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CANADIAN LIFE INSURANCE TAXATION—UPDATE

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MR. HARRY COHEN: The comments I'll be making today are based on research done by Alan Cheung, Janet Fuller and Cathy Senenski whom I thank for their excellent work.

In determining whether a life insurance policy is tax exempt in Canada, the accumulating fund of the policy (which ignoring policy loans is the greater of the cash value or the full preliminary term reserve) must be lower than the accumulating fund for the Exemption Test Policy (ETP). Otherwise stated, a life insurance policy is exempt if its accumulating fund is sufficiently small relative to its death benefit.

Universal Life type policies do not feature cash values and dividends, but rather a Dynamic Fund Accumulation. The yield or interest rate used in the exempt test process is generally the guaranteed interest rate in the policy. Let's look at how Universal Life policy A passes this test. You remember that if a policy is non-exempt, based on the test applied at issue, or at any future duration, the policy is not exempt at issue as well. Chart I illustrates how Universal Life Policy "A" passes this test.

CHART I

Universal Life Policy "A"

ISSUE AGE 40

GUARANTEE INTEREST RATE IN CONTRACT	EXEMPT AT ISSUE	NON-EXEMPT TEST FAILS LATER
4% 1ST 20 YEARS 6% THEREAFTER	YES	N/A
10% LEVEL	N/A AT ISSUE	22 YRS
20% LEVEL	N/A AT ISSUE	12 YRS

This chart shows us that by using the guaranteed interest rate in the policy, policy A is exempt at every duration in the future and therefore exempt at issue.

The guaranteed interest rate in this case is 4% for the 1st 20 years and 6% thereafter. This rate was chosen for illustration purposes only.

Interest rates in practice will differ from the guaranteed rates in the policy. Hence aside from the initial testing, future testing of the exempt status of the policy will be required.

If we use a 10% or 20% level interest rate on Policy A we do not have to do the exempt test initially using these rates. But if these rates of interest prevail over a long period of time Chart I shows that at 10% level interest rate, Policy A becomes non-exempt after 22 years, and using a 20% level interest rate, the policy becomes non-exempt after 12 years.

In fact Policy A need not become non-exempt. Universal Life policies of this type in Canada normally contain a clause that states that should the policy's exempt status be threatened in the future, 3 possibilities arise which are mentioned in the policy to keep the policy exempt:

(a) notify the insured to stop premiums;
(b) a partial taxable surrender could take place;
(c) the amount of insurance could be increased.

Chart II illustrates the option of increasing the amount of insurance. I will not discuss here whether evidence of insurability should be requested of the applicant.

CHART II

UNIVERSAL LIFE POLICY "A"

ISSUE AGE 40	LEVEL ANNUAL INCREASE REQUIRE IN AMOUNT OF INSURANCE TO KEEP POLICY EXEMPT
4% 1ST 20 YEARS 6% THEREAFTER	0
10% LEVEL	8% FROM YEAR 22
20% LEVEL	15% FROM YEAR 12 OR 8% FROM YEAR 0

By increasing the amount of insurance each year by 8%, if interest rates are at 10% for the life of Policy A, the exempt status of the policy is maintained.

If interest rates are at 20% level for the life of the policy, two options are available. First you could increase the amount of insurance by 15% each year starting from year 12. This however creates other problems in that each increase over 8% has to be kept track of separately for tax purposes. Alternatively, you could start increasing the amount of insurance fairly early in the life of the policy but you may not be able to take this approach if interest rates take off early during the life of the policy and start very high.

Chart III below shows us that for 10% level interest rates, and an 8% increase in the insurance amount per year from year 22, the policy will always remain exempt.

CHART III

INITIAL $1,000 UNIVERSAL LIFE "A"

ISSUE AT 40 LEVEL 10% INTEREST RATES

8% INCREASE IN INSURANCE PER YEAR

DURATION	AMOUNT OF INSURANCE	BENCHMARK VALUE	ACCUMULATING FUND
5	$1,000	$ 149	$ 54
10	1,000	289	153
20	1,000	596	533
30	1,000	1,470	1,410
40	1,000	3,809	3,035

For a Permaterm policy from an exempt testing standpoint, you will recall that if there is no cash value the benchmark reserve will be compared to the full preliminary term (FPT) reserve based on the pricing assumptions for tax exempt testing.

CHART IV

PERMATERM $100,000
AGE 35 - NON-SMOKER

DURATION	BENCHMARK VALUE	ACCUMULATING FUND	ADJUSTED COST BASE	CASH SURRENDER VALUE
5	3,400	1,200	2,900	360
20	13,700	10,000	7,300	10,000
30	26,700	22,800	3,700	22,800
40	46,500	39,500	--	39,500

Several interesting comments on Chart IV above.

(a) The policy is exempt since the accumulating fund (which is initially the FPT and later the cash value) is always below the benchmark reserve. As an interesting side point, some companies propose to use the accumulating fund if higher than the cash value for split dollar policies.

Since on split dollar policies, the employer generally pays for the increase in cash value, and the employee pays for the premium less the increase in cash value (and less the dividend if applicable). Where there is no cash value initially, where the accumulating fund is higher than the cash value, the company would pay the increase in accumulating fund for that year. On death, the company gets the accumulating fund or cash value as applicable, and the employee's beneficiary gets the total death benefit less the accumulating fund.

(b) The adjusted cost base (ACB) which is the sum of the premiums less the cost of insurance, increases for the first 20 years. After that the ACB decreases to zero as the net cost of insurance increases. It never goes below zero.

(c) Looking at the last 2 columns there would be no tax on surrender for the first 20 years, the benchmark is now based on the proportion of the benchmark reserve at duration 20 for the reduced amount of insurance.

With respect to Chart V below, relating to the tax exempt status if a policy goes paid-up, you will note that our 35 year old policyholder who goes paid-up in the first 20 years, becomes non-exempt in years 5, 6, 7 only. Even if the policy is non-exempt there will be no tax paid for many years. But the main point is that for most years the policy may still be tax exempt when going paid-up.

CHART V

PERMATERM $100,000

35 YEAR OLD NON-SMOKER GOES PAID UP IN YEAR

DURATION	ACCUMULATING FUND	TAXABLE INCOME	EXEMPT
5	361	-	NO
6	748	-	NO
7	1,162	-	NO
8	1,606	-	YES
9	2,083	-	YES
10	2,596	-	YES

Chart VI illustrates the tax treatment of a single premium permaterm policy.

CHART VI
PERMATERM $250,000
AGE 46 NON-SMOKER

DURATION	ACCUMULATING FUND	ACB	TAXABLE INCOME	CUMMULATIVE TAXABLE AMOUNT
1	25,611	25,611	0	
5	30,948	28,831	2,711	
10	37,763	34,902	2,861	17,600
20	57,761	52,150	5,521	59,900
30	81,899	69,659	12,240	143,257
40	127,225	107,433	19,792	305,602

In Chart VI above, we see for a 46 year old non-smoker, the accumulating fund, the ACB and the taxable income. Since this is a non-exempt policy, the ACB increases each year by the taxable income (which is accumulating fund minus the ACB) and is decreased by the net cost of insurance. Note that the taxable income becomes huge at the later durations.

It was mentioned earlier that an increase in the amount of insurance over 8% requires separate 'benchmark' testing. This problem can arise either in indexed policies providing for an increase in insurance equal to inflation, policies providing generous bonus additions, and Permaterm type policies at the 5 year renewal durations.

For Permaterm type policies, the premium is recalculated or the amount of insurance is adjusted about every 5 years. This adjusted premium is based on current pricing factor with interest as the critical assumption. If interest rates were higher at the end of 5 years relative to interest rates at issue, the insurer would increase the amount of insurance and maintain the same premium. If we assume that at the end of 5 years, the amount of insurance goes up by 20% under this scenario, a second benchmark reserve for the extra insurance over 8% (i.e. 20-8%), or 12% is set up starting in the 6th year and has to be calculated for tax exempt calculation purposes for the life of the policy although the policy should always prove to be exempt under this scenario as shown in Chart VII below.

CHART VII

PERMATERM TYPE POLICY
(NO CASH VALUE/OR LOW CASH VALUE
LOW PREMIUMS/REVIEWED EVERY 5 YEARS)
20% INCREASE IN INSURANCE AT END OF 5 YEARS
$100,000 INITIAL FACE AMOUNT

DURATION	ORIGINAL BENCHMARK RESERVE	SECOND BENCHMARK RESERVE	TOTAL BENCHMARK VALUE	ACC. FUND
5	1,716	-	1,716	542
6	2,059	57	2,116	710
(20% INCREASE)				
10	3,432	283	3,715	1,548
20	6,865	849	7,714	5,575
30	14,774	1,642	16,415	14,293
40	28,822	3,202	32,024	29,371
50	50,194	5,577	55,771	48,929

Finally, I will discuss the 'Hugging the Line' concept. This occurs when the accumulating fund is below the benchmark reserve, a policyholder can pay up to the difference between the accumulating fund and the benchmark reserve and retain a tax exempt policy. A number of companies have been providing illustrations of what the year by year additional premium is. As a follow up, the policy has to be tested the next year to make sure that the policy has not become non-exempt as a result of higher interest rates, or to warn the policyholder that the next premium may not be payable if the policy is to remain exempt.

MR. GORDON GRANT: On December 2, 1982, Accumulation Annuities along with Investment Contracts in general were made subject to accrual taxation. One of our tax officers maintains that the emphasis should be changed so that it should really be called 'a cruel' taxation. In actual fact, the problem is not the current taxation procedure, but that we didn't know how good we had it before, when such annuities were only taxable at disposition.

The major changes occurring December 2, 1982 can be summarized as follows. Under the new accrual rules, all annuity products will be taxed at least every three years, with the owner having the option of paying tax annually. There is a phase-in period for policies issued before December 2, 1982 whereby the first taxation can be deferred until 1987, with special rules applying for additional premiums paid on such policies. In effect post December 1982 premiums are to be treated as a separate policy. This means that such a policy, even though its on triennial taxation could be subject to taxation in 2 out of every 3 years. The original premiums would be taxable in 1987, 1990, 1993 etc. If the owner then paid an additional premium, suppose in 1983, it and subsequent premiums would be taxable in 1986, 1987, 1989, 1990 and so forth.

In discussing this point with others, I see that some people interpret this another way and assume that all premiums paid to pre-1982 policies which are subject to accrual taxation, fall into the regular triennial taxation procedures, to be first reported in 1987.

Except for the split at December 2, 1982, we treat each flexible premium policy as one unit and any T5's we issue will include the accrued gain on all premiums paid to that contract, up to December 31 of the accrual year. This could lead to very sophisticated buyers buying three separate accumulation contracts, one each year for three years, to obtain maximum deferral of taxation.

With all the time being spent on accrual taxation during the accumulation period, the substantial changes that have occurred with respect to taxation at death tend to be overlooked.

For contracts issued since November 12, 1981, all untaxed gain is taxable to the deceased in the year of death. In effect the year of death becomes an accrual year. For issues between November 17, 1978 and November 12, 1981 all untaxed gain is taxable to the beneficiary as received. For contracts issued before November 17, 1978, at death the full accumulated value was payable to the beneficiary, tax free. Combining this with the absence of taxation during the accumulation period, it is surprising that our industry wasn't taking in billions of dollars of savings each year

Discussions at branch meetings often prompt the question, "What are the chances that the new government will repeal the tax laws introduced as a result of the McEachan budget, as they apply to accumulation annuities, or in fact, the life insurance industry in general." I believe there is not much chance of this occurring. The government knows its much easier and safer for the conservatives to maintain a liberal imposed tax than it is to repeal it and introduce one of their own to generate the same income. The other difficulty would be to find another area that can be taxed to produce the same amount of income. The amount of money involved can be illustrated with our experience. Last year we canvassed our policyholders and only one third of those with pre-82 policies elected annual taxation. Consequently we issued T5's to those clients, reporting the gain incurred during 1982 and 1983. Sun Life has a lot of accumulation contracts in force, but is not the biggest player in this field. But the income reported by the life insurance industry on those T5's amounted to roughly nine million dollars. Just imagine what amount is going to be reported in 1987, when all those who elected triennial have to report 6 years of gain.

Altogether we sent out letters to about 12,000 owners of accumulation annuities asking them to choose annual or triennial reporting. We did not attempt to show the taxable amounts resulting from the two choices, but used general wording to describe how the taxation worked. This canvassing resulted in a few problems, many of which I'm sure others in this room ran into. These included designing the election forms, writing the accompanying letters, isolating all the policyholders that had to be contacted, and collating the policies for clients who owned more than one as the election can be made separately for each individual policy. The most time consuming part of the whole exercise was answering questions from both agents and clients.

We experienced two shock waves in our clientele. First was the consternation caused by the announcement that their policies would be taxed during the accumulation period. Most people did not realize how the tax changes would affect them personally. The second occurred in February of this year when we sent out the T5's and people realized the amount of income that had to be included in income. We had a number of those who decided that maybe triennial taxation would be better after all. Unfortunately, there is no option to switch back.

The lucky ones are the clients who were born in 1927 or earlier. They have the option of changing the contract to a payout annuity before December 31, 1987 and electing prescribed annuity treatment to avoid the accrual taxation on their policies by being able to spread the taxation of the gain over the payment period.

The really lucky ones are those whose accumulation annuities originally resulted from the exercise of an option under a life insurance contract. As such, each is considered to be a continuation of that life insurance contract, and hence is grandfathered. This means that not only is accrual taxation avoided entirely until disposition, but if the contract becomes a payout annuity the old prescribed rules apply after payments start.

At times the government seems to get upset at the insurance industry for selling contracts on the basis of the tax savings, but I think we would be remiss if we didn't point out these facts to our clients. Although its usually mentioned in connection with life insurance contracts, sometimes the government does, even though its done inadvertently, give us the best conversation tool we could ask for.

MR. JOSEPH GILMOUR: My remarks will centre around the practical applications of various statutes; life company administrative problems; and marketing concerns associated with the taxation of 'payout' annuities in Canada. These contracts have a specified income pattern determined at the date of inception even though payments may not begin until a later date. Both term certain and life annuities fall in this category.

I will divide this discussion between annuities which achieve level tax treatment, and those are taxed on a accrual basis. Each section will try to deal with a few current points of interest.

Level Taxation

1. In 1983 Prescribed Annuity Contracts (PAC) represented about 75% (500 contracts) of our post-budget non-registered payout annuity sales. The 1984 percentage seems to be about the same. Either our agents haven't found the concept any harder to sell or we haven't educated them any better.

2. The definition of PACs in Regulation 304 contains several unresolved matters:

a) the 'permanently disabled' criteria is not specifically defined. Our current practice is to set up PAC treatment for anyone who otherwise would qualify and meets our underwriting or the Canadian Pension Plan(CPP) definition of disability. We also inform other applicants that they could approach Revenue Canada (Revenue) for a ruling.

b) the requirement that a PAC must be held by an individual also runs into some problems, for instance with minors or incompetents. Finance believes that Revenue will interpret this requirement to mean a 'beneficial' holder and therefore in these situations an individual trust etc. could hold the contract. Finance does not anticipate any changes in the Income Tax Act (ITA) with respect to this matter.

c) it appears that no amendments to Regulation 304 are presently being considered to allow other registered retirement saving plan (RRSP) annuity forms, except those integrated with CPP or Old Age Security (OAS). Logically these annuities can be separated into two level contracts and since the higher income is at the front end rather than the back, Finance sees no problem with allowing PAC treatment. When this will be official is presently unknown.

3. On the business side it appears that many pre-budget accumulation annuities are being converted to a PAC basis, wherever possible, to avoid the large potential accrual tax bill at the end of 1987. This is a great source of business no matter how competitive your payout annuity rates might be, as it is not worthwhile for

annuitants to change carriers.

4. Currently Section 148(2)(b) creates a deemed disposition on death for any annuity whether or not it is a PAC. If followed this would mean that, in many cases the level taxable portion could not be applied to the remaining guaranteed payments as was the case with the pre-1982 treatment of annuities under Regulation 300. Apparently the Life Underwriters Association of Canada (LUAC) have been promised that a change will be made to allow a roll-over without disposition when death occurs under a PAC. Finance felt that this would be forthcoming with the next technical bill but the change in governments may cause things to happen in a different order.

5. A further problem exists with the lack of a commutation privilege under a PAC. Even though it is quite clear that a PAC can not be commuted, agents and policyholders feel that they should be able to obtain funds in case of hardship. The question of whether a life insurance contract can UN-PAC an annuity in the same manner as it can de-register one is a problem with which we are still wrestling. Part of our concern is the large gain that would be reported on the commutation (we only pay the commuted value of guaranteed payments) and the potential loss which could not be claimed if death occurred closely thereafter.

6. The grandfathering of deferred payout annuities as a settlement option under Section 12.2(3)(e) is being used by our company to imply level taxation for group survivor income benefit (SIB) annuities where the group contract was entered into before that date no matter when the benefit actually commences. Since my company has not sold an SIB group case during the post-budget era we have no SIB's subject to accrual taxation. We also have very few pre-budget corporate owned individual annuities, quite likely because we had trouble identifying them retrospectively in early 1983.

7. Our company allows pre-election of PAC treatment in the case of deferred annuities or those issued under age 60. To accomplish this we added two indicators on the tax trailer of our master record to identify cases where an annuity vests and/or the annuitant reaches age 60. From a quotation point of view we illustrate level tax for annuities deferred 3 years or less at ages over 57, if the age plus deferred period is greater than 60.

Accrual Taxation

1. The triennial accrual tax option is not offered by my company in the payout period. Our application forces the individual to elect annual reporting when payments begin. At first we thought this practice would have no effect on immediate payout annuities because of section 56.1(d.1) and would only have limited consequences for deferred payout annuities when the gain built up at vesting was greater than the payment made in that year. We have since realized that several types of annuities (e.g. indexed; younger issue ages at dual interest rate assumption) would have some tax deferral if we allowed triennial taxation in the payout period. We would have to see a larger volume of such cases to justify the administrative costs of changing our present practices.

2. The dual interest rate pricing assumption is one which is commonly used in Canada and if passed into the Maximum Tax Actuarial Reserves (MTAR) basis causes situations where the taxable amount is greater than the income received for the initial rate period. From our tests using a 20 year interest split, it appears that level payment single life contracts issued below age 60 fit into this category while those issued above age 60 always have an income greater than the taxable amount. Most increasing annuities fall into the taxable amount greater than income category regardless of the annuitants age. The break age increases with the first interest rate which is assured. After the 20th duration the taxable amounts for single life contracts are approximately 50% of the previous year while for joint and last survivor annuities, the decrease at year 21 can be significantly more.

While no legislative change has been made by the Department of Finance, Revenue will probably allow the use of a blended interest rate assumption for the MTAR basis to solve this problem of a front-ended distribution of tax. We are presently programming an iterative technique to calculate this blended rate which is unique for each case. Administratively, we will have to input MTAR reserves into our valuation system for each accrual case sold. From a marketing point of view, we feel that the blended treatment is necessary due to the tax disclosure which is required, and the expected desire of the consumer to obtain the best after-tax position for his/her contract.

3. The calculation or mortality gains and losses (Regulation 304) is a fairly loosely defined area and one which may also greatly affect the marketing of accrual tax annuities. If companies calculate these

values differently, the after-tax position of a particular annuity could be very dissimilar even if payments were identical, a consideration already discussed with regards to the blended interest rate MTAR.

Several situations require interpretation by either revenue or the Canadian Institute of Actuaries (CIA):

a) Most formulas for mortality gains (MG) are based on an annual payment in arrears assumption. In cases where guaranteed payments still remain and are not made at the end of a calendar year, the actual mortality gain is overstated when using this assumption. In other words:

$$\begin{bmatrix}\text{Actual}\\ \text{MTAR}(-1)\\ \end{bmatrix} + \begin{bmatrix}\text{Formula}\\ \text{Mortality}\\ \text{Gain}\end{bmatrix} + \begin{bmatrix}\text{Formula}\\ \text{Interest}\\ \text{Gain}\end{bmatrix} - \begin{bmatrix}\text{Actual}\\ \text{Payment}\\ \end{bmatrix} > \begin{bmatrix}\text{Actual}\\ \text{MTAR}(0)\\ \end{bmatrix}$$

Joint and last survivor (J&LS) annuities are most affected by the approximate MG formula. Adjusted Cost Basis (ACB) is greater than the accumulating fund because of overstated mortality gains soon after age 88 if the dual interest rate MTAR basis is employed. We haven't tested the blended rate assumption to determine when a zero tax position would arise.

b) Mortality gains are applicable in both the deferred period and the payment period. The calculation in the deferred period depends on the death benefit option: e.g. for J & LS, return of premium on first death, on annuitant death, or last death, as well as no death benefit with guaranteed payments made when due. At the present we have only programmed the case where no death benefit is paid.

The other formula are more complicated even if it is assumed that the change in reserve due to the insurance cost is not applicable to the mortality gain calculation.

c) Cash Refund annuities also present a problem when calculating mortality gains. In the cash refund period the insurance element of the MTAR basis can cause the MG to be negative. This would also occur in the deferred period generally if the insurance cost were included in the MG calculation mentioned in (b).

d) Reversionary annuities cause special problems. We typically sold these contracts in connection with a RRSP or a registered pension plan (RPP) to provide a longer guarantee period or to create a joint and last survivor situation. In most cases the accumulating fund for these reversionary annuities decreases if the contingent annuitant survives and increases if he/she dies. My interpretation of Regulation 308 would be that the reversionary contract has no mortality gains or mortality losses. This means that a bump-up of the ACB could not be claimed at death causing a large tax gain to be reported. Finance does not seem to have much sympathy for the reversionary concept because of the implied benefit it can give to an RRSP annuity. The practice is similar to issuing an insurance policy with no underwriting, but the tax treatment appears to be quite different.

4. Section 20 (20) allows a policyholder to claim a deduction in respect to an investment loss on disposition of an annuity contract not in payout status. The amount that may be claimed is the lesser of the accrual amounts included in income and the adjusted cost base less the proceeds of disposition. The LUAC was pushing for this rule to also be applied to annuities where payments have begun. They apparently have not obtained a firm commitment from Finance.

5. I have mentioned a few administrative problems with accrual tax calculations but would like to re-emphasize that the programming of MTAR values and mortality gains into our annuity quotation system has been the most time consuming function to date. The fact that our tax department will now use these values for reporting to the individual and to manually adjust MTARs (blended interest rate) makes some of this work worthwhile from more than a disclosure point of view. Our quotation system must still be programmed for the spreading of pre-1982 unallocated income to fulfill the tax reporting demand on all accrual tax annuities. One other problem which we have considered is the necessity to refile a return if death occurs in one calendar but is not reported until the next year.

6. From a marketing point of view we may be able to design an annuity with current income but low accrual tax by setting a pricing (MTAR) basis with low interest and high mortality. This would lead me to believe that the Finance Department will have to specify a minimum mortality standard, perhaps in Regulation 1401.

In summary, it appears that many things are far from being settled with regard to the taxation of payout annuities in Canada, and that we all have a responsibility to work for a common solution.

MR. ZUL MOHAMMED: 1. With respect to substandard life policies, what mortality basis should be used for calculating benchmark values?
2. With respect to deferred annuities, what non-contractual changes would be deemed upon disposition.

MR. WITOL: For a par policy you would use the mortality used in computing cash surrender values, while for a non-par policy, you would use the mortality used by the insurer in determining premium rates for substandard life policies.

MR. GRANT: Our company considers a change to either the amount or the date of first payment for a deferred annuity to be a disposition. While not subject to immediate taxing, this change may cause a policy which was previously subjected to prescribed annuity taxation to now be under accrual rules. The sale or transfer of owner would also be a disposition.

MR. JULIAN DUKACZ: I understood that the position of Canadian Life and Health Insurance Association (CLHIA) was to battle Ottawa once again as part of pension reform proposals for some relief on taxation of accrual annuities.

MR. WITOL: It is still the official position of the CLHIA that there should be an exemption from the accrual rule for deferred annuities that are designed for retirement. Designed for retirement might be interpreted as meaning either locked in to age 65 or a penalty for early cash withdrawl.

MR. CHUCK STAFFORD: With respect to the calculation of MTARs on substandard mortality, the MTARs are generally lower than they would be if you did the calculations with standard mortality and thus would decrease the margins under the benchmark test.

I generally felt that if you went reduced paid-up in the first twenty years of virtually any kind of life insurance you would wind up with a non-exempt policy. Your illustrations seem to indicate that in some situations these policies might be exempt.

MR. COHEN: It would depend on whether you used the original or paid-up amount when applying the exemption test. I believe if you use the reduced paid-up amount you would get a few years where the policy is non-exempt on the plan types in my discussion.

We also recommend an extended term type of approach to avoid this problem.

MR. PAUL EVENOFF: Regarding universal life policies which do not have guaranteed cash values, what basis would be required for the ETP reserve and for the accumulation fund for the policy.

MR. COHEN: I believe for both the ETP reserve and the accumulation fund you would use 4% in the initial testing. You would still have to do testing on a year by year basis to determine whether the policy was still exempt or not.

MR. EVENOFF: In a case like this, where the cash value is tied to the accumulation fund, would one compare the ETP reserve to the cash value or the accumulating fund.

MR. WITOL: The test is an accumulation fund test.

MR. RONALD BEAUBIEN: Is there any chance the CLHIA could publish the rules and updates to policyholder taxation in simplified terms.

MR. WITOL: Alan McNaughton of the Department of Finance has a paper which explained the policyholder taxation rules. There is an intent to send out circulars describing new or revised tax rules, but they would just deal with the odd-ball situations.

I will look into the situation further.

MR. BEAUBIEN: Has the issue regarding joint and last survivor life policies, were on the first death it would fail the exempt test, been resolved.

MR. WITOL: No it hasn't been resolved, but I am trying to get a group of people together to work on it. I believe that the CLHIA will push for a special rule in the case where premiums continue to the second death but where the reserve and cash value jump substantially after the first death.

MR. NORMAN COLLINS: We have received a ruling from Revenue Canada with respect to annual election rules. It stated that you may revoke them prior to the actual filing of your income tax.

If a pre-budget policy had a non-contractual change on it with no prescribed premium would the policy still be exempt?

MR. WITOL: The position of Revenue Canada would be that the policy would continue to be exempt as long as no disposition of the old policy occurred.

MR. ROBERT NIX: The subject of taxation of traditional life insurance products has not been addressed. Is there any benchmark plan where the process begins?

MR. WITOL: The thinking that went into defining the act was one of a 20-pay endowment at age 85. That's merely the conceptional basis as one must always apply the technical rules.

MR. RICHARD HARRIS: Mr. Gilmour mentioned the possibilities of using a blended interest rate for calculating MTARs for a prescribed annuity. Does Revenue Canada allow this?

MR. COHEN: One of our agents complained to Revenue Canada about this problem. Alan McNaughton responded by saying a level interest rate approach would be acceptable.

MR. WITOL: The tax regulations just stipulate that you must use the interest and mortality used in determining the premium. Since you can always calculate a level interest rate, who is to say you didn't use this rate for your premium.