premium remitted to the life insurer; the insurer then claims reimbursement from the Government thru a credit against its corporate income tax payable. This method simplifies the administrative burden on taxpayers and the tax authorities. To achieve this however, there must be one implicit tax rate applicable to everyone, usually lower than the highest income tax rate. This single rate tends to benefit the lower income taxpayers.

It is almost a universal practice that premiums employers pay for employee benefit plans are deductible as legitimate business expenses of employers, and these premiums are not also considered taxable income to the employees. There are certain conditions that are sometimes set for the payments not to be considered as taxable income of employees, and limits are sometimes also placed on the exempted amount of coverage. These conditions are intended to minimize the chances that higher paid employees receive a disproportionately large share of the benefits.

<u>Benefits payable during the lifetime of the insured</u>

<u>Policy dividends</u> - While it has been recognized that dividends paid on life policies represent a return of part of the premium, it is also known that part of the dividends is a share of the favorable investment experience. However, in practice to tax this portion is adminstratively very difficult. Few, if any countries tax policy dividends as income to policyholders.

<u>Policy cash values</u> - Interests credited to cash values of life insurance policies are income to the policyholder, and to achieve tax neutrality among various forms of savings it is right to tax such interests. This is termed in the USA and Canada as the "inside interest build-up" in cash value life insurance policies. However, because of the administrative difficulty of determining the tax due, few countries if any outside of these two impose such tax.

The administrative difficulty can be minimized by taxing the gain of the policyholder only upon surrender of the insurance policy. Under this procedure the gain is measured by the amount that the cash surrender value plus the sum of dividends received, less the sum of premiums paid under the policy, if positive; if negative, it is not considered a loss, hence cannot be deducted from taxable income.

But this solution to the administrative difficuity leaves out other issues such as that not all of the premium is savings, part of it is to pay for the cost of mortality risk. The gain therefore is understated because the premium is overstated by the cost of mortality risk. Another issue is that to tax the gain only upon surrender constitutes tax deferment, an advantage to a life insurance policyholder especially during times of high inflation. To tackle all these issues will add further complexity to the tax administration, and the resultant costs for compliance would likely outweigh the revenue generated. Furthermore, not taxing the interest build-up is justified by the recognition of the economic and social value of savings generated through life insurance.

In countries that levy a gift tax on the transfer of property by gift during the donor's life, the net cash value (gross cash value less policy loan if any) of a life insurance policy that is donated by one person to another, is the measure of the value of the gift. Example of this is a policy taken by a father on the life of a minor child, and is given to the child when he becomes and adult. However, if the father dies ahead of the time when the child reaches adulthood, the net cash value is added to the value of the estate and is thereby taxed under estate tax rules, not the gift tax.

Matured endowments - Taxation of maturity values of endowment life insurance fall under the same rules as taxation of cash values. To be consistent with the policy of tax neutrality, the maturity value should also be taxed like other kinds of maturing investments, for example certificates of deposits and bonds.

Annuities - The tax policies applicable to life insurance are applicable also to annuities. To analyze their applicability to annuities, the period of accumulation is analyzed separately from the liquidation period. The accumulation period is the time during which the currently or previously contributed funds are accumulating interest, and before payments to annuitants are commenced.

The issues that are subject of a tax policy during the accumulation phase are, whether any tax relief should be granted on contributions or payments into the annuity and, whether interest credited to annuity cash values should be subject to current taxation. When tax relief is not granted on contributions, the annual interest credited to annuity cash values are usually not taxed. The tax is imposed on the cash value only at the time of withdrawal of the cash value before the liquidation period.

Each annuity payment made during the liquidation period can be considered as composed of two parts, namely, payment of principal and payment of interest. When the annuity payments commence, a case can be made that annuity payments are subject to tax to the extent of the interest portion, if the interest accretions on the annuity cash values have not been taxed during the accumulation period. And if tax relief has been granted on the contributions during the accumulation period, the principal portion is also subject to tax.

Benefits payable upon death

Few countries impose tax on death proceeds of a life insurance policy in recognition of the great financial need of the surviving dependent individuals. However, the death proceeds when it forms part of the estate, is subject to estate taxes. When the insurance policy on the life of the deceased is owned by someone else, and the policy is not payable to, or for the benefit of the estate, then the proceeds is not included in the estate of the deceased.

HISTORY OF TAXATION OF LIFE INSURANCE COMPANIES IN THE PHILIPPINES

A study of the income taxation of life insurance companies in the Philippines require special emphasis because of the oscillating changes in the basis of its taxation that has take place over the years between 1939 to 1975. These changes have happened because of the unique nature of the life insurance business. A summary of the historical development of life insurance taxation in the Philippines and also in the USA where the Philippines has patterned its system, will help explain the bases for the changes.

The development of a satisfactory income tax formula for life insurance companies has been one of the more complicated tax problems that has faced the US Treasury Department and the US Congress. The problem has been that of finding a balance between a satisfactory level of revenue from life insurance companies and an equitable distribution of the tax burden among the companies. It is also appropriate to add that a conflict of objectives exists between that of the tax authority for more revenue, and that of the insurance regulator for life insurance companies to have stronger reserves.

Life insurance companies in the Philippines were being taxed like any other corporation since 1939. The tax was on net income but net additions to reserve funds and dividends paid on policy and annuity contracts were allowed as deductions. In 1957 the NIRC was amended whereby premium receipts were excluded from the category of income and only investment income was taxed. This put the life insurance companies in the same basis as their counterparts in the USA which were taxed on the basis of net investment income from 1921. The tax base was net investment income after a deduction of interest required to maintain policy reserves. Underwriting income was excluded from the tax base.

This approach was based on the theory that the only true income of a life insurance company is the investment income in excess of the needs of policy reserves. Premium receipts are treated as capital contributions which will be returned over the years in the form of death benefits, surrender or maturity values, dividends to policyholders, etc. Although this theory applies well to mutual life insurance companies, it is not as simple to justify its use for stock life insurance companies. However, since mutual life insurance companies dominated the life insurance industry in the USA at that time, the tax formula which was appropriate for them was made to apply to all life insurance companies.

From 1957 to 1968, Philippine life insurance companies were taxed on net investment income. The tax rate on net investment income was 6 1/2 %. During that period there used to be two levels of income tax rate for other corporations, 25% on the net income up to 100,000 pesos, and 35% on net income in excess of 100,000 pesos. The 6 1/2 % applied to net investment income of life insurance companies was the equivalent of the lower rate of 25% of net income for other corporations. In 1968 this rate for life insurance companies was raised to 8 3/4 %, to put life insurance companies at the level of other corporations, at 35%. While the income tax rate of 8 3/4 % applicable to a life insurance company appeared to be preferential, in theory it was not since the rate is applied on the net investment income before deducting interest required to maintain policy reserves. To apply the same tax rate of 35%, would necessitate the computation for each company of the amount of interest that is required to maintain its policy reserves. The adoption of the lower rate avoided this complication.

This difficulty of setting a standard for crediting interest on policy reserves have likewise been the problem for US companies. From 1942 to 1948, the tax base was changed somewhat by applying varying rates. Each year a ratio, called "Secretary's Ratio" was developed and applied against net investment income, and the companies were taxed at regular corporate rates. From 1948 to 1957, a series of "stop-gap" legislation was passed to solve the problem of determining an equitable tax base for life insurance companies. The objective was to eventually arrive at a new approach to taxation of life insurance companies. The net investment income as a basis for tax for life insurance companies was considered unsatisfactory for the following reasons.

1. The credit for reserves and other interest requirements were arbitrary, under which no recognition was taken of a company's actual reserve interest requirements.

2. There was failure to include in the tax base earnings other than investment earnings.

3. More tax revenues were desired from life insurance companies.

From 1958 the taxation of US life insurance companies has been based on the general corporate approach (total income) with modifications to accommodate the long-term nature of the life insurance business.

Similarly, when the Tax Code of the Philippines was again amended in 1975, the tax basis of life insurance companies were returned to the same basis as the other corporations, presumably to correct the privileged tax status of life insurance companies. From that year, the applicable income tax rates were 25% for the first 100 thousand pesos of net income from all sources, plus 35% of the net income in excess of 100 thousand pesos, also from all sources. Net income was defined as gross income from all sources including premiums and investments less the same deductions as other corporations, less additions to policy reserves and sums other than dividends paid to policy and annuity contracts. Unlike the USA, dividends paid to policy holders was not made a deductible for life insurance companies in the Philippines, for tax purposes. Why this is so is because there were no domestic mutual life insurance companies at the time of the amendment, while in the USA the business of mutual life insurance companies represented a substantial volume of the business of the insurance industry.

The very little understanding by most people of the technical aspects of life insurance creates tax problems for the life insurance industry in the Philippines. A specific example is in taxation of income of mutual life insurance companies. In 1982 an amendment to the tax code provided for a special 10% tax on the gross investment income of mutual life insurance companies in lieu of the regular corporate income tax rate of 35% on net income from all sources. This special tax rate was intended to be a preferential tax treatment for mutual life insurance which is considered "to promote wealth distribution". This change in tax basis for mutual life insurance companies did not turn out to be a preferential one. The Insular Life

Assurance Company which was completely mutualized after the 1982 amendment found this out. Application of the tax on gross investment income to Insular Life resulted in higher taxes payable for the company.

The problem on the income tax of mutual life insurance companies highlights the rough equivalence between taxing net investment income at the low rate of 8 3/4 %, and taxing all income sources at the higher rate of 35 %. The tax on gross investment income at 10 %, a rate which is 1 1/4 % more than the 8 3/4 % of net investment income, that life insurance companies were subjected to before 1975, not surprisingly, resulted in a higher income tax payable. The 8 3/4 % on net investment income was the estimated approximate equivalent of the 35 % tax on net income from all sources. This is because net income from all sources after all deductions, especially the additions to policy reserves which is the biggest deduction from total income of a life insurance company, results in a lesser taxable net income than the gross investment income.

Taxation of Life Insurance Products

The principal forms of taxes in the Philippines that this study note categorizes as taxation on the product are the premium tax and documentary stamp tax. Each form of tax is a substantial levy on the policy, which cost is directly or indirectly passed on to the policyholder. The tax rate on premium is 5 %, while the documentary stamp tax is 2.50 per 1,000 of the face amount of the policy. Documentary stamp tax is payable one-time, at issue of the policy. (Translated as a tax on the first year premium, the documentary stamp tax is about 7 %. On the first year of a life insurance policy, the premium and documentary stamp tax cost is therefore, at least 12 % of the first year premium.)

Premium Tax

In the United States of America the taxation of income of life insurance companies is essentially a function limited to the federal government, outside of a few states which also tax the life insurance companies. The few states that tax life insurance companies usually adopt an identical tax base as that of the federal government. All states however collect a tax on premium income. The tax rate is usually 2 %, and in some states it serves as a substitute for income tax. In the majority of those states which levy a state income tax, any income tax liabilty can be used to reduce the amount of premium tax paid. The state premium tax thus produces very little additional revenue over that provided by the basic premium tax, thus, further underscoring the fact that premium tax is basically a state tax, not a federal tax.

In the Philippines, the tax on premiums is a national tax. The revenue from this source goes to the national treasury, from where shares in the revenue of the local governments are paid out. While effectively the system may be equivalent as in the USA, the problem of setting the appropriate rates and maximum limits become an important issue, since the tax on premium become treated just like any other source of revenue for the government. Setting the rate is invariably based on the amount of revenue target the national government needs, as what had happened in 1982, when the premium tax rate was raised from 4 % to 6 %. This rate was part of the need to allocate the additional revenue requirements of the financially troubled national government at that time which was under pressure from the IMF to improve its fiscal position and help ease its balance of payments problems. The 6% rate was rolled back to 5 % upon petition by the life insurance industry, with the assistance of the Insurance Commission, and upon government's own rationalization of the rate against other similar direct taxes such as the 5 % tax on the gross receipts of banks at that time.

While the rate settled down at 5%, the approval of the Local Government Code of 1991, giving local governments the power to impose taxes, have increase premium tax rates by 1/2 % for municipalities, and 3/4 % for cities.

Premium tax was first imposed in 1939 at 1 % of premiums collected (minus what is refunded or returned) by the life insurance company during its first ten years of operation. After 10 years of operation of a life insurance company the rate is increased to 1 1/2 %. In 1952, the period of operation for applying the 1 % tax rate was reduced to 5 years, and in the next 5 years of operation a premium tax rate of 2 % was imposed; and after 10 years, the premium tax was 3 %. In 1956, the tax rate for the second five years of operation was again revised for domestic corporations newly organized after 1956 to a higher tax of 3 %.

From 1975 this tax rate was raised to 4 %. The increase of 1 % was programmed for operating funds of the Insurance Commission, to replace the assessment system existing at the time, which were based on each company's revenue, and particular item of operation where expenses for review and supervision are incurred. However, the additional tax did not go directly to the regulatory body but to the national treasury from where the budgetary requirements of the Insurance Commission was allocated. As experience would reveal, the 1 % tax on one year's premium became additional revenue for the national government, as the amount turned out to be more than the annual expense budget of the Insurance Commission.

Documentary Stamp Tax

This type of tax is probably of European origin. Spain is very likely the country where the Philippines adopted it from. There is no similar tax in the USA. A similar tax exists in countries in Asia that had British and French influences. As the name indicates, it is a tax on the document, which in the case of life insurance is levied on the policy contract and a few other documents issued by insurance companies. This type of levy on life insurance contracts usually come in three forms, namely: (a) a fixed amount per policy; (b) a percentage of the policy contract face amount; (c) a percentage of the premium.

As the name also suggests, this form of tax is imposed as a stamp to be affixed on documents to authenticate its legality. But over the years it has become like other taxes that are levied to raise revenue for the government, as in the case of life insurance. There is no better example of a confused purpose of a form of levy than the documentary stamp tax on the life insurance contract which is imposed upon the face amount of the policy; effectively a tax on the amount promised for future delivery. The documentary stamp tax rate on a non-life insurance policy is levied on the premium. Some documents are levied a fixed amount of documentary stamp tax such as bank checks, drafts, certificates of deposits not bearing interest.

While initially, the documentary stamp tax on a life insurance contract was not of significant amount, it increased five-fold over the years. Every time that the premium tax was revised the documentary stamp tax rate was also increased, to reach the present level of 2.50 per 1,000 of face amount of the policy contract, compared to 0.50 per 1,000 in 1939. At the present rate, it can be categorized as a confiscatory rate when compared with the consideration or premium rate for a yearly renewable term insurance policy. This unique practice of applying the tax on the face amount of a life insurance policy and not on the premium, like other types of insurance creates inequity when allocating the cost of this tax for different policies. Low premium plans carry a higher tax in proportion to the premium. The documentary stamp tax on life insurance policies is an example of a regressive form of tax.

SUMMARY OF THE UNIQUE CHARACTERISTICS OF LIFE INSURANCE FROM THE POINT OF VIEW OF TAXATION

Life insurance companies and their products have unique characteristics that make the application of the general principles and practices of income taxation different from the other kinds of businesses. These characteristics are as follows:

1. Participating policyholders are customers of life insurance companies, spending premiums that are generally classified as personal expenditure, and thereby non-deductible for income tax purposes; but can be classified as owners when they

receive dividends which are partly shares from profits, hence generally considered as taxable income.

2. A purchaser of permanent life insurance incurs an expenditure but also earns investment income from the amount spent. There is no simple, fair and easily understandable method of seggregating the taxable investment component from the personal expense component so that the premium may be properly allocated as taxable income and personal expenditure.

3. The long term duration of permanent life insurance contracts does not lend itself to an objective determination of annual income, for yearly taxation purposes.

4. The conservative accounting practices prescribed for regulation are primarily for the purpose of determining solvency, thus, are not satisfactory bases for the determination of income for tax purposes or for regular financial reporting.

5. Governments have amended income tax laws applicable to life insurance companies with the general objective of raising revenues, unconsciously or consciously disregarding the principles of taxation as they should apply to the unique characteristics of life insurance.

6. In the USA, permanent life insurance and annuity products have traditionally, been favorably treated by income tax laws, often to the detriment of term life insurance and non-life insurance forms of investments. Also, life insurance companies have historically argued for exceptions to general rules on income taxation, and have been successful; but this has been changing.

7. The application of theoretically proper tax principles to life insurance have failed in the USA, due to the general public's unwillingness to accept income taxation of the investment income build-up of the cash values of permanent life insurance policies,

whether annually, or at the time of death of the policyholder. In the Philippines taxation of this investment income, which is provided for in the Tax Code has also "failed" but for a different reason, that of the difficulty of quantifying and monitoring the taxable amount.

8. The strong presence of mutual life insurance companies in the USA has influenced government taxation policies. The income tax law has historically been used to keep a competitive balance between mutual and stock life insurance companies. This fact has also been a strong factor in deciding on the rules for taxation of policyholder dividends. Stock life insurance companies have succeeded in arguing that non-participating policyholders receiving excess interest credits, temporary premium reductions, or experience rating refunds are significantly different from participating policyholders receiving policyholder dividends even though from an economic and practical viewpoint, they are similar.