THE PUZZLE OF LIFE OFFICE TAX

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ABSTRACT

This paper takes a broad look at tax in general and some of the tax issues peculiar to life offices. A theoretical model for the taxation of life offices and their policyholders is then developed. Moving from theory to practice, the paper then offers its own solution to the 'puzzle'. Appended by way of background reading are brief histories and summaries of life office tax in the U.K., New Zealand, U.S.A. and Canada.

1. INTRODUCTION

We have heard a long argument and a most able argument, and a puzzling argument as all arguments about this income tax seem to be — it is enough to puzzle one's head off nearly.

Lord Esher, Master of the Rolls, in Clerical Medical and General Life Assurance Society v Carter, 1889

1.1 The motivation for this paper was the changes to life office tax that were introduced in Australia, New Zealand and the United Kingdom in January 1990. It was apparent from the debate that preceded these new regulations that a generally accepted theory on how life offices should be taxed was not available. A further review in the U.K. is now being carried out and a statement from the Inland Revenue was expected when this paper went to print.

1.2 This paper takes a broad look at tax in general and some of the tax issues peculiar to life offices. A theoretical model for the taxation of life offices and their policyholders is then developed. Moving from theory to practice, the paper then offers its own solution to the 'puzzle'. Appended by way of background reading are brief histories and summaries of life office tax in the U.K., New Zealand, the United States of America and Canada.

2. TAX IN GENERAL

2.1.1 The primary purpose of taxation is to raise revenue for national or local government. However, taxation is also used for social purposes (primarily the redistribution of wealth) and as a tool in the management of the economy.

2.1.2 The art of taxation, according to Baron de Colbert, is like plucking a goose — getting the maximum amount of feathers for the least amount of hissing. In recent times, the hissing which has most disturbed the authorities has not been from the goose, so to speak, but from the tax-induced distortions which

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lead to economic inefficiencies. These deadweight losses, as economists refer to them, are proportional to the square of the tax rate.

2.1.3 Tax distortions cannot be removed entirely (without removing tax), but the 'cliff face' of full tax to no tax can be made to have a lower drop by the device now commonly known as 'broadening the tax base'. In 1978 the top rate of marginal tax in the U.K. was 98% (83% plus the 15% investment income surcharge). The U.K.'s top rate of income tax is now 40%, in New Zealand it has fallen from 66% to 33%, and in the U.S.A. (federally) it was 28%.

2.2 *Desirable Traits of a Tax System*

2.2.1 Adam Smith, in 1776, set out four criteria that methods of taxation should satisfy in his *Wealth of Nations*, and these bear quoting:

(a) *Equality.* The subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities, that is, in proportion to the revenue which they respectively enjoy under the protection of the state.

(b) *Certainty.* The tax which each individual is bound to pay ought to be certain, and not arbitrary. The time of payment, the manner of payment and the quantity to be paid ought all to be clear and plain to the contributor, and to every other person.

(c) *Convenience of payment.* Every tax ought to be levied at the time, or in the manner, in which it is most likely to be convenient for the contributor to pay it.

(d) *Economy in collection.* Every tax ought to be so constructed as both to take out, and to keep out, of the pockets of the people as little as possible, over and above what it brings into the treasury of the state.

2.2.2 These four criteria are just as valid today, but in a changing modern world the list requires additions. Thus, tax bases should also be adaptable, flexible and, where necessary, compatible with overseas regimes. New bases must deal with transitional problems in an adequate manner, should be consistent with the overall tax regime and are expected to minimise tax-induced economic inefficiencies. Unfortunately these criteria can sometimes be contradictory. As an example, indexing for inflation is fair, but rarely simple.

2.3 *Income Tax*

2.3.1 An income tax requires a definition of income. In terms of welfare economics, monetary income is a poor measure of overall income, because it does not measure working conditions and the quality and quantity of leisure time. However, it is the best measure available.

2.3.2 Even with the monetary restriction, measuring income is less straightforward than one might at first imagine. In addition to 'normal' income from employment, an individual may receive income from investments, inheritance, alimony, gifts, scholarships, by trading (e.g., running a grocery store),

through capital gains, from gambling, in compensation for losses, from fringe benefits such as cheap lunches or free parking, or through tax-exempt payments such as lottery prizes. Individuals may also receive imputed income such as the services of an unpaid housekeeper and/or the rental value from home ownership. Then there are welfare benefits to consider, which can also be viewed as a negative tax. For the overall tax framework to begin to be consistent, and remembering that life offices can be viewed as a conduit for their policyholders' taxes, the above list (which is by no means exhaustive) needs to be borne in mind.

2.3.3   A second problem with ascertaining income (and one which is very relevant to long-term life policies) is in the setting of unambiguous rules for defining in which tax period the income was received. For determining profits, most organisations do not use a cash received basis, but what accountants call the accrual method. This recognises revenue when earned (as opposed to when received) and matches expenses accordingly.

2.4 *Taxation of Interest*

2.4.1   It is quite possible to have an income tax where investment income is tax exempt; presumably with the consequences that all interest paid should be non-relievable and that no relief would be granted on expenses incurred in generating investment income. Such a change would clearly favour investors currently paying tax on their investment income, but, by ceasing to discourage savings, interest rates should come down. This would partially offset any investor gains, and also allow borrowers to enjoy lower (gross) rates of interest.

2.4.2   There is much to be said for not taxing investment income. It would encourage savings, and therefore stimulate the economy, it solves the problem of how to tax capital gains (they become tax free) and also the problem, in times of high inflation, where tax on investment income becomes akin to an arbitrary wealth tax. The removal of tax on investment income would certainly mean a change for life offices currently taxed on investment income less expenses!

2.5 *Taxation of Capital Gains*

2.5.1   This area of tax is a minefield in its own right, and no attempt is made in this paper to cover fully the many problems which can arise in its application. However, some of the more general points can still be usefully raised here.

2.5.2   Because it is so easy to develop financial instruments which convert income to capital gains, a form of capital gains tax is a necessary partner to income tax if serious anomalies are to be avoided. The main argument for taxing capital gains (apart from being another way of raising revenue) is, therefore, where capital gains have, in one way or another, replaced taxable income. This brings us face to face with our first anomaly. Interest income is generally not indexed for inflation, but there is a tendency by tax authorities to allow indexation of capital gains in calculating a tax liability, mainly because it is patently unfair to ignore the effects of inflation if the capital gain has accrued

over a long period.

2.5.3 A second difficulty of taxing capital gains is the reluctance of the public to accept being taxed on unrealised gains. Another is the issue of what to do with capital losses, both realised and unrealised. There are also the problems of maintaining full records of purchase prices, subsequent expenses and depreciation figures for determining the gains to be taxed. Note also that the presence of a tax on capital gains will distort investment decisions.

2.5.4 Dealing specifically with life offices and their policyholders, generous personal exemptions in the U.K. mean that the majority of U.K. policyholders are not liable, in practice, to capital gains tax on their direct investments. However, U.K. life offices are liable to tax on all capital gains (less losses), even though they are supposedly taxed as a conduit for their policyholders.

2.5.5 Offsetting these disadvantages, a life office can often defer the realisation of gains through the natural process of meeting its claims from its cash flow, thereby automatically transferring assets from one generation of policyholders to the next without realising the underlying investments. Even when assets are realised, it can be done selectively to minimise tax. Indeed, there is some dispute as to whether the overall tax treatment of capital gains and losses for a U.K. life office is unduly advantageous to the policyholders. In recent times, some U.K. terminal bonus rates (which are largely funded from unrealised capital gains) have made up more than half of a policy's maturity value.

2.5.6 To muddy the waters further, in the current tax environment of the U.K. it is doubtful as to whether a capital gains tax on life office equity investments can be theoretically justified. The argument is that capital gains are generally made on equities for three reasons: the long-term effects of inflation (where tax is not justified); random fluctuations (where capital gains will be matched by capital losses); and where a share increases in value because of an expected increase in the future dividend stream. In the latter circumstance it is difficult to justify a capital gains tax for a life office because, under an imputation/tax credit system, the extra dividend was not going to be taxed in the hands of the life office. Similar arguments apply to buildings owned and occupied by a life office.

2.6 *Corporate Tax and Imputation*

2.6.1 Corporate tax is another area of tax that is something of a minefield. The problem is this; for many companies, especially large ones, it is not practicable to attribute the undistributed income (or losses) of that company to its shareholders for tax to be paid by the latter at their appropriate marginal rate. (The theoretical name for this tax treatment is 'Full Integration'.) On the other hand, taxing companies' profits and then treating dividends as taxable income in the hands of the recipients (the so-called 'Classical System' of taxing companies) is neither neutral nor equitable, particularly where dividends are passed through several companies before being paid to a natural person.

2.6.2 Apart from the enormous administrative difficulties of full integration (particularly for companies with overseas earnings and/or overseas shareholders),

full integration severely limits the use of tax concessions and special incentives for favoured businesses (lower rates of tax for small companies, for example). Favouring the classical system of double taxation, at least in some quarters, is the feeling that shares are predominantly owned by the rich, making higher levels of tax more acceptable.

2.6.3 A partial solution to the problem of taxing corporates has been the use of imputation credits, whereby a company that pays tax can then impute its dividends with a tax credit. While the system has many variations, generally the shareholder will then declare the dividend plus imputation credit as income, but use the imputation credit to offset any personal tax liability or, if a company, to impute its own dividends. Other approaches in use for dealing with corporate tax include split rates (one tax rate for retained earnings, another for those distributed), and dividend relief (dividends are taxable to shareholders, but the company can treat dividends as a tax-deductible expense).

2.7 *Taxes other than Income and Capital Gains Tax*

2.7.1 These include wealth tax, stamp duty, licence fees, death duties and expenditure tax. In terms of revenue raised, the last is by far the most important after income tax, and has been used in the U.K. as a partial replacement for income tax in the form of Value Added Tax (VAT). Unlike the current form of income tax, an expenditure tax does not penalise savings, and this is seen to be one of its advantages.

2.7.2 In a direct expenditure tax environment, tax would be calculated on taxable income less net savings. Assuming this environment was well established, a person with no income and living off savings would be liable for direct expenditure tax, but would not have paid tax on the income from which the savings were accumulated. Direct expenditure tax, accordingly, encourages saving and provides a disincentive to borrow for consumption.

2.7.3 The use of an indirect expenditure tax such as VAT enables the government to maintain lower rates of income tax if it so wishes, and so to reduce the corresponding distortions which lead to economic inefficiencies which come from high rates of income tax. To date, the problem of double taxation on savings accumulated at times of high rates of income tax, when an indirect expenditure tax is introduced or increased, has largely been ignored. It should also be noted that indirect tax on any one item is always at a flat rate, and does not allow, as with income and direct expenditure tax, for 'progressive' rates of tax except through the cumbersome approach of lowering the rate of tax on essentials.

3. TAXING LIFE OFFICES

3.1.1 In determining a base on which to tax life offices, there are two distinct issues: on what should the life offices themselves pay tax; and on what should the policyholders pay tax. The second issue can only be resolved when rules are

known for the first one.

3.1.2 One way of raising tax from life offices, and one (combined with others) which is currently in use in the U.S.A. and Canada, is by a simple levy on the premium. This method has recently been introduced for U.K. general insurance business. Another way is through stamp duty based on the sum assured (introduced in the U.K. in 1870, but now out of use). These methods, though attractively simple, are necessarily somewhat arbitrary, are subject to political interference, and are also inconsistent with the tax philosophy applied to other types of business; that is, a tax on profits.

3.2 *Life Office Profits*

3.2.1 Premiums received by a life office comprise three elements: a risk component; a savings component; and an expense component. These three components correspond to the services offered by the life office as an insurer, as an investment manager and as a provider of personal services (financial advice and administration). These three components also correspond to the office's main sources of profit.

3.2.2 A fourth source of profit/loss to the life office warrants comment. Payments by a life office to its policyholders will not always equal the reserves held, published or actual. There are three arguments why this source of profit/loss should not be taxed separately. First, it is much easier to include this profit/loss in the calculations of the life office's investment profits than to try and isolate it. Second, as a profit to the office is a loss to the policyholder and vice versa, not isolating surrender profits/losses should have little impact on the overall revenue raised. Third, for most life offices the profits on surrenders on longer-duration policies are balanced out by losses on policies of shorter durations.

3.3 *Measuring Life Office Profits*

3.3.1 Generally speaking, the profitability of a selection of life policies cannot be determined until the insurer has fully discharged all liabilities relating to those policies. There are several reasons for this: the quality of underwriting together with general changes in future mortality levels can only be guessed at; it is impossible to predict with accuracy what future levels of interest rates will be; and similarly for expense inflation rates, withdrawal rates, tax rates (and tax basis!), and new business levels (to share the overheads). Future profitability can be estimated, of course, but such estimates will usually depend heavily on the assumptions made.

3.3.2 It cannot be over-emphasised that the prime purpose of the actuary's annual valuation is to demonstrate solvency, and that the published valuation is rarely suitable for determining the company's profits.

3.3.3 For life offices offering with-profits policies, pooling of mortality, investment and expense experience will almost certainly be necessary. Life offices with a significant amount of with-profits business, therefore, need to be seen as an entity in their own right, in which the interests of shareholders and the

individual with-profits policyholders cannot be separately identified. This is the heart of the matter, and is the fundamental argument for treating the taxation of life offices as a *special case*, despite the problems that special cases usually bring.

3.4 *Mutual Offices*

3.4.1 Mutual offices in Canada and New Zealand are taxed in the same way as proprietary offices. The U.S.A. has imposed a harsher regime on mutual offices (a lower percentage of policyholders' dividends available for deductions), while the U.K. imposes a more generous basis for mutual offices (no application of the 'Notional Case 1 Profits' minimum basis). There is one argument that says mutuals should pay no tax, and another that they should pay extra tax. Which is right?

3.4.2 The argument that mutuals of any type should not pay tax is that mutuals exist (in theory) to provide goods and services to their members at cost, so any *profit* in the price should be returned tax free. This is an extension of the argument that a person cannot make a profit from trading with him or herself, and is known as the mutual trading principle. The argument is flawed, however, because the community itself is a mutual, and tax needs to be raised from somewhere. For life business, there is also the observation that most mutual offices behave in exactly the same way as proprietary offices, so, on practical grounds, why should mutual offices be excused from paying tax?

3.4.3 It is often stated that mutual offices are owned by their policyholders. However, as any member of a community can become a policyholder of a mutual, it would seem that the owner of a mutual is the community as a whole. If this is accepted, then, in answer to the question of how a mutual office's tax should compare with a proprietary office's, it becomes arguable that a mutual office should pay more. This is because a mutual office should not only be required to pay the tax that a proprietary company would pay, but also an amount that equates to *the dividend* that it owes to its owner, the community as represented by the government.

3.4.4 Treating the matter pragmatically, most governments will raise revenue from whatever source they politically can, so mutual operations of all types will end up being taxed if the government thinks they are worth taxing. It is still possible, however, for mutuals of any type to minimise tax on profits by pricing as far as they are able to make a zero profit.

4. A Theoretical Model

4.1 As previously stated in Section 3, there are two issues: how much tax should life offices pay; and how much tax should policyholders pay. Clearly the issues are interrelated.

4.2 *Tax Environment*

A theoretical model for life office tax cannot exist in a vacuum; it must be constructed within a given tax environment. For the model developed below and thereafter, we assume an environment where profits are taxable, investment income is taxable, investment expenses are deductible, and there is an indirect expenditure tax on services other than investment. This is the current situation for basic life insurance business in the U.K.

4.3 *Definition of Terms*

4.3.1 For the period which it covers, a premium P to a life office comprises four components as defined below (but see notes (a) to (f) in ¶4.3.4, they are important):

— the risk premium to cover the risk for that period $= RP$;
— a fee for issuing the insurance relating to $RP = FRP$;
— the investment premium, i.e., the amount for investment $= IP$; and
— a fee for managing IP and any other investments held $= FIP$.

Thus $P = RP + FRP + IP + FIP$.

4.3.2 The benefit $B(1)$, held by the life office on behalf of the policyholder at the end of the given period, comprises four components also:

— the benefit held at the beginning of the period $= B(0)$;
— the investment premium for that period as defined above $= IP$;
— if death occurs, the death benefit corresponding to $RP = DB$; and
— investment income credited to the policy in that period $= IIC$.

Thus $B(1) = B(0) + IP + DB + IIC$.

4.3.3 Lastly, define I to be the investment income received by the life office in the period (which may or may not equate to total IIC), and E to be the life office's expenses (which may or may not equate to the total of FRP and FIP).

4.3.4 These points should be noted:

(a)   The investment premium received in a period IP does not need to be positive, and often will not be. This is because the mechanism of a life policy allows a life office to automatically draw on $B(0)$ on behalf of the policyholder to meet RP, FRP and FIP as and when needed.

(b)   The management fees FRP and FIP are charges to policyholders, and should not be confused with the office's actual expenses relating to its insurance and investment costs. It can be assumed, without loss of generality, that any profit and/or contingency loading is included in FRP and FIP.

(c)   A death benefit will usually include a return to the policyholder of $B(0) + IP + IIC$. The difference between this amount and the total death benefit is known as the sum at risk. This is the term DB above, and although it would be uncommon, it and RP, the associated risk premium, could be negative.

(d)   It is important to remember that a published valuation is for demonstrating solvency, and will normally include safety margins. Thus $B(0)$ and $B(1)$ and the reserves shown in a published valuation may not be comparable. In particular, $B(0)$ and $B(1)$ at early policy durations may be negative.

(e)   Although *RP*, *FRP*, *IP* and *FIP* necessarily total *P*, individually they can often be quantified in very many different ways. It is also quite possible, in any given period, for any one or more of *RP*, *FRP* and *FIP* to exceed *P*.

(f)   For some policy types the investment income credited *IIC*, may be negative from time to time.

4.4 *Policyholders' Tax*

4.4.1   In the long run, and noting how the risk premium *RP*, and the death benefit *DB*, are defined, the expected value of the fluctuations in the life office's mortality profit, total *RP* minus total *DB*, will equal zero, and *RP* for all policies will total *DB* for all policies. The amounts *RP* and *DB* are, therefore, effectively transfers of capital between those policyholders who survive the period and those who do not. As such, these payments should be treated for policyholders as tax neutral; that is, no tax relief or indirect consumption tax on that part of the premium *RP*, and no tax due on that part of the benefit *DB*.

4.4.2   The investment premium *IP*, is also a capital item. When positive, it is a transfer from the policyholder to the policy reserve from where it will eventually be transferred back to the policyholder as part of the final benefit, or used to meet the costs of one or more of *RP*, *FRP* and *FIP* in later periods. When negative, *IP* is effectively a transfer from the policy reserve to the policyholder, and is used to meet one or more of the items *RP*, *FRP* and *FIP* in the current period. The item *IP* for policyholders should, therefore, be treated as tax neutral, regardless of whether it occurs as part of a premium or benefit.

4.4.3   As $B(0)$ is carried forward from the previous period, it is a capital item. Therefore, summarising the argument so far; *RP* and *IP* of the premium *P*, and $B(0)$, *DB* and *IP* of the benefit $B(1)$, are tax neutral for the policyholders. Thus *FRP* and *FIP* need to be considered for indirect expenditure tax, and the increase in benefit over the period less the items *DB* and *IP* needs to be considered for income tax.

4.4.4   In the tax environment modelled, *FIP* is not subject to indirect expenditure tax, but *FRP* should be subject to indirect expenditure tax. For income tax, the amount for the period on which the policyholders are liable is:

$$B(1) - B(0) - DB - IP - FIP = IIC - FIP \tag{1}$$

that is, the investment income credited less the fee for managing the investment premium and any other investments held.

4.4.5   The practicalities of collecting an indirect expenditure tax on *FRP* and income tax on $IIC - FIP$ are discussed in Section 5.

4.5 *Life Office Tax*

4.5.1 A life office has three main sources of profit: mortality; investment; and expenses. Mortality profits in this analysis are included in *FRP*, so assuming all three of these sources of profit to be taxable, the amount to be taxed in a given period is:

$$\text{investment profits} = I - IIC$$

$$\text{expense and mortality profits} = FRP + FIP - E.$$

Thus total taxable life office profits equals:

$$I - IIC + FRP + FIP - E. \tag{2}$$

4.5.2 By substituting $B(1) - B(0) - DB - IP$ for IIC, $P - RP - IP$ for $FRP + FIP$, and assuming that $RP = DB$, total life office profits can be alternatively expressed as:

$$I - [B(1) - B(0) - RP - IP] + [P - RP - IP] - E$$

$$= P + I - [B(1) - B(0)] - E. \tag{3}$$

4.5.3 Formula (3) can be expressed in words as:

Income $[P + I]$ less   Outgoings [Increase in Benefits + E].

Although the notation would be different, essentially this is the way that banks are taxed. Customers of banks, however, unless they are companies, are not taxed as per formula (1), $IIC - FIP$. They pay tax on the equivalent of IIC with no apparent deduction for bank fees. Many investment accounts carry no specific fees, however, because the bank takes its margin from the interest rate. In this way the bank fees on investment accounts are effectively deductible.

4.5.4 The practicalities of formulae (2) and (3) are discussed in Section 5.

4.6 *Combining Policyholders' and Life Office Tax*

4.6.1 The attraction of combining policyholders' income tax and life office profits tax into one taxable amount is that it then permits the life office to collect these two taxes by the use of a much simplified method and formula. Although there is no immediate theoretical justification for doing this, the method is used in practice, and therefore needs to be considered. Also, it can be argued, the effects of a policyholders' proxy tax and life office tax are combined in the setting of premium rates, so they might as well be combined for collection. Further discussion on the merits of this approach is deferred until Section 5.

4.6.2 We have that policyholders are liable to income tax on $IIC - FIP$ and

that life office profits total $I - IIC + FRP + FIP - E$. It is therefore apparent that the total taxable amount is:

$$[IIC - FIP] + [I - IIC + FRP + FIP - E] = I - E + FRP \qquad (4)$$

to which must be added the indirect expenditure tax on *FRP*.

5. FROM THEORY TO PRACTICE

5.1 Four important formulae were derived in Section 4, and for convenience they are repeated below:

Policyholders' tax: $\quad = IIC - FIP$ \hfill (1)

Life office tax: $\quad = I - IIC + FRP + FIP - E$ \hfill (2)

$$= P + I - [B(1) - B(0)] - E \qquad (3)$$

Combined tax: $\quad = I - E + FRP.$ \hfill (4)

Indirect expenditure tax on *FRP* is also theoretically required.

5.2 *Indirect Expenditure Tax*
5.2.1 Although *FRP* should be subject to indirect expenditure tax, in practice it has not been applied. There are several reasons for this. First, it is often difficult or impossible to ascertain an exact value for *FRP* for individual policies. Second, most policyholders would find it hard to understand such a tax, especially if a premium had not been paid in that tax year or if *FRP* exceeded the premium *P*. Third, there would be a high compliance cost.

5.2.2 Compliance costs would be high for three reasons: establishing the value of *FRP* in the first place; providing policyholders with individual VAT receipts; and in the apportioning of the VAT which is paid (as opposed to collected) by the life office. This apportionment needs to be done, because a life office could use the VAT it collected to pay the VAT it incurred in connection with the provision of life cover. This brings us to yet another reason for not applying VAT to *FRP* — the revenue raised would be limited.

5.2.3 On pragmatic grounds, the existing concessions of no indirect expenditure tax on *FRP* seem justifiable, particularly given the desirability of encouraging individuals to provide themselves with life cover.

5.3 *Policyholders' Tax on an Individual Basis*
5.3.1 The difficulties of attaining values for the taxable components of individual policies should not be underestimated. Policyholders (or their assignees) would then need to be notified, and they must then include the result

in their tax return. Formula (1), *IIC − FIP*, may look very simple, but the evaluation of *IIC* effectively requires a knowledge of $B(1)$, $B(0)$ and the invested portion of premiums received for every policy, whether unbundled or not. Even then, the use of formula (1) theoretically requires that *IIC* be separated into its components of income, realised capital gains (or losses) and unrealised capital gains (or losses), assuming (as in most tax systems) that each is taxed on a separate basis.

5.3.2 A practical solution to policyholders' tax on an individual basis, and the one used in the U.S.A. and Canada, is to allow the policyholder to defer tax until he draws a benefit from his policy. However, this method is only approximate, creates a lot of work because tax on each policy is then dealt with on an individual basis, encourages tax planning (cashing up policies in a year when the marginal tax rate is low), inevitably leads to some non-disclosure, deals unfairly with tax losses and still fails to deal properly with the separation of *IIC* into income and capital gains.

5.4 *Policyholders' Tax on a Proxy Basis*

5.4.1 The advantages of the proxy-based tax system are simplicity (particularly for the policyholders of course, but also for the life office and tax authorities), low compliance costs and minimum tax avoidance. The disadvantage is that a single rate of tax is applied irrespective of the individual's marginal rate. The U.K. tax authorities, who have successfully used a proxy-based system for very many years, have largely overcome the potential for tax abuse by the use of *qualifying policies* and *chargeable gains* (see Section A.1.2.). The tendency to flatter scales of tax rates has also served to diminish the problem of having a single rate for proxy tax when policyholders, themselves, may be subject to one of several tax rates.

5.4.2 A very important feature of the proxy-based tax system is the grouping of expenses and investment income (E and I). In addition to simplifying the basis, grouping also allows the benefit of a tax loss by one policyholder to be passed to another. This does not mean that advantage has been taken of those policyholders with tax losses. On the contrary, in any one period policyholders with losses can have those losses partially offset by having their tax loss redistributed. Given that pooling is the essence of insurance, it is more reasonable to group the losses than denying any relief whatsoever.

5.4.3 Where a proxy tax for policyholders is combined with the life office's tax, it is possible for the grouping of I and E to make it appear that a profitable life office is paying insufficient tax. It does not follow, however, that a life office which is paying little by way of tax has artificially inflated its profits. It could (and should) be passing the tax saving through to the relevant policyholders.

5.5 *Life Office Tax*

5.5.1 As derived in Section 4, an appropriate formula for a life office's tax

could either be formula (2) or (3). Of these two, formula (3) appears easier to apply, but still requires a value to be placed on the increase in benefits attributable to policyholders in the period. Because there is room for much debate (and therefore manipulation) in assigning a value to the increase in benefits, a formula (3) approach in practice is clearly not going to be perfect. Nevertheless, it can be made to work — as demonstrated by the fact that it is basically the method which is used in the U.S.A. and Canada.

5.5.2 An interesting observation regarding formula (3) is that it appears to put the tax authorities in the role of a reinsurer. For example, assuming a 30% tax rate, the tax authorities collect 30% of all premiums and investment income, but will effectively pay 30% of expenses and claims. Therefore, once the tax authorities have collected their first tax cheque, they had:

(a) better make sure that they can invest it as wisely as the insurance company; and

(b) hope that the insurance company is a good underwriter!

5.5.3 Where a life office is paying tax as a proxy for the policyholders, the rules for calculating the life office's tax can either be such that the life office's tax is calculated separately or calculated in combination with the proxy tax. A combined proxy tax would seem to be more practical than a non-combined proxy tax.

5.6 *Life Office Tax combined with a Proxy Tax for Policyholders*

5.6.1 The theoretical formula for policyholders' and life office tax combined is formula (4), $I - E + FRP$. Using a combined proxy-based tax has two main advantages: it is simple; and it avoids the disadvantages of having to quantify individual benefit increases as required by formula (3).

5.6.2 Although defining I and E in formula (4) is relatively straightforward, establishing a value for FRP is not. One approach to this problem, and one that has been used in the U.K., is simply to disregard FRP. However, the ignoring of the term FRP has been partly responsible for the 'Excess E' problem which arises in the U.K., and the need for such devices as a minimum tax basis and the enforced and unfair spreading of expenses. Thus, it might suit all parties if the term FRP was brought in explicitly, even if that required a degree of approximation. Three suggestions are given below.

5.6.3 One way of approximating FRP is to arbitrarily fix it as 15% of E, say, so that $I - E + FRP$ becomes $I - 0.85E$. This method has two disadvantages, however. It is subject to political interference, and it fails to discriminate between an office that writes mainly term insurance (with a relatively high FRP) and an office that writes mainly savings business (with a relatively low FRP). It is felt, therefore, that this approximation is probably unacceptable, despite the attraction of its simplicity.

5.6.4 For the second method we turn to RP as a base point for estimating FRP, for it seems reasonable to assume that FRP is proportional to RP. For

example, offices mostly pay commission based on premium income which, in turn, is related to the size of risk. Similarly, the office's expected mortality profit, which is included in *FRP*, can be expected to be proportional to *RP*.

5.6.5 Although it is impossible to ascertain an exact relationship between *FRP* and *RP*, experience suggests that a one-to-one ratio is not unreasonable as an *overall* approximation.The ratio varies by office and contract, of course, but, using the relationship between annual renewable term rates and raw mortality rates as an example, one-to-one seems acceptable. Unfortunately, *RP* is not that easy to estimate objectively either, even though it is still a lot easier than estimating *FRP*.

5.6.6 The third method of approximating *FRP*, and the one that is recommended here, is simply an extension of method two described above. If *RP* can be used as a replacement for *FRP*, then over time so can net death claims (*NDC*), where the 'net' refers to claims net of actual reserves held. However, *NDC* must also be adjusted for reinsurance to avoid double tax. Thus *NDC* becomes *NNDC* where the second '*N*' means net of taxed reinsurance; that is, an office that reduces its claims by using reinsurance could also reduce its tax providing that the reinsurer who meets the claim (using appropriately increased reinsurance rates) also meets the tax. It is therefore suggested, in practice, that $I - E + NNDC$ is substituted for $I - E + FRP$, where *NNDC* means net death claims as defined above.

5.7 *Combined Proxy Tax using* $I - E + NNDC$

5.7.1 Allowing a life office the ability to transfer part of its tax liability to its reinsurers through the use of *NNDC* may seem strange at first. Under a proxy-based system, however, and given that a life office and its reinsurers have common groups of policyholders, the proposal is not unreasonable. Note also that, while the approximation of *FRP* = *RP* may seem unreasonable for reinsurers by themselves, it becomes quite reasonable when reinsurers are grouped with the direct writers.

5.7.2 It is interesting to compare for reinsurers the formula of $I - E + NNDC$ with the U.K. formula of $I - E$. Ignoring products such as 'Income Bonds', which are designed to take advantage of anomalies in the U.K. tax system, $I - E$ for most U.K. reinsurers is usually negative. The addition of *NNDC* to the formula will mean, therefore, that reinsurer's expenses will generally become fully tax deductible. This, and the reduction in the tax liability for the ceding office, would offset the increase in reinsurance rates which would become necessary if $I - E$ became $I - E + NNDC$.

5.7.3 Overseas reinsurers not covered by the *NNDC* regime proposed could still be used, with the tax being covered by the ceding office. Because *NNDC* is defined as claims net of *taxed* reinsurance, the overall competitiveness of overseas reinsurance rates with local reinsurance rates would not be affected.

5.7.4 At this stage, it is useful to step back from the various arguments that lead to $I - E + NNDC$, and examine the result with regard to the criteria of

equity, certainty, consistency and simplicity — the desirable traits of a tax basis:

— *Equity.* Using the test of seeing how difficult it is to decide whether $I - E + NNDC$ gives an answer that is too high or too low compared to the theoretical $I - E + FRP$, the approximation seems fair overall. For individual policies, it is noted that it seems likely that there will be some subsidy of the tax burden by policies with large sums insured, but this is probably acceptable.

— *Certainty.* $I - E + NNDC$ meets the requirements of certainty.

— *Consistency.* $I - E + NNDC$ will give consistency between life offices, but as with any proxy-based tax system, it will inevitably give rise to inconsistencies with other aspects of the tax regime. For some possible policy types it is recognised that the inconsistencies of $I - E + NNDC$ will probably be too large to be acceptable, but see Section 5.8.

— *Simplicity.* $I - E + NNDC$ is clearly very simple.

5.7.5 There are two points that need to be covered regarding the use of $I - E + NNDC$ in practice. First, the tax due on the *NNDC* part of the formula will vary (slightly) with the strength of the office's reserves. To prevent tax avoidance, a simple solution to this is to use for tax purposes the policy's actual surrender value as its reserve. Second, the use of $I - E +NNDC$ will exaggerate an office's mortality experience by increasing tax when death claims are heavy and lowering tax when death claims are light. This will balance out over time, but, if necessary, could be controlled through reinsurance or by allowing *NNDC* to be averaged over a number of years.

5.8 *Tax-Paid and Taxable Life Policies*

5.8.1 Two basic methods have been put forward, a combined proxy tax using $I - E + NNDC$, or a separation of policyholders' tax and life office tax by formulae such as (1) and (3). In practice, however, and this is important, the methods can be used together very easily by applying (from outset) whichever is the most suitable for a given policy type.

5.8.2 The recommendation, therefore, is that life offices are required to divide their policies into tax-paid and taxable types (or *qualifying policies* and *non-qualifying policies*) on a pre-determined basis. In the formulae below, the two types are distinguished by a single dash for tax-paid policies and a double dash for taxable policies. Tax would then be payable as follows:

By the policyholder. No tax on benefits from tax-paid policies, but individual tax, as befits that country's tax environment, on benefits from taxable policies.

By the life office.

On tax-paid policies: $\qquad I' - E' + NNDC'$

On taxable policies: $\qquad P'' + I'' - [B(1)'' - B(0)''] - E''$

On policies in total: $\qquad I - E + NNDC' + P'' - [B(1)'' - B(0)''] \ (5)$

As $I = I' + I''$ and $E = E' + E''$.

5.8.3   It is noted that either or both the tax-paid or taxable classes of policies could be further divided if required.   An appropriate minimum basis could also be separately applied.

5.8.4   Commenting on formula (5), note that taxable business could include single premium unit-linked bonds, for example. Thus $B(1)'' - B(0)''$, for any given period, could be a very large number, positive or negative, because of unrealised gains or losses.   This is not a problem providing that the bulk of investment profits and losses are passed through to the policyholders, and providing that I, which includes I'', is suitably defined.

5.9   *A Minimum Tax Basis*

5.9.1   Minimum tax bases for life offices are used in the U.K. (proprietary companies only), the U.S.A., and, indirectly, in New Zealand. A minimum basis is acceptable when:

(a) It is just a minimum and does not become the norm.
(b) Any extra tax paid because the minimum basis is invoked is carried forward in some way as a credit (thus avoiding the possibility of double tax).   In the U.K., for example, this is achieved by recasting the amount of expenses that are used in the $I - E$ calculation to that which will yield the minimum level of tax required and then carrying forward the unused E.
(c) It is simple, there being no excuse to be otherwise.
(d) It applies to all life offices (and not just proprietary companies, for example).

5.9.2   Remembering that a minimum basis should be nothing more than just a minimum, the following, with appropriate provisions for carrying forward credits, would, perhaps, be suitable as a minimum basis:

$M \times$ the corporate rate of tax, where M is the higher of:
—   the transfer to shareholders (if any) grossed up for tax; and
—   4% (as a very crude profit estimate) of premiums received during the year.

6. SUMMARY

6.1   Whatever tax basis is used, it will need to deal with tax due from life offices and tax due from policyholders. The basis chosen by a country must also fit that country's tax environment. Generally, therefore, life offices should be taxed on their trading profits and policyholders on their investment profits.

6.2   Any suggested solution to the puzzle of finding a practical tax basis for life offices and their policyholders must also be tested against the criteria set out in Section 2.2; that is, that such a basis should be equitable, certain, consistent and simple. However, because these criteria invariably conflict in some way, it has to be accepted that a perfect solution does not exist and approximations will need to be made.

6.3   There is a strong argument (¶2.5.6) that life offices should be exempt from capital gains tax on equities and on buildings which they own and occupy.

6.4 A proxy-based tax has much to commend it, and a proxy-based combined tax even more. A proxy-based tax system (not combined or combined with the life office's tax) can very usefully be used side by side with a non-proxy system, as demonstrated in Section 5.8 using two classes of life policy (tax-paid and taxable).

6.5 Proxy-based tax systems can also be extended to reinsurers, with the reinsurers paying tax on behalf of the direct writers.

6.6 A solution to the puzzle of life office tax is suggested in Section 5. For that part of the tax liability which is collected via a combined proxy method, the formula recommended is $I - E + NNDC$, where $NNDC$ is death claims net of (taxable) reinsurance and policy reserves.

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APPENDIX 1

UNITED KINGDOM LIFE OFFICE TAX

A.1.1 The basic rules underlying the U.K.'s present tax regime for life offices were settled in their current form in the 1920s. As they then stood:
— Policyholders paid no tax directly on their policy benefits. All tax was collected at the level of the life office.
— Life offices paid tax on their life insurance business (at the then standard rate of income tax) on a single tax base, generally calculated as I minus E; that is, on investment income less all expenses of management including commissions.
— Proprietary companies were subject to a minimum level of tax referred to as 'Notional Case 1 Profits'. Where this was applied, it was done so by restricting the amount of expenses that could be used in the I minus E computation. Unused E was allowed to be carried forward.

A.1.2 *Qualifying Policies and Chargeable Gains*
A.1.2.1 An important tempering of the I minus E regime was the introduction in 1968 (and subsequent strengthening in 1975) of the *qualifying policy* rules. A qualifying policy is one which has been certified as such by the Inland Revenue, and in simple terms, requires that savings-type policies should have reasonably level premiums for ten years or more and a death benefit of not less than 75% of premiums due. Benefits from qualifying policies are generally tax free.
A.1.2.2 Life offices are free to issue non-qualifying policies if they wish, but for these, the policyholder will be liable to tax on any *chargeable gains*. With some over-simplification, the tax on chargeable gains is calculated on benefit(s) received less premium(s) paid multiplied by the difference between the policyholder's marginal rate of tax and the basic rate of tax.
A.1.2.3 Inland Revenue statistics for 1983-84 show that only about ten million pounds was collected in that tax year in respect of some 60,000 chargeable events. Nevertheless, the tax on chargeable gains has served the industry well by protecting a main feature of the bulk of its products, that of being tax free in the hands of the beneficiary. It has done this by effectively removing any serious potential for abusing the proxy-based tax system.

A.1.3 *Policyholders' Tax*
A.1.3.1 A deduction for life insurance premiums when calculating taxable income was introduced in 1799 when income tax was introduced, the argument being that life insurance should be encouraged. Although income tax was reintroduced in 1842 (having been repealed in 1816), life insurance premium relief did not return until 1853, the argument this time being that it encouraged savings. Life assurance premium relief then survived unscathed until an

office-based deduction system replaced it in 1979. In 1979, holders of qualifying policies lost their right to a personal deduction from their individual tax assessment, but paid to the life office only 82.5% of the premiums due on their policy(ies), the balance being reclaimed from the Exchequer by the life office. The discount of 17.5% was half the then basic rate of tax, and by 1984, when the basic rate of tax was 30%, had fallen to 15%. This facility was withdrawn from new policies in March 1984.

A.1.3.2 As indicated above, proceeds from a qualifying life policy are almost always tax free.

A.1.3.3 Broadly speaking, annuities are taxed as ordinary income if they are regarded as pensions business; that is, their purchase price was paid from a tax-exempt pension fund for which contributions will generally have been tax deductible, and the interest roll-up tax free. In the hands of the recipient, these annuities are therefore fully taxable.

A.1.3.4 Non-pension annuities are taxed in a way which recognises that an annuity payment is part interest that has not yet been taxed, and part return of capital. The formula for the calculation of the annual *capital content* of an annuity is laid down by the Inland Revenue. It is determined as the purchase price of the annuity divided by the expected duration (in the statistical sense) using a prescribed mortality table; that is, by the actuarial present value of a unit of payment at 0% interest. The recipient of a non-pension annuity is thus taxed at his or her marginal rate of tax on that part of the annuity which is deemed to be interest.

A.1.4 *Life Office Tax*

A.1.4.1 In very simple terms, life office business is divided into two groups. Basic life assurance business (BLAB) and 'other', where 'other' includes pensions business, overseas business, capital redemption insurance, permanent health insurance, and pension fund investment management business. BLAB is taxed on an I minus E basis, subject to a minimum level (for proprietary companies) of 'Notional Case 1 Profits' and with expenses relating to acquisition costs spread over seven years. (Transitional arrangements apply from January 1990 when spreading was introduced.) 'Other' business is basically taxed on profits.

A.1.4.2 The actual life office tax calculations for a U.K. office have become very complicated, and for a detailed description see Mehta & Instance (1990), and such material that updates this. Major changes to U.K. life office tax were made in the 1989, 1990 and 1991 Finance Acts.

A.1.5 '*Excess* E'

A.1.5.1 Rising expense and new business levels coupled with investment policies aimed at capital growth rather than actual income led to something like 25% of U.K. life offices (before the 1990 tax changes) having an E greater than I. These offices are said to have an 'Excess E' position. While it was expected

that new offices would have an 'Excess E' position, a number of well established offices, for the reasons given above, have also found themselves with 'Excess E'.

A.1.5.2 An office in an 'Excess E' position is disadvantaged to the extent that it has to meet part of its expenses without the benefit of tax relief in that income year. Some offices in the past have effectively sold their 'Excess E' through devices such as *Income Bonds* and special reinsurance arrangements.

APPENDIX 2

NEW ZEALAND LIFE OFFICE TAX

A.2.1 New Zealand life offices have had their own rules for tax for nearly a century, and until the last few years, have mostly been favourably treated. It is highly likely that the mutual nature of life insurance business would have been the main reason for this concessionary treatment, but some favouritism probably arose because of the lack of an alternative to the savings and protection offered by a life insurance policy, and because of the Victorian attitudes to thrift.

A.2.2 *From 1891 to 1982*

A.2.2.1 From a tax point of view, the first enactment to accord life insurance companies special treatment was when income tax was introduced in the Income Tax Assessment Act 1891. Clause 4 of Schedule C to that Act provided that companies wholly or mainly carrying on the business of life insurance were to be assessed for income tax at ordinary rates, but only upon investments other than those in land or mortgages.

A.2.2.2 The 1891 Act was amended by the Land and Income Assessment Act 1900, effectively replacing the expression 'wholly or mainly' with 'exclusively', and to include mortgage income in assessable income. The next change, which was set out in Section 96 of the Land and Income Assessment Act 1916, further broadened the tax base by removing the exclusion of investments in land. This second widening of the tax base to include all investment income was presumably considered necessary to help fund the war effort.

A.2.2.3 The next change of any significance was not by way of a broadening or narrowing of the range of items to be included in assessable income, but rather by way of concessional rates of tax. The first of these changes appeared in Section 7 of the Finance Act 1921, as follows:

> "Unless otherwise provided in the annual taxing Act for any year, the amount of income tax payable by any company carrying on the business of life insurance for the year.... shall be one half the amount that would be payable by the company if this section had not been passed."

A.2.2.4 A further concession was granted by the Land and Income Tax Act 1923, Section 95, which permitted a life insurance company to discount its income from investments of any kind by 2% before applying the appropriate tax rate. Although only supposition, the logic for this could well have been that a life office needs to earn a minimum amount on its funds to remain solvent, and therefore should pay tax only on amounts in excess of this.

A.2.2.5 The Land and Income Tax Amendment Act 1930 brought a radical change to the philosophy of taxing life offices which was to last for more than fifty years. Instead of taxing income, life insurance companies were now to be assessed on the amount of bonus allocated to policyholders. The 1930 Act also altered the rate of tax from half to nine-twentieths of the rate paid by other

companies. Apart from minor amendments, the 1930 legislation largely survived untouched until the 1982 legislative amendments to the Income Tax Act 1976.

A.2.3 *From 1982 to 1989*

A.2.3.1 The 1982 legislative amendments introduced a new Section 204 to the 1976 Income Tax Act, and was a return to the old philosophy of taxing investment income. Deductions for the life offices' investment expenses were allowed (but not for any other expenses), and a tax rate fixed at what was estimated to be the policyholders' weighted average marginal tax rate. Thus in 1984, when the top marginal rate was 66%, the life office tax rate was set at 31% — the marginal tax rate for someone on average income.

A.2.3.2 The 1982 changes saw life offices paying a lot more tax than they had in the past, mainly because the previous rules had been so generous; but from 1983 to 1989, the relative position of life offices worsened considerably, with the introduction of an indirect consumption tax (GST), a fringe benefit tax (FBT), a reduction in tax rates for all other companies by almost one third, and the halving in the top rate of marginal tax for individuals from 66% to 33%. Also, in a two-step process in 1984 and 1987, most life insurance premiums ceased to be deductible.

A.2.3.3 The new legislation for 1990 discussed below was, therefore, welcomed by most life offices, despite some criticism on compliance costs and certain aspects of detail.

A.2.4 *From 1990*

A.2.4.1 The 1990 New Zealand life office tax basis is a radical shift from that which applied previously. The main change is the introduction of a proxy-based combined life office tax in addition to a proxy policyholders' tax and the use of tax credits. Tax paid on the life office basis generates imputation credits, which can then be used to meet proxy policyholders' tax or as tax credits on dividends paid to shareholders.

A.2.4.2 The formula for the proxy-based combined life office tax is:

$$I - E + U \tag{6}$$

where I is investment income (including realised capital gains), E is expenses including commissions paid, and U is *underwriting profit*, defined to be the sum of three things: mortality profit; premium loading profit (set at approximately 20% of the expected death strain) and discontinuance profit. Formulae for these are laid down in the legislation, but there is still some significant scope for *actuarial judgement.*

A.2.4.3 The formula for the proxy policyholders' tax is:

$$\frac{C + (V_1 - V_0) - P + U}{1 - r} \tag{7}$$

where C is claims paid, $V_1 - V_0$ is the increase in reserves, P is premiums paid, U is underwriting profit as defined above, and r is the tax rate which is used for the life office tax. The actuary may use any reasonable basis for determining V_0 and V_1, but the opening V_0 for year X must be equal to the closing V_1 for year $(X-1)$.

A.2.4.4 It is of interest to note that the New Zealand authorities have recognised that the formula for policyholders' tax can give rise to a tax on unrealised gains (which does not apply to any other investor), and have thus included in the life office tax legislation special transitional arrangements which will allow a life office, if it so elects, to transfer its superannuation business to a non-life company.

APPENDIX 3

UNITED STATES LIFE OFFICE TAX

A.3.1 In the early years of this century, the U.S. life insurance market was predominantly whole of life and endowment policies issued by mutuals. Mutuals were regarded in the same light as other co-operatives, and the same tax philosophy was applied; that is, that co-operatives exist to provide goods and services to their members at cost, so that any margin in the price, the *customer profits*, should be returned to the members tax free. *Owner profits*, the profits derived by co-operatives from goods and services supplied to non-members, should be taxed.

A.3.2 *Policyholders' Tax*

A.3.2.1 Unlike the (reversionary bonus) method used in the U.K. (distribution of profits by enhancement of the sum insured at no extra cost to the policyholder), the U.S. and Canadian life offices distribute profits by paying *policyholder dividends* in cash or through a premium rebate. Policyholder dividends are deemed to be customer profits, and therefore non-taxable. However, in circumstances where the premium was tax deductible (there are not many of these), the premium to be deducted is netted down for any policyholder dividend.

A.3.2.2 Although policyholder dividends are tax free, policyholders are liable to tax on that part of a maturity or surrender which is deemed to be investment income. In the U.S.A. this is the cash benefit less net premiums, where net premiums are defined as premiums paid less policyholder dividends. Note the definition of net premium does not include a deduction for the portion of the premium used to cover insurance costs.

A.3.2.3 No tax is paid by the policyholder until the policy is surrendered or the policy matures. Under certain conditions, it is possible to exchange one life policy for another without taxable income being triggered on the surrender of the exchanged policy. If the policyholder wishes to raise income without incurring an immediate liability to tax, then he or she can take a policy loan.

A.3.2.4 Except for deferred annuities and some rare situations where the premium is tax deductible, proceeds from death claims are tax free. This is quite anomalous when compared to the situation for maturities and surrenders, but political pressure has to date been sufficient to resist this change.

A.3.2.5 Annuities which have been funded by tax-deductible contributions (typically for superannuation purposes) are taxed as income. For other annuities it is recognised that each payment contains an interest and a capital content, and allowances are made with the intention that only the interest content should be taxable. Abuse of the tax-free roll up of annuity funds by the issue of deferred annuities with attractive surrender values was curtailed by Congress through legislation passed in 1982.

A.3.3 *Life Office Tax*

A.3.3.1 From 1921 to 1958 life offices paid tax on their owner profits. This

was defined to be gross investment income with deductions for investment expenses, interest required to maintain policyholder reserves, and interest paid on policyholder funds on deposit and other indebtedness. Therefore, to the extent that investment income was allocated to policyholders, life offices themselves paid no tax on investment income.

A.3.3.2 The Life Insurance Company Income Tax Act of 1959 introduced a tax on underwriting profits with the important provision, given how underwriting profits were defined, for underwriting losses to be offset against taxable investment income. In overall terms, and with a great deal of simplification, underwriting income was all income other than that which was used to determine owner profits (see ¶A.3.3.1). Underwriting income, therefore, included premium income.

A.3.3.3 The adoption by the tax authorities of the very conservative accounting practices used for regulatory purposes by the state insurance departments had the effect, as intended, of giving favourable tax treatment to underwriting profits. The overall effect, and again this is simplified, was for offices to pay tax on owner profits with a deduction for policyholder dividends.

A.3.3.4 The 1959 legislation was not suited to a high inflation and interest rate environment, and was replaced in 1982 by temporary *stopgap* legislation, following the life office industry's estimated saving of $2 billion in tax revenue over the period 1979-1981 through the use of reinsurance tax deals.

A.3.3.5 The stopgap legislation recognised that policyholder dividends were rarely all customer profits and usually included a measure of owner profits. It was, therefore, considered appropriate in the tax calculations to limit the deduction for policyholder dividends to 77.5% for mutual companies and 85% for proprietary companies. Theoretical considerations aside, it is of interest to note that this differential was seen as a way to establish a competitive balance between the proprietary companies and the mutuals. It also boosted the Government's tax yield.

A.3.3.6 The Life Insurance Tax Act 1984 was a *true* income tax in that it taxed income from all sources. It has subsequently been amended by the Tax Reform Act 1986 which, amongst other things, provided for the top rate of marginal tax for individuals to be cut from 50% to 28%. This compares with a federal rate of tax for life offices of 34%, to which state premium taxes of usually 2% or 3% of all premiums received are payable in addition. The effective rate of tax of just under 40% may sound high when compared to individual tax rates, but the definition of the tax base makes the rate not too unreasonable. It is still necessary, for example, for life offices to be subject to the self-descriptive minimum tax legislation which is also applied to individuals and other corporations.

A.3.3.7 Further changes to the legislation which have taken place since August 1988 are not detailed here.

APPENDIX 4

CANADIAN LIFE OFFICE TAX

A.4.1   This appendix needs to be read in conjunction with Appendix 3.   It covers the period to August 1988.

A.4.2   In the years prior to 1969, the Canadian taxation of life insurance companies was very simple indeed.   Mutual offices paid no income tax, and proprietary companies were taxed on amounts transferred to their shareholders' accounts.   Not surprisingly, the revenue raised from life companies was insignificant.

A.4.3   A system of tax based on owner profits was introduced in 1969, and the salient features of that system still apply.   The present Canadian system, although differing significantly in most areas of detail, is similar overall to the U.S. system.   Thus tax is based on total income (including premium income), the provinces apply a premium tax, and policyholders are taxed on surrender and maturity values (but not death claims) if they are deemed to have received investment income.   Some of the important variations from the U.S. system are listed below:

(a)   From 1969 to 1977 and again from 1988, Canada taxes the investment income element of life insurance and annuity policies indirectly by levying a 15% tax on the companies' investment income in addition to the normal corporate tax. This special investment income tax is known as Part XII tax.

(b)   For tax purposes, Canada treats proprietary companies and mutuals alike.

(c)   Canada has no arrangements for exchanging one policy for another without incurring a taxable event.   This discourages policy replacements.

(d)   The calculation of a policyholder's tax liability on deemed investment income on a maturity or surrender value includes an allowance for the portion of the premium that was used to cover the insurance costs, and is, therefore, less generous to the policyholder and more complicated than the U.S. equivalent.

(e)   Canada, unlike the U.S.A., has a modified imputation system. This affects both corporations and individuals.   The rate of corporation tax in Canada, including tax due to the provinces, is approximately 43% (which compares with the U.S. rate, including state taxes, of just under 40%).

(f)   For tax purposes, Canada treats policy loans as an advance of policy proceeds and repayments of loans as premiums.   A loan from a bank, however, which uses the policy as collateral, is still treated as a loan and does not trigger a taxable event.

(g)   U.S. unbundled products (called *variable* products) are treated the same way as other U.S. life business.   In Canada, however, the funds to which these products are linked are treated for income tax purposes as a trust.   This is somewhat disadvantageous to the policyholder when compared to other life

insurance products, so unbundled business is not expected to become a very important part of Canadian office portfolios.

(h) Since 1985, Quebec has levied its 9% retail sales tax on all premiums other than individual life and health insurance. The original Quebec budget proposal only exempted the savings element of life insurance premiums, but its application was subsequently limited following strong political opposition.