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Résumé de l'article

Les relations du fisc et de l'assurance-vie au Canada sont assez curieuses à étudier. Elles ont passé d'une très grande laxité à une sévérité assez grande pour bouleverser pendant un temps la participation dans les bénéfices des assurés participants. Puis, le ministère des Finances a adouci ses exigences ou, tout au moins, il les a modifiées de façon assez sensible. C'est l'histoire de cette évolution, qui remonte à quelques années, que relate cet article que nous extrayons de *Study Notes of the Society of Actuaries*, avec l'autorisation de la Société.

The Evolution of Life Insurance Taxation in Canada

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This section is very brief and is intended only to give the student a sense of the steps which led up to the current income tax law(1).

1. *Pre-1969*

For over 50 years, insurance companies in Canada were taxed, as a very deliberate policy, in a very different way from other Canadian corporations. During this period, premium taxes of various levels were assessed, first by the Federal Government and then by the Provincial Governments. With respect to income tax, the treatment varied over the years, depending upon whether the company was a life insurance company or an other-that-life insurance company, and whether the company was a mutual company or a stock company. Stock other-than-life insurance companies were essentially subject to tax on their gain from operations since the Income War Tax Act of 1917 but were allowed a credit for premium taxes paid. Eventually, mutual other-than-life insurance companies were taxed in the same way(2).

However, Canadian mutual *life* insurance companies were completely income tax-exempt and Canadian stock *life* insurance companies were taxed only on net earnings transferred to the Share-

(1) For a more complete description of the pre-1972 history of insurance taxation in Canada, see the *Taxation of Insurance in Canada* by Raymond L. Whaley, TSA XXII, pgs. 81ff.

(2) See Whaley Supra page 89ff.

holders' Account. In other words, a tax of approximately $1 was paid for every $1 of dividends paid to shareholders. If an insurance company withheld earnings by not making a transfer to the Shareholders' Account, there was no tax paid on these earnings, or on the investment income on these earnings, until they were actually transferred to the Shareholders Account.

In 1962, the Royal Commission on Taxation (the so-called Carter Commission) was appointed by the Federal Government to carry out a complete investigation of federal taxation. The final report was published in 1967. With respect to life insurance companies, the Commission took the position that the then tax treatment was unduly favourable and that life insurance companies should be treated for tax purposes like "any other" company. Therefore, they recommended that the life insurance companies be taxed at regular corporation tax rates on any earnings not "passed on" to policyholders.

2. *1969 – 1971*

As a result of the Carter Commission recommendations, radical changes in the taxation of life insurance companies were proposed in the Budget of October 22nd, 1968, reflecting the Carter theories, but modified somewhat to eliminate most of the onerous calculations, recordkeeping and reporting requirements which would have been necessary to adhere strictly to them. Under the new system, all insurance companies – life and other-than-life, mutual and stock – were subject to corporate income taxation. The changes introduced in 1969 form the foundation of the current taxation of insurance companies in Canada.

3. *1972 – 1977*

In 1971, the Federal Government enacted a massive Tax Reform Bill completely overhauling the entire Canadian Tax system. This was the major result of the perceived needs for tax reform as outlined in 1967 by the Carter Royal Commission. Of course, as stated above, the major « reform » for insurance companies occurred in 1969 but many of the 1971 changes were equally applicable to life insurance companies as they were to any other company. One of the most important of these was the tax on capital gains.

Basically, during this period (1969-77) the tax systems for insurance companies involved the following major taxes (as well as a policyholder tax and provincial premium, income and capital taxes) :

(i) *Federal Business Income Tax* on the Company's "taxable business income" at normal corporate tax rates – referred to as the Part I Business Income Tax.

(ii) *Federal Investment Income Tax* on "taxable Canadian *life* investment income" – referred to as the Part XII Investment Income Tax.

The Part XII tax, applicable only to the non-segregated life part of insurance companies, was really a tax paid by the life insurance company on behalf of its policyholders. The Carter Commission, discussed briefly under Section I-B, had recommended that any investment income being applied directly for the benefit of life insurance policyholders (including not only interest credited to funds on deposit and the "interest element" in life annuity payments, but also the interest buildup in policy reserves) be reported to policyholders annually and taxed in their hands.

However, the Government recognized the administrative problems which would have resulted from such a complex reporting system and imposed instead, a tax on the net life investment income of insurance companies with adjustments to recognize :

- any amounts actually taxed directly in the policyholders' hands
- the principle of tax deferment on certain registered plans
- interest attributable to fixed premium business where companies were locked into an existing price structure
- that portion of the net investment income which is deemed to be the companies' "income", taxable under Part I, and therefore exempt from the Part XII tax.

In other words, rather than setting up complex machinery for taxing individual policyholders on their investment gains, the government taxed the insurance company at a flat rate of 15% on the assumption that this tax will be passed on to the policyholders in the form of higher premiums or lower dividends.

The 15% tax rate might be assumed to have approximated the average policyholder personal income tax rate. In any event, in most instances the policyholder's own tax rate would have been substituted (sooner or later) for the 15%. In the case of items such as interest credited to funds on deposit, the policyholder paid the tax at his own rate immediately. In the case of surrender or maturity (but not termination by death) of a life insurance policy, any gains were taxed in the policyholder's hands and allowed as a deduction in computing the Part XII tax.

During the years that the Part XII tax was in effect, both the computation of the tax liability for insurance companies in Canada and the tax planning process were extremely complicated. This arose because the Part I life business income could not be computed unless the Part XII investment tax was known, since the Part XII tax was a deduction from the business income tax base(3). At the same time, the Part XII tax couldn't be computed without knowing the Part I business income since such business income was a deduction from the investment tax base. In the final analysis, both taxes could be determined only by effectively solving two linear equations in two unknowns.

As a result, a very complex mathematical analysis was required to be able to make effective tax management decisions. Both for the historical record, and to demonstrate the application of complex mathematical principles and practices to a real life situation, the tax mathematics which was required under the 1972-1977 law is shown in Appendix 1.

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(3) The rationale was that part of the investment income attributable to the life insurance operations (after certain specified deductions) was properly the income of the life insurance company rather than income of the policyholder. Recalling that the purpose of the Part XII tax was to impose a tax *on behalf of* policyholders, then some deduction must be made from the tentative taxable investment income to arrive at an amount assumed to be the policyholders'.

In theory, the sources of operating gains and losses of the life insurance company should have been analyzed to determine that portion attributable to investment income ; this would then be the deduction. However, this was too complex and, in fact, might have been practically impossible. Therefore, the arbitrary assumption was made that *all* of the company's Canadian life "income" for tax purposes arose from investment income. Given this assumption, the appropriate deduction from the "tentative" figure to arrive at the policyholder share was the Part I life business income.

4. *Post – 1977*

In 1977, the Federal Government introduced legislation, which once again brought significant changes to the taxation of insurance companies and their policyholders.

The major corporate changes effective in 1978 were :

- elimination of the Part XII investment tax
- significant revision of rules for determining gross investment income of multi-national life insurers
- substantial reduction in the allowable deduction for policy reserves
- elimination of group life contingency reserve deductions
- phasing out of group health contingency reserve deductions over 10 years
- change to allow full deduction for taxable dividends received from nonsegregated property held in the life business[4].

There were a number of significant reasons for these changes :

(i) the inability of the system to generate sufficient tax revenue, e.g. :

- the Government considered the level of policy reserve deductions allowed to be far too generous
- the Government wanted a better matching of revenue and expenses
- insurance companies were allowed certain deductions for contingency reserves which were not available to other industries. The Government considered this inequitable
- the law contained a number of defects and "loopholes" which allowed some companies to reduce taxable income artificially.

(ii) to more fairly distribute the industry tax burden between companies in different circumstances (e.g. Canadian only vs multinational insurers).

(4) Formerly, such dividends were split into three portions with part deemed to be for the corporation or shareholder and hence eligible for a Part I deduction, part assumed to be for the benefit of policyholders and therefore deductible in computing the Part XII investment tax, and the remainder deemed allocated to tax exempt and tax deferred business and hence not allowed as a deduction at all.

(iii) to eliminate a number of problems posed by the existence of the Part XII Investment Tax

- with the introduction of the $1,000 special deduction for interest and dividend income (see Section IV-A-8), part of the investment income taxable at 15% in the hands of the insurance company would be tax free if it could be identified and attributed to individual policyholders.

This placed insurance at a distinct disadvantage when compared to other forms of savings.

On the other hand, a small portion of the Part XII tax base would, in the hands of policyholders with significant additional investment income, be taxed at a much higher rate than 15%. The Government in general appears to dislike indirect taxation of the Part XII type, because of the ability of high income taxpayers to benefit from the use of such average rates. (At the same time, low income taxpayers pay a higher tax rate than if they were taxed directly).

Notwithstanding the elimination of the Part XII Investment Tax and the deduction of dividends, the net effect of the changes was, in most cases, an increase in corporate tax due to the substantial reduction in the policy reserve deductions.

In addition to corporate tax changes, some major changes were made to the taxation of policyholders ; these are discussed in Section IV.

Therefore, the tax system for insurance companies and their policyholders involves five basic taxes :

- Federal Business Income Tax – on the Company's "taxable business income" at normal corporate tax rates – referred to as the Part I business income tax
- Policyholder Tax – paid by the policyholder at his own tax rates on various kinds of "income" from insurance and annuity policies
- Provincial Premium Tax
- Provincial Income Tax
- Provincial Capital Tax.