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THE TAXATION OF INSURANCE IN CANADA

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ABSTRACT

This paper was undertaken originally as a Study Note covering the 1969 amendments to the Income Tax Act of Canada, which radically altered the taxation of life insurance proceeds and life insurance companies.

As work on the Study Note progressed, it was felt desirable to cover not only the revised basis of taxation but the past bases as well, together with a discussion of the 1967 recommendations of the Royal Commission on Taxation upon which the 1969 amendments were based. It was also felt desirable to describe the interrelationship of the taxation of the policyholder and the insurance company by both federal and provincial governments and to note the parallels and differences between the treatment of ordinary businesses and insurance corporations, stock and mutual companies, life and other-than-life insurance, resident and nonresident business, and resident and nonresident insurers.

While much of the material covered is not particularly appropriate for the examination of students, it is hoped that it will provide useful background educational information in order to enable them to understand better not only where we now stand but how we got there. It is also hoped that the paper will serve as a useful reference for other members of the Society who may wish to gain some understanding of the basis of Canadian insurance taxation without immersing themselves in the complexities of the Income Tax Act itself.

But in this world nothing can be said to be certain, except death and taxes.

BENJAMIN FRANKLIN

A. INTRODUCTION

THE taxation of insurance in Canada is a complex blend of taxes imposed by different levels of government (primarily federal and provincial) upon different taxpayers (insurance companies and policyholders) and calculated on a variety of bases (premiums, benefits, investment income, corporate gains, and personal gains) at various taxation rates.

This paper attempts to review the history and the broad rationale of this taxation blend without dealing exhaustively with the many intricate details and exceptions contained in the various pieces of tax legislation and regulation.

No attempt is made here to deal with the various taxes, licenses, and fees imposed on corporations in general. These would include municipal taxes on real property; payroll taxes for unemployment insurance, the Canada Pension Plan, and the Quebec Pension Plan; filing fees for provincial registration of employee pension plans; and federal and provincial sales taxes on a wide variety of purchased goods and services.

B. TAXATION OF INSURANCE COMPANIES PRIOR TO 1969

1. *Pre-World War I*

Corporations were first taxed at the provincial level by Quebec in the 1880's. The other provinces followed slowly over the next thirty years. These early corporations taxes were not based on business profits but consisted of flat licenses and/or place-of-business taxes and taxes based on arbitrary but reasonably well-defined measures, such as corporation capital, railway track mileage, bank reserves, insurance premiums collected, and the like.

In the late 1800's and early 1900's, some municipalities were also successful in imposing taxes on insurance premiums paid through agencies located therein, but this practice has not been followed for many years.

The federal government obtained most of its revenue during this period from customs duties on imported goods and excise duties on alcoholic and tobacco products and did not impose direct corporation or personal taxes prior to World War I.

2. *World War I*

Even after Canada's entry into World War I in 1914, the federal government sought for a time to rely on its traditional means of financing, through increased customs and excise duties and borrowing. The entire war expenditure was, in fact, met through borrowing. Nevertheless,

three significant new forms of taxation were introduced during the war years. In the years to follow, two of these were to become increasingly important, until today they are the prime sources of federal revenue.

The first of these was the Special War Revenue Act enacted in 1915. This ostensibly temporary legislation was renamed the Excise Tax Act in 1947 and remains in effect today. The 1915 act included a long list of taxes, none very significant from a revenue point of view, on bank note circulation, certain insurance premiums, telegrams and cables, checks, railway and steamship tickets, and so forth. The act took on its real significance when it was extended to include in 1918 a tax on automobiles and in 1920 a general manufacturers' sales tax on practically all manufactured products.

The 1915 act included a tax of 1 per cent on insurance premiums other than life and marine, net of rebates, return premiums, and reinsurance ceded. Fraternal benefit societies and purely mutual companies were exempted; however, the exemption for mutual companies was removed in 1922.

The reason given by the Minister of Finance for exempting life insurance premiums from the new tax was as follows:

> It did not appear . . . that it would be advisable that this taxation should fall in any substantial measures upon the policy-holders of life insurance companies, because life insurance is a matter of such extreme importance to the individual and to his family. It seemed to me that we might very properly differentiate in our taxation in favour of the policy-holders of life insurance companies. The Superintendent of Insurance reports to me without any hesitation that any taxation that might be imposed upon life insurance will be borne by the policy-holder, and it is his view, and it is mine, that the policy-holders of the companies should not be burdened with taxation in making provision for their dependents.[1]

Reference was also made by another member to "the enormous taxes that have been imposed on these companies by the provinces,"[2] which then varied from 1 to $1\frac{3}{4}$ per cent of gross premiums.

Further federal taxes followed through the Business Profits War Tax Act, which remained in effect from 1915 through 1920. This law imposed a tax for the first time on the profits of businesses, to the extent that such profits exceeded a reasonable return (7 per cent) on working capital. Credit was allowed to insurance companies for taxes imposed under the Special War Revenue Act. Specifically exempted from the tax was "the business of life insurance."

[1] Canada, *Debates of the House of Commons* (Ottawa, 1915), CXX, 1178.

[2] *Ibid.*, p. 1179.

The third new tax act, and the one eventually to become the most important, was the Income War Tax Act enacted in 1917. This "wartime" legislation was rewritten as the Income Tax Act in 1948 and, with amendments, remains in effect today. The 1917 act imposed "income" taxes at the federal level for the first time, both on individuals and corporations. Corporations were allowed credit for taxes imposed under the Business Profits War Tax Act.

The Income War Tax Act provided a specific exemption for the income of "life insurance companies except such amount as is credited to shareholders' account." Canadian life insurance companies are required to account separately for the funds of participating life insurance policyholders, nonparticipating life insurance policyholders, shareholders, other-than-life insurance business, and so forth (and, since 1961, variable contract business). The basis of the above exemption in the 1917 tax law was simply that only those net earnings of a life company which were allocated to the *shareholders' fund*, whether or not distributed as share dividends, were properly subject to corporation income tax. *This principle remained in effect for over fifty years*, until the end of 1968.

Other-than-life insurance companies were subject to tax under the Income War Tax Act on their net underwriting gains and investment income but were allowed credit for the premium taxes imposed on them under the Special War Revenue Act as well as for any tax imposed under the Business Profits War Tax Act. The net effect of these credits was that the insurance company was subject in aggregate only to the greatest of the gross taxes produced under the three laws prior to credits.

Mutual life insurance companies, having no shareholders' funds, bore no tax under the Income War Tax Act. For many years mutual other-than-life insurance companies also paid no taxes under the Income War Tax Act, because it was considered under common law that surplus arising from transactions between a mutual insurance corporation and its members did not constitute income to the corporation.

Nonresident stock other-than-life insurance companies were theoretically subject to taxation under the Income War Tax Act on the same basis as resident companies. However, the "underwriting gains" reported by nonresident insurance companies to the Department of Insurance are overstated, because no provision is made for them to report any part of their home office or other expenses incurred outside Canada, even though they are incurred in connection with their Canadian operations. As a result, a practice arose, sanctioned in neither law nor regulations, of taxing nonresident stock other-than-life insurance companies only on their reported "underwriting gains" and permitting them to omit their

investment income in return for the nondeduction of expenses incurred outside Canada.

The same administrative practice was applied to nonresident stock life insurance companies with respect to their other-than-life insurance operations, but no taxes were levied under the Income War Tax Act on their life insurance operations.

3. *Between the Wars*

Following World War I, tax rates generally continued to rise for a few years, but by the mid-1920's there were reductions in some tax rates and even the elimination of some taxes. In March, 1929, Parliament abolished the 1 per cent federal premium tax on other-than-life insurance premiums previously imposed under the Special War Revenue Act. However, this tax was restored in 1932, and during the Depression the government found it necessary to increase other tax rates as well.

Likewise, most provinces found it almost impossible to raise the necessary revenues and were forced to adopt new forms of taxation and to increase existing tax rates, including those on insurance premiums. Some provinces permitted policy dividends to be deducted from premiums in computing tax; others continued to tax gross premiums. By 1939 the provincial premium tax rates varied from 2 to 3.3 per cent.

Although only two provinces taxed corporation incomes in 1929, by 1939 all nine had found it necessary to do so. In the case of corporations operating in more than one province, arbitrary formulas were developed to allocate their taxable income among the provinces. Companies already subject to the earlier special corporation taxes, such as those on insurance premiums, were generally either totally exempted from the newer income taxes or else allowed full credit for such taxes against the newer ones. Quite clearly, the various forms of taxes were originally regarded, at least by the provinces, merely as alternative means of taxing the earnings of corporations.

Increasing competition between the two levels of government for tax revenues, the disparate economies of different provinces, and the near bankruptcy of the poorer provinces led the federal government in 1937 to appoint the Royal Commission on Dominion-Provincial Relations (the Rowell-Sirois Commission) to assess the economic and financial basis of the seventy-year-old Canadian confederation, the distribution of federal and provincial powers, and the financial relations of the two levels of government. The Rowell-Sirois Commission completed its report early in 1940. In the meantime, Canada had entered World War II, and the federal government was faced with an urgent need for more revenue.

4. *World War II through 1961*

Within a few days after Canada's entry into World War II in 1939, Parliament increased most tax rates under the Income War Tax Act and the Special War Revenue Act and enacted the Excess Profits Tax Act, which remained in effect from 1940 through 1947. This law, like the Business Profits War Tax Act of World War I, imposed a tax on profits in excess of a reasonable return (5 per cent) on working capital. Credit was allowed for taxes imposed under the Income War Tax Act and, in the case of other-than-life insurance companies, for the premium taxes imposed under the Special War Revenue Act. The net effect of these credits was again that the insurance company was subject only to the greatest of the gross taxes imposed under the three laws prior to tax credits.

Among the recommendations of the Rowell-Sirois Commission was one that the federal government be given for all time the sole right to impose succession duties, personal income taxes, and corporation taxes of any kind but that it respect the remaining revenue sources of the provinces and pay to each province certain grants based on its natural resources and on the needs of its economy.

A federal-provincial conference was held early in 1941 to consider the report, but it soon ended in disagreement. Each province subsequently agreed, however, to enter into a Wartime Taxation Agreement with the federal government, effective in 1941.

One of the provisions of these wartime agreements was to suspend and "rent" to the federal government certain fields of provincial taxation, including personal income taxes and practically all forms of corporation tax, thereby giving the federal government a free hand to pursue an energetic fiscal policy during the war years.

With provincial insurance premium taxes thus suspended, Parliament amended the Special War Revenue Act to increase the tax on other-than-life insurance premiums from 1 to 2 per cent for stock other-than-life insurance companies and for all life insurance companies and to 3 per cent for mutual other-than-life insurance companies (since they were not paying income tax). A 2 per cent tax was also imposed on life insurance premiums net of premium returns and policy dividends, net as to reinsurance ceded, and excluding annuity considerations. This new system thus introduced uniformity and in some cases a reduction in the over-all tax burden on insurance.

The Wartime Taxation Agreements expired at the end of 1946. For 1947–51, a new Tax Rental Agreement was entered into by each province except Ontario and Quebec. The federal Excise Tax Act, as the old Special

War Revenue Act was renamed, was amended to allow credit against the 2 per cent premium tax for similar taxes imposed by a province. For this period, the situation in the various provinces was as follows:

a) Ontario reactivated its suspended Corporations Tax Act, thereby reimposing various forms of tax on different types of corporations. In the case of insurance companies, this took the form of a premium tax slightly in excess of 2 per cent. In 1948 this was reduced to the 2 per cent level for which credit was allowed under the federal law.

b) Quebec enacted a new Corporation Tax Act under which the form of corporation tax applicable to insurance companies was also a 2 per cent premium tax.

c) Under the new Tax Rental Agreements the seven "agreeing" provinces agreed to the continued suspension of their pre-1941 income taxes and corporation taxes (including insurance premium taxes) and, in addition, to suspend their succession duties. It was agreed, however, that these provinces would enact new corporation income tax laws imposing a provincial tax of 5 per cent, in addition to the federal 30 per cent, of taxable income, defined on the same basis as in the federal Income Tax Act, and that, for convenience, the federal government would administer the assessment and collection of these provincial taxes together with the federal income taxes.

The effect of these agreements was that the provinces were for the first time receiving an income tax from life insurance companies on the historic federal basis of net transfers to the shareholders' fund.

The agreements provided that, in the case of an insurance corporation, the taxable income to be attributed to each province would be determined by prorating its total taxable income according to the proportion of its net premium income received from residents of, or on property in, the province.

Upon entering the confederation in 1949, Newfoundland also entered into a similar taxation agreement with the federal government.

In 1948 the federal Income War Tax Act was rewritten and, by now obviously permanent, renamed the "Income Tax Act." The clause in the old act which had exempted from taxation the income of "life insurance companies except such amount as is credited to shareholders' account" was deleted. The same principle, however, was carried forward into the new act, not as an exception to an exclusion but through a positive definition, in Section 30, of the taxable income of a life insurance corporation.

In 1949 the federal corporation tax rate was changed from a flat 30 per cent to a split rate of 10 per cent of the first $10,000 of taxable income plus 33 per cent of the excess. At the same time a "dividend tax credit" provision was introduced to permit an individual resident in Canada to deduct from his personal income tax 10 per cent of dividends

received from taxable Canadian corporations, thereby reflecting to some extent the income tax already paid by the corporation.

A special provision was also added to the Income Tax Act in 1949 to grant resident life insurance companies a foreign tax credit in the form of a workable alternative to that provided ordinary corporations.

For 1952–56 a new Tax Rental Agreement was entered into by each of the provinces except Quebec. The nine "agreeing" provinces agreed not to impose personal income taxes, succession duties,[3] and practically all forms of corporation tax, including the 5 per cent income tax referred to above. (Corporations did not benefit from this elimination of provincial tax, since the federal tax rates were simultaneously increased rather substantially.) A new provision was added to the federal act to grant corporations an abatement in tax of 5 per cent of taxable income earned in any province which did not have a tax agreement with the federal government, since the federal government was not making tax-rental payments to such a province. Initially, of course, this applied only to Quebec. Since the provision was for an abatement of federal tax rather than for a credit for provincial taxes, it was applicable to insurance companies, even though the Quebec corporation tax on them took the form of the 2 per cent premium tax for which credit was already allowed against the federal premium tax imposed under the Excise Tax Act. For the purpose of the abatement provision, the taxable income of an insurance company in a province was defined in the Regulations in a manner similar to that in the 1947–51 taxation agreements described above.

For 1957–61 a new Federal-Provincial Tax-Sharing Agreement was again entered into by each of the provinces except Quebec. The nine "agreeing" provinces again agreed not to impose personal income taxes, succession duties,[3] and practically all forms of corporation taxes,[3] a new exception being taxes on insurance premiums. The federal government decided to turn this field over to the provinces, and so the federal Excise Tax Act was amended to eliminate the 2 per cent premium tax. The actions taken by the provinces, effective in 1957, were as follows:

a) Ontario enacted a new Corporations Tax Act. Like the suspended act which it replaced, it included both special taxes (including a 2 per cent insurance premium tax to replace the federal excise tax) and income taxes. Unlike the old act, it did not exempt insurance companies completely from the income tax but copied the approach in the federal Income Tax Act of imposing income tax on all other-than-life insurance companies, both resident and nonresident, and on resident stock life insurance companies on net credits to the shareholders' fund. The determination of the portion of the company's taxable income earned

[3] Excluded from the agreement with Ontario.

in Ontario was defined in the same manner as in the federal Regulations referred to above.

b) Quebec amended its Corporation Tax Act to tax insurance companies in a manner similar to that in the Ontario act.

c) The eight "agreeing" provinces enacted new insurance company taxation laws to impose a 2 per cent premium tax to replace the federal excise tax. In so doing, six of these eight provinces made reference to their suspended corporation tax or income tax laws to make it clear that, should these laws ever be reactivated, special treatment would be afforded insurance companies, either through complete exemption from the form of income tax imposed on ordinary corporations or through allowance of credit for premium tax against any other form of income tax.

During this period a number of changes were made in the federal tax rates and in the rate of abatement, which was also extended to corporation income earned in Ontario.

The Federal-Provincial Tax-Sharing Arrangements were not renewed beyond 1961.

5. *Old Age Security*

The federal Old Age Security benefits introduced in 1952 have been financed essentially on a "pay-as-you-go" basis. The original tax formula was "2-2-2," that is, 2 per cent of personal taxable income up to a specified maximum, 2 per cent of corporation taxable income, and a 2 per cent general sales tax. This formula was increased to 3-3-3 in 1959 and to 4-3-3 in 1964. The first two taxes are in addition to the personal and corporation income taxes imposed under the federal Income Tax Act, and the third is in addition to the general sales tax imposed under the federal Excise Tax Act.

6. *Mutual Insurance Companies*

In 1945 the federal Royal Commission on Co-operatives (the McDougall Commission) recommended that mutual other-than-life insurance companies be taxed under the Income War Tax Act (and consequently the Excess Profits Tax Act). Accordingly, the following were effective in 1947:

a) The Special War Revenue Act was amended to reduce the 3 per cent premium tax on mutual other-than-life insurance companies to the 2 per cent level applicable to stock insurance companies.
b) The Income War Tax Act was modified slightly specifically to exempt mutual insurance companies insuring only churches, schools, and other religious, educational, or charitable organizations.
c) The government began to assess income tax against other mutual other-than-life insurance companies.

The legislation proved insufficient. The assessment of income tax was successfully contested through the Supreme Court of Canada by the Stanley Mutual Fire Insurance Company on the grounds that a mutual company has no profits. Following this 1953 decision, Parliament enacted Section 68A of the Income Tax Act to provide that mutual other-than-life insurance companies were *deemed*, for the purposes of the Act, to be carrying on a business for profit and were subject accordingly to income tax. This provision was made effective in 1954 with respect to the underwriting gains of resident companies but retroactive to 1947 with respect to their investment income. It was also made retroactive to 1947 with respect to the entire taxable income (see sec. B, 2 above) of nonresident companies, many of whom could presumably claim these taxes as foreign tax credits against income taxes imposed in their own countries.

The exemption for mutual companies insuring only churches, schools, or other charitable organizations was retained in 1954, and an exemption was also added then for insurers, stock or mutual, at least 50 per cent of whose premium income was with respect to the insurance of farm property, property used in fishing, or residences of farmers or fishermen.

7. *Conversion of Stock Life Insurance Companies to the Mutual Basis*

A number of amendments to Canadian insurance legislation were enacted in 1957 to facilitate and encourage the conversion of stock life insurance companies to a mutual basis. Among others, provisions were incorporated in this legislation and in the Income Tax Act to the effect that amounts paid by a company for the purchase of its own shares would not be deemed to be taxable income either to the company (through its shareholders' fund) or to the shareholders.

8. *1962–68*

When the Federal-Provincial Tax-Sharing Arrangements expired at the end of 1961, they were not renewed. Instead, Parliament reduced the effective federal income tax rates by extending the abatement provision to all provinces, and the provinces were left free to impose their own personal and corporation taxes.

Under the new Federal-Provincial Fiscal Arrangements Act, the federal government agreed to make certain "equalization" payments to the poorer provinces, to share federal estate taxes with the provinces, and to collect provincial income taxes for any province that based such taxes on definitions compatible with those in the federal legislation. This collection arrangement was somewhat similar to that in effect during the period 1947–51 with respect to corporation income tax and was now offered for both corporation and personal income taxes.

In view of the enormous administrative convenience, the eight provinces other than Ontario and Quebec which had not collected direct corporation income taxes since 1940 decided to accept the offer. Accordingly, none of them reactivated its suspended tax legislation, but each enacted a new Income Tax Act, effective in 1962, in which the "taxable income" of a corporation was defined by direct reference to the federal Income Tax Act. The intentions that most of them had embodied in their 1957 premium tax laws, either to exempt insurance companies from future provincial taxes other than on premiums or to allow premium taxes as a credit against other forms of provincial income tax, were thus nullified.

For 1962–68 the combined provincial and federal taxes on insurance companies consisted of the following:

a) A provincial tax of 2 per cent on insurance premiums net of premium returns and policy dividends, net as to reinsurance ceded, and excluding annuity considerations.

b) A provincial tax on taxable income in the province (based in the case of other-than-life insurance companies on net income and in the case of resident stock life insurance companies on net transfers to the shareholders' fund) at normal corporation tax rates. For 1968 these rates varied from 10 to 12 per cent.

c) A federal tax on the same basis as item *b* at normal corporation tax rates. For 1968 the rates were:
   (i) 18 per cent of the first $35,000 of taxable income, plus
   (ii) 47 per cent of taxable income in excess of $35,000, plus
   (iii) a temporary surtax of 3 per cent of (i) plus (ii), less
   (iv) an abatement of 10 per cent of taxable income in each province (but not the federal territories), less
   (v) foreign tax credits.

d) The federal old age security tax of 3 per cent of taxable income.

The allocation of taxable income by province for items *b* and *c* was determined by prorating according to the company's net premium income as described earlier.

9. *The British Pacific Case*

It was noted earlier that from 1917 through 1968 other-than-life insurance companies were taxed under the federal income tax acts as ordinary corporations but life insurance companies only on net transfers to their shareholders' funds. This gave rise to somewhat different tax treatment of gains from other-than-life insurance operations (largely health insurance) as between other-than-life insurance companies (where it was taxed in full) and life insurance companies (where it was taxed

only if formally transferred to the shareholders' fund). Since the health insurance business of most life insurance companies was much less important than the life insurance business (and since it seldom gave rise to very great profits), the anomaly was not of great concern.

An interesting legal case arose in 1959 when British Pacific Insurance Company, which had previously sold only health insurance and had paid substantial income taxes, became reincorporated as a life insurance company. It thereupon admitted liability for future taxes only on the relatively small net transfers to its shareholders' fund. The Department of National Revenue sought to continue to impose substantial taxes on the earnings of the company's other-than-life insurance business. The dispute was eventually carried to the Exchequer Court of Canada, which ruled in 1968 in favor of the company on the grounds that it was legally a life insurance corporation and therefore was liable for tax only on its "taxable income" as specifically defined in Section 30 of the Income Tax Act.

10. *Fraternal Benefit Societies*

Prior to 1969, fraternal benefit societies and orders and "nonprofit" medical insurance associations were not subject to income taxes at either the federal or the provincial level. In most provinces they have also been exempt from premium taxes.

11. *Nonresident Tax*

In 1933, the federal Income War Tax Act was amended to impose a withholding tax on investment income paid by a Canadian source to a nonresident person or corporation. It was ruled, however, that a company incorporated outside Canada but licensed to do business in Canada would be deemed to be resident in Canada and therefore not subject to this tax.

After World War II, the government decided to reverse this position in the case of an insurance company incorporated outside Canada but registered to do business in Canada, with respect to any of its Canadian investment income which might be considered to be in excess of that consistent with its insurance operations in Canada. (Because of favorable investment returns, many nonresident companies had been investing substantial amounts in Canada on behalf of policyholders outside Canada.)

Effective in 1953,[4] regulations were adopted which provided, in effect, for tax on the investment income arising from that portion of such a

[4] The new tax was "phased in" at the rate of 20 per cent of the full tax in 1953, 40 per cent in 1954 . . . reaching 100 per cent in 1957.

company's Canadian assets which exceeded its Canadian statement liabilities plus a surplus margin. The surplus margin consisted of 10 per cent of life insurance liabilities plus 100 per cent of other-than-life insurance liabilities, with some modification for companies with less than $10 million of liabilities in Canada. For the purpose of this tax, specific assets were not designated as being held for policyholders in Canada and others for policyholders outside Canada; rather, the entire investment income (as well as the resulting tax) was merely prorated. The amount of nonresident tax payable could be represented by the expressions:

$$\frac{\text{``Excess assets'' in Canada}}{\text{Total assets in Canada}} \times \text{Gross tax}$$

$$= \left(1 - \frac{\text{Liabilities in Canada} + \text{Surplus margin}}{\text{Total assets in Canada}}\right)\Sigma r \cdot I_r ,$$

where

I_r = Gross investment income to which tax rate r applied;
r = 0 for certain "tax-exempt" securities
= 5 per cent for certain securities issued or guaranteed by provincial governments
= 15 per cent for all other investments including policy loans.

It should be noted that securities which were nominally "tax-exempt" could in fact attract tax through the requirement that their value be included in "total assets" in the above formulas. Consequently, even though the "gross tax" would remain unchanged, acquisition of additional assets in Canada, all tax-exempt, would result in $\$k$ of additional tax, where

$$k = \frac{(\text{``Tax-exempt'' acquisition}) \times (\text{Liabilities} + \text{Surplus margin})}{(\text{Assets before acquisition}) \times (\text{Assets after acquisition})} \times \text{Gross tax.}$$

The usual requirement that nonresident tax be withheld at the source has not been applicable in the case of registered insurance companies; instead, the tax has been calculated and paid annually by the insurance company.

Effective June 16, 1963, the tax rate was reduced from 15 to 10 per cent on share dividends received from a Canadian corporation "with a degree of Canadian ownership," that is, one at least 25 per cent of the voting shares of which are owned by Canadian residents.

C. TAXATION OF INSURANCE POLICYHOLDERS PRIOR TO 1969

1. *Proceeds from Life Insurance*

The Income War Tax Act of 1917 included in personal "income," for tax purposes,

> the income from but not the proceeds of life insurance policies paid upon the death of the person insured, or payments made or credited to the insured on life insurance endowment or annuity contracts upon the maturity of the term mentioned in the contract or upon the surrender of the contract.

This reference to life insurance was dropped in 1940, when a new approach to the taxation of annuity benefits was adopted, but the explanation was given that the nonincome nature of life insurance was fully understood.

Again in 1948 this was discussed in Parliament when a question arose of why proceeds of life insurance should not be given special treatment under the Dominion Succession Duty Act. The Minister of Finance replied that "there is this privilege, that earnings of life insurance policies are exempt from taxation, and properly so."[5] In keeping with this philosophy, gains connected with life insurance, with certain exceptions mentioned below, were not subject to income tax prior to 1969.

2. *Interest on Funds on Deposit*

Interest credited directly to insurance proceeds left on deposit, dividend accumulations, and so forth, has, however, presumably been taxable in the owner's hands as part of his interest income.

3. *Annuities and Income Settlements of Insurance Proceeds*

An excellent discussion of the difficulties in determining a satisfactory basis for the taxation of annuities is to be found in a paper presented to the Actuarial Society of America by Mr. A. D. Watson in 1940.[6]

In view of the exception in the Income War Tax Act cited in section C, 1, above, annuities were apparently not taxed either in whole or in part prior to 1930.

In 1928 the Exchequer Court of Canada held in *Kennedy* v. *M.N.R.*, which arose over a different question entirely, that payments under a dominion government annuity did not fall within the above exception and, following English law and precedent, were taxable *in full*. Since this decision threatened the sale of government annuities, Parliament amended the Act in 1930 to exempt from taxation the income, within

[5] Canada, *Debates of the House of Commons* (Ottawa, 1948), CCLXIV, 4639.

[6] *TASA*, XLI, 12, 492.

limits, "derived from annuity contracts with the dominion or provincial governments or any company . . . effecting like annuity contracts."

Considerable confusion then followed in interpreting the act, particularly with respect to installment settlements of insurance policies. These difficulties are exemplified in *Shaw* v. *M.N.R.*, in which a life installment settlement with period certain was held on appeal to the Exchequer Court of Canada in 1938 to be taxable in full but on further appeal to the Supreme Court of Canada to be tax-free. The life insurance industry attempted during the late 1930's to have the situation clarified and recommended that the Act be amended to embody the principle that annuity and installment payments should be considered for tax purposes as being partially a tax-free return of capital and partially taxable interest income and that some simple rule of thumb be adopted to effect this principle.

In 1940, however, Parliament amended the Act to follow British practice and to tax as income the interest element of annuities certain but the *full* amount of life annuities (life annuities with periods certain being considered the former during the period certain and the latter thereafter).

Public dissatisfaction with this procedure led to the appointment of a royal commission on the taxation of annuities (the Ives Commission), which recommended in 1945 the adoption of the principle recommended earlier by the life insurance industry and of the method suggested by Mr. Watson that the tax-free capital element in each year's payments be considered to be the *level* anount obtained by dividing the purchase price (or present value of the payments) by the expectation of life. These recommendations were promptly implemented in amendments to the Income War Tax Act.

4. *Deferred Annuities*

In 1963 the federal government became convinced that certain taxpayers were purchasing deferred annuities with the intention of surrendering them prior to maturity in order to obtain tax-free gains. Section 7(5) was accordingly added to the Income Tax Act to provide, in effect, that in the case of a deferred annuity purchased on or after June 14, 1963, and terminated prior to the commencement of annuity payments, other than by death, any gain on surrender would be treated as interest income of the recipient.

5. *Proceeds from Other-than-Life Insurance*

Proceeds from other-than-life insurance have not been considered income unless related to property used to produce business income, in

which case the amount of insurance proceeds, if any, to be included in income depends upon their relation to the value of the property not yet depreciated for tax purposes and upon the application of the proceeds for repair or replacement of the property.

Disability income benefits have not been taxed when paid from an insurance policy but have been taxed in full when paid from a registered pension plan.

6. *Employer Contributions to Group Insurance*

The original Income War Tax Act provided that an individual taxpayer must include in his income, among other things, "wages, salary or other fixed amount . . . directly or indirectly received . . . from any office or employment." Over the years this definition has been expanded to include specifically "the value of board, lodging and other benefits of any kind whatsoever received or enjoyed by him in the year in respect of, in the course of, or by virtue of the office or employment."

Specific exemptions to this broad rule have been provided for a number of items, including employer contributions to a group sickness or accident insurance plan and a group term life insurance policy. This exception was modified by a further provision enacted in 1960 which stipulated that the portion of the premium paid by an employer with respect to group term life insurance in excess of $25,000 on the life of an employee must be treated as income by the employee. The average premium rate for each group life insurance policy is determined annually, net of dividends, and is applied to each employee's excess coverage regardless of his age.

The expression "group term life insurance policy" was first defined in the Income Tax Act in 1963 as a "group life insurance policy under which no amount is payable as a result of the contributions made to or under the policy by the employer of the taxpayer except in the event of the death or disability of the taxpayer." It thus appears possible for an employer to contribute not only toward group term life insurance benefits on a "pay-as-you-go" basis but also toward prefunded postretirement benefits, without adverse tax implications for his employees, provided no cash surrender values are provided.

7. *Unauthorized Insurance*

In 1922, the Special War Revenue Act was amended to impose a tax on persons who placed insurance, other than marine insurance, with unlicensed nonresident insurers, covering property located in Canada. The tax was 5 per cent of premiums paid as compared with the 1 per cent tax imposed elsewhere under the same act on the premium income of

licensed insurers. The tax rate was raised to 15 per cent briefly in 1931 but reduced to the present 10 per cent level in 1932. In 1961, the scope of the provision was redefined to cover all insurance except life insurance, personal accident insurance, sickness insurance, and insurance against marine risks and, to the extent not available in Canada, nuclear risks.

In 1962 the provision was enlarged to cover such insurance not only if placed with unauthorized nonresident insurers but also if placed with authorized insurers through brokers or agents outside Canada.

Although nominally a tax, the impost called for by this provision is really more in the nature of a penalty or deterrent than a source of revenue.

8. *Provincial Taxation*

Most of the provinces adopted some form of personal income tax prior to 1941. These taxes were suspended by all provinces in 1941 under the Wartime Taxation Agreements with the federal government, and, except for Quebec, none of the provinces imposed personal income taxes during the period 1941–61, inclusive. Quebec enacted its Provincial Income Tax Act, effective in 1954, and generally followed the definition of "taxable income" in the federal Income Tax Act. Effective in 1956, the federal act was amended to grant an abatement to Quebec residents. This provision was extended to the other nine provinces effective in 1962, at which time each of them enacted a new Income Tax Act and re-entered the personal income tax field. In order to avail themselves of the federal offer to collect federal and provincial taxes on a joint return, each of these nine provinces defined its personal income tax as a percentage of the federal tax payable by a resident of the province; Quebec, however, has continued to define and collect its own taxes separately.

The federal tax treatment of insurance items in sections C, 1–6, above has therefore been generally applicable in all the provinces as well since 1962. Some of the provinces have also imposed tax penalties similar to those described in section C, 7, on residents who purchase unauthorized insurance, in order to protect the tax revenue obtained from licensed insurers.

Effective September 1, 1968, Newfoundland imposed a 7 per cent premium tax at the policyholder level on all forms of insurance other than life insurance, accident insurance, sickness insurance, and marine insurance. This parallels the province's 7 per cent tax on most retail sales and services and is in addition to the 2 per cent premium tax imposed at the insurance company level. The tax is collected through insurance agencies, which are allowed a commission of 2 per cent of taxes collected.

D. INHERITANCE TAXES PRIOR TO 1969

Ontario began levying succession duties on inheritances in 1892, and over the years all provinces have done so. In 1941, the federal government also began to impose succession duties. Under the Tax Rental Agreements of 1947, each of the provinces except Ontario and Quebec agreed to vacate this tax field in return for payment to it by the federal government of a large share of the federal taxes collected. These arrangements have remained more or less intact under the subsequent federal-provincial agreements, except that British Columbia began to levy its own succession duties again in 1964. In the three provinces collecting succession duties, the inclusion of life insurance is not based on ownership of the policy but on whether or not the decedent provided the money for the premiums.

In 1958 Parliament replaced the Dominion Succession Duty Act with the Estate Tax Act. Whereas under the former act the taxes were technically levied against each beneficiary, under the latter the tax was imposed on the estate itself, although the amount of exemption continued to depend upon the relationship of the beneficiaries to the decedent. With respect to life insurance, the principal change was that the test for inclusion of life insurance in an estate now became ownership of the policy. As a result, many in-force policies were assigned to spouses, and many new policies were purchased with the spouse as owner rather than the person whose life was insured. In the case of the usual type of employee group life insurance, however, an amendment added in 1960 had the effect of requiring its inclusion in the estate of the person insured.

E. REGISTERED PENSION PLANS AND REGISTERED RETIREMENT SAVINGS PLANS

Under the Income War Tax Act, payments from employee superannuation or pension plans were considered income of the retired employee.

Employer contributions to an employee pension plan were considered deductible under the same act as a business expense, apparently without limit, provided they were related to current service. With respect to past service, the British thinking prevailed that contributions were more in the nature of a capital expense and therefore not deductible. However, in 1938 specific provision was made for the deduction of past-service contributions, spread over ten years. In 1941, limitations were placed on the amount that could be deducted for current service. When the act was rewritten as the Income Tax Act in 1948, the provision for deduction of past-service contributions also included a stipulation that the special payment be pursuant to a recommendation by a qualified actuary, be ir-

revocably vested, and be approved by the government. The ten-year spreading requirement for past-service contributions was eliminated in 1958.

A provision was added to the Income War Tax Act in 1919 that any employee remuneration retained by the employer for an employee pension fund could be deducted by the employee in computing his personal taxable income. Limitations on the amounts of these current service contributions that could be deducted for tax purposes were imposed in 1936. In 1944 provision was also made for the employee to deduct, within limits, additional contributions made by him for past-service benefits.

Since 1942 plans have required government approval in order for employer or employee contributions to be deductible.

The investment income of registered pensions funded through government annuities or insurance companies has never been taxed. In 1927 the Act was amended to allow pension trusts to elect not to have their incomes taxed, but a curious condition was included to provide that, if the trustees so elected, employee contributions were not tax-deductible and the portion of the benefits arising therefrom was not taxable. Following the Ives Commission recommendations of 1945, this proviso was removed and trusteed pensions were placed on essentially the same tax basis as government annuities and insured plans.

The Ives Commission also recommended that the limits on contributions for both employer and employee be removed entirely, but this recommendation has never been adopted.

Representations were made to the Ives Commission that the privilege of tax deferral on pension savings available to employees be extended to all individual taxpayers. The Commission hesitated to so recommend, because they foresaw serious administrative difficulties. However, in 1957 such a provision was adopted through the enactment of Section 79B of the federal Income Tax Act. Under this provision, an individual life insurance policy or annuity, trust fund certificate, mutual fund share, or the like, may be registered as a "retirement savings plan" subject to certain restrictions on dividends, loans, and assignments and to the requirement that benefits be taken as an annuity. Contributions, within limits, may be deducted annually in computing the taxpayer's taxable income, the earnings of the fund are tax exempt, and benefits are taxed as income when received.

Under both registered pension plans and registered retirement savings plans, single payments made at death or discontinuance are taxed in full,

although provision is made in certain instances for use of a tax rate lower than the taxpayer's marginal rate.

Provision is also made for the taxpayer to transfer funds from one registered plan to another without incurring tax liability.

F. THE CARTER COMMISSION

In 1962 the federal government appointed the Royal Commission on Taxation (the Carter Commission) to investigate the entire area of federal taxation. After an exhaustive inquiry, a massive report was published in 1967. The report is a monumental exercise in theory and logic and a classic study of taxation. Unfortunately, its scope was confined largely to taxation at the federal level, whereas a totally co-ordinated taxation system must necessarily consider also provincial and municipal taxes.

The Carter Commission's principal conclusion was stated succinctly at the beginning of their report:

> The present system does not afford fair treatment for all Canadians. People in essentially similar circumstances do not bear the same taxes. People in essentially different circumstances do not bear appropriately different tax burdens.[7]

The solution recommended was not to attempt to repair the existing structure but rather to replace it entirely with a new one based on the Commission's concepts of "equity" and "neutrality."

The structure recommended was based on four principles which, if carried to their logical conclusion, would produce far-reaching changes:

1. The tax *unit* should be the family (or single person). The total income of husband, wife, and dependent children would be pooled for tax purposes. Financial transactions between members of the family would have no tax consequence. For example, there would be no gift or estate tax on money passing from husband to wife.

Only *people*, and not *organizations*, would theoretically bear taxes. As a practical matter, corporations and other organizations would be used to collect taxes, but these taxes would ultimately be reflected appropriately in the personal taxes of the shareholders (and policyholders) through a "grossing up" calculation. For example, a $50 share dividend would be deemed to have arisen from $100 of corporation earnings prior to a 50 per cent corporation income tax; the individual shareholder would "gross up" his $50 dividend to $100 of taxable income, to which he would apply his personal tax rate and then take credit for the $50 of income tax already paid on his behalf by the corporation.

2. The tax *base* should be related to ability to pay. The Carter Commission

[7] Canada, *Report of the Royal Commission on Taxation* (Ottawa, 1966), I, 1.

equated this with the receipt of money by the taxpayer from any source whatsoever: "We do not believe it matters, from the point of view of taxation, whether he earned it through working, gained it through operating a business, received it because he held property, made it by selling property or was given it by a relative. Nor do we believe it matters whether the increased command over goods and services was in cash or in kind. Nor do we believe it matters whether the increase in economic power was expected or unexpected, whether it was a unique or recurrent event, whether the man suffered to get the increase in economic power or it fell in his lap without effort."[8]

If adopted, this principle would result in capital gains being taxed for the first time in Canada and as ordinary income. Likewise, gifts and inheritances (including insurance) from outside the family tax unit would be taxed as ordinary income.

3. The tax *rate* should continue to be progressive but with a top marginal rate of 50 per cent, compared with the existing top rate of 80 per cent.

4. The tax *burden* should be reduced to reflect some of the expenses of raising a family, through direct reductions from the calculated tax rather than exemptions from the tax base.

With respect to life insurance, the Commission took the position that the existing tax treatment was unduly favorable and that there was no reason why insurance earnings and proceeds should be treated differently from other investments, or insurance companies and fraternal benefit societies from other corporations. This, they felt, would be consistent with their objective of neutrality.

Specifically, it was recommended that ways be found to attribute to and tax each life insurance policyholder annually on the following:

(i) His share of interest credited to policy reserves and other policyholder funds.

(ii) Annual dividends credited to his policies.

(iii) Any realized gains, that is, any excess of aggregate surrender, maturity, or annuity benefits received over aggregate premiums and amounts already attributed as taxable benefits. It was also recommended that perhaps at some future date, so-called mortality gains and losses, that is, the difference between the *death* benefit and the cost of the policy, might be brought into the tax base.

The life insurance company would be taxed at corporation tax rates on any operating gains not "passed through" to policyholders. However, through the "grossing up" calculation on his share dividends, the corporation tax rate would, in effect, subsequently be adjusted to a personal tax rate in the case of each stock company shareholder. A similar process

[8] *Ibid.*, p. 9.

might also be appropriate with respect to company gains considered to be held for the benefit of participating policyholders.

With respect to disability income and group life insurance, the Commission recommended that, in order to provide consistent treatment of employer and employee contributions, both should be deductible in computing their respective taxable incomes and benefits should be included in the taxable income of the recipient. With respect to group hospital and medical insurance, the Commission recommended that employer contributions be considered taxable income to the employee and benefits continue not to be taxed.

With respect to registered pension and retirement savings plans, the Commission recommended, on social grounds, continuance of the existing system of providing tax deferment. However, they calculated that the loss in tax revenue through deferment is not inconsiderable and therefore recommended that the privilege of tax deferment be subject to drastically stringent requirements, including an aggregate limit on the tax-deferred pension benefits a person might accrue.

Finally, with respect to all other forms of insurance, the Commission recommended that proceeds be brought into the income of the recipient with corresponding allowance for his losses.

Since the field of provincial taxation was beyond the scope of the Commission's terms of reference, they could only note that, if their recommendations were accepted, then, in order for life insurance companies to be on an equal footing with other financial institutions, either the provincial premium taxes should be abolished or similar taxes should be imposed on other savings institutions. Like the earlier Rowell-Sirois Commission, the Carter Commission favored the provinces' vacating the area of corporation taxation entirely but had no specific ideas on how to persuade the provinces to forgo this constitutional privilege.

The response of the life insurance industry to the recommendations of the Carter Commission was, briefly, the following:

1. With regard to shareholders, the existing law already taxed any profits allocated to them in an appropriate manner.
2. With regard to individual policyholders:
   a) The proposal to tax policy dividends as income (1) did not recognize that they are part of the mechanism used to determine the net cost of participating insurance and do not really increase the policyholder's economic power and (2) would establish a bias in favor of nonparticipating insurance.
   b) The proposal that investment income be allocated to policyholders and taxed annually in their hands would be complex and administratively costly and would be unfair in taxing amounts not actually received.

c) The proposed eventual "mortality gains and losses" system would run counter to the insurance process itself by granting small tax concessions during the taxpayer's lifetime but imposing a heavy tax burden at his death.

d) If new taxes were to be imposed in addition to existing premium taxes, they should be limited to a tax on gains realized by a living policyholder on surrender or maturity of his policy; gains realized at death should be exempt from tax on social grounds.

3. With regard to group insurance, the proposal to allow employee contributions as a deduction from personal taxable income but to include death benefits in taxable income would also constitute a reversal of the insurance process by granting a small benefit to employees who lived and imposing a substantial tax burden on the survivors of those who died.
4. With regard to registered pension and retirement savings plans, the existing system was basically sound and the proposed limitations too severe and administratively onerous.
5. With regard to the economy generally, adoption of the entire report might have an adverse effect on continued domestic savings and the investment of foreign capital in Canada and on foreign trade.

Since publication of the Carter Commission report, successive governments have been studying its recommendations. While it appears unlikely that they will all be adopted, some of the basic ideas in the report were implemented in the 1969 amendments to the Income Tax Act and the Estate Tax Act:

1. Gift tax and estate tax have been integrated to produce a similar impact in relation to the wealth of the donor or the decedent.
2. Gift tax and estate tax have been abolished on amounts passing in specified ways to the spouse of the donor or decedent.
3. A variation of the recommendations for taxing life insurance companies and insurance policies has been adopted.

Further proposals for major tax reform, many of them adapted from recommendations of the Carter Commission, were advanced for public and parliamentary consideration in a government white paper in November, 1969, but have not yet been acted upon by Parliament.

G. 1969 AMENDMENTS TO THE INCOME TAX ACT

1. *Background*

Radical changes in the taxation of insurance were proposed by the Minister of Finance in his budget of October 22, 1968. These proposals were clearly based on the theories underlying the recommendations of the Carter Commission, modified to eliminate most of the voluminous

calculations and reporting that complete adherence to them would have entailed.

Just as one of the objectives in the United States in formulating the Life Insurance Company Income Tax Act of 1959 was stated to be to devise a formula reasonably acceptable to the life insurance industry which would produce approximately $500 million of revenue in 1958, so the $95 million of additional revenue expected to be produced in 1969 from the new life insurance taxation in Canada formed part of the considerations in the October, 1968, budget calculations.

The Minister, however, also indicated that one of the government's objectives in Canada was to achieve "equity between those who save in the form of insurance policies and those who save in other forms" and, subject to special rules where necessary, to have "the general provisions of the Income Tax Act apply to this industry just as they do to all others."[9] Recognition of the social desirability of life insurance through preferential tax treatment (as in the United Kingdom through the deductibility of insurance premiums in computing personal taxable income) has accordingly been abandoned in Canada.

After intensive study and discussions involving both the government and the life insurance industry, the budget proposals, with some modifications, were implemented through the 1969 amendments to the Income Tax Act and Regulations. These amendments impose three new major taxes:

a) Income tax on an individual policyholder's realized gains on surrender or maturity of a life insurance policy (but not on death) and upon annual allocations to him under a segregated fund policy.
b) Income tax on an insurance company's "taxable income."
c) Investment income tax on "taxable Canadian life investment income." This tax is imposed on the insurance *company* in lieu of on the *policyholder* as the Carter Commission had recommended.

In the case of nonresident insurance companies, provision is made for two additional taxes: (*a*) "branch tax" on certain fund transfers and (*b*) penalties on a nonresident company maintaining insufficient assets in Canada related to its Canadian insurance operations.

Finally, provision is made for the imposition of the same taxes on the life insurance operations of fraternal benefit societies as are imposed on those of life insurance companies.

No changes were made in the existing taxation of the following:

a) Registered pension plans.
b) Registered retirement savings plans.

[9] Canada, *House of Commons Debates* (1st sess., 28th Parl., 1968), p. 1686.

c) Employer contributions for group life insurance in excess of $25,000.
d) Amounts paid on mutualization of a stock company.
e) Companies insuring churches, schools, charitable organizations, farms and fisheries.

The new taxes are described below.

2. *Policyholder Gains*

Section 6 of the Income Tax Act lists the various items which an individual taxpayer must include in his taxable income. This list was extended in 1969 to include (in addition to the insurance items mentioned in sections C and E above) amounts received on disposition of an interest in a life insurance policy and amounts of investment income allocated to a segregated funds policyholder by an insurer, both of which are described in detail in Section 79D.

a) *Proceeds of disposition.*—"Disposition" includes surrender, termination, or maturity of a life insurance policy but does not include death of the person whose life is insured, assignment for the purpose of securing a loan, or lapse if reinstated not later than sixty days after the end of the calendar year. The amount to be included in taxable income is the amount, if any, by which the proceeds of disposition exceed the "adjusted cost basis." Policy dividends as well as surrender values are deemed to be "proceeds of disposition." The "adjusted cost basis" as of a particular time is the excess, if any, of (i) the total cost to the taxpayer (generally the total premiums) for the policy before that time over (ii) the aggregate "proceeds of disposition" received before that time, excluding those which the policyholder has already been required to bring into taxable income. In most cases, the "adjusted cost basis" will thus be premiums paid less dividends paid or credited (unless applied as premiums for additional insurance).

If the proceeds of a life insurance policy are taken in the form of an annuity, they are not taxed as "proceeds of disposition" but as "annuity payments" (see par. G, 2, *c*, below).

Special treatment is afforded policies which were in force on October 22, 1968, in order to avoid retroactive taxation of gains already accrued on such policies. If the value of such a policy on its anniversary falling during the period October 23, 1969—October 22, 1970, inclusive, exceeds its "adjusted cost basis" on that anniversary date (i.e., if there is an accrued gain), the policy will be deemed to have been acquired on that anniversary at a cost equal to its value, prior premiums will be ignored, and only future "proceeds of disposition" will be considered. If there is no accrued gain on that anniversary date, the results on the policy will

be measured from its issue date, thus allowing the policyholder to set off "losses" incurred prior to that anniversary date against subsequent gains, before incurring tax.

Although policy dividends are not taxed directly as income in the manner recommended by the Carter Commission, it will be seen that they can in some cases be taxed if there is a gain on surrender or maturity. It is also possible, though exceedingly unlikely, that a point of time could be reached on an in-force policy where subsequent dividends represented proceeds of disposition in excess of the adjusted cost basis and therefore became taxable in the years they became payable.

Gains realized on the surrender of an annuity contract are excluded from the scope of Section 79D. As noted in section C, 4, above, the enactment of Section 7(5) in 1963 already had the effect of taxing as "interest" the gain on surrender of a life annuity contract, other than one entered into prior to June 14, 1963. This section was amended in 1969 to impose a tax on these previously exempt contracts, with respect to future gains on surrender, parallel to that provided under Section 79D on in-force life insurance policies.

Provision is made for the taxpayer to elect to have any taxable proceeds on surrender of a life insurance policy or annuity taxed at his *average* tax rate over the last three years rather than included in taxable income, where they would, in effect, be taxed at his current *marginal* tax rate. This three-year-average rate is computed with relation to the taxpayer's "income," not his "taxable income"; that is, before personal and charitable deductions, and so forth.

The exclusion of annuity contracts from the scope of Section 79D presumably also applies to life insurance policies which have been registered as retirement savings plans and are thereby considered to be "annuity contracts" under Section 79B. As noted in section E above, upon discontinuance of registration the entire cash value of such a contract is subject to tax.

b) Segregated fund allocations.—In the case of life insurance policies where all or any part of the insurer's reserves varies depending on the market value of a segregated fund, provision is made for the insurer to allocate investment income from the fund to policyholders and to exclude the segregated fund premiums and proceeds from the calculation of taxable amounts received on disposition. The annual allocation is to indicate the proportions attributable to dividends from taxable Canadian corporations, dividends from other sources, foreign taxes, and depletion allowances; all these items are then used by the individual taxpayer in computing his taxable income.

c) Annuity payments.—The principle described in section C, 3, above

continues to apply that a uniform portion of each annuity payment is considered to be a tax-free return of capital and the balance taxable interest. The original capital (called "consideration" or "purchase price") is determined according to the following principles:

(i) In the case of an income settlement at death, the present value of the annuity payments (e.g., the lump-sum death benefit payable if the settlement option were not elected).

(ii) In the case of an income settlement on "disposition" of an insurance policy, the "adjusted cost basis" of the policy immediately before the first annuity payment becomes payable. This has the effect of taxing gains arising during the lifetime of the policy after the effective date in the new law rather than just those arising after annuity payments commence, as was the average effect of the previous regulation.

(iii) In the case of purchased annuities, the premiums paid. This rule is modified in the case of contracts in force on October 22, 1968, along the lines outlined in paragraph G, 2, *b*, above, in order to avoid retroactive taxation of gains already accrued on such policies.

d) *Provincial tax.*—The Income Tax Acts of all the provinces except Quebec impose provincial personal income tax as a percentage of that imposed under the federal act. The 1969 federal amendments with respect to proceeds on disposition of insurance policies and annuities thus result automatically in provincial personal income tax revenue being generated in these nine provinces. Quebec defines personal taxable income in its Income Tax Act and would have to take legislative action to accomplish the same result.

3. *Insurance Company Income Tax*

a) *Applicability.*—As noted earlier, the Income War Tax Act enacted in 1917 had exempted from taxation the income of "life insurance companies except such amount as is credited to shareholders' account," and the same principle had been continued in 1948 in the Income Tax Act in the definition in Section 30 of the taxable income of a life insurance corporation. Section 30 was repealed by the 1969 amendments.

Section 68A (see sec. B, 6, above) was also repealed and replaced by a new Section 68A, which provides the following:

(i) All insurance corporations, stock and mutual, life and other-than-life, are deemed for the purposes of the Income Tax Act to be carrying on business for profit.
(ii) All premiums are deemed to be received in the course of that business.
(iii) All investment income is deemed to be income of the corporation.
(iv) "Income" and "taxable income" are to be determined according to the rules applicable to ordinary corporations, except as otherwise provided.

New provisions were also included to make it clear that the exemption of benevolent and fraternal benefit societies and orders from taxation under the Income Tax Act no longer applied with respect to their life insurance operations and that a society's "taxable income" would be computed on the assumption that there was no income or loss from any of its other activities.

The calculation of "income" for tax purposes thus commences with income from premiums and investments less disbursements for insurance benefits and expenses including provincial premium taxes. However, special treatment is necessary for certain items peculiar to insurance companies, such as increases in policy reserves. The chief distinctive features affecting the determination of the "income" and "taxable income" of an insurance corporation are described below.

b) Geographic limitations.—"Income" for tax purposes of all nonresident insurance companies and of resident life insurance companies is confined to that arising from the company's insurance business in Canada. This recognizes the impropriety of taxing the life insurance of policyholders in other countries. It is, however, an unusual departure from the normal approach of taxing domestic corporations on their world-wide operations and allowing certain credits for foreign taxes.

Consistent with the new approach, the usual deduction of foreign taxes from Canadian tax is not permitted resident life insurance companies. This denial is appropriate except in the case of foreign investments made by such companies on behalf of their Canadian policyholders, where a credit for taxes withheld at source would be appropriate. As discussed later, if a resident stock life insurance company pays shareholder dividends from the earnings of its nonresident operations, then additional income tax can arise, and in this case an approximation to the usual foreign tax credit is provided.

The allocation of business between "in Canada" and "out of Canada" may be according to the company's books if it maintains such regional accounting, subject to conditions prescribed in the Regulations, or alternatively may be made on a prorating basis, again as prescribed in the Regulations. Having chosen one alternative, the company may subsequently change to the other only with the consent of the government and subject to such conditions as it imposes.

While life insurance companies are taxed on the combined "income" arising from their life and other-than-life insurance business *in Canada*, Canadian other-than-life insurance companies continue as in the past to be taxed on their *world-wide* "income," with the usual foreign tax credit being allowed. This anomaly is of little practical consequence because

less than 2 per cent of the business of Canadian other-than-life insurance companies is written outside Canada.

The former practice referred to in section B, 2, above with respect to nonresident insurance companies has been reversed—like other insurance companies they are now required to bring into "income" the investment income related to their Canadian insurance business and are allowed to claim as a deduction an appropriate amount of expenses incurred outside Canada in connection with their business in Canada.

c) Capital gains.—The Income Tax Act does not define capital gains. The usual practice has been not to consider gains over cost on the disposition of securities as income unless the taxpayer is in the business of buying and selling securities. The same applies to property and equipment, except that provision is made for the deduction of "capital cost allowances," described below, in determining "income" from a business.

In the case of a life insurance company, the 1969 amendments specifically provide that, in the calculation of "income" from investments in "Canada securities" (bonds, debentures, mortgages, hypothecs,[10] or agreements of sale applicable to the company's life insurance business in Canada other than segregated fund business), realized gains and losses, amortization of premium, and accrual of discount are to be included. By implication, changes in book values and realized gains and losses on securities other than "Canada securities" are not to be considered in determining the "income" of an insurance company.

"Canada securities" held on December 31, 1968, are treated as though acquired on that day at their amortized values. A loss on disposition of any such security prior to 1979 must be spread until the end of 1978. This transitional provision was adopted as a deterrent to bond trading for the purpose of incurring losses and thereby deferring tax, a possibility accentuated by the depressed values of many older bond issues at the time the new tax legislation became effective.

d) Capital cost allowance.—In computing "income" from a business, a taxpayer is allowed to deduct "capital cost allowances" (that is, depreciation) on certain classes of property and equipment up to maxima prescribed in the Regulations. The maximum deduction in any year for each class of depreciable assets is determined by applying the specified depreciation rate to the undepreciated balance for that class. This "diminishing balance" basis of depreciation is in contrast to the "straight-line" basis normally used in business accounting and usually requires the maintenance of separate depreciation records for tax purposes. The

[10] Although differing technically, as a practical matter a hypothec is equivalent under the civil law system of Quebec to a mortgage under common law systems.

balance in each class is increased by the cost of additional assets in the class and diminished by tax deductions taken and by the proceeds on disposition of assets (including insurance proceeds payable on the loss or destruction of assets) up to their original cost, any excess of proceeds over cost being treated as capital gain; if the undepreciated balance for the class is insufficient to absorb a reduction on disposition, the remainder must be brought into "income." If all the assets in a class are disposed of, any remaining undepreciated balance for that class can be deducted from "income" as a "terminal loss." Finally, it should be noted that the taxpayer is permitted to take all or part or none of the maximum capital cost allowance available to him in any particular year.

Any depreciable assets owned by a life insurance corporation on January 1, 1969, are treated as though acquired on that day at the following values, which thereby become the initial balances in its capital cost-allowance records for tax purposes:

(i) Buildings are deemed to have depreciated on a 2½ per cent "straight-line" basis from the year of acquisition, except that any renovation or addition costing in excess of $100,000 is deemed to be a separate building.

(ii) Automotive equipment is deemed to have depreciated on a 15 per cent "straight-line" basis from the year of acquisition.

(iii) Leasehold interests are deemed to have depreciated in proportion to the period of the company's interest which had expired.

(iv) Other depreciable property acquired after 1958 is deemed to have depreciated on a "straight-line" basis at half the normal allowable rates prescribed in the Regulations.

e) Special deductions for life insurance.—In addition to deductions of disbursements in accordance with the usual rules applicable to ordinary corporations, life insurance companies are allowed the specific deductions described below. In the case of deductions for reserves (items i, ii, iv, and viii) the amount deducted in any year must be brought into "income" for the following year, so that only the net increase in reserves is actually charged against the year's operations.

(i) Policy reserves for life insurance. The reserves that may be claimed for tax purposes are not necessarily the same as those reported in the company's annual statement. The "maximum tax actuarial reserves" that may be claimed are defined in the Regulations. In the case of contracts other than deposit administration or segregated fund contracts, these are reserves calculated on the following bases:

A. Group annuities: Reserves calculated on the same mortality tables as, and at interest rates 1 per cent lower than (rounded to the lower ¼ per cent), those used in calculating premiums. As an alternative, for contracts issued

prior to 1970, the insurer may make a one-time election to calculate reserves on the Ga-1951 Table with Projection C to 1961 (rated down five years for females) with interest at 5½ per cent with respect to premiums "determined before 1969" and at 6¼ per cent with respect to premiums "determined in 1969." The Regulations are silent as to possible alternatives for contracts issued after 1969.

B. Individual annuities except deferred annuities with guaranteed cash values: Reserves based on the same principles as item A, except that the mortality table for the alternative is the a-1949 Table with Projection B to 1959 (rated down five years for females).
C. Group term insurance renewable annually or more frequently: Unearned premium statement reserves.
D. Insurance policies (and individual annuity contracts) with guaranteed cash-surrender values: Net level premium reserves using the same mortality and interest bases as are implicit in the cash-surrender values.
E. Other policies: Net level premium reserves using the same mortality and interest bases as used in calculating statement reserves.
F. Incidental benefits (e.g., accidental death, disability, etc.): Statement reserves to the extent that they are "reasonable in the circumstances."

In the case of deposit administration contracts, the insurer's statement liabilities to policyholders may be claimed.

In the case of segregated fund contracts (other than deposit administration) the maximum tax actuarial reserves consist of the excess, if any, of the statement reserves plus accumulated realized and unrealized capital losses (except to the extent that such losses have been reflected in payments to policyholders) over the sum of corresponding capital gains and accumulated amounts allocated to policyholders under item (vii) below but not actually paid to them. This calculation reflects the fact that capital gains and losses are not considered as income and must therefore be removed from statement reserves in determining appropriate reserves for tax purposes.

The starting reserves to be brought into 1969 "income" are the December 31, 1968, "maximum tax actuarial reserves" less the companys' "accumulated 1968 deficit," if any, as of that date with respect to its life insurance operations, based on assets and liabilities recalculated where necessary to conform with the starting values stipulated by the new law for the computation of 1969 "income."

For any taxation year, the company may claim as a deduction *any* amount of policy reserves up to the "maximum tax actuarial reserves" for the current year end. If a company experiences an operating loss in a particular year, it may well choose for tax purposes to deduct lower reserves than the maximum allowed, thereby permitting greater increases

in reserves to be charged against operations in future years. The effect of this provision is that losses can be carried forward indefinitely and recouped out of future earnings before taxation.

During the course of passage of the 1969 amendments, the life insurance industry presented a strong case to the government and to Parliament for the allowance of certain contingency reserves as a deduction in addition to tabular actuarial reserves, in view of the highly contingent nature of mortality risks and of the possibility over the potentially long-term duration of life insurance contracts of also experiencing adverse results with respect to investment income, operating expenses, and losses on liquidation of investments to meet surrender demands. The Senate was somewhat sympathetic and, in passing the legislation, recommended that provision be made in the Regulations for further deductions. However, the government held to the view that there already was some margin for contingencies in the deductions allowed for policy reserves and that the effect of any unusual losses would be cushioned through the special procedure for the indefinite carryforward of losses. For these reasons, and also because other types of corporations are permitted to establish contingency reserves only out of posttax earnings, no provision has been made for deductions for contingency reserves other than for group term life insurance.

(ii) Additional reserves for group term life insurance. Starting with a nil position as of December 31, 1968, the company may build up a group term life insurance contingency reserve at a rate not exceeding 2 per cent of each year's premiums until a maximum deduction of 50 per cent of the year's premiums is reached. There is a further limitation that this contingency reserve, together with the unearned premium reserve referred to in item (i) above, may not exceed the policy reserves for group term life insurance reported in the company's annual statement.

(iii) Dividends on life insurance policies.[11] Dividends payable during the year (other than those out of segregated funds) may be deducted, subject to a limit. The limit is defined in the Regulations as the sum of the dividend reserve deducted the previous year plus the predividend pretax earnings for the year from the participating life insurance business (individual and group combined), based on "maximum tax actuarial reserves" and ignoring investment reserve changes, capital gains and losses, amortization of premium, and accrual of discount on "Canada securities." Dividends disallowed in one year may be carried forward and deducted in a future year when a margin is available.

[11] These are dividends incurred for the current year; the increase in reserves for dividends to be credited in future years is treated as a separate item.

(iv) Reserve for future life insurance policy dividends. The starting reserve as of December 31, 1968, to be brought into 1969 income is the amount of dividends payable in 1969. The limit on the reserve that may be deducted each year thereafter is the least of (*a*) the company's statement reserve for the next year's dividends, (*b*) 110 per cent of the next year's actual dividends, and (*c*) the excess in item (iii) above of the limit allowed over the dividend deduction claimed. The limitation in item *b* will require a recalculation of the company's tax return if it turns out that its estimated liability under item (*a*) is more than 110 per cent of the actual dividend disbursement.

(v) Return of premiums. Deductions are allowed for premium returns on nonparticipating life insurance similar to those allowed under Section 74 for other-than-life insurance.

(vi) Investment income tax. This is the amount of tax payable by the company under Section 105R after credits for dividends received and premium taxes paid (see sec. G, 4, below).

(vii) Investment income allocated to segregated fund policyholders. Whether or not disbursed, this income is "passed through" and is taxable in the policyholders' hands.

(viii) Investment reserve for life insurance. In computing its "income," an ordinary corporation is allowed to review amounts owing it and, if reasonable, to deduct a "reserve for doubtful debts." In order to avoid a review of individual mortgage loans, a mortgage-lending corporation is allowed instead to deduct a "special mortgage reserve," determined by formula. In lieu of either of these deductions, a life insurance company is allowed to deduct an "investment reserve" with respect to its life insurance operations, which is determined by the same formula as the "special mortgage reserve" but is applicable to all its "Canada securities."

The starting "investment reserve" as of December 31, 1968, to be brought into 1969 income is 1½ per cent of the sum of the amortized value of "Canada securities" then owned and interest thereon due and unpaid, excluding bonds and debentures maturing during 1969. A similar formula is used to determine the maximum reserve that may be deducted at future year-ends. However, if in any year there are net realized losses in excess of one-third of the reserve that would otherwise be held, the maximum reserve is reduced in such a manner that such excess is, in effect, charged to the reserve rather than to income.

f) Special deductions for other-than-life insurance.—The intent of the 1969 amendments is to continue to tax domestic other-than-life insurance companies as in the past and to extend the applicable provisions to life insurance companies.

(i) Policy reserves. Section 85B of the existing act provided for the deduction by other-than-life insurance corporations of "policy reserves," prescribed in the Regulations as 100 per cent of unearned premiums plus such other policy reserves as are required by the insurance regulatory authorities; reserves deducted in one taxation year must be brought into income of the following year. This section was amended to apply to the other-than-life insurance business of all insurance corporations.

(ii) Policy dividends and premium returns. Section 74 of the existing act provided that other-than-life insurance companies could deduct policy dividends and premium returns in computing "income." This section was amended to apply to the other-than-life insurance business of all insurance corporations.

(iii) Special mortgage reserve. Presumably the "special mortgage reserve" allowed a mortgage-lending corporation may be claimed by both life and other-than-life insurance companies with respect to mortgages in the other-than-life branch.

g) *Taxable income.*—"Taxable income" of a corporation consists of its "income" less the deductions allowed under Sections 27 and 28. In the case of a stock life insurance company, a further adjustment may be required with respect to share dividends paid.

(i) Gifts and losses. Section 27 permits the deduction by a corporation of up to 10 per cent of "income" for gifts to certain charitable organizations and governmental bodies (with a one-year carryforward of unused deductions) and of business losses (five-year carryforward and one-year carryback). It is unlikely that life insurance companies will make use of the latter provision in view of the provision for unlimited carryforward of losses described earlier; however, the Section 27 provision is available to both life and other-than-life insurance companies.

(ii) Share dividends received. Section 28 permits the deduction by a corporation of share dividends received from another taxable Canadian corporation. However, under Section 68A this deduction is denied life insurance companies; instead, a similar deduction is allowed but only with respect to that portion of such dividends (other than those arising from segregated funds) which is deemed to remain in the company's "income" after the allowance of other deductions. The portion allowed is $0.97 \times P/S$, where 0.97 reflects an assumed investment expense rate of 3 per cent, P is "income" from life insurance business in Canada, and S is "net Canadian life investment income" (defined in sec. G, 4, below) plus the deduction allowed for certain general expenses. (If smaller, the value of the numerator allowed instead of P will be only "net Canadian life investment income" less interest required for registered pension and

retirement savings plans and "existing fixed-premium" policies.) A further discussion of the rationale of this approach follows in section G, 5, below.

(iii) Share dividends paid. Section 68A also provides that, if the aggregate of shareholder dividends paid by a stock life insurance company after 1968 exceeds the aggregate of items A–E, then twice such excess must be brought into the "taxable income" of the company:

A. Its shareholders' surplus as of December 31, 1968.
B. The lesser of
   1. Its "accumulated 1968 deficit" described above;
   2. Its 1968 maximum tax actuarial reserves.
C. Its post-1968 net contributions to surplus from its Canadian operations including nonincome realized capital gains and losses (for example, on the sale of stocks and real estate).
D. For each year after 1968, the lesser of
   1. Shareholder dividends arising from or deemed to arise from nonresident operations;
   2. Nonresident income taxes.
E. One-half the amounts already taxed under this provision.

This "grossing up" to twice the amount merely approximates an appropriate base for a corporate tax rate of about 50 per cent. The intent of this provision is to preclude the payment of shareholder dividends out of any income or gains that have not been taxed, after first making allowance for distribution of the initial surplus in the shareholders' fund (which has arisen either from shareholder contributions or earnings previously taxed) or the initial deficit (which is deemed to have been paid out of shareholder contributions). The most likely sources of such dividends would be surplus held on December 31, 1968, in the policyholder funds rather than the shareholders' fund, and gains from nonresident operations. It is important to note that Canadian income taxes are imposed on the nonresident operations of a Canadian life insurance company only to the extent that shareholder dividends arise or are deemed to arise from such operations and that the effect of the treatment described in item D above is roughly to allow the equivalent of the usual foreign tax credit against the amount of corporation income tax imposed by Canada on the pretax earnings from which such dividends are assumed to have arisen. Of course, so long as shareholder dividends fall short of the aggregate allowance above, *no* Canadian tax will arise on the company's nonresident operations.

h) *Provincial tax.*—The Income Tax Acts of all the provinces except Ontario and Quebec define "taxable income" of a corporation by direct reference to the federal Income Tax Act and Regulations. The 1969

federal amendments with respect to insurance companies thus resulted automatically in provincial income tax being generated in these eight provinces. Ontario subsequently amended its Corporations Tax Act to define the taxable income of an insurer by similar direct reference to the federal definitions. Quebec also announced its intention to enact parallel changes in its Corporation Tax Act.

4. *Investment Income Tax*

a) *General.*—Section 105R imposes a tax on the "taxable Canadian life investment income" of a "life insurer." Presumably this includes fraternal benefit societies as well as life insurance companies.

As noted earlier, the Carter Commission had recommended that the portion of the net investment income of a life insurance company being applied directly for the benefit of policyholders be reported to them annually and be taxed in their hands. This would have included not only interest credited to funds on deposit (including dividend accumulations and annuities certain) and the "average interest" in life annuity payments (see sec. C, 3, above) but also the interest element in policy dividends and in the increase in policy reserves.[12]

The government has recognized the administrative problems that such a complex reporting system would have entailed and has imposed instead a tax on the net investment income of the insurance company, with an adjustment to give recognition to the ultimate taxation at the policyholder level of gains realized on surrender or maturity of a policy. An adjustment is also made to continue to recognize the principle of tax deferment on registered pension and retirement savings plans. A further adjustment is made for the portion of the company's net investment income which is not applied directly for policyholder benefits but is deemed to be the company's "income" and therefore subject to the income tax described in section G, 3, above.

b) *Gross Canadian life investment income.*—The calculation of investment income tax starts with the company's "*gross Canadian life investment income.*" This consists of gross investment income allocable to the Canadian life insurance operations other than segregated funds (including realized gains and losses, amortization of premium and accrual of discount on "Canada securities") after deducting any increase in the investment reserve being claimed in computing "income" (see par. G, 3, *e*, viii, above).

[12] Actually the Commission recommended that the full amount of policy dividends be taxed, on the assumption that they consisted largely of investment earnings.

c) Net Canadian life investment income.—This consists of "gross Canadian life investment income" less the following deductions:

(i) Investment expenses, other than for segregated funds.
(ii) Interest paid pursuant to a legal obligation in the course of carrying on the life insurance business. This would include not only interest on borrowed money but also interest payable in accordance with resolutions of the company's board of directors on insurance funds on deposit, such as dividend accumulations, policy proceeds, and so on.
(iii) "Capital cost allowance" in respect of a building at least 80 per cent of which is used regularly by the company to earn investment income.
(iv) Fifty per cent of the general expenses in the life insurance branch (other than for group life insurance), including commissions, "capital cost allowance" other than that in item iii, and miscellaneous taxes other than provincial premium taxes. The purpose of this deduction is to equate in an approximate way the tax position of the "savings" element of life insurance with that of savings in other institutions (banks, etc.) which are permitted to deduct all general expenses from investment income.

However, it is not intended that there be a deduction for those general expenses and commissions related to the "risk" element of life insurance. In order to avoid complex calculations as to the "savings" and "risk" portions, it was decided simply to permit a deduction of 50 per cent of total general expenses.

d) Taxable Canadian life investment income.—This consists of the excess, if any, of "net Canadian life investment income" over the following:

(i) The "interest element for the year" for "existing fixed-premium life insurance." This means the interest required in the calculation of "maximum tax actuarial reserves" for the closed block of nonparticipating business in force on October 22, 1968. This block of business is excluded from the effect of the investment income tax because of the impossibility of reflecting new taxes in the price structure of in-force nonparticipating policies.
(ii) The "interest element for the year" for policies issued as registered pension and retirement savings plans, since taxation of earnings on such plans is deferred until benefits are paid.
(iii) The company's "income" from life insurance as described in section G, 3, above. This can be considered as consisting of four elements:
   A. The portion of the allowable gifts to charitable organizations and governmental bodies that is allocated to the company's Canadian life insurance branch.
   B. Allowable recoups of losses in the company's Canadian life insurance branch.
   C. The "income" portion of share dividends received from taxable Canadian corporations (see secs. G, 3, above and G, 5, below).

D. "Taxable income" from the company's Canadian life insurance operations.

The effect of this deduction is that items A, B, and C are freed from investment income tax as well as from income tax; item D is also freed from investment income tax since it is the amount which, after imposition of income tax, represents the net income from the company's Canadian life insurance operations flowing into contingency reserves and surplus. It is thus assumed for tax purposes that the company's "income" arises entirely from investment income; while not technically accurate, this assumption avoids an exceedingly complex analysis of the sources of operating gains and losses.

(iv) Amounts received by policyholders that are taxable in their hands. This consists of the interest element of annuity payments and proceeds on disposition of a life insurance policy (see sec. G, 2, above).[13]

e) Tax rate.—Section 105R imposes a tax of 15 per cent on "taxable Canadian life investment income" and allows a deduction from this tax on account of provincial premium taxes and dividends received from taxable Canadian corporations.

The 15 per cent rate is a traditional rate for withholding taxes and similar taxes on the source of income where the income cannot be subjected to the normal progressive personal income tax rates.

On the surface it might appear that an appropriate rate might be an average policyholder *marginal* income tax rate in order to produce the same additional revenue that would have been obtained had the investment income been reported through and taxed in each individual policyholder's hands as the Carter Commission recommended. In the eyes of the individual taxpayer, however, there can be little justification for treating one form of personal income as "first dollar" and another as "last dollar," and thus an *average* personal tax rate might appear more appropriate; in determining such a rate, a very important consideration is that many life insurance policyholders do not have enough income to incur any income tax at all.

More to the point is the fact that, in the case of surrender or maturity of a life insurance policy, any gains are taxed in the policyholder's hands and allowed as a deduction in computing the company's taxable investment income. Consequently, it can be considered that the ultimate effect

[13] Apparently through an oversight in drafting, no provision was made here for including the taxable gain on surrender of a deferred annuity prior to the commencement of annuity payments; however, as noted in section G, 2, above, this is treated as "interest" in the policyholder's hands under Sections 7(1) and 7(5), and so a deduction can presumably be taken by the insurance company under the "interest paid" provision described in paragraph G, 4, *c*, ii, above.

in these cases is the substitution of the policyholder's personal tax rate for the flat rate. Under this view, it is not important if the investment income tax rate is arbitrary, so long as it is not so high as to inhibit gains and is not higher than the average personal tax rate.

It should be noted that, although policies which terminate by death are not subject to a tax on gains, they are subject to their year-by-year share of investment income tax at the full rate while they remain in force.

f) Provincial premium taxes.—The deduction allowed on account of provincial premium taxes is the smaller of (i) 50 per cent of provincial premium taxes paid on other than annuities, group term life, and "existing fixed-premium life insurance," or (ii) 1 per cent of such premiums. (This is obviously to guard against federal tax loss should any of the provinces increase the present provincial premium tax level above 2 per cent.)

As in the case of general expenses, the purpose of this deduction is roughly to equate the tax position of "savings" life insurance with that of savings in other institutions, which bear no premium tax. No deduction is intended for the "risk" element of life insurance or for types of insurance excluded from investment income tax. Again, to avoid complex calculations as to the "savings" and "risk" portion of premiums and premium taxes, it was decided simply to use the proportion 50 per cent.

g) Share dividends received.—An individual taxpayer in Canada is permitted to deduct from his gross tax an amount equal to 20 per cent of share dividends received from taxable Canadian corporations. A parallel deduction is allowed a life insurance company in computing its investment income tax with respect to that portion of such dividends (other than those arising from segregated funds) which is deemed to find its way into policyholder earnings. The proportion of such dividends which is allowed as a deduction is $0.194 \times Q/S$, where 19.4 per cent is 20 per cent $\times$ 97 per cent (reflecting an assumed 3 per cent investment expense rate), Q is "taxable Canadian life investment income" plus the deduction allowed for taxable proceeds to policyholders on disposition, and S is "net Canadian life investment income" plus the deduction allowed for general expenses.

h) Provincial tax.—The investment income tax imposed under Sections 105R and 105S of the federal Income Tax Act has no counterpart under the provincial Income Tax Acts.

5. *Treatment of Dividends from Taxable Canadian Corporations*

From the foregoing, the following equation can be deduced:

$$S = P + Q + R,$$

where

S = "Gross Canadian life investment income"
− investment expenses
− interest paid
− capital cost allowance
= "Net Canadian life investment income"
+ the 50 per cent general expense deduction.

P = "Income" of the company from life insurance.

Q = "Taxable Canadian life investment income"
+ taxable proceeds to policyholders.

R = Interest elements for "existing fixed-premium life insurance" and registered pension and retirement savings plans
+ the 50 per cent general expense deduction.

Share dividends received from taxable Canadian corporations, other than those arising from segregated fund investments, are normally deemed to be prorated among P, Q, and R. After a 3 per cent deduction for assumed investment expenses:

(i) The proportion P/S is treated as the company's "income" and is therefore allowed to be deducted in full in determining its "taxable income" (see par. G, 3, *g*, ii, above). However, if $S - R < P$, then only the proportion $(S - R)/S$ is so treated. Since this proportion is treated as "income" and since "income" is deducted in computing "taxable Canadian life investment income" (par. G, 4, *d*, above), it is implicit that this proportion does not bear investment income tax either.

(ii) The proportion Q/S is treated as income applied for the benefit of policyholders, and 20 per cent of this proportion is therefore allowed as a deduction from the company's investment income tax (par. G, 4, *g*, above). It is also implicit that this proportion will have been contained in items allowed as deductions in computing "income" and therefore does not bear income tax.

(iii) The proportion R/S results in no direct tax reductions or credits. However, it is implicit that it is contained in other items allowed as deductions in computing both "income" and "taxable Canadian life investment income" and thus bears neither income tax nor investment income tax.

This treatment is more or less consistent with the treatment applied to trusts and investment companies (mutual funds), whereby the income arising from share dividends which is passed on to beneficiaries and investors is ultimately treated in effect as dividend income in their hands. It is not consistent with the treatment afforded ordinary corporations, including banks and trust companies, whereby share dividends are considered to flow directly into the corporation's "income" and not to be used as an offset against specific disbursements. A more consistent treat-

ment with the latter would appear to have been to allow a complete deduction (or at least 97 per cent) of such dividends in computing "taxable income."

In the case of a life insurance company, the above ratios appear to apply to share dividends in its other-than-life insurance branch as well as in its life insurance branch. This again is inconsistent with the treatment afforded other-than-life companies, which is the same as that of ordinary corporations.

6. *"Branch Tax"*

Ordinary nonresident corporations operating in Canada pay normal Canadian corporation income tax on their Canadian operations, whether these operations are conducted through a subsidiary Canadian company or simply as a branch of the nonresident company. If the subsidiary returns posttax earnings to its nonresident parent by way of share dividends, a withholding tax of 15 per cent is imposed on the dividends under the usual provisions of the Income Tax Act regarding payments from a Canadian source to a nonresident payee. Prior to 1962, there was no corresponding Canadian tax on the automatic return of post–income-tax earnings of a branch operation into the company's surplus.

Section 110B was enacted in 1962 to impose a parallel 15 per cent additional tax, commonly known as "branch tax," on the post–income-tax earnings of the Canadian branch operation of a nonresident corporation, whether or not these earnings are in fact repatriated.

Extension of this principle to life insurance companies would have been improper in the case of a company which intended to hold some or all its Canadian posttax earnings for the benefit of its Canadian policyholders. Accordingly Section 110B was amended in 1969 to provide that the "branch tax" is imposed on a nonresident insurance company only on such amounts as it chooses to withdraw from its "Canadian investment fund," the latter being defined as the company's liabilities in Canada plus its post-1968 net earnings not previously withdrawn from its Canadian insurance operations.

7. *Nonresident Tax*

New Regulations were adopted in 1969 to replace the Regulations described in section B, 11, above. Under the new Regulations, nonresident tax is payable by a registered nonresident insurance company on investment income arising from sources in Canada except the portion included in computing its income from business carried on in Canada for the purposes of its income tax described in section G, 3, above. Thus the

former artificial division of investment income between that allocable to Canadian policyholders and that allocable to nonresident policyholders has been replaced by one presumably more closely related to each company's actual operations.

The gross investment income of a company which has elected to be taxed on the regional accounting basis referred to in section G, 3, *b*, above, other than that arising from investments related to its Canadian insurance operations, is subdivided into four classes to which different tax rates apply:

	Per Cent
a) Tax-exempt interest	0
b) Interest on certain securities issued or guaranteed by provincial governments	5
c) Share dividends from Canadian corporations with a degree of Canadian ownership	10
d) Other investment income	15

For other companies, the division of gross investment income between Canadian and nonresident insurance operations is determined by a prorating formula. The subdivision of the nonresident portion into the above four taxable classes, however, is *not* determined by prorating but rather by considering the nonresident portion to include all (or as much as possible) of the tax-exempt interest and then all (or as much as possible) of each succeeding tax class until the total of the nonresident portion is reached.

8. *Interrelation of Premium Tax, Income Tax, and Investment Income Tax*

The following simplified algebraic demonstration ignores the following factors:

a) Segregated fund business.
b) Group life insurance.
c) Other-than-life insurance business.
d) "Existing fixed-premium life insurance."
e) Registered pension and retirement savings plans.
f) Share dividends received from taxable Canadian corporations.
g) Share dividends paid, arising from foreign business and untaxed surplus.
h) "Branch tax" on nonresident companies.
i) Gifts to charitable organizations and governmental bodies.
) Business losses from other years.

Let

A = Premium tax.
B = Income tax.

$C =$ Investment income tax.
$r =$ Income tax rate.
$I =$ "Net Canadian life investment income" less taxable amounts received by policyholders;
$=$ "Taxable Canadian life investment income" plus "income."
$F =$ Gain from operations after premium tax, but before policyholder dividends, income tax, and investment income tax.
$D =$ Dividends to policyholders allowed as deduction.
$E =$ Dividends to policyholders not allowed as deduction.
$G = F - D$;
$=$ "Income" plus investment income tax.

Then

$$B = r(G - C) \geq 0$$

and

$$C = 0.15[I - (G - C \geq 0)] - 0.5A \geq 0$$

$$= K - \frac{0.15}{0.85}(G - K \geq 0) \geq 0,$$

where K is $0.15I - 0.5A$.

A number of different situations can arise which give rise to different values of B and C (see Table 1). The typical situation for an established

TABLE 1

Situation	B	C	$B+C$
1. $K \geq 0 \geq G$ 2. $K \geq G \geq 0$	0	K	K
3. $G \geq K \geq 0.15G \geq 0$	$\frac{r}{0.85}(G-K)$	$\frac{1}{0.85}(K-0.15G)$	$\frac{1-r}{0.85}\cdot K+\frac{r-0.15}{0.85}\cdot G$
4. $0.15G \geq K \geq 0$ 5. $G \geq 0 \geq K$	$r\cdot G$	0	$r\cdot G$
6. $0 \geq G \geq K$ 7. $0 \geq K \geq G$	0	0	0

company with a normal distribution of business is situation 3, although other situations may apply to specific branches of business within the company.

The net addition to surplus after taxes is $G - (B + C) - E$. Substituting $K = 0.15I - 0.5A$, we obtain Table 2.

The value of r varies by province and by amount of taxable income, as follows:

FEDERAL TAX RATES

Basic rate: 18 per cent of the first $35,000 of taxable income plus 47 per cent of the excess.

Surtax: 3 per cent of the basic tax (i.e., 0.54 per cent of the first $35,000 of taxable income plus 1.41 per cent of the excess).
Provincial abatement: 10 per cent of taxable income.
Old age security tax: 3 per cent of taxable income.

PROVINCIAL TAX RATES

	Per Cent		Per Cent
Alberta	11 (10 prior to July 1969)	Nova Scotia	10
British Columbia	10	Ontario	12
Manitoba	11 in 1969; 13 in 1970	Prince Edward Island	10
New Brunswick	10	Quebec	12 (see par. G, 3, *h*, above)
Newfoundland	13	Saskatchewan	11

Should Quebec adopt a revised definition of taxable income parallel to the amended federal definitions, the above numbers can be combined as shown in Table 3.

The rates for a particular company will vary depending upon the distribution of its net premium income by province. For the industry as a whole, the approximate average rates are 23.1 per cent on the first $35,000 of taxable income and 53.0 per cent on the excess over $35,000. The

TABLE 2

Situation	Taxes $B+C$	Addition to Surplus $G-(B+C)-E$
1 or 2	$0.15I-0.5A$	$G-0.15I+0.5A-E$
3	$\frac{1-r}{0.85}(0.15I-0.5A)+\frac{r-0.15}{0.85}\cdot G$	$\frac{1-r}{0.85}(G-0.15I+0.5A)-E$
4 or 5	$r\cdot G$	$(1-r)G-E$
6 or 7	0	$G-E$

TABLE 3

	First $35,000	Excess
British Columbia, New Brunswick, Nova Scotia, Prince Edward Island, and business not allocated to a province	21.54%	51.41%
Alberta, Saskatchewan	22.54	52.41
Ontario, Quebec	23.54	53.41
Manitoba, Newfoundland	24.54	54.41

average values for the tax rate r for different amounts of taxable income are shown in Table 4, where

$$\text{Taxable Income} = G - C = 0 \text{ in situations 1, 2, 6, and 7}$$
$$= \frac{1}{0.85}(G - K) \text{ in situation 3}$$
$$= G \text{ in situations 4 and 5}.$$

TABLE 4

$G-C$	r
$35,000 or less	23.1%
$50,000	32.1
$100,000	42.5
$200,000	47.8
$500,000	50.9
$1,000,000	52.0
$2,000,000	52.5
$5,000,000	52.8
$10,000,000	52.9

TABLE 5

Situation	r	Taxes $B+C$	Addition to Surplus $G-(B+C)-E$
1 or 2	....	$0.15I-0.50A$	$G-0.15I+0.50A-E$
3	0.231	$0.095G+0.136I-0.452A$	$0.905G-0.136I+0.452A-E$
	0.530	$0.447G+0.083I-0.276A$	$0.553G-0.083I+0.276A-E$
4 or 5	0.231	$0.231G$	$0.769G-E$
	0.530	$0.530G$	$0.470G-E$
6 or 7	....	0	$G-E$

Substituting the extreme values of $r = 23.1$ and 53.0 per cent in the earlier formulas produces Table 5. From Table 5, the effect on surplus after taxes of various operating items can readily be determined. The typical case of a company in situation 3 with over $35,000 of taxable income is shown in the last column in Table 6.

H. OTHER LICENSES AND FEES

In addition to the various forms of corporation taxation described above, assessments are levied against federally registered insurance companies to cover the cost of operation of the federal Department of Insurance. These are based on premium income and approximate 0.04 per cent of premiums.

Each of the provinces requires an annual license fee from insurance companies. Some make assessments to cover the operating costs of their insurance departments, and some also impose small fees in connection with the filing of annual statements. In most provinces, fire insurance companies must also pay an additional tax based on fire insurance premiums, designed to support the provincial fire marshal's office. In Saskatchewan, there is an additional premium tax on net automobile insurance premiums, designed to finance programs of safe-driving instruction.

TABLE 6

INCREASE IN SURPLUS AFTER TAXES

INCREASE OF $1 IN:	SITUATIONS				
	1, 2	3	4, 5	6, 7	Typical
Net investment income*	85¢	77¢ to 47¢	77¢ to 47¢	100¢	47¢
General expenses†	−92½	−84 to −51	−77 to −47	−100	−51
Claims, reserves	−100	−90 to −55	−77 to −47	−100	−55
Premium taxes‡	−50	−45 to −28	−77 to −47	−100	−28
Policy dividends:					
Deductible§	−99	−90 to −55	−75 to −46	−98	−55
Nondeductible‖	−99	−99	−98 to −99	−98	−99

* From either an increase in gross income or a decrease in investment expenses or interest paid.

† Decreases G by $1 and I by 50¢.

‡ An increase of $1 in A also decreases G by $1.

§ Decreases A by 2¢ and hence decreases G by 98¢.

‖ An increase of $1 in E also decreases A by 2¢ and hence increases G by 2¢.

Some municipalities also impose license fees on insurance companies operating agencies therein.

I. DISCLAIMER

This paper has been prepared primarily as a reference for the use of Fellowship students and other members of the Society of Actuaries and is not intended as a legal or accounting interpretation of the provisions of the tax laws and regulations.

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Shaw v. *Minister of National Revenue*, [1939] Ex. C.R. 35; [1939] S.C.R. 338; [1939] 4 D.L.R. 81; [1938-39] C.T.C. 341, 346.

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Abbreviations refer to Canada Tax Cases, Dominion Law Reports, Dominion Tax Cases, Exchequer Court Reports, and Supreme Court Reports.

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