

Decoding the Direct Taxes Code - III
Taxability of Amount Receivable under Life Insurance Policies
By CA. Pradip R Shah
pradip@pradiprshah.com

Introduction:

- 1.0 In any system when major structural changes take place, certain sections are bound to be affected. It is the duty of the stakeholders to ensure to represent their case in proper perspective to the policy makers. This requires examination of the existing structure, to what extent it is within the permitted norms of the system and to what extent unauthorised parts have evolved therein. Any justification for redressing the adverse impact can be only for those sections that have operated within the norms permitted. No society can permit perpetual immunity to any section of it who have defied the norms laid down by the said society itself. This is not only logical but equitable as well. No society can permit perpetual impunity for defying its rules and regulations. This is for the reason that, if done so, its very foundation will get shaken and it can no longer survive.
- 1.1 The case in point is the proposal under the Direct taxes Code (DTC) to levy tax on amount received under life insurance policy. It is vehemently argued that the Government is playing foul by changing the rule of the game in between. Having declared the said amount exempt so far, the policy cannot be changed overnight, making life difficult for numbers of tax payers. It is also argued that based on the existing provisions of the Income Tax Act (ITA) the taxpayers have made long-term commitments and changing the rule when these commitments have not been fulfilled, will put them into difficulties. When one reads the provisions of ITA on which, these arguments are based, and see the ground reality, one gets totally different picture. This is not to say that the proposed provision will not hit the taxpayers. It will certainly hit the hardest to those who have tried to out-smart the system.
- 1.2 It is also arduously argued to remove the provisions in this respect. As usual, the layman is confused failing to understand where lays the truth. For ordinary taxpayers, they have been told by marketing people of the insurance companies about the tax benefits available for all the insurance policies sold by them. Of late, in order to capture market share, most of the insurance companies have structured insurance products which are more of investment and lending of money rather than investment as such.
- 1.3 All these are complex issues and require study of the history how the ITA has treated insurance policies so far, at what point of time the same were changed and for what reasons. It will also be interesting to see how the Income Tax Department itself has turned blind-eye to these provisions and relegated it to as of no consequence. First of all, let us see the present status, proposed provisions, and how many and which types of taxpayer get affected.

Historical Background:

- 2.0 S. 10(10D) of the ITA contains provisions relating to exemption of any amount received under life insurance policy. Finance Bill 2003 made major amendment in this respect. Prior to the said amendment, it read thus:

Any sum received under a life insurance policy, including the sum allocated by way of bonus on such policy other than any sum received under sub-section (3) of section 80DDA or under a Keyman insurance policy.

2.1 As can be seen, any amount received under the life insurance policy, were exempt. With the relaxation of licensing policy of the Government of India, private sector was also permitted to operate therein. With large numbers of companies were permitted to carry business of life insurance; the competition is bound to be fierce. In order to capture market, and lure the high net-worth individuals (HNI), insurance products were structured leveraging the provisions of S. 10(10D). The insurance policies structured were becoming more of financial products and less of insurance as such. An analysis of these policies will reveal that the element of coverage of risk was extremely low. In fact, these policies were structured around keeping in mind the rate of interest prevailing, rate of Income Tax etc. In order to make it attractive, the insurance companies made it addressed to various needs like tax –free income and high yield rather than insurance. The idea of selling life insurance to common man at affordable rates was relegated to the background, rather it was almost forgotten. A problem with these products was that under the shield of tax exemption for insurance, HNI started using it for deriving tax-free income.

2.2 The development came to the notice of the Government. The Finance Bill 2003, with effect from assessment year 2004-05, replaced the erstwhile S. 10(10D) with a totally new one and made certain amendments in S. 88 i.e. relating to deduction from gross total income. Newly inserted section 10(10D) which is applicable today reads as follow:

- (10D) *any sum received under a life insurance policy, including the sum allocated by way of bonus on such policy, other than—*
- (a) *any sum received under sub-section (3) of section 80DD or sub-section (3) of section 80DDA; or*
 - (b) *any sum received under a Keyman insurance policy; or*
 - (c) *any sum received under an insurance policy issued on or after the 1st day of April, 2003 in respect of which the premium payable for any of the years during the term of the policy exceeds twenty per cent of the actual capital sum assured:*
- Provided** *that the provisions of this sub-clause shall not apply to any sum received on the death of a person:*
- Provided further** *that for the purpose of calculating the actual capital sum assured under this sub-clause, effect shall be given to the Explanation to sub-section (2A) of section 88.*

2.3 Let us see its salient features:

- 1) It exempts any amount received under life insurance policy except the one stated under sub-clause (a), (b) and (c).
- 2) Sub-clause (a) makes taxable the amounts which have been received u/s 80DD and 80DDA. These sections are relating to tax deduction granted in respect of amount spent for treatment of disabled persons.
- 3) Sub-clause (b) provides for taxing the amount received under Keyman Insurance Policies.
- 4) Sub-clause (c) is the most important clause and is villain in the drama. It did not permit exemption to certain types of the policies viz.
 - a. any sum received under an insurance policy issued on or after the 1st day of April, 2003; and
 - b. in respect of which the premium payable for any of the years during the term of the policy exceeds twenty per cent of the actual capital sum assured

2.4 A proviso was also inserted making it clear that, in the case of death of a person, exemption will be available even if the policy did not satisfy the above two conditions. Thus, exemption was withdrawn for the policies which were not within the permitted norms. It should be noted that the above provisions indirectly permitted exemptions to following types of cases:

- a. Life Insurance policies which were issued before 1-4-2003 irrespective of the amount of the premium payable with respect to the capital sum assured.
- b. Policies wherein the premium payable was less than 20.00% of the capital sum assured.

Justification for Amendment:

3.0 What was the justification for the amendments? The “Notes on Clauses” and “Memorandum to Finance Bill, 2003”, in clear terms, spell out the reasons for the amendments. Read the following two paragraphs.

Notes on Clauses

Under the existing provision contained in clause (10D), any sum received under a life insurance policy, including the sum allocated by way of bonus on such policy other than any sum received under sub-section (3) of section 80DDA or any sum received under a Keyman insurance policy, shall be exempt.

It is proposed to substitute the said clause, so as, inter alia, to provide that any sum received, under an insurance policy in respect of which the premium paid during any year exceeds twenty per cent of the actual capital sum assured, shall not be exempt. However, such sum received under the proposed sub-clause (iii) on the death of a person shall be exempt. It is also proposed to clarify that for the purpose of calculating the actual capital sum assured under this clause, effect shall be given to the Explanation to sub-section (2A) of section 88 of the Income-tax Act. It is also proposed to provide that any sum received under sub-section (3) of section 80DD shall not be exempt.

This amendment will take effect from 1st April, 2004 and will, accordingly, apply in relation to the assessment year 2004-2005 and subsequent years.

Sub-clause (b) proposes to insert a new sub-section (2A) so as to provide that the provisions of sub-section (2) shall apply only to so much of any premium or other payment made on an insurance policy other than a contract for a deferred annuity as is not in excess of twenty per cent of the actual capital sum assured.

It is also proposed to clarify by the Explanation in the proposed sub-section (2A) that in calculating any such actual capital sum, no account shall be taken of the value of any premiums agreed to be returned, or of any benefit by way of bonus or otherwise over and above the sum actually assured, which is to be or may be received under the policy by any person.

This amendment will take effect from 1st April, 2004 and will, accordingly, apply in relation to the assessment year 2004-2005 and subsequent years.

Memorandum to Finance Bill, 2003

Rationalization of the tax concessions in respect of insurance policies having the amount of premium more than twenty per cent of the actual capital sum assured

Under the existing provisions contained in clause (10D) of section 10, any sum received under a life insurance policy, including the sum allocated by way of bonus on such policy, (other than any sum received under a policy for the medical treatment, training and rehabilitation of a handicapped dependant under section 80DDA or any sum received under a keyman insurance policy), is exempt.

Under the existing provisions of section 88, a deduction from the income-tax payable is allowed to an individual or a Hindu undivided family (HUF), in respect of any sums paid or deposited in PPF, GPF, NSC, insurance premia, etc. The deduction is allowed at specified percentage of such sums.

The insurance policies with high premium and minimum risk cover are similar to deposits or bonds. With a view to ensure that such insurance policies are treated at par with other investment schemes, it is proposed to rationalise the tax concessions available to such policies. It is therefore, proposed to substitute the clause (10D) of section 10, so as to provide that the exemption available under the said clause shall not be allowed on any sum received under an insurance policy in respect of which the premium paid in any of the years during the term of the policy, exceeds twenty per cent of the actual capital sum assured. However, any sum received under such policy on the death of a person shall continue to be exempt. It is also proposed to clarify that the value of any premiums agreed to be returned or of benefit by way of bonus or otherwise over and above the sum actually assured, which is to be or may be received under the policy by any person, shall not be taken into account for the purpose of calculating the actual capital sum assured under this clause. The new provision also provides that the amounts received under sub-section (3) of section 80DD, shall not be exempt under this clause.

It is also proposed to insert a new sub-section (2A) in section 88 which seeks to provide that the deduction in respect of the sums paid or deposited as premium under an insurance policy shall be available only on so much of the premium or other payment made on an insurance policy, other than a contract for a deferred annuity, as is not in excess of twenty per cent of the actual sum assured.

It is also proposed to clarify that the value of any premiums agreed to be returned or of any benefit by way of bonus or otherwise, over and above the sum actually assured, which is to be or may be received under the policy by any person, shall not be taken into account for the purpose of calculating the actual capital sum assured under this clause.

The proposed amendment will take effect from 1st April, 2004 and will, accordingly, apply in relation to the assessment year 2004-2005 and subsequent years.[Emphasis supplied]

- 3.1 As can be seen, the policies with high premium and minimum risk were considered as deposits and bonds and, therefore, the same were not considered fit for tax exemption. The objectives of S. 10(10D) were made known to the tax payers i.e. exemption is available for insurance and not earning interest or capital appreciation. Let it be understood that the above

Notes and Memoranda are part of the Budget proposals and are, therefore, in the domain of public knowledge.

Proposals under DTC:

- 4.0 S. 56(2)(f) of DTC provides for inclusion of the entire amount received under the head “Income for Residuary Sources” (IRS). The section reads as follow:

(f) any sum received under a life insurance policy, including the sum allocated by way of bonus on such policy;

However, S. 57 providing for deduction from IRS includes a clause permitting deduction of certain type of amount in this respect. Sub-clause (3) reads as follow:

(3) The amount of deduction referred to in clause (b) of sub-section (1) shall be the following -

(a) any sum received under a life insurance policy, including the sum allocated by way of bonus on such policy, if -

(i) the premium payable for any of the years during the term of the policy does not exceed five per cent of the actual capital sum assured; and

(ii) the sum is received only upon completion of the original period of contract of the insurance or upon the death of the insured;

It can be analysed as follow:

- a) As against the limit of 20.00% of the sum assured, it has been brought down to 5.00%
- b) Secondly, the sum should have been received on completion of the term of the contract or the death of the insured. Provision in this respect is exactly the same as they are under the ITA as on today.

4.1 A typical nature of the insurance policy is that they are of longer duration, at times, running into 20 or more years. Therefore, there will be cases wherein the provisions of DTC will be applicable to the policies taken prior to 1-4-2003 as well. Let us examine various dimensions involved herein in detail, as each one will affect taxability of the amount received.

4.2 First dimension is the time frame during which the policies were taken. We have three scenarios viz.

- (i) policies taken prior to 1-4-2003,
- (ii) policies taken between 1-4-2003 and 31-3-2011; and
- (iii) policies taken after 1-4-2011.

4.3 Second dimension is with respect to premium payable and sum assured. There are three cases viz.

- (i) policies where the premium is equal to or less than 5.00% of the sum assured
- (ii) policies where the premium is equal more than 5.00% but less than 20.00% of the sum assured ; and
- (iii) policies where the premium is equal to or less than 5.00% of the sum assured and issued after 1-4-2011 i.e. under DTC

4.4 The third dimension is with reference to the circumstances under which the amount of life insurance policies is received. Both ITA and DTC, provides for certain exemptions. The three cases covered for examination are as follow:

- (i) policy amount received upon completion of the original period of contract
- (ii) policy amount received upon the death of the insured; and
- (iii) Pre-mature Withdrawal

4.5 Thus, in order to examine in totality under the DTC, we have to examine 27 cases. An attempt has been made to present it in the form of a table giving some clarity.

			Repayment / Receipt		
	(A)	(B)	(C)	(D)	(E)
	Policy taken during the period	Type of Policy – Amount of premium with reference to capital sum assured	upon completion of the original period of contract	upon the death of the insured	Pre-mature Withdrawal
1	Prior to 1-4-2003	less than 5.00 %	Exempt	Exempt	<i>Taxable</i>
2		More than 5.00 % but less than 20.00%	<i>Taxable</i>	Exempt	<i>Taxable</i>
3		More than 20.00%	<i>Taxable</i>	Exempt	<i>Taxable</i>
4	1-4-03 to 31-3-2011	less than 5.00 %	Exempt	Exempt	<i>Taxable</i>
5		More than 5.00 % but less than 20.00%	<i>Taxable</i>	Exempt	<i>Taxable</i>
6		More than 20.00%	<i>Taxable</i>	Exempt	<i>Taxable</i>
7	1-4-2011 onwards	less than 5.00 %	Exempt	Exempt	<i>Taxable</i>
8		More than 5.00 % but less than 20.00%	<i>Taxable</i>	Exempt	<i>Taxable</i>
9		More than 20.00%	<i>Taxable</i>	Exempt	<i>Taxable</i>

4.6 As can be seen from above, in the normal course, it is only in the case of 2,3,5, 6, 8 and 9 the amount becomes taxable. It means that all the cases wherein the amount of premium is high and the risk element is low, are made taxable. One need not remain under an impression that DTC makes the entire amount received as taxable.

Who gets affected by the provisions in DTC?

5.0 Although the Discussion Paper does not spell out in clear terms, certain unhealthy development, particularly of laundering black money into white thru insurance policy, has surfaced. The modus operandi is simple. Premium for long term policy is being paid by cash or thru undisclosed bank account. These policies mature after 15 to 20 years. At that time, since it is receipt from insurance companies, it will be treated as exempt income. At present, there is no system under which premium paid by the policyholders for various types of policies are reported to the I Tax Department. Since these policies will mature after 20 years or so, the question of providing any records for the source of investment does not arise. Even the ITA does not require the assessee to maintain records for such a long period nor does it authorises the Assessing Authorities to call for such old records. Keeping unaccounted money idle at home or in the bank locker does not earn anything. Moreover, it is comparatively easy to store pieces of papers containing policies rather than currency notes. Thus, tax evaders were (and are) having hey days as they were getting the best of all the

worlds. Read the following news item which appeared in “The Economic Times” of 21st June, 2009. It will give some idea of what is going on under the garb of insurance policies.

The I-T department is baffled by the new trend of huge amounts of cash being used to buy financial products which they suspect is black money.

Tax officials have investigated a number of cases in which investors have bought insurance policies by paying cash up to Rs 1 crore, forcing the department to re-examine many assesseees with income of up to Rs 5 crore per annum, an official in Central Board of Direct Taxes (CBDT), who did not wish his name to be disclosed, said.

The department is now investigating a case of a husband and wife duo in one of the metro regions using cash to buy an LIC policy worth Rs 1.1 crore. Similarly, it's also examining two cases in which insurance products worth Rs 44 lakh and Rs 38 lakh were bought using cash in Karnataka, the official said.

The I-T department normally investigates most of the returns filed by those earning above Rs 1 crore annually. However, several cases in the Rs 1-5 crore annual earnings bracket escape scrutiny. This, tax officials say, may have encouraged tax evaders to use unaccounted for cash to invest in financial products.

“It's an audacious attempt on the part of some upper middle class investors to use black money for buying LIC policies as everything here gets recorded unlike in the case of buying a house,” an official of the I-T department, who did not wish to be named, told Sunday ET.

When contacted, CBDT member (Investigation) Sudhir Chandra confirmed to Sunday ET that some cases in which cash was used to buy financial products were being investigated into, but refused to elaborate on individual cases.

He further said that tax evasion of assesses between Rs 1 crore and Rs 5 crore had increased over the years, but did not confirm whether the segment may come under I-T department scanner. About 80% of the data provided by Financial Intelligence Unit-India (FIU-IND), the national agency hunting for suspicious financial transactions under the finance ministry, is used by the I-T department alone.

[The Economic Times dt. 21st June, 2009]

High Yield Returns?

- 6.0 Even in the case of high-premium policies, the objective was to get tax free income rather than insurance. Provisions regarding premium permitted being less than 20.00% of the sum assured are in the statute since 1-4-2003. Having been fully aware of the weakness of the tax assessment system, certain section of the society has misused it to their advantage. To some extent the Income Tax Department is also at fault. This is for the reason that no attention has been paid to this aspect of tax evasion. As we all know, the Assessing Officers have never looked into it seriously. Any amount shown as received under a life insurance policy is considered as exempt by default. It is forgotten that the provision of S. 10(10D) are with the riders.

Relevance of 5.00% / 20.00%

7.0 For a layman, all these may sound confusing. Why should the Government lay down the limit at 20.00% or at 5.00%? Why not any other figures? We have seen the reasons for laying down the limit of 20.00% of the capital sum assured. Although, not so stated specifically in the Finance Bill 2003 or even in DTC, the intention is to exempt the amount received under the insurance policy, and not any other amount. Except in the case of Term Insurance plan, when a person makes payment of insurance premium it consists of two parts viz. cost of insurance and investment with the insurance company. The insurance company treats receipt of premium accordingly. Therefore, if the insurance component is only required to be permitted as tax-free then the policies can be identified with the amount of premium payable with reference to the capital sum assured. If the premium consists of element of cost of insurance only, which is the case with Term Assurance Plan, it means that the said policy is for the purpose of insurance only and there is no question of earning any return. In view of this, rate of premium payable on Term Assurance Plan provides a bench mark. Look at the Table below for a Term Assurance Plan of Life Insurance Corporation of India called Jeevan Amulya-I. Term Assurance Plan of the private sector companies also charges the premium around this line only. It is a plan wherein only death benefits are available and no amount is returned to the assured during his life time. (For many of the people this may sound strange for the Insurance Company not returning any capital. However, look at the premium paid for two or four wheeler. How much money is being returned by the insurance company at the end of one year? Nothing.)

Annual Premium:

Age (yrs.)	Term of the Policy (years)						
	5	10	15	20	25	30	35
20	1.97	1.97	1.97	1.97	2.05	2.18	2.38
25	2.07	2.07	2.08	2.18	2.35	2.61	2.94
30	2.13	2.19	2.36	2.57	2.92	3.36	3.88
35	2.43	2.64	2.94	3.40	3.97	4.65	5.47
40	3.04	3.43	4.07	4.81	5.70	6.77	-

7.1 As can be seen from above, maximum rate of premium is at Rs. 6.77 per Rs. 1,000 of sum assured. This works out to approximately 0.7% of the sum assured. Thus, keeping margin of around 4.93 % for with – profit policies, wherein some amount is also returned by the insurance company to the policy holders, the bench-mark of 5.00% must have been arrived at. Whether it is sufficient enough to cover majority of the cases of low income group is a matter of debate. The only question that one finds difficult to digest is climb-down by the Government from 20.00% to 5.00% of the sum assured.

7.2 In all one can say that the idea is to promote pure term assurance plan and the policies wherein very low rate of return is assured by the insurance company. For rest of the policies, are proposed to be termed as financial asset and tax the amount received as income.

Are the provisions of DTC equitable?

8.0 This issue needs to be examined from various angles. Let us take the case of a person who has taken policy of 15 years duration and premium is more than 5.00% of the sum assured

prior to 1-4-2003. Since at that time such provisions were not there he will be in serious problem as the entire amount received will be taxable. In the case of policies taken during the period 1-4-2003 to 31-3-2011, and having rate of premium more than 5.00% but less than 20.00% of the capital sum assured, will also be facing problems. These are the cases wherein the taxpayers have operated within the declared policy and the statutory provisions prevailing at the relevant point of time. There can, certainly any element of equity in putting them to hardship. One should not shed tears for those who have defied the provisions of the ITA as prevailing at the relevant point of time. For example, those who have gone for the policies wherein the rate of premium is more than 20.00% for the capital sum assured have to blame themselves for their ignorance of law and greed. They do not have any ground to complain.

8.1 As far as those who have opted for insurance policies for laundering unaccounted money, they may find themselves in more difficult situation. What they wanted to hide will come out on the surface and will be visible.

What is the way out?

9.0 Blanket exemption is certainly out of question as it will give undue advantage to those who have placed their money for laundering. It will also not be fair to salaried and middle class tax payers who are required to pay tax even on interest income earned of Rs. 100. Certainly there cannot be case for providing HNI an opportunity for earning tax free income.

9.1 A way out can be to modify the provisions in the following way.

9.2 Firstly, the proposed provisions of DTC should be applicable only for those policies which have been taken after 1-8-2009.

9.3 Secondly, as far as policies prior to the said period are concerned, policies issued before 1-4-2003 should be made totally exempt. In the case of policies issued after 1-4-2003 till 31-3-2011, exemption be granted for the cases wherein the premium paid is less than 20.00% of the sum assured. Clauses in this respect should be with sun-set period of, say, 15 to 20 years. This will address to the demand of large number of ordinary policy holders who have relied on the policy of the Government.

Which types of policies DTC proposes to exempt?

10.0 A question may arise in the mind of a common man as to which type of policy he should opt for? The message conveyed is clear. The people should go for the policies wherein the element of insurance is high as compared to financial investment. For better return on investment, one will have to look at the financial markets and various products made available thereat.

Long Term Impact of the proposal of DTC

11.0 It is a fact that majority of the people of India are not covered by the insurance. Those who are covered under insurance, considering their requirements, life styles and future needs, are under insured. It is also a fact that most of the people are not aware of the concept of insurance, its value in one's life and its true cost, as a result of which they become victim of high pitched marketing game plan. DTC proposals of laying down the limit of 5.00% will bring to the notice of the people that the real cost of insurance cannot be more than 5.00% of the sum assured. A look at the rate of premium for any term insurance plan will show that it is around 5.00% of the sum assured. Therefore, what the insured are paying in terms of heavy premium is nothing but investment of surplus funds. An analysis of such plans will reveal that,

if tax incentives are taken out; yield on such insurance plans, in majority of the cases, will be lower than the rate of interest offered on bank fixed deposits.

- 11.1 DTC proposal will make insurance companies sit down and re-draw their market strategy as the people are becoming aware of the hidden cost of high-yield insurance policies. As the people are becoming aware, the trick of luring the insured by high numbers of tax-free income will not do. They will have to become cost competitive and cover more areas of the society rather than focusing on HNI only.

Options for the Policy-holders

- 12.0 A time has come for all of us to take out old policy papers and examine its terms and conditions. At the time of buying the insurance plan we generally do not bother about these issues. However, the time has come to review the whole issue a fresh and take long term view of the situation emerging.
- 12.1 What should the policy-holders do? Should they go for pre-mature payment for whatever surrender value is available? Or should they continue with the policies and pay the tax in future? It is difficult to generalize, for solution to these questions depend upon one's set of circumstances. For example, those who have invested for laundering unaccounted money may find that, if the money is withdrawn at this stage even after incurring losses, it will pose another problem. The debate on this issue has made the tax authorities at lower level enlightened about the provisions under the ITA. Any receipt of money under the insurance policy will prompt them to invoke the provisions of S. 10(10D). Not only that, since the time for re-opening the cases has not gone too far, it may prompt them to invoke the relevant provisions for source of investment.
- 12.2 In the case of assesseees who have opted for it purely for high rate of return i.e. wherein the rate of premium is more than 20.00% of the capital sum assured, may have to work out the cost-benefit analysis. Of course, the danger of paying tax on premium paid and additional amount received, if any, will always remain.
- 12.3 For all those who have gone purely for insurance cover and premium paid is within the limit laid down, there is no cause for worry.

Conclusion:

- 13.0 On thing that can be said about the DTC proposal is that there is no question of giving blanket exemption to amount received under insurance plan forever. And certainly the DTC cannot be a party to the unaccounted money launderers nor can it hold the brief for HNI. Why should one shed tears for such individuals? However, as explained above, in the process of conversion to new system, there are genuine cases which have got trapped for no fault of their own. Their grievances certainly need to be addressed to.