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Separate Account Products in the U.S. and Canada: Comparing Their Design, Regulation, and Taxation

Track: Life Practice Area

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Summary: The panelists compare and contrast separate account products sold in the U.S. and Canada in both the qualified/registered retirement market and the nonqualified market. The separate account product is designed, regulated, and taxed differently in Canada than in the U.S.

Mr. Christian J. DesRochers: I'm a partner with Avon Consulting Group in Avon, Connecticut. My specialty is product design and U.S. taxation, particularly Sections 7702 and 7702A and various other Sections that address the taxation of life insurance products.

Our panel consists of two attorneys: John Adney and Phil Friedlan. John Adney is a graduate of Millikin University and Yale Law School. He is a founding partner of the law firm of Davis & Harman LLP in Washington, DC. John has an extensive background in life insurance and annuity products and was instrumental in much of the legislation that has affected those products. John has participated in every major tax development involving the life insurance industry in the U.S. since the late 1970s. I can assure you that he understands actuarial issues as well as and probably better than most actuaries.

Phil Friedlan could be described as John's Canadian counterpart. He has an LLB from the University of Toronto. He has a Bachelor of Civil Law from the McGill University of Civil Law, and an MBA from York University. He is a member of the Law Society of Upper Canada, which he tells me is the Ontario Bar. He's a member of the Canadian Tax Foundation, the Canadian Bar Association, and the Tax Committee of the Toronto Board of Trade. Phil practices tax and life insurance law at the Toronto law firm of Sheppherd, Friedlan & MacInnis. His practice includes advising on tax and legal matters related to insurance products, including life

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insurance and segregated fund products. He also represents life insurance companies, financial institutions, and private corporations.

We will discuss separate account products in the U.S. and Canada—how they're the same and how they are different. We will compare the regulatory and tax systems and what, if anything, our relative countries can learn from each other.

Mr. John T. Adney: What we are now going to do is to provide a brief review of the law south of the border. I will assume most of you already are conversant with the U.S. rules for separate accounts, but I want to spend some time talking about them to set up the comparative discussion with all the points that Phil will raise.

Legal Definition of Variable Products in the U.S.

Our first topic is the legal definition of separate accounts and their products, giving us a frame of reference to compare those products with equity-related offerings available in the U.S. We will then review their regulation by the states, the SEC, and the like and, finally, the tax rules governing separate accounts.

Starting with the legal definition, what we're dealing with in the U.S. basically is a separate account that is defined under state insurance law or, in some cases, territorial insurance law. We were having a discussion yesterday about the comparison of the Canadian and U.S. systems, and Phil was saying how Canada has ten different sets of legal rules that Canadian insurers need to follow. I counted 54 for the U.S. Now there are efforts underway, as you know, to try to make some of those more uniform, but I think the separate account law is somewhat similar and uniform from state to state and territory to territory.

State law permits the creation of separate accounts—accounts separate or segregated from the general account of the insurance company. Certain rights and obligations are attached to the separate account in the hands of the insurance company and in the hands of the policyholder.

The tax law refers to these same creatures as segregated asset accounts in Section 817 of the Internal Revenue Code (IRC), which deals with variable contracts. It refers to them as segregated accounts or segregated account assets in Section 817A, which deals with modified guaranteed annuities and life insurance. In Canada, Phil will be talking about segregated funds, but these are comparable.

What we have here are insurance company products that can be delivered in individual or group form. The separate account products in the U.S. are annuities, life insurance, and pension-funding instruments. They often will have variable benefits that are not necessarily purely variable. There can be guarantees in them; sometimes separate account products are fully guaranteed, so what we're talking about here is an emphasis on the word "often" with respect to variable benefits. The reserves and the assets typically are valued at market, with emphasis on the word typically.

There are differing definitions of separate account products amongst state insurance law, federal securities law, and tax law. The tax law refers to variable products when it is talking about the Section 817 separate account. State insurance law sometimes talks about variable products, but it often is referring to products issued out of a separate account organized under state law.

We also have modified guaranteed products. The tax law considers a modified guaranteed contract a separate account instrument. That is not necessarily always true of the modified guaranteed contract, so let me define that.

A modified guaranteed contract typically is a contract with guaranteed benefits if the contract is held to the end of a defined guaranteed period, which could be a multiyear period. If there is a surrender of the product before the end of that guarantee period, surrender being for cash or an exchange or otherwise, then the company has the right to impose a market value adjustment (MVA) to protect itself from disintermediation. Some of these are issued out of separate accounts and some are issued out of the general account, but when the tax law refers to a modified guaranteed contract it is always talking about the separate account.

One of the hallmarks of a separate account product—and Phil will go into more detail on this from the Canadian standpoint—is insulation of the assets from the insurer's creditors. That's a major benefit that I think people see in the separate account products in the U.S. For example, many of these products are very popular with banking institutions that are buying corporate-owned life insurance. They like the idea of the priority, not that they're expecting the insurer that they buy from to become insolvent. However, if the insurer were to become insolvent, then the protection would be there and that's easier for the banks to explain to banking regulators.

Separate Account Product Features in the U.S.

What are the features of the separate account contracts? Well, we could have fixed or flexible premiums, or single or multiple premiums. The contract values may vary with the market. Again, in the modified guaranteed contract issued out of the separate account there are full guarantees. The only variation will be if there is a disintermediation of the contract prior to the end of the guaranteed period.

On the other hand, the variable annuity (VA) or variable life insurance product will have contract values that vary with the market. The separate accounts, however, could also be used for pension contracts, and the separate accounts themselves may not be market-valued. They may have assets and reserves that are fully book-valued with book-value guarantees to the pension fund so that the purpose of the segregation is really to keep a body of assets separate and apart. The benefits will thus be viewed as having special protections in the event of insolvency, and the separate account also provides a way of keeping track of the money.

VA and variable life insurance in the U.S. will often permit the policyholder to allocate amounts among differing investment options representing differing strategies. There could be a bond fund, a stock fund, and a money market fund;

sometimes there are 20 stock funds, 15 bond funds, and several money market funds. In this respect, we are concerned in the U.S., in the taxation of variable contracts, with giving too much choice to the policyholder among or within investment options or different strategies; that they're defined too finely or the policyholder has too much control over the separate account assets underlying the contract. We call this investor control, which is viewed as a problem from the policyholder's standpoint because the policyholder will not be viewed as holding an insurance contract, with deferral or exemption from income tax, but rather as holding assets with income subject to current tax. Now, when Phil gets up to talk about this, you'll find a very different, almost diametrically opposed, approach to this from Canada.

In the U.S., we also have enhanced death benefit guarantees and annuitization guarantees available in the separate account contract. It's become very typical, and has been discussed elsewhere in the sessions of this meeting, that there will be guarantees in VAs such that, in addition to a traditional guarantee that on death, the beneficiary will receive the greater of the premium paid or the cash value of the contract (with or without a surrender charge), the funds will be marked at various points in time so that there will be a ratcheting up of the benefit at death if the market has since gone down and hence the values of the contract have dropped. In other words, the death benefit would be held at the last point where it is marked in the contract. We're seeing other forms of death benefit guarantees as a reversion of sorts going back in time to the point where the insurance company is taking risk and is protecting the policyholder against certain risk events.

In addition, we have annuitization guarantees. One of the hallmarks for tax, securities, and otherwise is that an annuity has to have annuitization guarantees (life insurance policies do as well). These are annuity purchase rates applied to a fund at the market at the time of the annuitization. Some efforts are being made now to provide enhanced annuitization benefits by way of a minimum income benefit guarantee, so that even if the market has dropped the company will keep track of a shadow fund and will use that as the purchase payment for the annuitization. Phil will mention to you that some of the Canadian products go even further than this, which makes them quite attractive.

What are the competitors in this market in the U.S.? As you know, VAs have been around since the 1950s, and variable life insurance has been written since 1975 when the Equitable wrote the first policy. Today, we also have equity-indexed annuities and life insurance, much of which is written out of the general account. Elsewhere in this meeting, the efforts to come to grips with the regulation of these contracts has been discussed and rules have been evolving for reserving for the products. Mutual funds are clearly competitors of these products, and that would include index funds. The mutual funds would be competitors with the VAs and life insurance. In addition, group annuities are sold out of the separate account for pension funding.

Regulation of Variable Products in the U.S.
In the U.S., we have state-based regulation of insurance. The Gramm-Leach-Bliley legislation of last year confirmed that the McCarran-Ferguson Act is alive and well. McCarran-Ferguson in 1945 gave the states exclusive rights to regulate the business of insurance. Gramm-Leach-Bliley reaffirmed that this is the law of the land, but said that the states cannot use that power in a way to disadvantage banks from being sales agents. However, any company underwriting insurance has to deal with state regulation; hence, we have state insurance department approval of forms, and so forth.

State insurance departments, of course, are heavily involved in the approval of separate accounts and the operating plans for separate accounts. Some states, as you know, will permit forms to be filed and then used; others require extensive review of the form, and some often suggest revisions of forms, as you well know. We have diversity, generally speaking, among the 54 jurisdictions in the U.S. in this respect. Today there also is discussion at the NAIC level about trying to make this a little more livable for the insurance industry by moving to state rules that are much more uniform, even with the prospect of national chartering of insurance companies. I think you're going to see much more movement in that direction. The states, of course, license agents too. That's how Gramm-Leach-Bliley came to exist: the states were not allowing banks to be licensed.

In the U.S., while the states regulate the business of insurance, the Federal Securities and Exchange Commission, the SEC, is responsible for the securities regulation. The states have the power to regulate securities as well, but they conform their regulations to the federal rules and defer to the federal regulator. The variable business written out of separate accounts, and some of the modified guaranteed contract business written out of separate accounts, is treated as a security under the federal securities laws, including the 1933 act. The accounts generally are registered under the 1940 act, the Investment Company Act.

There are prospectus delivery and registration requirements for variable contracts. This has been clear since the Supreme Court said in 1959 that the contracts are securities. We also have licensing by the National Association of Securities Dealers, which is an industry-based organization concerned with the regulation of the sale of contracts.

One of the issues the SEC is currently looking at for VA contracts relates to the so-called bonus contract, which provides a bonus credit as a part of an exchange, often to make up for the surrender charge. The SEC has let it be known that there's no such thing as a free bonus, so the SEC is looking very closely to see whether there is adequate disclosure of information to policyholders who are accepting exchanges with bonus contracts.

So, the general regulatory framework consists of state-based regulation, federal securities regulation, and some self-policing by the sales agents.

Taxation of Separate Account Products in the U.S.
In the U.S., as you know, we have a federal income tax. We also have state income taxes in many places. My prediction is we'll have more as the states have trouble collecting sales taxes in an age of global commerce. We also have a federal estate tax, which is very important to life insurance companies. As you may know, the House of Representatives has voted to repeal the federal estate tax and to phase it out over a ten-year period. That was not exclusively a partisan vote. The president has said his plan is to veto it, so the Republicans have that as a major campaign issue. It's unclear that this is going to go anywhere in the Congress because the session is rapidly running out of time before it adjourns. But the estate tax is part of the landscape, and needs to be dealt with. Many life insurance contracts are sold, of course, to help pay the federal estate tax.

We have premium taxes at the state level. These are retail sales taxes on life insurance and sometimes on annuities.

In the taxation of separate accounts and their products, the U.S. has distinguished between qualified and nonqualified uses. The qualified plan types include the Section 401 plans, especially Section 401(k) plans. These are trusteed, qualified pension and profit-sharing plans. We also have Section 403(b) tax-sheltered annuities for public school teachers, university professors, and those who are employees of tax-exempt organizations. These are all deferred compensation plans where the premium is deductible; the amounts growing in them are tax-deferred.

We have IRAs for those who are within the income limits to buy them, and they can be issued as Section 408(b) annuity IRAs or Section 408(a) IRA accounts. We also have Section 408A or Roth IRAs, which are not premium-deductible but are completely excluded from tax when they're paid out.

The tax law imposes very specific limits on the design of all of these plans. Deductions are allowed for the premiums within limits. The law allows deferral of tax, but limits that deferral and requires distributions at specific times.

As distinguished from this, we have the nonqualified deferred annuity market. Nonqualified annuities, from an income-tax standpoint, are characterized by income-tax deferral. This includes circumstances where the contract holder is changing investment options under a variable contract. (That would not be true of a mutual fund.) We have taxation only upon distribution of the amounts from the annuity, and for premiums invested after August of 1982. The taxation is on an income-first basis—the so-called LIFO rule for partial withdrawals.

On surrender or withdrawal, policyholders are taxed on the gain the excess of the cash value of the contract over the investment in the contract. There can be a penalty tax as well, where the withdrawals are premature and basically come out before age 59.5. There's no deduction for a premium paid for a nonqualified annuity, and there are limitations on the length of deferral imposed by Section 72(s) of the IRC. That provision limits the extent of the deferral to the life of the owner of the contract plus five years, unless there's a lifetime annuitization or a spouse to step in the shoes. Those rules must be written into the annuity contract. If they're not, then the tax deferral does not apply.

There are special Section 72(s) rules applicable to a non-naturally-owned annuity—for example, one owned by a trustee. If it's owned for the benefit of natural persons, the measuring life for the length of deferral is the annuitant under the contract. If the contract were owned for the benefit of, say, a corporation, not for individuals, then there is no tax deferral.

Finally, let's compare this with mutual fund taxation. In the case of the mutual fund, there is no tax deferral. The dividends from the mutual fund are currently taxed. Capital gain distributions are currently taxed. If it's a growth fund and all of the growth is unrealized, there would not be current tax, but otherwise there would be. If you've changed your mutual fund investments, there would be a surrender of shares and the gain on that would be taxable. It might be taxed at the favorable capital gain rates, depending upon the holding period.

In the case of mutual funds, the Congressional Joint Economic Committee recently issued a report to change the taxation of mutual funds, and companion legislation was introduced. Because there is current taxation of a mutual fund's capital gain distributions, this draws down the value of the mutual fund. You don't have the value of these amounts compounding without tax over time, as you would in a life insurance company separate account product. The Joint Economic Committee suggested that tax not be imposed on capital gain distributions currently, but only when the fund shares are sold, thus moving somewhat away from an income tax and more toward a consumption-type tax. It will be interesting to see what happens with this legislation, as it would put mutual funds a bit more on par with VAs.

Phil, I think that's a good setup for the discussion you're going to have about segregated funds in Canada, which somewhat blend the rules for annuities and mutual fund taxation in the U.S.

And then, of course, we have nonqualified life insurance sales; that is, sales to the person in the street. Again, there is income-tax deferral on the inside buildup, even when investment options are changed under variable contracts and a tax-free death benefit. The latter is the principal distinguishing hallmark of the life insurance policy from a tax standpoint. Of course, for this treatment to apply, there must be compliance with Section 7702, the tax definition of life insurance.

The taxation of lifetime withdrawals from nonqualified life insurance differs depending upon whether the policy is fairly heavily funded—hence, a modified endowment contract (MEC) under Section 7702A—or whether it is not. If it is an MEC, then the lifetime withdrawals are taxed like those from annuities. LIFO taxation, maybe with the penalty tax, doesn't affect the tax-free death benefit. If the contract is a non-MEC, then the lifetime withdrawals are taxed very favorably, with no penalty tax and basis recovery first; policy loans are treated as loans and not distributions (as they would be under an MEC or an annuity), so we have much more favorable rules for the non-MECs.

Of course, there's no premium deduction for nonqualified life insurance. And, again, the comparison with mutual fund taxation would be similar to that of annuities. The principal exception relates to the tax-free death benefit of life insurance. With a mutual fund, there's a step up in basis in the hands of the beneficiaries at death, so the result would be more comparable to life insurance than to an annuity.

How is the life insurance company separate account taxed? Well, here's where it gets interesting because the rules of the federal tax law basically assume that everything is taxed under the general account rules for life insurance companies unless somewhere in the Code it says otherwise.

The general account rules of the life insurance company tax law will treat the assets of the company the same as the assets of any individual. Thus, there is gain when the asset is realized, but if there's unrealized gain or loss, there is no recognition until a realization event; that is, a sale or a disposition of the asset. Income from the assets, such as dividend or interest income, is current income. Of course, the insurance company, if it's holding a reserve for the liability for that current income to be passed onto policyholders, would get a deduction, so it would not be net income in the insurance company's hands.

The tax-deductible reserves for general account contracts are determined at issuance of the contracts. They basically follow the general account rules. There is an interest rate that is fixed by the tax law for valuing the reserves. The contract reserve also picks up various other rules under Section 807 of the Code.

This scheme works pretty well for book accounting, but doesn't work at all when the contract values vary in the hands of the policyholders. To address the latter, Section 817 was written into the tax law in 1984.

It made use of prior rules for annuities, and expanded them to include life insurance, to deal with variable contracts. Under these rules, in the insurance company's hands the gains in the assets which are recognized, even if they're unrealized, on the green blank (the separate account of the insurance company) are not recognized for tax purposes. Until there's a realization event, the tax law does not recognize them. That's the same treatment that normally applies under the tax law, but what Section 817 has to do to achieve this is to take the reserve numbers on the separate account statement for the variable contracts and restate them as if they were book-value numbers. Chris DesRochers calls that a mark-to-book method, and I think that's a good way of looking at Section 817 of the Code.

The definition in Section 817(d) basically says that a variable contract is a life insurance, annuity, or pension plan contract, the values of which vary with the market. That is, they have to reflect the market value of the assets. They can have some guarantees in them, but as long as they're essentially reflecting the market value up or down, there is a variable contract. There are other aspects to the definition, but, again, if the contract doesn't meet that definition, Section 817 doesn't apply. Instead, the general account rules will apply unless the contract meets the definition in Section 817A.

Section 817A contains the rules for other market-valued separate accounts, and this is where the definition of modified guaranteed contract appears in the tax law. These rules are complex. We explained these rules in an article called "A Tale of

Two Amendments", with apologies to Charles Dickens. It talks about the amendment of Section 817, which said a variable contract can still be subject to Section 817 even if there are guarantees in it, and Section 817A, which said that if a company issues a modified guaranteed contract that is based on a market-valued separate account and provides for a cash-surrender value, a mark-to-market tax regime will apply. This is the only mark-to-market regime in the insurance company tax rules. It is the new technology, as it were. It was enacted in 1996, and we're still coming to grips with what it means.

What Section 817A does is mark the separate account assets to market in the insurance company's hands, recognizing unrealized gains and losses and treating them as ordinary income items. That's a sea change for insurance company tax accounting, but it happens to match what's occurring on the green blank. Significantly, the reserves are also valued at market.

The U.S. tax law is very concerned about reserves. Congress decided some years ago that insurance companies were taking reserve deductions that were too large, so it enacted rules in the IRC that govern the reserves for tax purposes. In the case of Section 817A contracts, the tax reserve is the greater of the federally prescribed reserve or the cash-surrender value with the MVA taken into account. We're still trying to define that federally prescribed reserve. IRS Notice 97–32 provides an interest rate that doesn't work, and there is a business plan item open with the Treasury Department this year to try to revise that rate.

Changes in Regulation and Taxation in the U.S.

There is change afoot in state regulation. At what pace we don't know, but the pace seems to be quickening, particularly in efforts to try to make the rules a bit more uniform. The SEC was encouraged by Congress in 1996 to simplify somewhat the rules for variable contracts, and the SEC is looking at simpler prospectuses. It is looking at a new filing form, form N-8, for the registration of variable contracts. This would be the first time since the dawn of the registration rules that we have a specific form for variable contracts.

We may very well see some major improvements coming along in the taxation of qualified products. Congress is looking for ways to help people save more for retirement, so the Portman-Cardin legislation, which has been under consideration in Washington for several years, does have a chance of passing this year.

In the case of nonqualified product taxation, we usually don't talk about improvements, only about threats. One glaring exception to that is an effort now being made to try to improve the tax rules for nonqualified annuities. The proposal is to give capital gains treatment to the income items in the nonqualified annuity, provided that there's a life-contingent payout. That's a new insurance industry initiative.

Beyond that, the Treasury Department sees it the other way around. They want to collect more taxes from the insurance industry and have proposed increases in the DAC tax, and a worsening of a variety of other rules as well, so we'll have to stay tuned to learn what will happen.

Mr. Philip Friedlan: What I propose to do first of all, by way of background, is to spend a few minutes just talking about the Canadian tax system in a general way. Then I'll talk about some of the legal aspects related to segregated fund products, particularly the consumer products as opposed to group-type products, which have more traditional uses. I will also go over some of the segregated fund product features that we see in the Canadian marketplace these days, as well as competitive equity-type offerings, both on the insurance side and the noninsurance side. I will briefly talk about the regulatory aspects of segregated fund products in Canada, taxation, and then a bit about where the regulatory environment in Canada seems to be going as it relates to these types of products.

Canada has a federal system consisting of a federal government, ten provinces, and 3 territories. We have a tax system under which the federal government has unlimited taxing powers and the provinces have more limited taxing powers in that they're limited to direct taxation in the provinces.

Both the provinces and the federal government impose income taxes on individuals, corporations, and trusts. In addition, we have capital taxes and particularly heavy capital taxes on financial institutions. We also have other related taxes, including premium taxes on life insurance, but not on annuities.

The main body involved in Canada in collecting taxes is now known as the Canada Customs and Revenue Agency. It collects most of the federal taxes. The reason I say most is because we have a Goods and Services Tax, which is a value-added tax, which is generally collected by the federal agency. In Quebec it's collected by the provincial government.

The Canada Customs and Revenue Agency collects provincial income tax for nine of the provinces and some of the provincial corporate taxes. One thing that I think is significantly different in Canada than the U.S. is that we do not have any estate or gift taxes. What we have instead is a regime that basically causes accrued gains and losses to be realized in capital assets and some other assets on the death of an individual.

Life insurance is sold to pay for this liability. The difference between the Canada and U.S. tax systems at death creates some very complex tax situations.
The Canadian legal system. Under the Canadian Constitution, the provinces are given jurisdiction over property and civil rights, which means that the law of

insurance is governed by provincial law, including the aspects of insurance relating to licensing and insurance contract law.

The federal government does have a large role in the regulation of insurance companies, as you'll see, particularly since most of them are federally incorporated. In addition, the federal government has jurisdiction over certain areas such as bankruptcy and insolvency. So the federal government does play a significant role in the regulation of the insurance industry.

Securities are also provincial, and we have provincial securities commissions that are responsible for regulating securities. There is no federal role at this time in securities regulation, though there has been some discussion of trying to create a federal regulator, but, again, nothing has happened.

As John talked about earlier, the segregated fund policies or segregated fund products are offered by life insurers, and they can be individual or group contracts. In terms of group-type policies, these have typically been used for things such as pension funding, investment management, and group retirement savings plans. These are the vehicles that the insurance industry has used as its competitive products in competing against, for example, trust companies, that are also in these businesses.

In addition, the products can be in the form of life insurance or annuities. In terms of annuities, they can be deferred annuities or immediate annuities, and they can also be group annuities.

The first part of the regulation of segregated fund products has to do with the Federal Insurance Companies Act; though there is, in addition, similar regulation for provincial companies. Most insurers in Canada are federally incorporated and are subject to federal regulation of these aspects of insurance. In addition, there are a few provincial companies who have voluntarily subjected themselves to federal regulation under this statute.

Now, as it relates to separate account or segregated fund products, the legislation requires that where the liabilities of a life insurer in respect of the policies it issues vary in amount depending on the market value of the fund consisting of a specified group of assets, the life insurer has to do certain things with respect to that pool of assets. It has to create a separate account, and it has to establish that as a separate fund in its books.

As a result, certain legal consequences occur. For example, the insurer is released from the limits placed on the type of investments that can be made out of its general account. It's still subject to some regulation by the federal authority—that's the Office of the Superintendent of Financial Institutions (OSFI). However, in this sense, the insurer is now allowed to make investments on a more general basis.

From an insurance law perspective, each province has an insurance statute. In the province of Quebec it's the civil code that defines what constitutes life insurance.

Now, that definition in the common law jurisdiction, which is nine out of ten provinces, includes the type of products that you would typically regard as life insurance.

In addition, the legislation specifically provides that annuities are life insurance. That has important consequences because this means that annuities are assimilated to life insurance for the kinds of rights and obligations that accrue under these statutes. The inclusion was made necessary because there was a Supreme Court of Canada case that held that annuities weren't life insurance.

Segregated fund contracts are also defined in the insurance legislation; they're technically referred to as variable insurance contracts. Again, they have a similar definition to the one that I described with respect to the Federal Insurance Companies Act, which is it's an annuity or a life insurance contract for which the reserves or part thereof vary in amount with the market value of a specified group of assets held in a separate and distinct fund.

So, again, a variable insurance contract, or what's colloquially known as a segregated fund policy, is basically a policy that offers these separate account funds within the policy. The policy does not have to technically be exclusively offering those funds. You could have the more traditional type of features as well.

Now, another significant aspect of the regulation of insurance is the securities legislation. What's important to know is that currently provincial securities legislation provides for exemptions for segregated fund policies from regulation under such laws, provided they meet certain requirements.

A segregated fund policy under the provincial law would be regarded as a security, but for the exemptions provided in the statute. The main exclusion from what constitutes a security is a contract issued by an insurance company which provides for payment at maturity of an amount not less than three-quarters of the premiums paid by the purchaser for a benefit payable at maturity. Now, that's one of the exclusions under the Ontario Securities Act.

The other provinces have similar exclusions. Now the exclusion is extremely important because it means that the consumer-segregated fund product offerings of life insurers in Canada are not subject to securities law regulation. These products are regulated under the insurance legislation, which you'll see generally has been far less onerous than the securities law.

Then finally, tax law. Actually, under the Canadian Income Tax Act there is no specific definition of what constitutes a life insurance policy or annuity contract except that it specifically includes an annuity and a contract that would be considered to be a segregated fund policy.

The issue whether a particular policy was life insurance or an annuity would be made either based on the definitions provided in insurance legislation or possibly under what the terms would ordinarily mean in the general parlance, however, this has not been an issue in Canadian tax law as yet. So far this has not been a contentious issue in Canada.

One of the significant benefits that the consumer products in the marketplace have over their competitors is creditor protection. This is something that is unique to life insurance. First of all, the segregated fund policies under the corporate legislation are given protection from the insurer's creditors. That means that if the insurer went bust, the assets held in the segregated fund would not be available to satisfy the insurer's creditors. That was, for example, a big issue when Confederation Life went bust because they had significant pension assets, which were protected from the claims of the creditors of the insurer itself. In addition, the provincial insurance laws protect the policy from the owner's creditors, provided certain conditions are met.

Under provincial law, the owner of the policy is entitled to make a beneficiary designation in the common law provinces under their insurance legislation and in Quebec under the civil code. There are two forms of creditor protection.

First of all, on death the insurance proceeds payable to a beneficiary, which would not include the owner's estate, passes outside of the deceased's estate and goes directly to the beneficiary. So, in effect, that means that the proceeds of the insurance policy, and that would include an annuity contract, are not available to satisfy claims of the owner's creditors.

In addition, if you have an appropriate designation, and in the nine common law provinces if you have a designation in favor of a spouse, child, grandchild or parent of the person who was life-insured, then the rights and interests of the owner in the insurance money and the contract are exempt from execution and seizure.

In the province of Quebec we have a similar protection except that it's based on the relationship between the beneficiaries and the owner. Now that means in a general sense that those policies are protected from the creditors of the owner.

I should point out that this protection isn't absolute because we have other legislation in Canada that is available to attack the beneficiary designations such as the Federal Bankruptcy and Insolvency Act and provincial fraudulent conveyance legislation, as well as provincial dependents relief legislation, which allows family members who aren't adequately provided for on death to challenge designations. However, this feature is something that is not available in noninsurance products and is a very attractive element in terms of marketing the product.

Mr. Adney: Phil, I guess it's fair to say in the U.S. we have comparable rules. The protections from the owner's creditors would be state-based, so they will vary from state to state. But there would be comparable rules, and the protection from the insurer's creditors likewise would be another strong point of comparison.

Mr. Friedlan: In terms of product features, I'm going to talk about the consumer product. In today's marketplace the product offerings are almost exclusively in the form of an annuity, particularly a deferred annuity. There have been some combined products around, but certainly these days most of the product offerings are in the annuities area and these products have a number of common features.

First, they allow for flexible premiums. The policyholder, subject to insurance company limits, is allowed to pay in an initial premium and subsequent premiums. These premiums are allocated based on the policyholder's choices to a variety of segregated fund investment options.

As John said, the offerings can be a huge variety of separate accounts or segregated funds, equity accounts (both Canadian and U.S.), international bond accounts, and so on. The premiums are allocated among those funds as the policyholder selects.

Each segregated fund is typically divided into notional units, and the policyholder is credited with a number of units based on the amount of premium paid into that particular account and the market value of the particular separate account. But, as I think is the case in the U.S., the policyholder has no ownership interest in the underlying assets of the separate accounts. The only rights that the policyholder has are the rights as provided for in the policy.

These annuities at maturity should offer an annuity option to the policyholder, but most of them do not require that the person take an annuity. You're usually given the choice between taking the cash-surrender value, or converting into an annuity.

In addition, all of them will offer a death benefit based on the fair-market value of the policy. Some of them offer increasing benefits. All of them will have partial withdrawal/surrender features. In addition, they'll also allow you to make reallocations of funds among the various accounts. In the case of withdrawals and surrenders, charges may apply and the amount may depend on the manner in which the policy is purchased. The surrender charges could be fairly significant in the earlier years, perhaps as high as 5–6% of the value.

One of the key elements of these products is the guarantees. There is, as far as I'm aware, no product out there that does not offer the maturity guarantees because all of them have to offer these guarantees to be outside the securities legislation. And what we've seen over the last few years is enhanced guarantees both at maturity and at death. Now, historically, the guarantees were quite simple. They were basically 75% or 100% of the original premiums paid on maturity or death.

Generally the maturity guarantee was only available after ten years. Now over the last few years, insurers have become very creative as the segregated fund products have become more popular in offering a variety of guarantees.

First, the maturity guarantee could be policy-based, in that the maturity date is measured from the policy issue date and subsequent deposits are based on that date, so you have a guarantee starting on day one and then in ten years the owner gets a guarantee based on all deposits. We now have guarantees based on specific deposits, so each deposit would have its own maturity date. So, for example, the initial premium might have a maturity date ten years from now and if there were subsequent deposits in the next policy year, there would be an additional maturity date specifically related to the deposits ten years from when that deposit was made. In some cases, the deposits in a particular policy year are aggregated and you're given a ten-year maturity date based on deposits in a particular policy year.

Some of the policies give the policyholder the right to reset the maturity guarantees if the current fund value increases. They can be given multiple resets in a year, usually subject to a limit. If the value of the fund has increased, obviously you get a higher guarantee, but the maturity date is extended out further because the ten-year period starts over again. In addition, some of the products also have automatic resets so that on each maturity date the policyholder, unless he or she does something, gets a new maturity date which is ten years into the future.

Mr. Adney: Phil, are you saying that even apart from death there is a guarantee of essentially a return of principal or a portion of principal at least at maturity during a life?

Mr. Friedlan: Correct.

Mr. Adney: And this could even be for an annuity segregated fund policy that was based on equity instruments?

Mr. Friedlan: Oh yes, absolutely. In fact, you have to have that guarantee for security law purposes. What's happened over the last few years is the insurers have become more creative in the types of guarantees they've been offering because this guarantee has been one of the key aspects of promoting this product.

Now, at the same time that the insurers become more creative, there has been more concern raised about what is the likelihood of an insurer having to pay on these guarantees. There's been increasing awareness of the risk, and a number of things have happened in that regard.

It's very difficult, if not impossible, for an insurer to get reinsurance for these maturity guarantees in particular. In addition, both the Office of the Superintendent of Financial Institution and the Canadian Institute of Actuaries (CIA) have been looking at guarantees to see whether the capital and reserving requirements that insurance companies have been using have been adequate. We're likely to see changes in the near future.

The CIA produced a report with some recommendations. The OSFI has been looking at this issue and we're likely to see changes or specific guidelines dealing with these matters.

Let's just quickly run through the offerings. In the segregated fund market, we've had what I call traditional products. Now these are basically segregated funds of the insurer. In other words, the insurer would establish a fund, a U.S. equity, a Canadian equity fund. The insurer would take in premiums and manage the investments and invest in the appropriate assets, and they would have a range of these offerings available through their policies. What we've seen in the last few years is insurers creating separate accounts or segregated fund accounts that basically mirror a specific mutual fund of one or more mutual fund companies.

So, for example, you could have 10, 15, or 20 different separate accounts that mirror these mutual funds. What that means is, for example, if an insurer was going to offer a particular company's Canadian equity mutual fund, the insurer would create a separate account that invests exclusively in units of that particular mutual fund. Basically the premiums would be paid and deposited into that particular segregated fund, which would essentially have a similar name to the mirror mutual fund. The insurer would then take those funds and purchase units of the mirror mutual fund.

Mr. Adney: Now if we did that in the U.S., we may have an investor control problem with the annuities. The IRS has ruled, and one court at least has agreed, that that would be essentially wrapping an annuity around a mutual fund to change the mutual fund's tax treatment and create tax deferral. It's been held that that would not be recognized, but that the policyholder would be viewed as owning the mutual fund shares rather than the annuity. Could you comment on that tax situation in Canada?

Mr. Friedlan: Well, the creation of this type of mirror-segregated fund would have no impact on the taxation right now. In other words, the tax treatment of segregated funds that either offer traditional funds or segregated accounts that mirror mutual funds would be the same.

Now, one of the insurance competitors to the segregated fund product is universal life (UL) insurance. Now these products from a tax point of view have a deferral. They're designed so that the inside buildup is not taxed.
There are certain specific rules in the Income Tax Act that have to be met in order for the policy to get these benefits, but once it does the two main benefits are that the inside buildup is not taxed unless there's a withdrawal or a policy loan and that the death benefit is tax-free.

Now these products, in addition to offering the usual types of interest-type accounts, are now offering accounts that are linked to an outside index—for example, the Standard & Poor's 500 or the Toronto Stock Exchange 300. What these accounts will do is credit amounts to the policy's account based on the performance of these indices.

Now these are considered to be general account products, not separate account products; therefore, within the exempt-type product you have the ability to get equity-type performance. In the past, there have been some questions raised as to whether these types of accounts should be in the general account. For the moment, the federal regulator has not done anything in that regard. This product is extremely popular in Canada right now; it is not subject to the same kind of insurance regulation as segregated funds.

The other product that might be regarded as a competitor is an index-linked annuity, which gives you a capital guarantee and allows you to get some benefit of stock market performance.

Noninsurance-type products that are competitors. The main ones I think are the mutual funds. You have the traditional mutual funds, which are basically a mutual fund company offering a range of mutual funds. These are typically trusts, though we do have some mutual fund offerings that are in the form of shares of mutual fund corporations.

An example would be TriMark, which has a variety of funds: U.S. equity fund, the Canadian equity fund, bond fund, and so on. In addition, what we've seen in a limited way are attempts by mutual funds to offer guarantees in their products, either through the use of insurance or the guarantee of, say, a bank.

In addition to that, mutual fund companies have been going out and making arrangements with insurers to basically offer their portfolio mutual funds through a segregated fund annuity product.

So, in effect, what you would have is an insurer offering in one policy segregated funds, each of which invests units of a particular mutual fund of a particular mutual fund issuer. For example, the segregated fund policy would offer a particular company's Canadian equity mutual fund as a segregated fund, and it would invest exclusively in units of that particular mutual fund or similarly with the U.S. equity fund and so on. So, basically the mutual funds are offered through the use of a segregated fund policy while getting the insurance benefits.

Index-linked GICs and pooled funds and investment management products are also competitors, the latter being for larger-sized funds.
One of the key elements of segregated fund regulation that differs in Canada from mutual funds, provided the segregated fund product is exempt from securities law, is that it is governed by provincial insurance legislation, which, from a regulatory point of view right now, is far less onerous than the provincial securities legislation requirements for mutual funds.

Let me just talk a minute about mutual funds. For mutual funds there are extensive requirements regarding disclosure and registration requirements. In particular, if someone wants to offer a mutual fund, they have to produce a prospectus that has to be approved by the provincial securities authorities before it's made available.

There are annual filing requirements. In addition, only certain licensed people are allowed to sell it or to give advice in connection with those products.
As a comparison, if you have a segregated fund product that has the appropriate exemption from securities law, you are required to produce what's called an information folder and a policy; the information folder basically being the segregated fund equivalent of the prospectus.

These documents technically have to be approved by the insurance regulators of the ten provinces. However, the procedure to get that approval is far less onerous.

First, these documents have to comply with what I'm calling the CLHIA guidelines. These are the guidelines produced by the Canadian Life and Health Insurance Association (CLHIA), which is the industry association for the Canadian life insurance industry.

There are two ways to obtain the approval. If the company is a member of the CLHIA, it would submit it's documents to lawyers employed by the CLHIA who would vet the documents and see whether or not they met the requirements. Once those documents have been vetted, the CLHIA submits those documents to the Superintendents of Insurance for approval. However, there's typically not an in-depth review in the offices of the insurance regulator. The review is done by that industry association.

Alternatively, a lawyer can give an opinion as to whether those guidelines are satisfied. That opinion would be submitted to these insurance authorities and, typically, they have 30 days to give their approval.

Mr. Adney: So Phil, you're saying that this would be comparable, in the U.S., for lawyers at the ACLI to say that the prospectus or the folder was fine and send that over to the SEC to be rubber-stamped.

Mr. Friedlan: Correct.

Mr. Adney: OK. The SEC would not be amused.

Mr. Friedlan: Now we're in a state of flux, so things may not be quite that easy in the future.

The segregated fund policies can be offered in a nonregistered environment, that is just an individual purchasing a product, or in a registered environment, that is offered as an investment in retirement vehicles, the equivalent of the kinds of things John mentioned before.

The registered retirement savings plan is an accumulation retirement vehicle which requires the product to be converted into an annuity by age 69 or transferred to a distribution vehicle called the registered retirement income fund. Now these particular products can be offered in the form of an insurance product, but they can also be offered by a bank in the form of a deposit-type instrument, or by a trust company in the form of a trust. Now, one of the types of trusts that are available is called a self-directed retirement vehicle, which allows the owner to decide what investments should be made.

These investments have to be qualified investments, but one of the qualified investments could be a segregated fund policy that meets the requirements in the Income Tax Act, which would be an annuity but not a life insurance policy.

As in the U.S., these retirement vehicles offer a tax deferral. In the case of contributions to the registered retirement savings plan, there's a tax deduction for contributions subject to certain limits, but any distributions from these plans are taxable. There are limits on the type of investments if you're dealing with a trust-type vehicle, and there are also limits on the types of foreign property that can be held in these trust-type vehicles.

The nonregistered segregated fund vehicle. Theoretically, you can actually have a policy that offers traditional life insurance features and segregated funds, but most of the products in today's market are basically almost exclusively segregated fund offerings, with the exception of the guarantees. Basically, the tax rules related to nonregistered segregated fund policies are intended to make these products, in terms of taxation, equivalent to the mutual fund trust taxation.

For tax purposes, each segregated fund is deemed to be a trust for tax purposes of which the insurer is the trustee and the holder of the property. The policyholders who have units are the beneficiaries of the trust. This mirrors mutual-fund-trust-type treatment. In addition, the interest that the policyholder has in the property is a capital property, so that if those units are disposed of either by surrender or transfer to another segregated fund, a taxable event occurs, which could create a capital gain or loss. These nonregistered segregated fund policies are currently taxable. There is no deferral.

Dividends, interest, and realized gains or losses are currently taxable to the policyholder on a flow-through basis. The trust itself is not taxed.

There is a great deal of uncertainty as to the manner in which the guarantees are to be taxed. It is likely there will be legislative changes to deal with this issue. You have some companies there that are treating the maturity benefits as either fully taxable or taxable as capital gains.

With respect to the death benefits, there are situations where they're treated as either fully taxable, taxable capital gains, or nontaxable. The federal government is looking at the taxation of segregated fund policies, and I think we're going to likely see some changes. Interest expense on borrowings to buy segregated fund policies that are annuities is deductible. If the policy happened to be life insurance, you wouldn't be entitled to a deduction for interest expense.

Mr. Adney: Phil, just going back to make a U.S. comparison, you're saying that the nonregistered, which we call nonqualified, segregated fund annuity would have current taxation of the inside buildup of a policy?
Mr. Friedlan: Correct.

Mr. Adney: And it's been a canon of theology in the U.S. that that would not work, that if we did not have tax deferral for the nonqualified annuity, including VAs, that the policies would not be sold. Can you just go back and summarize again the reasons why, despite the current taxation, people in Canada would find this product of merit and interest?

Mr. Friedlan: I think the two main reasons why segregated funds have seen a revival are the creditor protection that's offered and the guarantees, which have been heavily promoted. I think the success of the insurance industry is reflected by the fact that there are a significant number of mutual fund companies now offering their products using segregated fund policies. So, the deferral from that perspective has not been an issue.

In fact, the rules which are, I guess, now 20 years old, were basically designed to put the 2 types of products on an even footing. And I think the other thing to remember is that on the insurance side the deferral opportunity is still available through exempt life insurance products such as UL.

Mr. Adney: Right.

Mr. Friedlan: So that is perhaps why the insurance industry has been less concerned about the lack of a deferral on the segregated fund policies. What about the future? What we've seen over the last few years is a number of reports doing an analysis of the investment industry from the consumer perspective. In particular, we had the Stromberg Report, which was commissioned by the federal government that reviewed from a consumer perspective the product offerings in the marketplace. It essentially recommended a convergence in the manner in which these products were regulated.

It also suggested that basically the kind of regulation that mutual funds were being subjected to should be imposed on the segregated fund product. Subsequent to that over the last year or so, the regulatory association for securities regulators and the insurance regulators commissioned a comparative study of mutual funds and segregated funds. They came up with a huge list of comparisons. I think they had 100 items. As a result of that, we had a joint forum of financial market regulators, which basically is, again, recommending harmonization of the rules.

Most recently, in the Ontario budget, which came out in May 2000, it is now proposed that the Ontario Securities Commission, which is responsible for regulating securities in the Province of Ontario, be merged with the Financial Service Commission of Ontario, which is a body responsible for regulating insurance and pensions.

Now I think that the merger should be viewed as almost a takeover by the Ontario Securities Commission. There may be a big push for segregated fund products to get the same kind of scrutiny and review and regulation as mutual funds, which means that the approach in terms of disclosure and registration may become more onerous.

As an aside, which doesn't relate to segregated funds, I think that there may be some concern about how equity-linked-type products like UL may be regulated in the future. And then, finally, there is some review going on of the taxation of these segregated fund products by the federal government. I think we may see some changes there as well.