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EFFECT OF TAXATION IN THE 1980'S

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The impact of U.S. and Canadian federal income taxation on the life insurance industry has been historically increasing, affecting tax levels incurred, attractiveness of products, and the nature of its markets. During this session the panel will examine the tax issues affecting the industry and discuss in particular those which are expected to change in the 1980's under conditions described in the scenarios.

1. Company taxation in the 1980's

   a. What possible changes may occur in the Life Insurance Company Income Tax Act of 1959 or in the Canadian income taxes on life insurance companies?

   b. The impact of taxation is accounted for in a number of ways under common pricing methodologies. Has any 'best way' evolved to date? What changes are likely to occur in the methodology for handling taxes in the pricing function?

   c. How will the impact of taxation on gross premium and profit levels change in the 1980's? What options are available to compensate for any changes?

2. Taxation of policyholders in the 1980's

   a. How will the possible changes in the 1959 Tax Act affect policyholders?

   b. Will the tax advantages to individuals of life insurance ownership in the U.S. and Canada continue to be a strong inducement for purchasing throughout the 1980's?

   c. What is the future of the tax effective products and markets, such as: Section 79, retired lives reserve, minimum deposit, split dollar, deferred compensation, and last to die joint life.

3. Taxation of tax-qualified (U.S.) and registered (Canadian) products in the 1980's

   a. Will the nature of taxation of tax-qualified and registered products change in the 1980's?

   b. Will public demand for tax-qualified and registered products increase in the 1980's?

MR. LOUIS M. WEISZ: In the U.S., there have been two major outcomes which had not been anticipated when the 1959 Tax Act was passed and which have had a significant impact on U.S. life insurance company taxation in the last two decades. First, Edward A. Green's paper on investment generation was published two years after the Tax Act was enacted. Had these events been reversed so that Green's paper preceded the Tax Act, there might not have been a problem with the taxation of pension business now. Second, at the time the Tax Act was passed, no one ever anticipated the current high level of interest rates. Had current circumstances been anticipated, the Menge 10-for-1 adjustment may have been written differently into the law. Currently with increasing interest rates, the Menge adjustment causes a progressive tax on non-pension business.

On the other hand, Canada is about 10 years ahead of the U.S. having just gone through a long period of tax revision and upheaval.

CORPORATE TAXATION

MR. QUINCY S. ABBOT: The Life Insurance Company Income Tax Act of 1959 has lasted longer than any prior scheme for taxing life insurance companies. It was a compromise document that should, after the courts are through, succeed in raising its $500,000,000 tax revenue goal for 1958; it clearly has exceeded by a wide margin its goal of increasing tax revenues thereafter! The 1959 compromise balanced the tax burden between the competing interests of stock companies and mutual companies, traditional companies and specialty companies, large, mature companies and small, growing companies and between qualified pension business and other business.

High Inflation Scenario.

The environment of the 1980's, however, is calling into question some of this delicate balance. Many feel that the time for a change in the 1959 Tax Act is now. The principal cause is a high rate of inflation accompanied by high interest rates. The high inflation scenario will aggravate some or all of the structural problems in the 1959 Tax Act. We can expect legislative review before the first half of the 1980's is completed. Pressures for change are being generated from such diverse interests as a General Accounting Office study of the taxation of life insurance companies and their policyholders, the inaccurate opinion of some congressional staffs and congressmen that the life insurance industry is undertaxed, the Internal Revenue Service, Treasury Department and Justice Department concern for plugging certain "loopholes" and last, but not least, the mounting industry concern that it is increasingly overtaxed.

Issues that may give rise to legislative change include the following:

1. At many companies, the Phase I tax deduction for interest credited to qualified pension plan reserves is significantly less than the amount of interest actually credited to the policyholders.

   This problem arises when the new money rates credited to recently acquired qualified pension plan reserves exceed significantly the portfolio current earnings rates used to generate the tax deduction. The rapidly increasing investment of non-pension liabilities in low yielding policy loans decreases the portfolio current earnings rate and aggravates the problem. At other companies, the reverse situation exists. The Phase I tax deduction for interest credited to qualified pension plan reserves exceeds the amount of interest actually credited to those policyholders. This occurs when the new money earnings on pension funds receiving interest paid treatment raises the current earnings rate above the rate at which interest is being credited to qualified pension plan reserves.

It will be difficult to find a satisfactory solution to the problem of the first group of companies without raising the taxes of the second group.

2. The amount of Phase I policyholder requirements attributable to non-pension life insurance reserves is no longer deemed totally appropriate by either the industry or the government. The approximation formulas used to revalue preliminary term reserves to net level premium reserves under Section 818(c)(2) and to revalue statutory reserves to the adjusted reserves rate under the 10-for-1 rule (Menge formula) do not produce reasonably accurate answers for some companies under today's conditions. Furthermore, the IRS does not always allow use of the appropriate assumed valuation rate of interest in making the 10-for-1 rule calculations, e.g., with respect to split interest reserves or "excess interest" contracts. In addition, the government is unhappy with the Supreme Court decision in the Standard Life case.

   Solutions being considered for non-pension reserves problems include:

   a. Exact revaluation of reserves to an interest rate within 2% of the adjusted reserves rate followed by application of the 10-for-1 rule to get to the final adjusted reserves. Alternatively, a geometric 10-for-1 rule could replace the existing arithmetic 10-for-1 rule. Under a geometric 10-for-1 rule, the adjusted reserves factor would be $(.9)^n$ where n is the excess of the adjusted reserves rate over the assumed valuation rate.

   b. An elimination or modification of the Section 818(c)(2) approximation formula used to revalue preliminary term reserves to net level premium reserves.

   c. Elimination of deferred and uncollected premiums from premium income, reserves and assets, i.e., a reversal of the U.S. Supreme Court decision in the Standard Life case.

   d. A revision of the definition of assumed rate of interest so that it is clear that excess interest credited directly to a reserve is part of the assumed rate, especially in the annuity area.

3. The Section 820 election to treat modified coinsurance as regular coinsurance for tax purposes was designed to avoid double taxation of investment income. Under some circumstances, it has been used to avoid all tax on investment income. It will likely be revised or eliminated.

4. Section 809(f) limits certain special deductions including the deduction for policyholder dividends to no more than $250,000 plus the amount by which the gain from operations before such deductions exceeds taxable investment income. Reduction in taxable investment income will, of course, increase the limitation on the amount of dividends and special deductions that may be taken. It is also possible that the $250,000 will be raised or perhaps even indexed in accord with the high inflation scenario. Tax revenue constraints and the relationship to policyholder taxation will likely prevent further increases in the limitation

although there are significant pressures for a full, or at least a larger, deduction for policyholder dividends.

Incentive and Investment Scenario.
Under the incentive and investment scenario, the U.S. will have ended the corporate income tax. Any law eliminating the corporate income tax can be expected to tax policyholders on the dividends they receive from insurance companies and perhaps on the interest added to their reserves. Such a tax bill might however, encourage purchase of additional insurance by not taxing any dividends applied to purchase such additional insurance.

Social Democracy Scenario.
Under the social democracy scenario, Congress has legislated a value-added tax (VAT). While this is a simple, noncontroversial tax to administer in many industries, it would cause tax departments in many life insurance companies to expand by 50%. This is because complex formulas would be used to determine the savings element of the premium that is not taxed and the portion of the policyholder dividends that is deductible in arriving at the VAT tax base. The VAT tax base formula could incorporate many elements of the present life insurance company taxable income formula.

Pricing Considerations.
It seems clear that no single best pricing methodology has evolved for handling the impact of taxation. A company's future tax situation and the stability of that tax situation are the key factors in the choice of the method for handling taxes. A company whose tax situation under GAAP accounting rules will differ from its tax situation and its filed returns may have another layer of complication in its pricing methodology.

In 1980 we are pricing in a period of extreme uncertainty as to the tax cost. Complex actuarial formulae that precisely incorporate the tax under today's law may inaccurately reflect the tax burden that will be borne during the life of a policy. This uncertainty clearly must be considered in pricing. The range of possible variation in the Phase I tax is from a significant reduction in the tax due to improvement in the 10-for-1 rule to a significant increase in the tax due to use of statutory assumed interest and preliminary term reserves in arriving at policyholder requirements. The range of Phase II and Phase III tax options is equally wide. These uncertainties might even affect product design by requiring a larger margin for dividends in participating insurance or expanding the use of a low initial non-par premium with the right to increase the premium each year up to a maximum guaranteed level.

MR. WAYNE E. BERGQUIST: In Canada, life insurance companies are taxed on pure income but only with respect to their Canadian operations. There is no multi-phase mathematically complicated tax law as there is in the U.S. An exception to this general lack of mathematical complication is the determination of the Canadian business of multi-national life insurance companies. For pricing purposes, income taxes can either be ignored or simply handled. There is no chance of possible phase changes except possibly for those few companies with a Section 138(7) problem. This is the Canadian analogue of the U.S. Shareholders' Surplus Account.

Policyholder dividends are deductible to the extent that there is Participating Account income to support the payment of such policyholder dividends. There is no theoretical problem with allowing the deduction of policyholder dividends since there is already in Canada an effective integration of corporate and individual taxation with respect to the receipt of shareholder dividends. Customer profits have also been given a wider definition in Canada.

The 1977 Federal budget amendments effective for 1978 and subsequent taxation years significantly overhauled the Canadian corporate income taxation of life insurance companies. These amendments ended the chaotic situation which had persisted for earlier taxation years wherein there were annual "band-aid" amendments to plug loopholes, especially those available to multi-national life insurance companies. Conservative actuarial reserve deductions and contingency reserve deductions were also eliminated. For actuarial reserve deductions, the one-year full preliminary term valuation method was prescribed but it is subject to a cash value floor on a policy-by-policy basis. The new tax actuarial reserves are still more conservative than annual statement actuarial reserves except for those companies with extremely conservative valuation actuaries or with extremely optimistic policy guarantees relative to investment performance.

Other important changes included the elimination of the company and policyholder share concept to the deduction of dividends received from other Canadian corporations such that, henceforth, there was a deduction for 100% of shareholder dividends received. The elimination of the Part XII tax on the life insurance company's net investment income was also repealed, thereby eliminating the multi-phase element of Canadian income taxation of life insurance companies.

These amendments provided for a stable tax law. The taxation of life insurance companies is now generally consistent with the taxation of other corporations except for non-Canadian insurance operations not being subject to Canadian income taxation except through Section 138(7). There are now no major inconsistencies in tax treatment between life insurance companies. Tax savings will now only be accomplished through long-term tax planning rather than through "smart filing" or artificial-type transactions.

In the future, it is my opinion that the tax law will be fine-tuned to become even more consistent with the taxation of other corporations, especially financial corporations. Particular areas for fine-tuning include investment reserves, leasing arrangements, and the definition of Canadian operations for multi-national insurers. Actuarial reserve deductions may be further restricted. The ½% deduction in the valuation interest rate allowed for certain annuity business may be eliminated. This change may be offset by the allowance of more liberal investment reserves. There is also some possibility that there may be a required capitalization of some direct acquisition expenses should they exceed 100% of the first-year premium in order that taxable income be defined to be more consistent with the definition of income in the general purpose financial statements. One can also expect the Department of Finance to closely review those areas where the recognition of tax deductible items are deferred for general purpose financial statements; e.g., "Canada Security" (Life Account bond and mortgage) losses on disposition.

The combined Federal/Provincial tax rate will remain around 50%. There will be no shift of the tax burden to other taxes, such as a value-added tax. The amount of income taxes paid by life insurance companies will continue to be very modest due to the receipt of tax-free shareholder dividends and the full deductibility of policyholder dividends. This situation will be acceptable to governments since the general tax system will be seen as working. The lack of sizeable amounts of income taxes being paid to the provinces by life insurance companies will mean that there will be few practical arguments for the repeal of provincial premium taxes on life insurance business. Life insurance premium taxes will stay at 2% due to the influence of the retaliatory provisions of U.S. premium tax law. There is a possibility of a deduction for the savings portion of the premium if the policyholder "death tax" (which will be discussed later) is resurrected. In summary, the future situation is that there will be very little change in regard to the impact of taxation on gross premiums and profit levels.

I do not see any major differences by scenario. Under the high inflation scenario, life insurance tax accounting will continue to be on an original cost basis with some isolated and essentially uncoordinated adjustments to reflect current value accounting with annual patchwork changes to eliminate the more troublesome areas. Even under the incentive and investment scenario, it would be politically impossible to eliminate the capital gains tax in Canada. One possible exception would be the elimination of capital gains tax on the sale of corporate shares. Theoretically, there should be no tax on proceeds representing the sale of a right to receive future tax-free dividend income. Because of the political sensitivity of U.S. ownership of Canadian business, Canada cannot, however, tax capital gains at a rate considerably higher than the U.S.

MR. WEISZ: Will the tax revenues from the life insurance industry be reduced so that it can compete more effectively for the investment element of the premium dollar?

MR. ABBOT: It is unlikely that the tax revenues will be significantly reduced. However, the rate of increase may go down. We are a big industry with many visible assets, and in today's environment it is hard to get tax reductions.

MR. BERGQUIST: From a Canadian viewpoint, I do not see the taxes on life insurance companies as being higher than other financial institutions, so we can already compete effectively with other financial institutions.

MR. RICHARD S. ROBERTSON: I agree with Quincy. I have yet to see persuasive evidence that we as an industry are overtaxed, although I have heard it mentioned formally and informally on many occasions. We are going to have a very difficult time persuading somebody else. I also agree that we have a good chance of warding off some of the increases that will result if the tax law is allowed to go through the next decade unchanged. And we have some good arguments that in certain specialized markets, such as the pension market, some relief would be appropriate to put us on an equal footing with some of our competitors.

MR. WEISZ: Should the U.S. life companies be taxed similarly to other companies, particularly property-casualty insurers and Canadian insurers? Would revenues increase or decrease? Would the taxes be allocated any differently by product or by company?

MR. ROBERTSON: You started by asking will we be taxed the same as other companies, and then you mentioned property-casualty insurers and Canadian insurers, neither of which is taxed like any other organization. Property-casualty insurers are basically taxed on a statutory basis, which we would welcome. Canadian insurers are also taxed on a basis that generally is quite favorable to the industry. The danger implied by your question is that the IRS would look at things like GAAP income, and tax us on a basis where our acquisition costs are deferred, and perhaps where our reserves are revalued to a lower mortality basis or higher interest basis. There is a long term danger in that, although I do not see any immediate danger even if the tax law were reopened in the near future. It is something we always have to keep in mind.

MR. ABBOT: Implicit in that question is the suggestion that we could receive a full deduction for dividends that we pay to policyholders without having the policyholders include in their income the amount of the dividends we deducted. This would be unlike other cooperative types of organizations. I am not sure that we really want to be taxed like other organizations.

MR. BERGQUIST: I, perhaps, am quite biased in this regard, but I think a multi-phase system of taxation is basically unstable. I would espouse a single phase approach where policyholder dividends should be deductible if the dividends are taxable in the hands of the policyholder. That would mean that each product should be taxed the same regardless of company. You run into trouble with a tax system where the same product is taxed differently in different companies, and I see that as the basic problem with the U.S. tax system now.

MR. ROBERTSON: Wayne, the concept of the same product being taxed differently in different companies takes place in all industries. There are companies that are in a loss position that pay no tax; there are companies operating in different states that pay different taxes. Why is this something that ought not to take place in the life insurance industry?

MR. BERGQUIST: Usually when you are in a competitive situation, you are not too concerned with companies who are in a loss position if the tax law is basically consistent with the real income of the company. If you are offering a product in Canada, it would be nice if the Canadian companies offering that product were taxed the same as the U.S. companies offering that product. This would also apply in the U.S. You get into trouble when you have completely different taxes between the two companies. Small differences you can live with but not the huge differences that now exist.

MR. WEISZ: Will a value-added tax be imposed during the 1980's, and will it apply to life insurance companies?

MR. ABBOT: My reading of the legislative tea leaves is that a value-added tax is fairly unlikely in the next five to seven years. When you get beyond that point in time, who knows what will happen? The only bill that we have before us dealing with a value-added tax is Congressman Ullman's proposal and that value-added tax does apply to life insurance companies. It excludes the investment element of premium. Determination of that element could be a problem.

MR. ROBERTSON: I agree that a value-added tax is not likely to be imposed on business in general. If it is, I do not see how we, as an industry, can escape it. A group of us have studied what it would mean in terms of the life insurance industry, and came away with a couple of conclusions.

First, we would agree with Quincy's assessment that it would require a major increase in the staff of company tax departments, especially as it would probably be an add-on tax rather than a replacement of the current tax. It would be incredibly complicated. There would be new complications on top of the present law that we have finally begun to be somewhat comfortable with, at least to the point where we understand it. We also concluded that it would increase the burden on the life insurance industry unless it was very carefully designed not to do so.

MR. WEISZ: What are the prospects for an end to double taxation of corporation profits (a) when they are earned and when they are distributed to stockholders and (b) for income from equity investments of qualified pension plans which are taxed before being paid into the qualified plan, and taxed again when the pension is being paid out to retirees?

MR. ABBOT: There was a big flurry of interest a year or two ago in the elimination of double taxation of corporate dividends. The practicalities seemed to cause this interest to go away. It is nice theoretically, but there were many practical problems in its implementation. There was absolutely no agreement within the corporate community on what approach to use and how to be neutral among industries. Until such time as the business community can agree on one approach, I do not think it will happen. The effects are so different by industry that it will be very difficult to get that consensus.

MR. ROBERTSON: The best we can hope for is some minor chipping away of the tax burden on individuals by expanding the dividend credit or something similar, probably in the guise of creating incentive for capital development.

MR. BERGQUIST: In Canada, we do not have double taxation when dividends are paid to a recipient. There is integration of the corporate and the individual tax, and the corporation gets full deduction for dividends. The only place where we have double taxation is when dividends are received by a registered pension plan (i.e., the Canadian equivalent of a tax-qualified plan in the U.S.). Then there is a problem of how to tax practically. I would see something developing here by the 1980's. The people who set Canadian tax laws are the bureaucrats, and they tend to be more concerned with technical niceties than their U.S. counterparts.

MR. ROBERTSON: There is some possibility that we will get a limited tax deferral for funds invested under dividend reinvestment plans, but very limited.

MR. WEISZ: Will the tax treatment of policy loans be changed so that they will be considered to be advanced payment of benefits and deducted from the life company federal income tax reserves?

MR. ABBOT: One approach to resolving the problem that people have today with company taxation of pension business is to eliminate policy loans from investment yield, assets and reserves. However, if you do that, it calls into question the policyholder's deduction for the interest he pays, so I do not think that option will come about.

MR. ROBERTSON: We have reached an uneasy truce as to taxation on both sides of policy loans and policy loan interest. I do not see either side wanting to bring it up at this point.

MR. BERGQUIST: The reduction of actuarial reserves by policy loans is a fait accompli in Canada. We have had it since 1978. In the definition of a U.S. life insurance company, policy loans are eliminated from both the reserves in the numerator and the reserves in the denominator. It is at least conceivable that with the increase in policy loans, some companies could find they are no longer life insurance companies under the federal tax law.

MR. WEISZ: In offering competitive interest rates on immediate annuities and life income settlement options, companies are often caught between nonparticipating rates with generally unbearable surplus strain and nonguaranteed rates with nondeductible policyholder dividends. What is the outlook?

MR. ROBERTSON: We are getting squeezed awfully hard from various sources on our annuity business, including unreasonable guarantees we have made in the past on our interest returns and pressures from our policyholders to pay the kind of interest rates that are available on short term investments. We are investing long, and taxes add to the burden. There are days when I question whether this is a viable insurance product at all. In the long term, the industry is going to have to fundamentally rethink what this product is for, what it is supposed to do and what its role in a company is.

MR. WEISZ: The investment and incentive scenario assumes that double taxation of corporate profits has been ended by eliminating the corporate income tax. Is it feasible to eliminate the income tax on life companies and still retain the tax free inside build-up for life policies?

MR. ABBOT: If that is a technical question the answer is yes; if it is a political question, I am not so sure that the answer is yes. It would be very difficult to eliminate the tax on the life insurance company without replacing it to some extent with a tax on the policyholder.

MR. ROBERTSON: The toughest part of that question is trying to imagine how we arrive at a set of circumstances where we have eliminated the corporate income tax. It would have to be an environment where a heavy premium is placed on savings and individual initiative. That is what the investment and incentive scenario is all about. If that environment were to take place, it would be consistent to have a heavy incentive toward the use of life insurance as a medium for accumulating value. So I would be less likely to rule out keeping the tax deferred benefit of individual life insurance. There are other strong arguments for keeping it. The cash value in a life insurance policy is not an immediately realizable value, but is only realizable if the policyholder borrows or surrenders his policy. The reality is there is much political power for retaining this tax benefit.

MR. WEISZ: Should companies press for the removal of the limitation on policyholder dividends in the U.S.?

MR. ROBERTSON: I want to take the opposite view of what I just said about 30 seconds ago. The relationship between the tax benefits to the purchaser of life insurance and the taxability of interest income to the insurance company is one that is going to be very difficult to break down except under the circumstances of a complete abolition of the corporate income tax. If we press for reduction in the taxation of investment income of life insurance companies, it is inevitable we are going to bring the taxation of investment income to the policyholder into view. However, the arguments for sheltering the policyholder's tax position are very strong. If that is the case and if I am right that the tie between the policyholder and company taxation is strong, pressing for tax relief on the investment income of life insurance companies is futile.

MR. WEISZ: Should the limitation on dividends apply only to non-qualified business as a way of reducing the tax on qualified business?

MR. ABBOT: If you can arrive at a taxable investment income formula that gives a deduction for the full amount of interest credited to the qualified business, then you essentially have no limitation on the dividends paid on that business. It has been eliminated from the limitation. That is probably the most feasible way to go about it.

MR. ROBERTSON: Politically, if we can demonstrate that we are paying a significant tax on products that are supposed to be tax favored or tax qualified, we have a good shot at correcting the situation. In terms of tax reforms that favor the industry, this is going to be high on the list, and we might have a chance for accomplishing it.

MR. ABBOT: My concern, Dick, is that this is very hard to demonstrate. As I said in my prepared remarks, some companies are getting a Phase I deduction for more than they actually pay to the policyholder; some companies are getting a Phase I deduction for less. Furthermore, underwriting gains on pension business are not taxed, or are taxed at a lesser rate. We have to be very sure of our statistics in pursuing that line of argument.

MR. HENRY B. RAMSEY, JR.: Both Dick Robertson and Quincy Abbot said we might have some difficulty in establishing that as an industry we are taxed more than others, and, therefore, there might be some difficulty in changing the basic structure of the law. This misses the point of what I see as the pressure, i.e., the taxation on the policyholder as he participates in our companies. From your viewpoint, we may have had reasonable profits as an industry based on historic situations. As we go forward with a much more competitive pressure, the ability to have the policyholder share the tax becomes much less feasible, and it is that aspect which I would expect should change the basic taxation of the company, rather than the relative taxation of what might be considered to be company profits.

MR. ROBERTSON: Can you pursue that a little further? Why is the competitive position of the industry going to make passing the tax through to the policyholder, which admittedly we have to do, more difficult? All companies are in basically the same position are they not?

MR. RAMSEY: All life insurance companies are in the same position, but we are not competing solely with life insurance companies. In the future, our competition is certainly much more likely to be non-life insurance companies. If, among our competitors, there is some protection for the investment element, we have to have something similar here. The ordinary life insurance contract may be somewhat unique, but even there I suspect we have to do some splitting and comparing, and it is a question of what our competition is able to do.

MR. ABBOT: When we are competing head on with banks, we are selling a product which has an interest rate credited to it and does not have any insurance aspect to it. With that kind of a product we can get an interest paid deduction, and we are totally competitive with the banks whether it is in the group or in the individual area. When we have insurance guarantees, we are selling something unique that the bank cannot sell, and it is up to us to stress that uniqueness and charge for it!

MR. ROBERT H. JORDAN: Quincy, if I understood what you said correctly, you were referring to the policy loan situation and the possibility of companies failing to qualify as life companies. Would you care to expand on the significance of that?

MR. ABBOT: In order to qualify as a life insurance company you must first be in the insurance business. Second, the ratio of your life insurance reserves to your total insurance reserves must be over 50%. For purposes of determining that ratio, you exclude policy loans from reserves in both the numerator and denominator.

As a non-life insurance company, you would get a deduction for your life insurance reserves as an unearned premium reserve and for all of your policyholder dividends without limitation. You would lose the non-par deduction; the 2% accident and health premium deduction; the Section 810(c)(6) deduction for premium stabilization reserves; and the Section 818(c) revaluation also. There are many differences; however, it might be something you should explore. Like all tax planning in the insurance industry, work it out in the context of your own particular facts because what is good for the next company may hurt yours and vice versa.

MR. PAUL E. SARNOFF: I am under the impression that the rate of growth of United States corporate income tax on life insurance companies in the recent past and probably for the next several years in the future is around 20% a year versus around 10% for corporations generally. This is a matter of some concern for my company and it is related to some extent to a theoretical problem with the 1959 Income Tax Law. Quincy mentioned that there is quite a burden under the Menge approximation when the spread between the average reserve valuation rate and the 5-year average earnings rate becomes wide. I would like to emphasize that it is not wholly due to the fault in the Menge formula. The theoretical structure of the income tax is inherently progressive, and could lead, for example, to a doubling of the effective rate of income tax within a very short period of time just because of the way companies' average rates of earnings are increasing in relation to their reserve interest assumptions.

MR. ABBOT: Since 1965 the average rate of growth has been about 11% a year. It has not reached 20% in any year so far. The recent development of new tax planning techniques will keep the 1979 and 1980 rate of growth well below 20%.

MR. ROBERTSON: The things that will happen to the life insurance company tax positions if portfolio rates continue to increase are going to make the law fall under its own weight. We will have investment income tax rates well over the corporate tax rate; theoretically they may even get above 100%. You can imagine what that would do to tax planning. The marginal tax rate on assets is going to become negative. I would not be surprised if it were already negative for some companies, which means that all the tax planning and litigation in the last 20 years would have to be reversed, at least as it applies to assets. There are other things that would happen. Those of us in the tax planning area probably would welcome these changes because they would make us heroes.

MR. DOUGLAS G. DRAESEKE: Coming up in the very near future is the consolidation of life companies with non-life companies. Do you have a few thoughts on the matter?

MR. ROBERTSON: We have thought it through with regard to our company. We would welcome the opportunity to use some life gains to offset some non-life losses and we probably will eventually, but we are frustrated in not having the law defined yet. The law does not even tell us how to consolidate two life companies although we have some guideline for ideas of how it is to be done. For a company that has both a life and a non-life company within the same group, there probably is some tax savings but we have not figured out what they are yet; we are still waiting.

MR. ABBOT: Regulations or proposed regulations for consolidating two life insurance companies is a priority project in the Treasury Department. Hopefully, there will be some draft regulations out on life-life consolidation this year. That is the first building block to life-non-life proposed regulations. I doubt they will be issued before we file our 1981 returns. I am sure that a few of us will be seeking rulings to nail down some of the critical issues. Savings from consolidation should include investment credits and foreign tax credits in your non-life loss companies offset against the life company tax. Capital gain and loss planning will be different. If you have the classic situation of a life company with bonds that can be sold to realize a loss and stocks in your casualty company that can be sold to realize a gain, you will have some tax savings opportunities. Your non-life casualty company losses will be utilizable against the life company income so that you will not be forced to move your investment portfolio out of tax-exempts into taxables. This will enable the non-life companies to realize more net investment income over a period of time than they could have without this legislation.

MR. OWEN A. REED: I am not as optimistic as Wayne Bergquist on the Canadian tax scene. The Canadian tax people will not realize how much the life insurance industry is being taxed until they see the 1980 returns because of certain interim problems. We may end up being affected by some of the revisions that the U.S. people are considering. On that score, I really hope that the U.S. people will push for a 100% deductibility of the dividends.

MR. JORDAN: The second question in topic 1.b. is "What changes are likely to occur in the methodology for handling taxes in the pricing function?" With the 10-for-1 rule causing problems and a tendency on our part to insert high interest guarantees into our premium or reserve bases, we have tended to think traditionally that we are going to allow these guarantees to last forever, which is the way we have always treated our permanent products. Is there some tendency to think about introducing five or ten year guarantees into our interest assumptions for permanent plans with a rollover at the end of that period to whatever is appropriate then, especially with the attempt to introduce flexibility of the interest rates so we do not have to keep going back to the states?

MR. ABBOT: First, the most effective pricing technique for taxes is a good Ouija board. Second, the danger you run in setting your guarantees at one rate for a period of time and then changing them for a later period of time is that the government may consider you have a dividend after you have made the change.

MR. ROBERTSON: My company writes both participating and non-participating insurance. One of the nice things about participating insurance is that it is neither necessary nor appropriate to try to forecast what your tax position is going to be in the future. It is very difficult when we get outside that area where we do not have the flexibility of a dividend scale to adjust. Basically, we have to get conservative. When we are pricing a non-participating product, we have to allow for the possibility that the tax situation may be different 10-20 years from now when the assets accumulate.

MR. GARY CORBETT: In response to Bob Jordan's question, the answer has to lie primarily outside of the tax area there. First, will the investments be available that will enable us to guarantee long term? There is certainly much consideration now of the fact that lenders may no longer be willing to loan on a long term basis, in which case it is going to be very difficult for us to guarantee long term rates in the products. Secondly, in regard to product design, will we be permitted to get away from liabilities payable on demand in individual type policies (i.e., guaranteed cash values) which, of course, require changes primarily to the standard nonforfeiture law.

POLICYHOLDER AND TAX QUALIFIED PRODUCT TAXATION

MR. ROBERTSON: One issue that has received much attention in the recent past and probably will continue to receive attention in the near future is the deferral of any taxation of the increasing policyholders' equity in a permanent life insurance policy--the so-called "inside build-up". Many believe that efforts to relieve life insurance companies of taxation of investment income will inevitably bring the taxation of policyholders into question. Indeed, one of the arguments against taxing policyholders on the increasing cash value is that tax on life insurance investment income is already levied at the company level. My opinion is that the arguments against taxing the inside build-up to policyholders are very strong. In addition, the political realities are on our side. However, I believe the linkage between insurance company and policyholder taxation is sufficiently strong that the tax-favored treatment of policyholders is likely to doom any significant tax relief for companies.

The program lists a number of insurance products which receive favorable Federal Income Tax treatment. There is a "life cycle" for these products. Stage 1 in that life cycle is where creative people discover how to use insurance products to produce significant favorable tax benefits. After a while, Stage 2 is reached where the product or concept is widely marketed by a large number of companies and their agents. This leads to Stage 3 where the Internal Revenue Service seeks to close what they characterize as a tax loophole, typically by proposing draconian measures which would seriously hamper the providing of traditional insurance products not related to the specific area where alleged abuses take place. This usually leads to Stage 4 where a reasonable compromise is worked out that does not destroy the concept and does not seriously impact other insurance products but which does severely limit abuses. Finally, this leads to Stage 5 where the product or concept is relegated to the stable of established insurance programs and, where the IRS and the industry are reasonably comfortable with the tax implications, and where no significant changes in tax law are expected for a reasonable period of time.

Most of the products listed in the program are in Stage 5. Deferred compensation, minimum deposit plans and split dollar insurance certainly belong in that category. With the new Section 79 rules, I suspect Section 79 is there as well. It is always possible that any of these subjects could be reopened, but there does not appear to be substantial pressure to do so at this time.

Retired life reserves may be at Stage 2 of this process. If so, we might expect some activity on the part of the IRS within the next year.

Although not on the list, the use of deferred annuities to defer taxes, where the primary objective is probably not retirement planning, has reached the abuse stage and may well be even into Stage 3 where the IRS proposes programs to control the abuses.

The atmosphere surrounding the tax-qualified products listed in the program is much more favorable. These are not loopholes, or, if they are, they are loopholes that were intentionally woven into the tax fabric. I think we can continue to see the use of these products encouraged through tax law and probably will see an expansion of the potential.

Let us turn now to the three scenarios for the 1980's.

The high inflation scenario would undoubtedly affect the use of these products because it would make any form of retirement planning unattractive. This would tend to dampen the sale of those products intended for retirement planning. This would be partially offset by the high interest returns which would be available under these products and the need of individuals to shelter those returns from current taxation. Also, the limits to contributions contained in the tax law pertaining to these products would presumably be indexed along with the rest of the tax law.

High inflation would continue to increase the tax pressure on individuals--even middle-income individuals. This would increase the importance of those programs which do offer tax benefits--especially those which essentially use term insurance including Section 79 and minimum deposit.

The incentive and investment scenario would, of course, be very favorable to all insurance products including those which offer tax incentives. Even though the scenario involves a presumed lessening of the tax burden on individuals, we would anticipate that incentives for individuals to provide for their security which are in the tax law would be maintained and probably expanded.

The social democracy scenario would probably be the most damaging in terms of policyholder taxation. Personal security programs provided by the private sector might be seen as a competitor to federal programs, and it is possible that the incentives which are now present to provide for security would be removed. On the other hand, the heavy tax burden contemplated in this scenario would presumably lead individuals to seek whatever shelters are possible. This is certainly the case in Europe. Hence, we would expect to continue to see an active market for these products to the extent they would be allowed.

One aspect of the social democracy scenario we might expect would be incentives for individuals to acquire a relatively limited insurance or pension program--for example, by providing for deductibility of a limited amount of life insurance premiums. This might open up opportunities for the industry in the middle-income market which are very difficult to reach today.

MR. BERGQUIST: Policyholder Taxation
In Canada, life insurance is presently an industry protected by favourable tax laws. There is no current taxation on cash value increases on either permanent life insurance or on deferred annuity policies. On permanent insurance, there is no death tax (i.e., tax at death on the excess of the then cash value over the policy's adjusted cost basis). As well, there are similar breaks in the corporate tax law which gives certain forms of corporate-owned life insurance, such as keyman and split-dollar policies, a significant tax advantage.

For the future, I see the reintroduction of the death tax as only being a matter of time. There is a tax vacuum occasioned by the 1978 removal of the Part XII tax on the investment income of life insurance companies. This served as an indirect tax on the interest build-up inherent in the cash values. Department of Finance officials would like to bring back the death tax. Consequently, it is only political considerations that block the reintroduction of the death tax.

As life insurance products become more competitive with other forms of savings, life insurance companies will be viewed as exploiting the lack of a death tax. Examples of such exploitive products are new money life insurance products, especially single premium policies. Since Canadian tax law changes are usually triggered by taxpayers unduly exploiting or abusing the current tax law, it is quite possible that these new high-yield products will provide the catalyst for the reintroduction of the death tax.

Any reintroduced death tax will not be unduly burdensome. There will, in all likelihood, be an exemption for the first $10,000 (or perhaps some larger amount) of gain. Since the proceeds out of which the tax can be paid pass to the beneficiary, it would be reasonable for the Government to allow treatment of the taxable amount as a "Right or Thing Transferred to a Beneficiary" under Section 70(3) of the Income Tax Act, thereby making available the option of the amount being taxed in the hands of the beneficiary rather than in the decedent's last tax return. The beneficiary may also be allowed to defer tax by taking the proceeds in the form of an annuity.

Even with a death tax, life insurance will retain significant tax advantages. Pre-tax investment income is still being used to fund after-tax term insurance costs, and there continues to be deferral of tax on any investment income in excess of such term insurance costs. In my opinion, the presence of the death tax will not have an adverse effect on non-corporate permanent life insurance sales except on a temporary basis. Moreover, new products will be designed to take advantage of any revised tax law or to minimize the effect of the death tax.

Along with a reintroduced death tax, policy loans, regardless of use, will be treated as partial surrenders. There will be no tax deduction for repayments as any repayments will be treated simply as premium payments. Such tax law changes will discourage policy loans, and this will benefit life insurance companies.

I would expect that there will be no change in the tax law respecting the non-taxation of the annual cash value increments on life insurance and deferred annuity products either directly or indirectly through the resurrection of a Part XII-type tax. However, if the interest accumulation under deferred annuities becomes basically indistinguishable from that under bank savings accounts and certificates of deposits, then it will be only a matter of time before this interest accumulation is taxed on an annual basis so as to have consistent tax treatment with alternative forms of demand savings.

Along with the foregoing changes, there will be associated changes in corporate tax law so as to reduce the tax advantages of corporate-owned life insurance vis-a-vis personally-owned life insurance.

I do not foresee any major differences by scenario. Any expansion of social insurance benefits will be modest, and will not serve to decrease the market for individual insurance and annuity policies. Under the high inflation scenario, there will be a substantial public demand for all forms of investment income to get tax relief because of continuing high inflation causing a reduction in the purchasing power of the underlying capital. Under the incentive and investment scenario, non-business interest will become tax deductible to the extent of other investment income. Under the Canadian form of government, Constitutional-type spending limits are not a possibility.

Taxation of Registered Business

I foresee continued expansion of the registered market. Tax deferral is seen by the common person as being as good as tax avoidance. The common person will enter into tax deferral arrangements even at the expense of little or no improvement in his after-tax financial situation. To him, the all-important thing is the reduction of current cash taxes. Moreover, in the future, the tax law will tend to shift to taxing consumption rather than income. Registered business presently provides a very substantial and stable pool of investment funds which it is essential not only to preserve but also to expand. Funds must be found to provide reasonable cost residential mortgages, and Government borrowing needs will continue to be huge.

As a consequence, I expect that registered plan contribution limits will be increased. For Registered Retirement Savings Plans, the contribution limits should increase slightly faster than inflation unless inflation remains exceedingly high. Registered Pension Plan contribution levels and maximum pension limits will increase at a slightly lower rate because higher limits will be viewed as unduly assisting the more affluent members of society. Portability will become a feature of registered pension plans. If private enterprise does not develop portability, Governments will intervene to force portability on the private pension system.

I foresee the possible creation of new registered plans and the development of what might be called quasi-registered plans. New registered plans could assist in the tasks of providing low-cost residential mortgages and of decreasing the foreign ownership percentage of Canadian business. Quasi-registered plans will have non-deductible contributions, but investment earnings will be taxable on a deferred basis as amounts are withdrawn from the plan. These plans will develop for the same reasons that the true registered market will continue to expand.

Plans included in this quasi-registered classification might include deferred annuities, certificates of deposit, certain long-term bank savings accounts, Canada Savings Bonds, and segregated fund deferred annuities. Technically, permanent life insurance would also be included in this classification. The general eligibility requirements for quasi-registered treatment would be to serve a desirable social purpose (e.g., permanent life insurance and retirement savings) and/or to provide funds for desirable economic or political purposes such as providing funds for residential mortgages and for investing in shares of Canadian corporations, especially venture capital situations. Consequently, certain mutual funds and specially-designed mortgage funds might also be included in this classification.

There is currently double taxation of corporate dividends and capital gains in registered trusts, since when such amounts are paid to recipients, they are taxed as normal income. Over time, I foresee the tax law changing so as to allow recipients to have such amounts taxed as dividends and capital gains when such amounts are paid to recipients. The alleviation of this double taxation would also encourage such trusts to invest in shares of Canadian corporations, thereby contributing to a decreased foreign ownership of Canadian business. Such alleviation would also remove one of the tax advantages enjoyed by the registered non-segregated products of life insurance companies, since there is no such double taxation when funds are passed through the life insurance company providing it has other income against which the deductions for the amounts paid to policyholders in respect of such dividends and capital gains can be taken. On the other hand, the registered segregated fund products of life insurance companies will have an improved tax situation as they are taxed the same as registered trusts.

In general, Canadian tax laws will be changed so as to tend towards tax neutrality between competitors and their various products. Tax neutrality will not automatically cause life insurers to lose market share. Tax neutrality is only to be feared if life insurance companies offer products with inferior rates of return. I do not believe that the income tax system should be used to protect inferior products. On the other hand, given low or modest inflation rates, I believe there is an excellent market outlook for life insurance companies with a superior investment return relative to their competitors both within and without the life insurance industry.

MR. WEISZ: Will the tax-free inside build-up continue to policyholders on products which are primarily investment vehicles?

MR. ROBERTSON: There are some products that I would characterize as being in the Stage 2-Stage 3 category, where the buyer is predominantly using life insurance as a way to do nothing more than shelter income as opposed to meeting some broader social needs such as retirement planning. I fear we are going to have some limitations in that area, such as when the IRS attacked the so-called minimum deposit plans a few years ago and tried to limit the potential for using that as primarily a form of tax avoidance.

MR. WEISZ: Is the SEC getting involved in these investment vehicles?

MR. ROBERTSON: From a different perspective, their greatest ambition would be to regulate all life insurance products. They know that they cannot achieve this, certainly not all at once, and will probably pick at the ones that have the greatest visibility, those that provide the smallest perceived social need. Here we are talking about the tax avoidance programs. In a sense, they will become involved for different reasons but most likely on the same types of policies.

MR. WEISZ: On policy loans, will the payment of interest lose its tax-deductible status to policyholders, and will policy loans be considered to be an advance payment of benefits with the resulting tax treatment to policyholders?

MR. ROBERTSON: I do not see any pressure to change the taxation of policy loans now. If there is a vulnerable point, it would be on annuities.

MR. BERGQUIST: In Canada, the present situation is that policy loan payments are regarded as partial surrenders, and they are taxed in the hands of the policyholder should that result in a gain to the policyholder.

MR. ABBOT: We know that the General Accounting Office, as part of its study, is looking at Canada to see in what ways the Canadian tax law is different from the U.S. tax law.

MR. WEISZ: What are the prospects in the U.S. for a death tax like they have had in Canada at the moment of death on the excess of the cash value over the net payments by the policyholder?

MR. ROBERTSON: I am not comfortable with my ability to forecast political changes, certainly that kind. Since Congress cannot even make a tax stick on what amounts to the capital gains on an ordinary asset or capital asset held by the decedent. They are not going to go a step further and tax the gain incurred on an insurance contract prior to death.

MR. BERGQUIST: Canada and the U.S. are somewhat different because generally in Canada, with the exception of Quebec, there is no estate tax. This means that the capital gains or income tax treatment at death is really in place of an estate tax and vice versa.

MR. WEISZ: Are most non-qualified sales for basic needs purposes or are they really tax-related?

MR. BERGQUIST: From the Canadian standpoint, single premium immediate annuities, term insurance and permanent insurance are for basic needs, while deferred annuities are simply another form of savings.

MR. ROBERTSON: With a couple of exceptions particularly in the annuity area, the primary sale is on the need. However, were the tax consequences to the policyholder significantly different, and in particular if he were paying a tax on the inside build up and the company were also, the attractiveness of participating insurance would be significantly less, enough so that we would see even more term insurance being sold today than it is now. Tax consequences are a big factor in pushing further the impetus towards term insurance, but in terms of the individual ordinary life insurance sale death protection is by far the motivating factor in the great majority of cases. You buy something else for tax avoidance.

MR. WEISZ: Yet, many ordinary life sales are related to estate tax purposes or keyman insurance for business where there is some tax relationship that is causing the basic sale.

MR. ROBERTSON: With estate taxes, you are right. If there were no estate taxes, many of the large sales would not take place. But the purpose of the sales is to fund the estate taxes, not to avoid them. Maybe this is just semantics, but it is to avoid an unreasonable problem that the estate tax creates in terms of the individual with a large illiquid estate. Having said that, I am not going to deny that there are some tax consequences or tax advantages in a number of cases from an insurance sale, and certainly insurance is designed to take advantage of those.

MR. WEISZ: Because of the life company taxation in non-qualified products, will the major growth in investment related products occur either in (a) tax-qualified market and products or in (b) individual products or group products?

MR. ROBERTSON: Whether we realize it or not, I think it has occurred in the tax-qualified market. If each of us looked at the cash flow of his company, he would see that there has been large growth in the pension area. It is a combination of factors including inflation and the less attractive role of permanent insurance relative to term insurance together with the more attractive role of pension plans and their ability to capitalize in that market. It has been taking place. I am not sure that it can accelerate any faster than it has and, in fact, we are beginning to see some problems as a result of the complete shift of so much of our cash flow to the pension market.

MR. BERGQUIST: In this day of high inflation, you are pretty foolish to save unless you are getting a tax break by doing so.

MR. WEISZ: Will life insurance companies in Canada ever be able to sell Registered Home Ownership Savings Plans (RHOSP's)?

MR. BERGQUIST: The last thing we want to do is to get into the RHOSP market, for then our competitors will want to enter our market.

MR. WEISZ: On non-qualified products, should the life company taxation be reduced to stimulate the investment aspects so that they would be more competitive with the tax-qualified business and non-qualified business in other savings media?

MR. ABBOT: The issue would seem to be, can you reduce the life company tax without increasing the policyholder tax? If you can, then it is a goal to be desired. If the trade off for reducing the life company tax is putting the tax burden onto the policyholder, then I do not think it is a very good idea.

MR. ROBERTSON: If inflation and interest rates continue at the level they have been at in recent years, especially the last year, we are going to have to do something different if we are going to continue to offer permanent life insurance. I am not sure whether that involves insurance with a side fund or a form of variable life insurance with the assets in a money market fund or just some way to get the kind of interest rates available on the market, particularly the money market, to the policyholder. Something has to happen or we are all going to be primarily term insurance and minimum depoist companies.

MR. WEISZ: Having the savings elements going only into tax-qualified markets is a risk. I am optimistic that things are going to get better. But if you look at the high inflation scenario, the industry has quite a challenge ahead if this is the scenario we have to plan for.

MR. ABBOT: What I keep coming back to is the ridiculous though that a 5% or 6% interest rate is exactly as unimaginable today as it was in 1959 when the Tax Act was passed. Therefore, it can happen. I hope it does.

MR. BERGQUIST: Under Canadian taxation, whether a product is registered or non-registered has no effect on the amount of taxes that the company pays. The fact of registration and non-registration is only of concern to the policyholder and to the Department of National Revenue. The company has no interest in it.

MR. CORBETT: If we could ever come to an incentive and investment scenario, there are some rather positive implications that Dick really touched on. They are not in the elimination of the corporate tax at all; rather they are in the policyholder area.

When we talk about abuses and annuities where the IRS might want to reduce the tax free build up, particularly on annuities, it is very easy to forget that this country is extremely conservative on how it taxes annuities and life insurance products. By conservative, I mean it taxes them heavily compared to many other countries. The qualified plan area is a very restricted area in the United States compared to what it is in Canada, Great Britain, and many of the Commonwealth countries where you can make deductions or make contributions to life insurance that are quite outside of any qualified pension plan and still get a deduction. If the country really comes to an incentive and investment scenario, this is the thing to push from the policyholder's side to increase savings. As an industry, we have a fine record of making responsible investments, i.e., the money which has been channeled to use has been invested very wisely for society, and that argument should be pursued more than the reduction of taxes on the corporate side.

MR. ABBOT: Gary, several proposals are being pursued in that area. The so-called LERA's, Limited Employee Retirement Annuities, would allow individuals to set aside their own retirement funds, tax deductible and tax sheltered on the inside build up, in addition to any monies that might be put aside by their employers under a qualified plan.

MR. ROBERTSON: The concept of looking at three different scenarios is a good one because it tends to focus attention, but in reality we are not going to see any one of these scenarios. What we will see are pieces of each perhaps with more emphasis on one general scenario than another. In the investment and incentive area, abolition of the corporate income tax is highly unlikely, but increased incentive for individual savings through insurance or through other vehicles is very likely. It may happen even if the emphasis is on other scenarios. There is much going on today. In fact, we just obtained a very small piece in the so-called windfall profits tax on oil companies. They increased the deduction for interest income earned. That is something we can look forward to with a high likelihood.

MR. BERGQUIST: I would like to expand on the comment about the qualified market in the U.S. being very small compared to Canada. The ability of a Canadian person to invest in registered savings funds is very many times what you can do in the U.S. Furthermore, in Canada you get a deduction for the first $1,000 of investment income, and there is integration on the corporate and individual income tax as we also do not have any limitation on the deduction of policyholder dividends paid by life insurance companies. So it is a much better situation in Canada with respect to those types of investments.

MR. REED: But Canadians are not allowed a deduction for mortgage interest.

MR. BERGQUIST: If Eastern Canadians had voted for the Conservative party on February 22, we would have had deductibility of mortgage interest on personal residences.

MR. REED: This morning James O'Toole referred to this question of Great Britain. He was making the comment that the first scenario was not all that bad because under high inflation, things seemed to be going along not too badly in Britain where, of course, the situation is entirely different. The British are taxed under a different income tax formula. The individual policyholders get tax deductibility for the premiums, but there are no guaranteed cash values. However, that latter point is something that is starting to interest Canadian actuaries, and they are also starting to think about saving permanent life insurance from oblivion by introducing policies that have zero or very small cash values. Unfortunately, this has a tax implication as well because we would not be allowed as high a deduction for reserves.