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DISCUSSION OF PAPER PRESENTED AT LATER REGIONAL MEETING

THE TAXATION OF INSURANCE IN CANADA

RAYMOND L. WHALEY

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THOMAS B. BOWLING:

The publishing of this paper is a well-deserved recognition of Mr. Whaley's tremendous effort to compile such a comprehensive Study Note on the subject at a time when so little information was available.

While attending the Part 10I Seminar at Northeastern University, we students at first found some difficulty in absorbing Mr. Whaley's Study Note for examination purposes. We felt that the formulas at the end assumed so many variables equal to zero that the worded text could not be assimilated by reference to the formula. It just was not as easy as the United States Tax Study Note has become, and so we prepared an expanded Canadian tax formula. We first defined "inflow" and "outflow" to grasp the Canadian way of expressing the gain from operations. After assigning letters to each significant item, we found that "income" as well as "gross," "net," and "taxable" Canadian life investment income became less confusing.

WILLIS B. HOWARD, JR.:

There is one section of Mr. Whaley's paper which has caused me a great deal of confusion. In the discussion of "Insurance Company Income Tax" in section G, 3, he defines income for tax purposes as consisting of premiums plus investment income, minus benefits and expenses, including several special deductions, minus capital cost allowance, minus gifts, minus share dividends received, plus an adjustment for dividends paid in excess of certain limits.

One of the special deductions is investment income tax. I therefore turned to section G, 4, of the paper, which discusses investment income tax, and made this interesting and confusing discovery: Investment income tax is based upon taxable Canadian life investment income, which is defined as gross investment income minus any increase in the investment reserve, minus amounts allocated to segregated funds, minus investment expenses, minus interest paid, minus capital cost allowance, minus 50 per cent of life insurance expenses, minus the interest element for the year for existing fixed-premium life insurance, minus the interest for the year on pension plan funds, minus "income" as described in section G, 3, minus amounts paid to policyholders that are taxable in their hands.

"Income" is then defined as the sum of gifts, plus recoups of losses, plus the income portion of share dividends received, plus "taxable income."

In section G, 3, of the paper, where "taxable income" was defined, however, we found that "taxable income" included both premiums and investment income. Thus we have investment income being both an income and a deduction item in the definition of taxable Canadian life investment income. This obviously cannot be true. Therefore, there must be some confusion on my part as to the definition of taxable income in either the discussion of taxable income or the discussion of taxable investment income.

(AUTHOR'S REVIEW OF DISCUSSION)

RAYMOND L. WHALEY:

In preparing my paper, I had felt it desirable to avoid going too deeply into detail, in order to present an over-all view of the theoretical basis of the new taxation laws.

The comments in Mr. Bowling's and Mr. Howard's discussions, as well as other questions that have been directed to me by Part 10 students, suggest that perhaps some greater detail may have been desirable in order to clarify some points in the paper which appear to have proved particularly confusing to students.

Section G, 8, of the paper contains a simplified algebraic demonstration of the interaction of the three forms of tax on life insurance and the resultant marginal effects of various operating items on surplus. For completeness, I should now like to add the more general formulas which take into account the factors that were omitted in the paper for simplicity. In addition to the notation defined in sections G, 5, and G, 8, we now define the following:

H = Gains or losses from segregated fund and other-than-life operations.
J = Taxable Canadian life investment income.
L = Business losses from other years.
M = Gifts to charitable organizations and governmental bodies.
N = Shareholder dividends in excess of allowable limits.

T = Share dividends received from taxable Canadian corporations other than for segregated fund business.
U = Taxable proceeds to policyholders.
$f = T/S$.

We shall also use the second definition of I previously given, namely,

I = "Taxable Canadian life investment income" plus "income"
= "Net Canadian life investment income" less interest element in registered and existing fixed-premium policies and taxable amounts received by policyholders.

The investment income tax C' may now be defined by formulas parallel to those given before:

$$\begin{aligned} C' &= 0.15J - 0.194T(Q/S) - 0.5A \geq 0 \\ &= 0.15J - 0.194f(J + U) - 0.5A \geq 0 \,, \end{aligned}$$

where $J = I - (G - C' \geq 0) \geq 0$.

Alternative ways of expressing C' are as follows:

$$\begin{aligned} C' &= \frac{(0.15 - 0.194f)(I - G) - 0.194f \cdot U - 0.5A}{0.85 + 0.194f} \geq 0 \\ &= K' - \frac{0.15 - 0.194f}{0.85 + 0.194f}(G - K' \geq 0) \geq 0 \,, \end{aligned}$$

where $K' = (0.15 - 0.194f)I - 0.194f \cdot U - 0.5A$.

As suggested by Mr. Bowling, the formulas given earlier for C and K are simply those that result for C' and K' when $f = 0$, that is, when no income (other than in segregated funds) is received from share dividends from taxable Canadian corporations.

The values of the total company income tax B' (covering all branches) can next be derived from the general formula

$$\begin{aligned} B' &= r \cdot (\text{taxable income}) \\ &= r\,(P + H - 0.97f \cdot Z - L - M + 2N) \geq 0 \,, \end{aligned}$$

where $P = G - C'$ (whether positive or negative) and Z = smaller of P and $(S - R) \geq 0$.

In the paper, the value of B is again simply that taken by B' when f, H, L, M, and N are all zero.

The introduction of the several additional factors clearly precludes the simple combination of B' and C' and hence modifies the formulas and values shown in Tables 1, 2, 5, and 6 of my paper. The heading in the first column of Table 4 would also have to be changed to "Taxable Income" $= P + H - 0.97f \cdot Z - L - M + 2N$.

The general forms of the seven situations defined in Table 1 are given in Table 7, together with the corresponding values of C'.

Mr. Bowling has noted that a listing of all the significant "inflow" and "outflow" items entering the tax calculations has proved useful to him and other students. He had submitted such a listing as part of his discussion but, in order to avoid publication of conflicting notation, has kindly agreed to the use of the notation in Table 8.

Table 9 relates the notation used in my paper and earlier in this discussion to the items in Table 8, and the major items in the tax law are in turn defined in Table 10. The alternative expressions shown in Table 9 for J, that is, "taxable Canadian life investment income," demonstrate

TABLE 7

Situation	C'
1. $K' \geq 0 \geq G$ 2. $K' \geq G \geq 0$	K'
3. $G \geq K' \geq (0.15 - 0.194f)G \geq 0$	$\dfrac{K' - (0.15 - 0.194f)G}{0.85 + 0.194f}$
4. $(0.15 - 0.194f)G \geq K' \geq 0$ 5. $(0.15 - 0.194f)G \geq 0 \geq K'$ 6. $0 \geq (0.15 - 0.194f)G \geq K'$ 7. $0 \geq K' \geq (0.15 - 0.194f)G$	0

that the base for the investment income tax may be regarded either as the company's gross life investment income less certain deductions or as the excess of *disbursement* items related to policyholder operations (other than amounts taxed in their hands or given special tax treatment) over noninvestment income.

Another Part 10 student of the Society has raised an interesting question concerning the apparent omission in section G, 4, *d*, iii, of the paper of any reference to the "grossed up" shareholder dividends described in section G, 3, 8, iii. However, in section G, 4, we were referring only to those portions of "income" and "taxable income" which are considered to arise from the *current* year's *Canadian* life insurance operations, and accordingly, since the adjustment for shareholder dividends paid relates generally to earnings from prior to 1969 and/or from foreign operations, I believe that the description is accurate as written.

I sympathize with Mr. Howard in his confusion, which apparently arises from the fact that "income" for tax purposes is more or less synonymous with "profit" in normal accounting terminology. "Income" and "taxable income" for tax purposes are both defined in section G, 3, of the

TABLE 8

Item	Life		Other than Life
	Nonsegregated	Segregated	
1. Premium income	x_1	y_1	z_1
2. Share dividends from taxable Canadian corporations	x_2	y_2	z_2
3. Other gross investment income	x_3	y_3	z_3
4. Canada securities, profit on disposition	x_4	....	....
5. Canada securities, accrual of discount	x_5	....	....
6. Canada securities, investment reserve B.O.Y.	x_6	....	....
7. Mortgage reserve B.O.Y.	....	....	z_7
8. Policy reserve B.O.Y.	x_8	y_8	z_8
9. Group life contingency reserve B.O.Y.	x_9	....	....
10. Dividend reserve B.O.Y.	x_{10}	....	z_{10}
11. Miscellaneous income	x_{11}	y_{11}	z_{11}
12. GROSS INCOME (Items 1–11)	x_{12}	y_{12}	z_{12}
13. Policy payments	x_{13}	y_{13}	z_{13}
14. Interest payments	x_{14}	y_{14}	z_{14}
15. Policy dividends*	x_{15}	....	z_{15}
16. Premium returns	x_{16}	....	z_{16}
17. Segregated fund allocations	....	y_{17}	....
18. Canada securities, loss on disposition	x_{18}	....	....
19. Canada securities, amortization of premium	x_{19}	....	....
20. Canada securities, investment reserve E.O.Y.*	x_{20}	....	....
21. Mortgage reserve E.O.Y.*	....	....	z_{21}
22. Policy reserve E.O.Y.*	x_{22}	y_{22}	z_{22}
23. Group life contingency reserve E.O.Y.*	x_{23}	....	....
24. Dividend reserve E.O.Y.*	x_{24}	....	z_{24}
25. Expenses, other than investment	x_{25}	y_{25}	z_{25}
26. Investment expenses	x_{26}	y_{26}	z_{26}
27. Capital cost allowance, investment property*	x_{27}	y_{27}	z_{27}
28. Capital cost allowance, other property*	x_{28}	y_{28}	z_{28}
29. Bad debts established during year	x_{29}	y_{29}	z_{29}
30. Premium taxes	x_{30}	y_{30}	z_{30}
31. Investment income tax	x_{31}	....	....
32. DEDUCTIONS FROM INCOME (Items 13–31)	x_{32}	y_{32}	z_{32}
33. Losses from other years*	x_{33}	y_{33}	z_{33}
34. Gifts*	x_{34}	y_{34}	z_{34}
35. "Excess" dividends to shareholders	x_{35}	y_{35}	z_{35}
36. Interest element, old nonpar policies	x_{36}	....	....
37. Interest element, registered plans	x_{37}	....	....
38. Items 25, 28, 29, excluding group life portion	x_{38}	....	....
39. Item 30, excluding portion re group life, registered, and old nonpar policies	x_{39}	....	....
40. Policyholder gains	x_{40}	....	....

* Amounts claimed for tax purposes, up to limits allowed.

TABLE 9

A	x_{39}
C'	x_{31}
D	x_{15}
F	$(x_{12} - x_{32}) + x_{15} + x_{31}$
G	$(x_{12} - x_{32}) + x_{31} = \sum_{1}^{11} x_n - \sum_{13}^{30} x_n$
H	$(y_{12} - y_{32}) + (z_{12} - z_{32})$
I	$\sum_{2}^{6} x_n - \sum_{18}^{20} x_n - (x_{14} + x_{26} + x_{27} + x_{36} + x_{37} + \frac{1}{2}x_{38} + x_{40})$
J	$I - P = I - (x_{12} - x_{32}) \geq 0$ $= (x_{13} + x_{15} + x_{16}) + (x_{22} - x_8) + (x_{23} - x_9) + (x_{24} - x_{10})$ $+ (x_{25} + x_{28} + x_{29} + x_{30} + x_{31} - \frac{1}{2}x_{38}) - (x_{36} + x_{37} + x_{40})$ $- (x_1 + x_{11})$
L	$x_{33} + y_{33} + z_{33}$
M	$x_{34} + y_{34} + z_{34}$
N	$x_{35} + y_{35} + z_{35}$
P	$x_{12} - x_{32}$
Q	$J + U = I - P + U$
R	$x_{36} + x_{37} + \frac{1}{2}x_{38}$
S	$P + Q + R = I + R + U$ $= \sum_{2}^{6} x_n - \sum_{18}^{20} x_n - (x_{14} + x_{26} + x_{27})$
T	$x_2 + z_2$
U	x_{40}
Z	Smaller of P and $(S - R) \geq 0$

TABLE 10

Income	$P + H = (x_{12} + y_{12} + z_{12}) - (x_{32} + y_{32} + z_{32})$
Taxable income	Income $- 0.97(T/S)Z - L - M + 2N$
Gross Canadian life investment income	$\sum_{2}^{6} x_n - \sum_{18}^{20} x_n$
Net Canadian life investment income	(Gross Canadian life investment income) $- (x_{14} + x_{26} + x_{27} + \frac{1}{2}x_{38}) = S - \frac{1}{2}x_{38}$
Taxable Canadian life investment income	(Net Canadian life investment income) $- (x_{12} - x_{32}) - (x_{36} + x_{37} + x_{40}) = J = I - P \geq 0$
Income tax	$r \cdot$ (Taxable income) ≥ 0
Investment income tax	$0.15 \cdot$ (Taxable Canadian life investment income) $- 0.194(T/S)Q - \frac{1}{2}x_{39} \geq 0$

paper; the description given in section G, 4, *d*, iii, is not a new definition of "income" but merely a transposition of the equation that may be deduced from section G, 3, 8, restricting it (as just mentioned) to the elements applicable to the current year's Canadian life insurance operations.

Perhaps an oversimplification may serve to clarify the basic tax philosophy which seems to apply to life insurance with a substantial investment element:

The insurance company receives both premium income and investment income. The year's premium income can generally be thought of as being *entirely* used up in order to pay current benefits, half of the general expenses, part of the reserve increases, and part of policy dividends. The year's investment income can then be considered to be split into these different portions:

1. The portion used to cover investment expenses, depreciation of investment property, and half of the general expenses (including depreciation of non-investment property).
2. The portion paid or credited directly to other taxpayers, which is "income" in their hands.
3. The portion applied to reserve increases and dividends on registered plans, on which taxes are deferred until benefits are paid.
4. The portion applied to reserve increases on the closed block of nonparticipating business, on which no taxes will be paid except on future gains on surrender or maturity.
5. The portion applied to reserve increases and dividends other than in items 3 and 4.
6. The portion used to pay investment income tax.
7. The portion donated to charitable organizations and government bodies.
8. The portion applied to recoup losses of other years.
9. The company's share of dividends received from taxable Canadian corporations.
10. The remainder, which is considered to be the taxable profits of the company, that is, its "taxable income."

No taxes are applied at the company level on items 1, 2, 3, 4, 7, and 8. Investment income tax is imposed on item 5, with an adjustment for gains on disposition which constitute taxable "income" at the policyholder level. Items 7, 8, 9, and 10 together comprise the company's "income," and income tax is imposed on item 10, "taxable income."

For insurance with little or no investment element, such as group term insurance, the above oversimplification obviously breaks down, since "income" can arise directly from underwriting gains, that is, the excess of premiums over benefits, reserve increases, expenses, and policy dividends.

I wish to correct an error in section G, 3, *b*, where it was stated that less than 2 per cent of the business of Canadian other-than-life insurance companies is written outside Canada; it appears that a more accurate figure is 5 per cent. There is also an omission in the first sentence of section G, 4, *f;* in addition to the policies mentioned there as being ineligible for premium tax credit, there should be included policies registered as pension plans or retirement savings plans, since the interest element on such policies is excluded elsewhere from the investment income tax base.

I appreciate the opportunity that those who submitted discussions have afforded me to offer some elaboration and, hopefully, clarification of the original paper.