PERSONAL INCOME TAX APPLIED TO POLICHOLDER DIVIDENDS IN CHINA

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Abstract

The policyholder dividend of participating insurance is essentially different from the usual equity and bond profit. There are disputes on taxing methods in theory and practice, and different countries adopt different taxing methods. This paper designs a basic framework of the personal income tax system for participating insurance policies in China. This is based on the reality that participating insurance accounts for a higher proportion in the Chinese insurance market, which is conducive to an increasing insurance demand and tax source. The author believes that levying taxes is justified, but there is no basis to tax the total policyholder dividends, while tax on part of policyholder dividends is reasonable. Finally, this paper analyzes the impact on the demand for life insurance and the total tax revenue flowing from levying personal income tax on policyholder dividends. The author concludes that the taxing method designed in this paper is better than the taxing method which levies tax on the total policyholder dividends.

Keywords: *China market; policyholder dividends; design of tax system.*

บทคัดย่อ

ผู้ถือกรมธรรมธรรม์ประกันภัยแบบมีเงินปันผลสำหรับกรมธรรม์ประกันภัยที่มีส่วนร่วมนั้นแตกต่างจากตราสารทุนทั่วไปและพันธบัตรที่มีผลกำไร มีข้อถกเถียงมากมายเกี่ยวกับวิธีการคำนวณภาษีทั้งในเชิงภาคทฤษฎีและภาคปฏิบัติ ซึ่งแต่ละประเทศก็มีวิธีการคำนวณภาษีที่แตกต่างกันออกไป เอกสารฉบับนี้ได้ออกแบบโครงร่างเบื้องต้นสำหรับการคำนวณภาษีรายได้ส่วนบุคคลสำหรับกรมธรรม์ประกันภัยแบบมีส่วนร่วมในประเทศจีน โดยใช้พื้นฐานความจริงที่ว่ากรมธรรม์ประกันภัยแบบมีส่วนร่วมมีสัดส่วนที่สูงมากในตลาดประกันภัยของประเทศจีนซึ่งก่อให้เกิดความต้องการด้านประกันภัยและแหล่งที่มาของภาษีมากขึ้น ผู้เขียนเชื่อว่าการจัดเก็บภาษีนี้ถูกต้อง แต่ยังไม่มีหลักเกณฑ์ทางด้านภาษีเกี่ยวกับเงินปันผลทั้งหมดที่ผู้ถือกรมธรรม์ประกันภัยได้ ในขณะที่ภาษีที่คำนวณจากเงินปันผลบางส่วนนั้นสมเหตุสมผล สุดท้ายนี้เอกสารฉบับนี้วิเคราะห์ถึงผลกระทบของความต้องการของ

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การประกันชีวิตและภาษีรายได้ทั้งหมดที่เกิดจากการเก็บภาษีรายได้ส่วนบุคคลจากเงินปันผลของผู้ถือกรมธรรม์ประกันภัย ผู้เขียนสรุปว่าวิธีการคำนวณภาษีที่ได้ออกแบบไว้ในเอกสารฉบับนี้ดีกว่าวิธีการคำนวณภาษีที่เก็บภาษีจากเงินปันผลทั้งหมดที่ผู้ถือกรมธรรม์ประกันภัยได้รับ

INTRODUCTION

Life insurance and tax are two important concepts in the modern economy; they display social management functions both in the micro and macro economy. The relationship between life insurance and tax reflects that on one hand the tax policy may encourage or inhibit the demand and supply of life insurance, and on the other hand the development of the life insurance industry also affects the government's tax revenue to a certain extent. Many countries in the world have detailed provisions for the tax system of the life insurance industry. China, due to the shorter period of development in the life insurance industry, lacks the basic data and operational experience which are necessary to formulate a scientific tax policy. Therefore, there is still a lot of controversy over how to design the tax system. Especially, the question of whether personal income tax should be levied on policyholder dividends from the participating insurance policies (hereinafter referred to as participating insurance) is controversial. There are two different views on whether personal income tax should be levied on these dividends.

The first view is that the tax authorities of some provinces and cities in China think that personal income tax should be levied on policyholder dividends from participating policies. According to the Personal Income Tax Law of the People's Republic of China Enacted in 2007, Item 7 of Paper 2, it stipulates that personal income tax should be levied on the income from interest, dividends and bonuses, and thus, the dividend income from participating insurance should pay personal income tax. Liu (2009) also states that insurance policyholder dividends should be treated as investment income, and therefore insurance policyholders must pay personal income tax.

The second view, which mainly comes from the insurance industry and the insurance educational field, holds that personal income tax should not be levied on the dividend income from participating insurance policies. It argues that the participating insurance dividends are essentially different from the usual equity and bond profits, as they are the surplus earnings from the actual operating result. The actual operating result is superior to the predetermined operating result. Therefore the insurance policyholders should not pay personal income tax. Wang (2006) believes that the policyholders only purchase a commodity; they do not have a creditor's rights or a stockholder's rights to the assets of the insurance company, therefore policyholder dividends do not belong within the collection scope of personal income tax. OECD (2001) insisted that personal income tax should not be levied on participating insurance, unless the accumulated dividends surpassed the original premium paid (Li, 2006). Skipper (2001) also insisted that personal income tax should not be levied on participating insurance (in a special report on the tax system of

the insurance industry).

As the leading product of the life insurance industry in China since 2002, the proportion of participating insurance premium income in the total premium income of life insurance has been more than 50% for a long time. It had reached 57.09% in 2008. Therefore, how to design a reasonable personal income tax system to be applied to the dividend income from participating insurance has a significant impact on the stable development of China's life insurance industry and even the whole insurance industry. The previous research in this area is mostly limited to the discussion of whether to levy tax, but lacks systematic study and any planned design for a tax system. This paper designs a concrete plan on how to levy personal income tax on participating insurance in China. At the same time, this paper analyzes the possible impact of this plan and makes an empirical test of the impact.

VARIOUS RELEVANT TAX SYSTEMS

In analysing the personal income tax system on policyholder dividends from participating insurance in the developed insurance market, the tax system can be divided into two categories, that tax should be levied, and that tax should not be levied. Each of these two categories has two modes, to tax premiums, and to tax dividends. The two categories and their modes are now described.

The first category is the levying of personal income tax on policyholder dividends. This mode stipulates the exact personal income tax from policy holders within a certain range. Considered within the practice of insurance tax, it may be divided into two modes according to the different calculations.

The first mode is that the premium must not be exempted from taxable income. Take USA and Canada as representative of this. The U.S. Internal Revenue Service defines the policyholder dividend as a partial refund of premium paid by policyholders, which reduces the cost to policyholders, and should not be included as income (IRS, 2004). The question of whether to tax, depends on the total amount of policyholder dividends. If the total amount of policyholder dividends surpasses the net premium of the insurance policy, the excess should be levied; on the contrary, it should not be taxed. Canada also regards the policyholder dividend as a partial refund of premium paid by policy holders, and its mode of tax collection is similar to that of the United States.

In the second mode, the premium is exempted from taxable income. Take Japan as representative of this. Unlike the United States, the Japanese tax law stipulates that the premium paid by the policy holders can be exempted from taxable income, and the dividend is considered to be a return of premium. Therefore, in the calculation of taxable income, the policyholder dividends should be subtracted from the exemption premium, namely:

Taxable income = the taxable income before insuring, ***minus*** *(the premium minus the dividends)*

The second category is exempting policyholder dividends from personal income tax. There are also two modes. First, taking the United Kingdom as representative, its tax exemption is mainly determined by its special dividend distribution. Unlike the USA, Canada and Japan, in England policyholder dividends are usually added to the insurance amount and therefore these dividends are tax-free. Second, taking Hong Kong and Singapore as representative, they regard the total policyholder dividends as a return of premium, therefore these dividends are completely tax-free.

WHETHER TO TAX, AND IF SO, DESIGN A TAX SYSTEM

In view of current contradictions and problems in taxing participating insurance business, the author believes that we should proceed by examining two aspects: one is whether we should levy tax, the other is how to design a basic framework for the tax system.

On the question of whether tax should be levied, the viewpoint of this author is that levying tax is correct, but with the proviso that it should not be levied on the total policyholder dividends, but only on part of those dividends. The rationale is as follows:

- First, consider the nature of policyholder dividends. They have a dual nature, that is, they are composed of the premium return and investment income.

Policyholder dividends derive from three benefits:

i. the benefit from the actual mortality being lower than the hypothetical mortality,
ii. the benefit from the actual investment rate being higher than the hypothetical investment rate,
iii. the benefit from the actual expense rate being lower than the hypothetical expenses rate.

The first and third benefits can be viewed as the return of premium, because they come from the cautious pricing of insurance companies. However, the second benefit cannot be treated as a return of premium, because the buying behavior of the policyholders should be regarded as an endorsement of the hypothetical rate, therefore if the actual investment rate is higher than the hypothetical investment rate it should be regarded as a benefit of insurance company investment, and therefore should be treated as investment income of policyholders.

- Second, in regarding the functions of participating insurance, the safeguard function has replaced the social function of the national finances to some

extent. Therefore tax exemption should be granted for this safeguard part, while tax should be levied on the investment part.

- Third, regarding the insurance premium structure of participating insurance, the investment part can be regarded as non-voting shares[1] of the insurance company. Therefore, personal income tax should be levied according to the existing personal income tax law.
- Fourth, regarding accumulated policyholder dividends and foreign experience, tax should be levied on the excess when the accumulated policyholder dividends exceed the cost of insurance, such as in the U.S., Canada, Japan and elsewhere.

DESIGNING A BASIC FRAMEWORK IN CHINA FOR TAXING DIVIDENDS

The personal income tax system for participating insurance must follow the principles of fairness and efficiency, otherwise a tax should not be levied. At the same time; we should try to avoid the impact of taxation on the life insurance market. By learning from foreign experience and following the operating characteristics of the life insurance industry, the basic framework of the personal income tax system on participating insurance in China should include the following four aspects:

- First, consider the tax source and the tax base. The tax source and the tax base of participating insurance include the three benefits mentioned above as well as the accumulated interest of policyholder dividends. In the situation where the three benefits apply, policyholder dividends should be completely tax-free. However, if the benefit from the actual investment rate is higher than the hypothetical investment rate, then the dividends should be taxed. The accumulated interest of policyholder dividends should also be taxed.
- Second, consider the taxing method. The personal income tax system on participating insurance adopts a tax-deferred withholding[2] taxing method. The taxation time point is deferred to the end of the policy period when the policyholder receives the income. This method not only saves some administrative cost, but also produces an incentive effect on policyholders.
- Third, consider the determination of the tax rate. Due to the social management function of the life insurance industry, some preferential taxation should be reflected in the determining of the tax rate. This paper proposes that the preferential tax rate be set at 10%;
- Fourth, the implementation time of the personal income tax system on participating insurance. This should be consistent with other investment products, and should be introduced at the right moment.

AN ECONOMIC ANALYSIS OF THE IMPACT ON LIFE INSURANCE

Levying personal income tax on policyholder dividends will undoubtedly affect life insurance demand. Currently, the main motivation for participating insurance policyholders is to obtain an investment return which should be higher than the market average investment rate. The impact of taxation on life insurance demand is that levying personal income tax on policyholder dividends leads to a decline in the expected return rate for policyholders. On the one hand, compared with other investment products, participating insurance becomes more expensive, and on the other hand, the actual income of the participating insurance policyholders declines. A rising relative price and falling real income make participating insurance policyholders turn to alternative financial products. The above factors lead to an overall decline in life insurance demand, as in Figure 1 below:

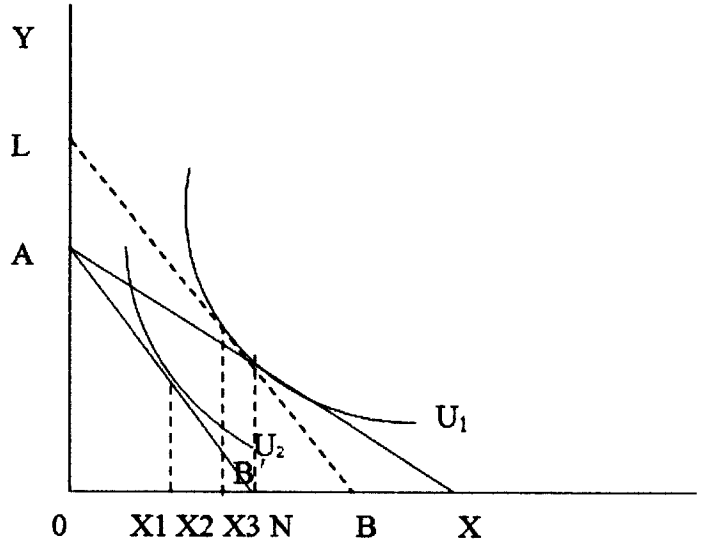

Figure 1: The income effect and substitution effect of levying personal income tax on policyholder dividends

In Figure 1, the X-axis represents the participating insurance demand; the Y-axis represents the demand for other investment-oriented financial products; AX and AN represent separately the Pre-tax and Post-tax budget lines while the income stays at the same level. Before levying a tax on policyholder dividends, the demand of the participating insurance is X3 when the budget line-AX is tangential to the Difference Curve in the Demand - U1. After levying tax on policyholder dividends, the demand for participating insurance is x1 when the budget line-AN is tangential to the Difference Curve in the Demand - U2. In Figure 1, the distance between X2 and X1 represents the demand reduction for participating insurance. The reason which causes the reduction is that the rising relative price makes the policyholders turn to other alternative investment products, which is the substitution effect. Likewise, the distance between X2 and X3 represents the demand reduction for participating insurance, while the reason causing this reduction is that the

rising relative price of the participating insurance causes a decline in actual income, which is the income effect. The distance between X1 and X3, aggregating the substitution effect and the income effect, is the demand reduction for participating insurance caused by the introduction of personal income tax on policyholder dividends.

AN EMPIRICAL ANALYSIS OF THE IMPACT ON LIFE INSURANCE

Regarding the difference between the tax systems of participating insurance as designed in this paper and the tax system stipulated by the tax authorities, we will now investigate their impact on the life insurance industry and the total tax revenue.

Data selection

This paper takes the proportion of participating insurance premium income in the total homochronous life insurance premium income as the output variable, and takes the investment rate as the input variable. For the policyholders who purchased participating insurance, their participating insurance investment rate is based on that of the previous year, which means that if they buy the participating insurance in period T, they will refer to the investment rate in period T-1. This paper selects the proportion of participating insurance premium income in the total homochronous life insurance premium income for the 2001-2008, and the insurance fund investment rate for 2000-2007 in China as the sample data. This is shown in Table 1 below.

Table 1: Participating insurance 2001-2008, and insurance fund investment rate 2000-2007

Period T	the proportion of participating insurance premium income in the total homochronous life insurance premium income (%)	Period T-1	investment rate of insurance fund (%)
2001	36.64	2000	3.59
2002	49.3	2001	4.3
2003	57.84	2002	3.14
2004	56.54	2003	2.68
2005	56.89	2004	2.9
2006	59.37	2005	3.6
2007	49.76	2006	5.8
2008	57.06	2007	12.17

Source: Yearbook of China's Insurance (2001-2009)

Research Methodology

This paper applies the output contribution ratio to the input in order to analyze the relationship between the proportion of participating insurance and the investment rate. The contribution ratio is an indicator for analyzing economic efficiency. It refers to the ratio of the effective or useful results and the resource consumption or occupancy, namely the ratio of the output to the input, or the ratio of the obtained output and the consumption input. The formula is:

Contribution ratio (%) = Contribution (output, the obtained) / Input (consumption, occupancy) x 100%

This paper will take the investment rate as the input, and take the proportion of participating insurance premium income in the total homochronous life insurance premium income as the ouput contribution. The Contribution Ratio of the investment rate to the proportion of participating insurance premium income refers to the proportion of participating insurance premium income in the total homochronous life insurance premium income corresponding to the unit of investment rate. Under the assumption that the contribution ratio of the participating insurance is γ_T in period T, the pro-portion of participating insurance premium income in the total homochronous life insurance premium income is γ_T in period T, the investment rate is x_{T-1} in period T-1, that is: (Equation 1)

$$\gamma_T = \frac{\text{the proportion of participating insurance premium income in the total homochronous life insurance premium income in period T}}{\text{the investment rate period T - 1}} = \frac{\gamma_T}{x_{T-1}}$$

ANALYSIS OF THE RESEARCH DATA

According to Equation 1 and the data in Table 1, the contribution ratio of the participating insurance to the investment rate in China for 2001-2008 can be obtained. It is shown in Table 2 below.

Table 2 shows that during 2004 to 2008, the contribution ratio of the participating insurance to the investment rate in China has been rising rapidly, while in the same period the contribution ratio of the investment rate diminished gradually. The reason is that from 2001 to 2004, the capital market in China was in a bear market over a long period of time. Also, there are not many other investment products in the financial market, while the dividend rates of the participating insurance were much higher than the homochronous bank deposit interest rate. So the participating insurance had rapid development. From 2001 to 2004, the capital market became active gradually; lots of investment products began to emerge. During this time, the stimulating effect of the dividend rates to participating insurance demand decreased gradually.

Table 2: Contribution ratio of the investment rate in China for 2001-2008

Period T	the proportion of participating insurance premium income in the total homochronous life insurance premium income (%)	Period T-1	the investment rate (%)	the contribution ratio of the investment rate (%)
2001	36.64	2000	3.59	10.21
2002	49.3	2001	4.3	11.47
2003	57.84	2002	3.14	18.42
2004	56.54	2003	2.68	21.10
2005	56.89	2004	2.9	19.62
2006	59.37	2005	3.6	16.49
2007	49.76	2006	5.8	8.58
2008	57.06	2007	12.17	4.69
Average	52.925		4.7725	13.82

Source: Yearbook of China's Insurance (2001-2009)

In the tax system of participating insurance, there are differing views between this paper and the tax authorities. In order to analyze their impacts on the life insurance industry and the total tax revenue, we make the following assumptions. All the existing participating insurance policies are single premium; the total premium amounts to 40 billion Yuan; the insurance period is 10 years; the annual policyholder dividends rate is 5%; the personal income tax rate is 10% on policyholder dividends; the market interest rate is 0; and the policy dividends in excess of the insurance cost accounts for 80%. According to the calculation formula of the contribution ratio, this paper selects the average contribution ratio between 2005 and 2008 as a reference point for the impact degree of the participating insurance, which is 12.35.

If we take 2007 as the example, then:

First, let us examine the tax system stipulated by the tax authorities. The total Post-tax policyholder dividend is 400*5%*(1-10%) *10 = 18 billion Yuan. Taxable personal income amounts to 400*5%*10%*10 = 20 billion Yuan. After taxation, the proportion of participating insurance premium income in the total homochronous life insurance premium income is calculated as 49.76%-5.8*10%*12.35 = 42.6%?dropping by (5.8*10%*12.35/49.76%) *100% = 14.39%. After taxation, the premium income of the life insurance industry drops by (5.8*10%*12.35/49.76%) *49.76% = 7.16%.

Second, we design the tax system of participating insurance as explained in this paper. The viewpoint in this paper is that the tax-deferred withholding taxing method should be adopted to levy personal income tax on policyholder divi-

dends. The tax scope includes those policyholder dividends greater than the insurance cost and the accumulated interest of policyholder dividends. Therefore, at the expiry time of an insurance policy, the policyholder dividends and interest amounts to $400*5\%*\frac{(1-1.05^{10})}{1-1.05}= 25.156$ billion Yuan, of which the policyholder dividends are 20 billion Yuan, and the accumulated interest is 5.156 billion Yuan. Taxable personal income tax totals 200 * 80% * 10% +51.56 * 10% = 2.116 billion Yuan, an increase of 116 million Yuan more than the original. After taxation, the total policyholder dividends amount to 251.56-21.56 = 23 billion Yuan, the policyholder dividends rate is 5.75%, the proportion of participating insurance premium income in the total homochronous life insurance premium income is 49.76%-5.8* (5-5.75?/5*12.35 = 60.50%) increasing by 10.74%. After taxation, the premium income of the life insurance industry increases by 10.74%*49.76% = 5.35%.

CONCLUSION AND SUGGESTIONS

This paper has conducted a theoretical and empirical analysis to explore the question whether personal income tax should be levied on the policyholder dividends of participating insurance. By contrast, we conclude that if 10% personal income tax is levied on the policyholder dividends of the participating insurance in accordance with the claims of the tax authorities, the market share of the participating insurance will drop by 14.39%, and the premium income of the participating insurance will decrease by 7.16%.

However, if we follow the recommendations in this paper, levying personal income tax would depend on the different sources of policyholder dividends. On one hand, the market share and premium income of the participating insurance will increase; on the other hand, the tax revenue of tax authorities also increases. The viewpoint in this paper is that the tax-deferred withholding method should be adopted to levy personal income tax on the policyholder dividends, compared with the system now used by the tax authorities in China. This taxing method has a strong advantage, both for policyholders' policy benefits and also on the total tax revenue of the tax authorities.

In short, there will be a greater negative impact on the development of the life insurance industry in the present system of levying personal income tax on the policyholder dividends. However we can minimize this negative impact through designing a reasonable tax system, where even the negative impact can be transformed into a positive impact, and make the participating insurance business develop healthily.

Endnotes

[1]Nonvoting shares refers to the shares which do not entitle the holders the right to operate and manage the Corporation according to the laws or the company's Charter, but the shareholders can still participate in the general meeting.

[2]Withholding taxing method means the tax amount shall be withheld and paid to the tax authorities by the enterprises, and individuals obligated to pay tax, according to the tax law, from the taxpayer's income.

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