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ROYAL COMMISSION REPORT ON TAXATION

by H. E. Harland

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

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

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

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

(3) Vertical equity should be achieved. That is, persons in different circumstances should pay appropriately different taxes. This concept is easy to agree with but impossible to implement to everyone's satisfaction. The Commission concluded that vertical equity demands a steeply progressive personal tax schedule. Even with the top personal rate limited to 50% as recommended,

(Continued on page 3)

To All Our Readers,

A Happy New Year

The Editors

PHILADELPHIA CLUB DISCUSSES MUTUAL FUNDS, LIFE INSURANCE

Recently the Actuaries Club of Philadelphia had an informal discussion on mutual funds and life insurance companies.

John Hearst gave some figures to show that the interest of insurance companies in mutual funds and variable annuities seems to be catching up with the public's interest and the institutional investor's interest in common stocks. More and more retirement plans are providing variable annuities. The General Electric Company in its Saving and Security program has chartered a mutual fund as part of its employee benefit program.

The interest in equity investment reflects the higher yields which have been realized on these as compared to other types of investment. The College Retirement Equities Fund experience showed an average yield of about 10% over the last fifteen years.

Influences Prompting Entry

Henry J. Heintzberger discussed the relationship of life insurance and mutual funds from the viewpoint of a company which recently acquired a mutual fund management company. Some of the considerations which prompted entrance into the mutual fund market were:

- the interest of pension funds in common stock investments;
- formation and acquisition of life insurance companies by mutual funds, causing older life companies to form mutual funds in self-defense;

(Continued on page 5)

HEALTH INSURANCE REPORT AT CHICAGO MEETING

by J. Henry Smith

At the moment we are enjoying a high degree of encouragement from government officials and welfare state advocates. There is a new spirit which seems to be based on the idea of partnership of government and private insurers; and we are being encouraged—even pressured—to make haste in shoring up our side of the partnership.

Three conferences have been convened by Secretary John W. Gardner of H. E. W. at the direction of President Johnson. The first, held in June, focused on medical costs. The second, in September, examined private health insurance, and the third, in October, discussed the group practice of medicine.

These have been summarized in *The Actuary*. All three conferences were highly significant to the health insurance business. Some of the main issues and challenges emerging are:

- The discussion apparently rested on the proposition, taken almost as an axiom, that it is now national policy that adequate medical care is a right owed to all.
- As presently conceived, government's role is to provide for those who cannot provide adequately for themselves — presumed to include all over 65; and also to encourage the private insurers to do the ideal job for the rest.
- There is a shift in emphasis from care for acute conditions to care for chronic and long-term conditions, mental health and preventive medicine. Insurance should accommodate itself to these new needs.
- Insurance benefits should be designed to encourage improvements in the pro-

(Continued on page 4)

Royal Commission

(Continued from page 1)

the proposed rates applied to the comprehensive tax base would result in a considerably more progressive tax structure than the present.

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

Life Insurance Taxes

With respect to the tax proposals for the life insurance industry, several issues arise. The most obvious and important is the question of whether any substantial change in taxation is necessary or desirable. The life insurance industry has made and continues to make a major contribution to Canada's economic growth and social well-being. Tax laws of the past and present clearly recognize the importance of this contribution. It should not be lightly dismissed in the framing of new tax laws.

The Commission has recognized the continuing social desirability of encourging provision for retirement income by means of tax incentives. It is difficult to understand why the socially desirable operation of life and health insurance should not be similarly regarded.

The Commission has proposed a tax at the company level on a net gain from operations approach. If this new tax is to apply, the recommended recalculation of policy reserves at some rate of interest exceeding 4% would be highly questionable. Presumably, the mortality table is to remain unchanged, although the report is silent on this score. The resulting reserves would in most cases be inadequate to cover guaranteed cash values or to meet the minimum reserve requirements of the Department of Insurance in Ottawa.

The Commission states that solvency of life insurance companies is the concern of the Department of Insurance, not of the tax structure. This is true, but it does not impress me as a reason for disallowing, for tax purposes, reserves which we must hold in order to stay in business.

The report recommends that no special surplus or contingency reserves be allowed in determining the companies' taxable gain from operations. This proposal may be questioned. The long-term commitments inherent in the life insurance business have no good parallels in other businesses. The report points out that industries such as petroleum and forestry often commit capital for periods of 50 years or more with no way of measuring accurately the income that will be derived in the future. This argument seems to miss the vital point that we not only take action today that will affect us 50 years from now, but we also guarantee the results to be achieved on that distant day.

The Commission has made a number of proposals for the taxation of policyholders. One of the most contentious of these is the tax on interest credited to reserves, calculated annually on an artificial reserve basis at some rate of interest exceeding 4%. Quite clearly, policyholders do not have the kind of access to this interest that they do to interest earned on bank accounts, bonds, policy proceeds on deposit, etc. They can make current use of the interest only by surrendering their policies or taking policy loans.

Serious Problem

The first of these courses would fundamentally alter the position of the policyholder, perhaps irreversibly. The second would entail policy loan interest charges exceeding the interest credited on reserves. Therefore the interest earned annually on reserves fails to meet the Commission's own tests of "availability to pay" and "discretionary economic power of tax units".

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

A third important proposal affecting policyholders is the tax on mortality gains, to be effective sometime after other changes. Roughly speaking, a tax would be imposed on the excess of the amount paid on death over the value of the policy immediately prior to death. The cost of insurance would, however, be allowed as a deduction.

This proposal is open to serious challenge. The Commission itself admits that this element of their proposed tax structure would not generate any significant revenue, because mortality gains and losses tend to cancel out over the whole group of insured persons. The only purpose of the proposal is a supposed improvement in equity.

Our industry is based on the widely-held conviction that the fundamental risk-sharing feature of life insurance is socially desirable. In my opinion, a partial negation of the beneficial consequences of life insurance by a non-revenue-bearing tax provision would be improper in the extreme.

Public Reaction

Public reaction to the report has built up rather slowly. This may not be surprising in view of the enormous volume of reading facing the serious student. However, recent months have seen a crystallizing of views. Much informed comment has appeared in newspapers and magazines as well as on the air. In addition, a large number of written briefs has been addressed to the Minister of Finance before the Oct. 31 deadline.

The impression I have gained from public comment on the report is that a widespread opposition to enactment of its major recommendations has developed. This opposition is not localized in a few special industries or interests who feel that their ox is being too severely gored. A recurring theme is the danger of imposing tax revolution on an economy which is still not highly predictable and manageable, even over relatively short periods of time.

I sense also a great concern over the effect of the Commission's recommendations on the relative positions of the individual and the state. The report appears to have less regard for individual rights and privacy than many would like to see. Many objections have also been raised to the vastly increased record keeping and reporting problems posed by the recommendations of the Commission.

(*Editor's note*: This digest of the presentation by Mr. Harland at the Chicago Annual Meeting builds upon the series of articles in earlier issues of *The Actuary*, which outlined the major recommendations of the Carter Commission Report that bear upon life insurance.) □