TRANSACTIONS OF SOCIETY OF ACTUARIES
1967 VOL. 19 PT. 2 NO. 55

DIGEST OF REPORTS ON TOPICS OF CURRENT INTEREST

CARTER COMMISSION REPORT

MR. H. EDWARD HARLAND: In 1962 a royal commission, headed by Mr. Kenneth Carter, was established to consider the incidence and effects of federal taxation in Canada and to make recommendations for improvements in the tax laws.

The report of the Commission was made public on the twenty-fourth of February of this year. It is composed of six volumes and about 2,700 pages of analysis, discussion, and recommendations. In addition to the report itself, about eighteen of a projected twenty-seven supporting studies have been published.

The Commission might have used the existing tax structure as a base for tax reform, with the appropriate plugging of loopholes, removal of inequities, and reconciliation of anomalies. It rejected this approach and has recommended instead an entirely new structure, built from the ground up.

The report quickly reveals itself to be much more than simply a detailed recommendation of the best way of raising tax revenues. It expresses a philosophy that would profoundly alter the fabric of Canadian society. It conceives the tax structure to be the proper tool of government in aggressive and far-reaching policies of income redistribution and management of the economy.

The Commission has attempted to provide a logical basis for its recommendations by postulating a number of underlying concepts:

1. *The tax base should include all increases in discretionary economic power, regardless of source or nature.*—This concept has led to the comprehensive tax base, with inclusion of such items as implied benefits, realized capital gains, gifts, inheritances, and so forth, in addition to the types of income reached by the present law.

2. *Horizontal equity should be achieved; that is, persons in similar circumstances should pay similar taxes.*—This concept is clearly valid. However, there is a rather rigid adherence even in instances of minor importance. As a result, a number of specific recommendations are made which would give a much more complicated law than we now have.

3. *Vertical equity should be achieved; that is, persons in different circumstances should pay appropriately different taxes.*—This concept is easy to agree with but

impossible to implement to everyone's satisfaction. The Commission has concluded that vertical equity demands a steeply progressive personal-tax schedule. Even with the top personal rate limited to 50 per cent as recommended, the proposed rates applied to the comprehensive tax base would result in a considerably more progressive tax structure than the present one.

4. *The tax system should be neutral; that is, tax considerations alone should not result in one method of organization or operation being favored over another.*— This concept, like that of horizontal equity, seems eminently fair and sound. I believe, however, that the tax proposals are unnecessarily complicated in ways that offer, at best, only minor improvements in neutrality.

Most of the recommendations in the report can be rationalized on the basis of one or more of these concepts. Mr. Gray has already given, in a series of items appearing in "The Actuary," an outline of the major recommendations that would affect our industry. Also, Mr. Adams gave a report at the June meeting in Toronto. Therefore, rather than repeating the list of suggested tax changes, I propose to spend the short time available to me in a brief discussion of a few of the more contentious recommendations. I believe that my Canadian associates will agree with most of my observations, but some differences of opinion exist. The views that I will express are my own.

With respect to the tax proposals for the life insurance industry, several issues arise. The most obvious and important of these is the question of whether any substantial change in taxation is necessary or desirable. The life insurance industry has made and continues to make a major contribution to Canada's economic growth and social well-being. Tax laws of the past and present clearly recognize the importance of this contribution. It should not be lightly dismissed in the framing of new tax laws. The Commission has recognized the continuing social desirability of encouraging provision for retirement income by means of tax incentives. It is difficult to understand why the socially desirable operation of life and health insurance should not be similarly regarded.

The Commission has proposed a tax at the company level on a net-gain-from-operations approach. If this new tax is to apply, the recommended recalculation of policy reserves at some rate of interest exceeding 4 per cent would be highly questionable. Presumably, the mortality table is to remain unchanged, although the report is silent on this score. The resulting reserves would in most cases be inadequate to cover guaranteed cash values or to meet the minimum-reserve requirements of the Department of Insurance in Ottawa. The Commission states that solvency of life insurance companies is the concern of the Department of Insurance, not of the tax structure. This is true, but it does not impress me as a reason

for disallowing, for tax purposes, reserves which we must hold in order to stay in business.

The report recommends that no special surplus or contingency reserves be allowed in determining the companies' taxable gain from operations. This proposal may be questioned. The long-term commitments inherent in the life insurance business have no good parallels in other businesses. The report points out that such industries as petroleum and forestry often commit capital for periods of fifty years or more with no way of measuring accurately the income that will be derived in the future. This argument seems to miss the vital point that we not only take action today that will affect us fifty years from now but we also guarantee the results to be achieved on that distant day.

The present tax law in the United States recognizes the unique long-term and uncertain nature of our industry. It does so by special allowances for certain nonparticipating contracts and for certain accident and sickness insurance and group life insurance contracts, as well as in the 50 per cent of normal tax rate for undistributed underwriting gains.

The Commission has recommended that the tax treatment of corporations and shareholders be "integrated." The corporation tax would become, in effect, a withholding tax. Corporate earnings would, in net result, be taxed only once, at the appropriate personal rate of the shareholder.

The suggested attempt to achieve integration of company and participating policyholder taxes does not seem appropriate. Unlike shareholders in a corporation, policyholders have no definable and transferable interest in the retained earnings of the company. Therefore the policyholder's earnings retained in the company cannot properly be measured and allocated to him for taxation at his personal-tax rate. If integration is to be implemented for corporations in general, it might be appropriate to impose any new tax at the company level at some reduced rate. This rate should approximate the average effective tax rate of policyholders.

The Commission has made a number of proposals for the taxation of policyholders. One of the most contentious of these is the tax on interest credited to reserves, calculated annually on an artificial reserve basis at some rate of interest exceeding 4 per cent. Quite clearly, policyholders do not have the kind of access to this interest that they do to interest earned on bank accounts, bonds, policy proceeds on deposit, and so forth. They can make current use of the interest only by surrendering their policies or by taking out policy loans. The first of these courses would fundamentally alter the position of the policyholder, perhaps irreversibly. The second would entail policy-loan interest charges exceeding the interest credited on reserves. Therefore the interest earned annually on reserves

fails to meet the Commission's own tests of "ability to pay" and "discretionary economic power of tax units."

From the companies' point of view the annual calculation and reporting of interest credited on an artificial reserve basis for every permanent ordinary insurance policy in force have serious implications. I cannot see how a company without access to a computer could reasonably comply. Even companies with large and sophisticated computer systems in operation would undoubtedly experience the need for very extensive systems changes.

If policyholders are to be taxed on the interest credited to their reserves, I think that something akin to the United States approach should be adopted. The interest should not be taxed until it is actually received at the termination of the contract for some reason other than by death of the insured. This would be accomplished by a relatively simple calculation of the "realized gain" under the policy at the date of termination. Reporting procedures for both policyholders and companies would be greatly simplified.

Another recommendation affecting policyholders, namely, the full and immediate taxation of policyholder dividends, does not seem warranted. The Commission itself has admitted that dividends may represent, at least in part, a return of excessive premium. In spite of this admission, it invokes considerations of administrative convenience for proposing the taxation of the full dividend when paid or credited. The abandonment of equity for administrative convenience in this case is in strange contrast with the rigorous approach taken in most other sections of the report. The loading factor in the policyholder's dividend is simply the return of excessive gross premium and as such should not be taxed. For reasons that I will explain in a few moments, I believe that no mortality gain or loss should be subjected to income tax.

Unlike these other two factors in the dividend, the interest element may be thought of as income. However, the Commission has seemingly failed to understand that, in proposing to calculate the interest on reserves year by year on some basis involving an interest rate exceeding 4 per cent, it has already accounted for much of the interest element in the dividend.

I believe that if policyholders are to be taxed, dividends, like interest credited on reserves, should be brought into the tax base only when the policy matures other than by death.

A third important proposal affecting policyholders is the tax on mortality gains, to be effective sometime after other changes. Roughly speaking, a tax would be imposed on the excess of the amount paid on death

over the value of the policy immediately prior to death. The cost of insurance would, however, be allowed as a deduction. This proposal is open to serious challenge. The Commission itself admits that this element of their proposed tax structure would not generate any significant revenue, because mortality gains and losses tend to cancel out over the whole group of insured persons. The only purpose of the proposal is a supposed improvement in equity. Our industry is based on the widely held conviction that the fundamental risk-sharing feature of life insurance is socially desirable. In my opinion, a partial negation of the beneficial consequences of life insurance by a nonrevenue-bearing tax provision would be improper in the extreme.

The proposals concerning policyholder taxation of group life insurance are consistent with those for mortality gains and losses, except that immediate implementation is suggested. They involve full taxation of amounts paid on death, deductibility of employee contributions, and nonincludibility of employer contributions. These proposals should be rejected for the reasons that I have just outlined.

Continued tax-favored treatment of qualifying pension plans is recommended. However, the proposed limit of $12,000 annual income under tax-sheltered pensions seems unnecessarily low. To me, it suggests some lack of concern for the small but important segment of the population with substantial earned income.

Public reaction to the report has built up rather slowly. This may not be surprising in view of the enormous volume of reading facing the serious student. Recent months, however, have seen a crystallizing of views. Much informed comment has appeared in newspapers and magazines, as well as on the air. In addition, a large number of written briefs have been addressed to the Minister of Finance before the deadline of October 31. These submissions will receive careful attention, and some will no doubt result in conferences to elicit further information or expression of opinion.

The impression that I have gained from public comment on the report is that a widespread opposition to enactment of its major recommendations has developed. This opposition is not localized in a few special industries or interests who feel that their oxen are being too severely gored. A recurring theme is the danger of imposing tax revolution on an economy which is still not highly predictable and manageable, even over relatively short periods of time. I sense also a great concern over the effect of the Commission's recommendations on the relative positions of the individual and the state. The report appears to have less regard for individual rights and privacies than many would like to see. Many objec-

tions have also been raised to the vastly increased record-keeping and reporting problems posed by the recommendations of the Commission.

The Canadian Life Insurance Association and the Canadian Health Insurance Association have both presented written submissions to the Minister of Finance. In general, they recommend serious consideration of the continuing reasons for favorable tax treatment of the industry. They take issue with specific recommendations that appear to be incorrect in principle or impractical. They make suggestions for alternatives to the Commission's proposals if the present tax basis is not to continue. In addition, a separate brief from the Canadian Life Insurance Association reviews the projected economic and financial impacts of the Commission's recommendations. It is expected that industry representatives will have full opportunity to participate in further events leading to any new law which may be enacted.

MR. J. HENRY SMITH: It is well known that health insurance and its environment have been and continue to be subject to very rapid, almost violent change, perhaps more than any other line of insurance. So much happens so fast as to make it difficult to select for reporting here the few items which will fill my time allowance.

Medicare is an obvious subject, although you know most of that story. The administering companies and the Blues had their hands full for many months. By now, however, the routines are well established. Working relationships are mostly smooth and, generally speaking, claims service is good. Some other facts in brief follow: Congress is considering some minor changes which would ease some of the administrative problems; there is a new open-enrollment period under Part B; soon there will be an increase, probably to $4 a month (from the present $3), in the premium paid by the individual (and matched by the government) under Part B; in a few months we should have an important revelation of the financial experience under both parts; and Congress seems unlikely to accept the Administration's request to extend coverage to the disabled under 65. Otherwise, relative quiet prevails in Medicare.

I would not try to predict how long quiet will continue on this most important front. Someday we will see vigorous efforts to extend Medicare in several directions. The age-65 line is a strong one, but will surely be assaulted. At the moment, however, we are enjoying more encouragement from government officials and welfare-state advocates than I can ever remember. There is a new spirit which seems to be based on the idea of partnership of government and private insurers; we are being encouraged —maybe I should say pressured—to make haste in shoring up our side of the partnership.

Now if that sounds too good to be true, hold judgment until the conditions are noted. Those conditions, plus some of the goals to be accomplished, were stated and examined at some length recently in a series of important meetings. I refer to three conferences convened by the Secretary of HEW, John W. Gardner, at the direction of President Johnson. The first, held in June of this year, focused on medical costs; the second, in September, examined private health insurance; and the third, in October, discussed the group practice of medicine.

In each of these there was extensive and, I think, effective participation by persons of outstanding competence and leadership in our industry.

The sessions were marked by candor and objectivity and by a healthy recognition by all that the problem of health is so immense, so all-pervading, that no one can lay claim to "the answer." Indeed, at the very first conference Secretary Gardner put it well when he said:

> Everyone seems to agree that the existing system—or lack of system—has rather marked shortcomings. But there is not yet any agreement as to what a more perfect system would look like. It seems likely that we will go through a period of experimentation and in true American fashion. . . . One thing is certain. The two or three years immediately ahead must be years of intensive experimentation and data gathering. . . . We need vigorous experimentation.
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> We cannot go on as we have in the past. New patterns will be necessary. Those who entertain some apprehension as to what the new patterns will be had better plunge in and experiment with their own preferred solutions. Standing back and condemning the solutions that others devise won't stem the tide of change.

All three of these conferences were highly significant to the health insurance business, although the second one was focused directly on insurers. It was here that we got our marching orders. I cannot take the time to summarize the discussion adequately but will outline some of the main issues and challenges:

1. The discussion apparently rested on the proposition, taken almost as an axiom, that it is now national policy that adequate medical care is a right owed to all.
2. As presently conceived, government's role is to provide for those who cannot provide adequately for themselves, presumed to include all over 65, and also to encourage—maybe I should say to apply pressure to—the private insurers to do the ideal job for the rest, always with the threat of stepping in, of course.
3. There is a shift in emphasis from acute care to chronic and long-term care, mental health, and preventive medicine. Insurance should accommodate itself to these new needs.
4. Insurance benefits should be so designed as to avoid hindering improvements in the provision of care, such as more ambulatory and home care. Ways should be found for insurers to link arms with medical practice groups even where the physicians are paid on a capitation basis instead of fees for service.
5. Insurers must help in community planning of health facilities and in the establishment and functioning of medical review and utilization committees.
6. We must overcome the deficiencies of health insurance—its inadequate benefits, its gaps in coverage, and its sometimes overly high expense.

As the conference came to its close, we were handed a severe set of challenges by Undersecretary Wilbur Cohen, the man often called the architect of Medicare. He stated that his response to the question, "Will

Medicare be extended?" is, "If private insurance is able to provide adequate protection for high quality care to the 90–95 per cent of the population at the prices they can afford—then little public pressure will develop to extend Medicare to those under 65 who are employed." His version of "adequate protection" seems to require that insurance cover at least 90 per cent of all consumer expenditures for health care.

This is a tall order, probably unreasonable. At the moment it would seem so, and I was glad to hear Charles Siegfried, president of the Metropolitan and president of the Health Insurance Association, challenge Mr. Cohen's parameters. Siegfried said, "I, for one, question the limit set by the Undersecretary as a target measure of coverage at which to shoot. For many persons health insurance coverage which covers much less than 90 per cent of total medical bills will be highly satisfactory coverage. I do not think success or failure should be measured by this target point."

Mr. Cohen's objectives, if they are sensible at all, are certainly very long term.

I have already mentioned community and area-wide planning of health facilities. This subject has rather suddenly become of considerable importance to health insurance. For us it is a part of a general problem of how insurance should relate to the organization of health-care facilities, quality of care, duplication, overutilization, and other factors having a bearing on the efficiency and cost of care and insurance.

We used to feel that such matters should be left to the doctors, hospitals, and so forth. Gradually we have come to realize that we cannot remain uninvolved. Better solutions to many of the problems in the environment of health insurance may be one of our main hopes for the future of our system.

The area-wide-planning part of these concerns received a great deal of emphasis late last fall when Congress passed (with remarkably little fanfare) a piece of legislation that probably deserves the label "landmark." I would like to spend a few minutes on this subject, because it is not well enough known and its implications widely enough appreciated.

This Act—the Comprehensive Health Planning Act of 1966—abolished some sixteen direct federal grant programs and replaced them by a "block" grant for the states to use as they see fit. But it tied a big string to the package—a string in the form of a requirement that, in order to get federal funds, each state must embark on a system of planning for health. The Congress insists that every state take real responsibility for looking objectively at its health needs and resources and that it set priorities and make decisions. To help get the job under way, the Congress is providing funds for state and community planning. It requires that in the planning

there be active participation not only of the *providers* of care—the physicians, hospitals, environmental health specialists, and so forth—but of the *consumers* of health care as well. This did not catch the health insurance business wholly unawares, in that the Health Insurance Association had previously been considering and experimenting with active involvement in such planning. With the stimulus of the new law it proceeded early this year to effect a well-considered, integrated action program aimed to put private insurers into the mainstream of what is now called the "partnership for health."

Let me briefly tell you what has been accomplished. First, a top-level policy group was established in the Health Insurance Association, with an operating committee in the Health Insurance Council. Then the policy went to about forty key company presidents and asked them to convey to each state governor the message that our industry feels that the idea of comprehensive health planning is sound and that as an industry, as companies, and as individuals we are prepared to be of assistance. Incidentally, the Health Insurance Association also got that message to the Congress through testimony and statements at hearings.

In addition the presidents were asked to see that an experienced and effective person was assigned in each state to keep tabs on health-planning developments for the industry. As a member of the policy committee and one of those who was asked to help in getting this project started, I can report that the program is well under way and is being received very favorably indeed.

At present there is, in each state except two, a HiCHAP Co-ordinator, and most were on the job within thirty days of the decision of our industry to proceed. I should explain the word that I just used—HiCHAP. That is shorthand for "Health Insurance Council, Community Health Action-Planning Project." The story is in the name—*Community Health*, involving all of us where we live, and *Action-Planning*, not merely action for the sake of action, or sterile planning, but planning *for* action for results.

These HiCHAP Co-ordinators have been busy talking with all the people involved in community health planning—the physicians and hospital people, the voluntary planning groups, the public health officers, and the governors. Our message is coming through—we are ready, willing, and able to participate in the "partnership for health." And we are being asked in, usually as "representative of consumers," to use the language of the law.

Already insurance personnel—as individuals of course, not as spokesmen for the industry—are being asked by governors to sit on the new state

health planning councils. In fact, we have word thus far of perhaps twenty states in which our people will be playing key roles in comprehensive health planning. In at least four states, the governor has named or is naming an insurance person as chairman of his advisory council. And there are insurance people on perhaps half or more of the present seventy area-wide planning groups now in operation.

These are but a few of the significant developments in health insurance lately. The only thing that I can be sure about with regard to the future is that there will be more challenging developments.

RECENT DEVELOPMENTS IN VARIABLE ANNUITIES

MR. MALCOLM D. MACKINNON: There has been a sharp increase in the last two years in the adoption of state laws permitting the writing of variable annuities. Group variable annuities may now be written in all states except Mississippi, Missouri, North Carolina, North Dakota, Pennsylvania, and South Carolina; individual variable annuities are now permitted in thirty states and the District of Columbia. An excellent summary of the state legislation and regulation governing variable annuities is contained in a paper presented last month to the Conference of Actuaries in Public Practice by Maximilian Wallach, Actuary of the District of Columbia Department of Insurance.

Under certain circumstances, variable annuities can be sold only by a person who has taken a special examination. This is required under the Securities Exchange Act of 1934 and also by certain states. In conjunction with the SEC, the National Association of Insurance Commissioners has developed a variable annuity examination known as the NAIC examination. This is a two-part examination administered by the states. Part I satisfies SEC requirements, and Part II satisfies state requirements for the sale of variable annuities. To date, about thirty states have adopted this examination.

An important development was the formation of a subcommittee of the ALC-LIAA Joint Legislative Committee to study administrative and legislative developments in connection with federal and state regulation of segregated accounts and variable annuity contracts, both individual and group, with a view to determining whether there should be an industry approach to the problems involved.

This subcommittee has set up two task forces. One of these is dealing with the regulatory problems involved where registration under the Investment Company Act of 1940 is required. This includes consideration of possible amendments to the federal securities statutes to deal specifically with variable annuities, difficulties currently being experienced under the 1934 Act, and the SEC's proposed amendments prohibiting the front-end load and limiting sales charges in connection with mutual funds. The other group is concentrating on regulatory problems involved where registration under the 1940 Act is not required. This includes consideration of the current SEC review of Rules 3c-3 and 156, possible amendment of Section 3(c)(13) of the 1940 Act to give insured pension plans the same

treatment as bank-trusteed plans, and possible future problems under the 1940 Act.

There have been many recent news items concerning the sale of variable annuities:

1. The three oldest commercial variable annuity companies are no longer independent. PALIC has been purchased by the Aetna. EALIC and VALIC have been merged and are now a part of the American General group.

2. A number of insurers have set up separate accounts which register as investment companies under the 1940 Act. Among these are the Continental, Lincoln National, and Paul Revere.

3. Most of the leading insurers of group annuity contracts are now participating actively in the group variable annuity field under SEC Rule 3c-3.

4. The John Hancock has stated that it will offer individual variable annuities.

5. The Travelers has announced its entry into the variable annuity field, concurrent with the establishment of an investment-management company and a mutual fund.

6. Several actuarial consulting firms have highlighted the importance of equity products to their insurance-company clients. For example, in a recent newsletter, Bowles & Tillinghast concluded: "It appears logical to assume that the company which determines to be aggressively competitive in the equity oriented product area may decide that both the variable annuity and mutual fund should be in the portfolio ultimately."

7. LIAMA has just surveyed its members to determine the extent of their offerings or plans to offer mutual funds, variable annuities, segregated or separate funds, and equity-based life products. It is expected that the results of the survey will be published in a few weeks.