The Society of Actuaries in Ireland
Life Assurance Taxation Changes - Policyholder Issues

Preamble

The Council of the Society of Actuaries in Ireland has approved the issue of this Position Statement. It is intended as a general expression of the views of the profession on an important topical issue. It is however neither formal guidance nor a definitive expression of the position of the profession as a whole. In particular, it is not intended as individual/specific advice to members of the public, who should take advice as appropriate in the light of their particular circumstances.

Introduction

Fundamental changes in the basis of taxation of life assurance products were announced in the Finance Act 2000 and will come into effect from the 1st of January 2001. The main impetus for change stemmed from the success of the IFSC, which became a major centre for life assurance and unit trust business in the 1990s. The introduction of the new taxation system for domestic Irish business will bring the taxation systems for domestic and IFSC business into line for new business sold from the 1st of January 2001.

This paper sets out the Society's position in relation to those changes and their effect on life assurance policyholders. The Society welcomes the changes but cautions that there are policyholder issues which need careful consideration.

Main Changes

Gross roll-up

The changes apply to policies sold after the 1st of January 2001 only. They involve a move from taxing income and gains on life assurance investments as they arise, to the 'gross roll-up' arrangement where life assurance investments accumulate gross of tax, and an exit tax is then levied on the proceeds of the policy.

Exit Tax

The exit tax will be based on the standard rate of income tax plus 3% (currently this would give an exit tax of 25%) and in the case of full encashments will be applied to the encashment value less the premiums paid into the policy. The tax will be deducted by the insurance company on behalf of the policyholders and passed over to the Revenue.

Death or Disability

On death or disability, no exit tax will be applied.

Position of the Society

Which regime is better for policyholders? There is no definitive answer to the question of whether existing policyholders are better off under the existing or the new tax regimes. The answer depends on the exact terms of the existing policy and the exact terms of the proposed new policy.

There are two main risks for policyholders:

- Some policyholders will cancel their existing policies and set up new policies under the new tax rules without due consideration of all the factors involved in the decision.

- Some policyholders will continue with their existing policies when it would be more beneficial to switch.

The Society recommends that customers considering such a switch should compare the existing and proposed new policies in detail before switching.

Customers should ask their advisor and/or insurance companies for a set of projected future values for the existing policy and for the new policy. Such comparisons should be made using the methods and assumptions set out in the Society's Guidance Note "GN22(ROI)# – Product Disclosure". Customers should compare these projected future values before making a final decision. One policy may give higher values in the shorter term, the other may offer better longer term values. Customers will need to consider their likely investment timeframe before making the final decision.

However, while it is not possible to give a definitive answer that will apply in all cases, it is possible to make a number of statements that will generally be true.

- *If there is an entry charge for the new policy, it is unlikely that the customer will benefit from a switch.*

  Policyholders will have already paid entry charges on their existing policies and may be subject to them again if they cancel and set up a new policy.

- *The higher the cost of exit on the existing policy the less likely it is that the customer will be better off after a switch.*

  The cost of exit includes such charges as surrender penalties. Policyholders switching to a new policy may also forego bonuses which were due under their existing policy. In some cases, policyholders may have to go through an initial waiting period once again before bonuses are due on their new policy.

- *If the new policy has higher ongoing maintenance charges, it is unlikely that the policyholder will benefit from a switch.*

Policies available from the 1st of January 2001 may have higher charges as companies re-price to make up for the loss in profits which they would otherwise suffer due to changes to their corporate taxation basis. The approach will vary from company to company. Customers should check the level of charges before switching.

- *If there are no exit charges on the old policy, no entry charges on the new policy and the ongoing maintenance charges have not increased, then a policyholder will benefit from a switch.*

- *It is likely to be more beneficial to switch within the same life company, in order to minimise the charges involved in switching. Switching between companies is likely to incur higher charges which may negate the benefit of gross roll-up.*

- *Future changes in the basic rate of tax may also affect the balance of taxation paid between a gross roll-up policy and a policy under the current system.*

in draft, pending issue of Life Disclosure Regulations

As can be seen from the above, there are a lot of factors to consider before deciding to make a switch. There is a risk that policyholders may be encouraged to switch inappropriately. It is therefore important that compliance procedures should be in place to ensure that policyholders are not encouraged to switch when it is not in their interests to do so.

Disclosure

The Society welcomes the proposed Life Assurance Disclosure Regulations which are to be introduced in 2001. The disclosure of product details, projected values and commission will provide customers with information on which to base their decisions.

The Life Disclosure Regulations will also require that when a new policy replaces in full or part an existing policy the customer must be advised of the financial consequences of such a replacement and of any possible financial loss as a result. Customers will be asked to sign a declaration that they have received this information. The Society believes that this is an important consumer protection initiative that will act as a control on inappropriate policy replacement.

New customers considering whether to buy a policy now or to wait until 2001 to avail of the new tax regime also need to consider their position carefully. Some companies may reprice their products in January 2001, while others may maintain prices. The approach will also vary by product line. Customers should ask their advisor and the companies for information on policy terms now and in 2001. There could be other consequences in delaying taking out a policy and customers should bear these in mind.

Bundling

As the exit tax is applied to the proceeds of the policy, there is an incentive to 'bundle' protection and investment products together to maximise the tax relief available on protection charges. There has been a move away from this type of bundled product over the last number of years. Companies have separated the protection and investment elements of policies in order to facilitate understanding and transparency. If bundled products do re-emerge, the charges levied for individual aspects of the bundled policies may become less transparent. It will be necessary to take measures to ensure that such policies are readily understood by the policyholder.

Recommendations

The Society of Actuaries in Ireland recommends that:

- Customers considering switching their policies into the new tax regime should compare the policies in detail before switching. Customers should ask their advisor and/or insurance companies for a set of projected future values for the existing policy and for the new policy.

- Compliance procedures need to ensure that policyholders are not encouraged to switch when it is not in their interests to do so. Comparison systems should be set up so that policyholders are fully informed of the consequences of changing existing policies.

- If bundled products are introduced, companies should ensure that they are accompanied by clear disclosure of all the charges for each element of the policy.

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