

Date: 20080115

Docket: A-490-06

Citation: 2008 FCA 14

**CORAM: DÉCARY J.A.
PELLETIER J.A.
RYER J.A.**

BETWEEN:

HER MAJESTY THE QUEEN

Appellant

and

THE NATIONAL LIFE ASSURANCE COMPANY OF CANADA

Respondent

Heard at Toronto, Ontario, on November 7, 2007.

Judgment delivered at Ottawa, Ontario, on January 15, 2008.

REASONS FOR JUDGMENT BY:

RYER J.A.

CONCURRED IN BY:

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REASONS FOR JUDGMENT

RYER J.A.

[1] This is an appeal from a decision of Hershfield J. of the Tax Court of Canada (2006 TCC 551), dated October 13, 2006, allowing the appeal of The National Life Assurance Company of Canada (the “taxpayer”) from reassessments of its income tax liability for its 1997 and 1998 taxation years pursuant to the *Income Tax Act*, R.S.C. 1985, c. 1 (5th Supp.) (the “ITA”). The reassessments reduced the amount of the policy reserve deduction that the taxpayer claimed pursuant to subparagraph 138(3)(a)(i) for its 1997 and 1998 taxation years, with the result that the taxable income of the taxpayer was increased in each of those years.

[2] The issue before this Court relates to the calculation of the amount of the deduction that the taxpayer is entitled to claim as a policy reserve, pursuant to subparagraph 138(3)(a)(i) (the “Policy Reserve Deduction”), in respect of certain of its segregated fund policies, as defined in subparagraph 138.1(1)(a) (the “Segregated Fund Policies”), in each of the taxation years under consideration. The resolution of this issue requires the Court to interpret paragraph 1406(b) of the *Income Tax Regulations*, C.R.C., c. 945 (the “ITR”), which provides a direction with respect to the calculation of an amount that is an essential component in the determination of the Policy Reserve Deduction. Unless otherwise indicated, all statutory references in these reasons are to the corresponding provisions of the ITA and the ITR for the taxation years under consideration.

INTRODUCTION

[3] A Segregated Fund Policy is a life insurance policy, within the meaning of subsection 248(1) (a “life insurance policy”), under which the life insurer, within the meaning of subsection 248(1) (a “life insurer”), has an obligation to make benefit payments (“Variable Benefit Payments”) that vary in amount depending upon the fair market value of a specific group of properties that have been segregated from the other assets of the life insurer and are maintained in a separate fund (a “Segregated Fund”, within the meaning of subsection 138.1(1)). A Segregated Fund Policy may also contain an obligation on the part of the life insurer to make a payment (a “Minimum Guaranteed Benefit Payment”) to ensure that Variable Benefit Payments made thereunder are not less than a minimum amount.

[4] According to the publication of the federal Department of Finance, *Canada's Life and Health Insurers* (September 2002), segregated funds may be described in the following terms:

Segregated funds, available only from life and health insurance companies, are similar to mutual fund products offered by other financial institutions in that they offer shares of investment funds in a variety of securities (e.g. equities, bonds, balanced funds). However, they differ from mutual fund products in that a minimum percentage of the investment – usually 75 percent or more – must be returned to the investor when the fund matures. The term “segregated” is used because the funds must be kept separate, or segregated, from the other assets of the insurance company.

The nature of segregated funds has also been described in *Norwood on Life Insurance Law in Canada*, 3rd ed. (Toronto: Carswell, 2002) at page 81, as follows:

Variable insurance or annuities, under both individual and group policies, are distinguishable by the fact that the amount of the benefits or values varies depending on the market value, from time to time, of the specific segregated assets which the insurer holds as its reserves for the policies. In other words, the benefits and values are not fixed or guaranteed. The insurer, however, may include a certain minimum guaranteed surrender or maturity benefit and, if so, the marketing of these policies is given exemption from securities legislation. **[Footnote: Usually, the insurer guarantees a 75 percent surrender or maturity value.]** But, with or without such minimum guarantees, the contractual aspects of all variable policies are governed by the life insurance legislation applicable to life insurance contracts.

The Policy Reserve Deduction Generally

[5] Life insurance corporations, within the meaning of subsection 248(1) (“life insurance corporations”), are subject to taxation under the ITA in the same general manner as other corporations, but they are also subject to a number of special rules that recognize the unique nature of the life insurance industry. In computing its income for a taxation year, a life insurer is required to include all premiums that it receives and is permitted to deduct all benefits that it pays under its life insurance policies. While the ITA generally prohibits the deduction of reserves in respect of contingent liabilities, life insurance corporations are permitted to deduct reserves in respect of a

number of types of contingent liabilities. The ITA also requires that the amount of any reserve that is deducted by a life insurance corporation in a taxation year must be included in the computation of its income for its next taxation year.

[6] A life insurer is entitled to deduct a Policy Reserve Deduction for a taxation year in respect of its life insurance policies. A separate policy reserve is determined in respect of each of the life insurance policies of the life insurer, pursuant to the applicable provisions of the ITR, and the aggregate of those individual reserves is the Policy Reserve Deduction that the insurer may claim for the year. For post-1995 insurance policies, as defined in subsection 1408(1) (“post-1995 insurance policies”), such as those under consideration in this appeal, the applicable provision is subsection 1404(1). Paragraph (a) of that provision stipulates that the maximum amount that may be claimed by the life insurer for a taxation year in respect of those policies is the amount determined under subsection 1404(3) in respect of the life insurer for that year, provided that amount is positive.

[7] The amount determined under subsection 1404(3) for a taxation year in respect of the post-1995 life insurance policies of a life insurer is the positive or negative amount determined by the formula $A + B + C + D - M$ (the “Tax Reserve Formula”). Component A of that formula (the “component A amount”), the only item that is relevant for the purposes of this appeal, is an amount in respect of the post-1995 life insurance policies of the life insurer for a taxation year equal to the lesser of the two amounts:

- (a) the total of the reported reserves, as defined in subsection 1408(1), (a “Reported Reserve”) of the insurer at the end of the year in respect of those policies; and

- (b) the total of the policy liabilities, as defined in subsection 1408(1), (a “Policy Liability”) of the insurer at the end of the year in respect of those policies.

[8] The Reported Reserve in respect of a life insurance policy is defined in subsection 1408(1) to mean, essentially, the amount of the reserve that would be reported to the life insurer’s regulator in respect of the insurer’s potential liability under the policy in respect of a year if the reserve had been determined without reference to projected income and capital taxes (other than the tax payable under Part XII.3 of the ITA). The Policy Liability in respect of a life insurance policy is defined in subsection 1408(1) to mean, essentially, the amount of the reserve of the insurer in respect of its potential liability under the policy in respect of a year, determined in accordance with accepted actuarial practice, but without reference to projected income and capital taxes (other than the tax payable under Part XII.3 of the ITA).

Income Tax Treatment of Segregated Funds

[9] For income tax purposes, Segregated Fund Policies are considered to be so fundamentally different from other life insurance policies that they are governed by specific rules under the ITA. Those rules are contained in section 138.1 and may be summarized as follows:

- (a) an *inter vivos* trust (a “Related Segregated Fund Trust”) is deemed to have been created and to continue in existence while a Segregated Fund is in existence and the value of the properties held in it determines the amount of any benefits (i.e. Variable Benefit Payments) payable under the related Segregated Fund Policies (paragraph 138.1(1)(a));

- (b) all property in the Segregated Fund and all of the income generated by that property are deemed to belong to the Related Segregated Fund Trust and not to be the property or income of the life insurer (paragraph 138.1(1)(b));
- (c) the life insurer is deemed to be the trustee of the Related Segregated Fund Trust (paragraph 138.1(1)(c));
- (d) holders of Segregated Fund Policies who have paid premiums that were used to fund property in a Segregated Fund are deemed to have an interest in the Related Segregated Fund Trust that is not in any particular property in the Segregated Fund and those premiums are deemed not to be premiums paid under the Segregated Fund Policy (paragraph 138.1(1)(e));
- (e) the income of the Related Segregated Fund Trust is deemed to be payable to its beneficiaries, the holders of the Segregated Fund Policies, in amounts to which they are entitled under the terms of those policies (paragraph 138.1(1)(f)); and
- (f) the obligation of the life insurer to make benefit payments under a Segregated Fund Policy that vary with the fair market value of the property in the Segregated Fund at the time that such benefits become payable (i.e. Variable Benefit Payments) are deemed to be obligations of the Related Segregated Fund Trust, and not the life insurer, and any amount received by a policyholder in respect of those obligations is deemed to be proceeds from the disposition of an interest in the Related Segregated Fund Trust (paragraph 138.1(1)(j)).

[10] The impact of these rules on a life insurer is significant. Under paragraph 138.1(1)(e), premiums paid by policyholders under Segregated Fund Policies are deemed not to have been paid as premiums under those policies. Accordingly, unlike premiums received by a life insurer under other types of insurance policies, premiums received by an insurer under a Segregated Fund Policy are not required to be included in the income of the life insurer for the year of receipt. Moreover, under paragraph 138.1(1)(j), the obligations of the life insurer to make Variable Benefit Payments are deemed to be the obligations of the Related Segregated Fund Trust, and not the life insurer. Accordingly, unlike benefit payments made by a life insurer under other types of insurance policies, Variable Benefit Payments made by a life insurer under a Segregated Fund Policy are not deductible to the life insurer in computing its income for the year of payment.

The Policy Reserve Deduction and Segregated Fund Policies

[11] Although section 138.1 provides specific rules with respect to the taxation of life insurers in respect of their Segregated Fund Policies, that section is not a complete code and does not preclude the application of the other provisions of the ITA that apply to life insurers. In particular, nothing in section 138.1 or in any other provision of the ITA prevents a life insurer from claiming a Policy Reserve Deduction in respect of its Segregated Fund Policies. However, in recognition of the special characteristics of Segregated Fund Policies, paragraph 1406(b) mandates adjustments to the determination of the Policy Reserve Deduction in respect of those policies. That provision, which is at the heart of this appeal, reads as follows:

1406. Any amount determined under section 1404 or 1405 shall be determined

1406. Les montants déterminés selon les articles 1404 et 1405 sont calculés comme suit :

(b) without reference to any liability in respect of a segregated fund (other than a liability in respect of a guarantee in respect of a segregated fund policy).

b) compte non tenu du passif relatif à un fonds réservé, sauf le passif relatif à une garantie au titre d'une police à fonds réservé.

[12] Paragraph 1406(b) provides that the Policy Reserve Deduction that a life insurer may claim in respect of the Segregated Fund portion of its Segregated Fund Policies does not include any liability in respect of a Segregated Fund other than a liability in respect of a guarantee in respect of a Segregated Fund Policy.

BACKGROUND

[13] The basic facts are relatively straightforward, which is, no doubt, why the hearing before the Tax Court of Canada proceeded on an Agreed Statement of Facts.

[14] The taxpayer was a life insurance corporation at all times during the taxation years that are under consideration in this appeal. In those taxation years, the taxpayer issued policies, known as “UltraFlex policies”, that constituted Segregated Fund Policies (“UltraFlex policies”). The Segregated Fund Policies that are the subject of this appeal are post-1995 insurance policies.

[15] An UltraFlex policy was described in the Agreed Statement of Facts as “a flexible premium variable deferred annuity which offers both segregated funds and Guaranteed Accounts (similar to GICs) investment options. Policyholders may choose to purchase units of any of five Segregated Funds and/or deposit funds into Guaranteed Accounts”.

[16] Where a policyholder under an UltraFlex policy has chosen to purchase units of a Segregated Fund, that policyholder will be entitled to both Variable Benefit Payments and a Minimum Guaranteed Benefit Payment.

[17] During the period in which a policyholder holds units in a Segregated Fund under an UltraFlex policy, the value of those units will be affected by fluctuations in the market value of the properties in that Segregated Fund and by:

- (a) additional cash contributions to the Segregated Fund;
- (b) investment returns generated by the assets in the Segregated Fund;
- (c) commissions, administrative charges and management fees payable to the life insurer out of the assets in the Segregated Fund;
- (d) payments of death and maturity benefits to policyholders; and
- (e) payments to policyholders on redemptions or surrenders of their units prior to death or maturity of their policies, less any applicable redemption or surrender charges.

[18] For the taxation years under consideration, the relevant authority, within the meaning of subsection 248(1), of the taxpayer was the Superintendent of Insurance under the *Insurance Companies Act*, S.C. 1991, c. 47, and the taxpayer was required to report to the Office of the Superintendent of Financial Institutions (“OSFI”) pursuant to that legislation. In those years, the taxpayer filed reports with OSFI that contained policy reserve calculations in respect of its life insurance policies, including its UltraFlex policies. There is no dispute with respect to any of the

computations made by the taxpayer in calculating either the Reported Reserves or the Policy Liabilities in respect of its UltraFlex policies for those years.

[19] A single policy reserve is determined in respect of each UltraFlex policy notwithstanding that each such policy may contain a Guaranteed Account portion and a Segregated Fund portion. It is only the policy reserve calculations in respect of the Segregated Fund portion of the UltraFlex policies that are in issue in this appeal.

[20] The methodology that was used by the taxpayer to calculate its policy reserves in respect of the Segregated Fund portion of the UltraFlex policies, for regulatory purposes, was described in the actuarial reports that the taxpayer filed with OSFI. That methodology consisted of a formula (the “Actuarial Reserve Formula”) that was reproduced at page 604 of the Appeal Book, in respect of the 1997 filing with OSFI, as follows:

5.3.2 RESERVE for SEGREGATED FUND LIABILITIES

Total reserve for this block of business can be described by the following formula

$$\text{Total Reserve} = A + B + C$$

- A = A liability equal to the segregated fund account balance. This liability is included in National Life’s Segregated Fund Statements and, therefore, not part of the general fund reserve.
- B = A “PPM Reserve” calculated as the present value of future commissions, investment and administrative expenses, less the present value of future management fees and surrender charges. Since renewal management fees and loadings are greater than the renewal commissions and expenses, “B” is usually a negative number.
- C = Reserve for minimum death and maturity benefit guarantees.

The amounts determined under elements A, B and C of the Actuarial Reserve Formula are referred to in these reasons as the “sub-component (i) amount”, “sub-component (ii) amount” and “sub-component (iii) amount” respectively.

[21] This methodology utilized the so-called “policy premium method”, or “PPM”. In the years under consideration, this methodology was in accordance with generally accepted actuarial practice as prescribed by the Canadian Institute of Actuaries, and with generally accepted accounting principles as prescribed by the Canadian Institute of Chartered Accountants.

[22] A summary of the calculation of the policy liability of the taxpayer in respect of the Segregated Fund portion of the UltraFlex policies is reproduced at page 608 of the Appeal Book in respect of 1997 and at pages 806 and 807 of the Appeal Book in respect of 1998. Copies of those summaries are attached to these reasons as Appendices “A” and “B” respectively. The references in those summaries to “Individual Annuities” are references to the Segregated Fund portions of the UltraFlex policies. The amounts referred to in column 5 of each of those summaries (“Total Liabilities”) are the actuarially determined policy reserves in respect of the Segregated Fund portions of the UltraFlex policies (totalling approximately \$274,193,000 for 1997 and \$375,628,000 for 1998). The amounts referred to in column 2 of each of those summaries (“Liabilities Carried in the Segregated Fund” – the sub-component (i) amount) are required to be, and were in fact, separately reported in the taxpayer’s annual report on Form OSFI 85 as “contractholders’ equity”.

[23] In computing its income for its 1997 and 1998 taxation years, the taxpayer determined the amount of its Policy Reserve Deduction in respect of the Segregated Fund portion of the UltraFlex policies without reference to the sub-component (i) amounts and sub-component (ii) amounts.

[24] The Minister reassessed the taxpayer for its 1997 and 1998 taxation years on the basis that paragraph 1406(b) requires the calculation of the amount of the Policy Reserve Deduction in respect of the Segregated Fund portion of the UltraFlex policies to be made on a basis that included the sub-component (ii) amounts. The effect of the reassessments was that the Policy Reserve Deduction of the taxpayer was reduced by \$7,922,000 in respect of its 1997 taxation year and by \$15,770,000 in respect of its 1998 taxation year, and that the taxable income of the taxpayer for each of those taxation years was increased by \$7,922,000 and \$7,848,000 respectively.

[25] The taxpayer objected to these reassessments, the Minister confirmed them and the taxpayer appealed to the Tax Court of Canada.

THE DECISION OF THE TAX COURT OF CANADA

[26] Hershfield J. explained the key provisions of the ITA and the ITR that operate to provide a Policy Reserve Deduction to a life insurer in respect of post-1995 life insurance policies. He focused on subsection 1404(3), which sets out the Tax Reserve Formula that gives rise to the maximum tax actuarial reserve (essentially the Policy Reserve Deduction) that may be claimed by a taxpayer in a year. In the circumstances, he determined that the relevant portion of the Tax Reserve Formula was

the component A amount, which is the lesser of the two amounts: the Reported Reserves and the Policy Liabilities in respect of the UltraFlex policies at the end of the years in question.

[27] Hershfield J. found that the amounts of the Reported Reserves and Policy Liabilities were derived from “formalistic actuarial calculations” that are “wholly external” to the ITA and the ITR, and are required to be made in accordance with three components that are essentially the same as the three components in the Actuarial Reserve Formula. He then concluded that the Reported Reserves and Policy Liabilities are required to be recalculated on the basis set forth in paragraph 1406(b), which he concluded was directed at the three components in the Actuarial Reserve Formula.

[28] The issue before Hershfield J. was whether paragraph 1406(b) requires the sub-component (ii) amount to be excluded from the calculation of the component A amount for the purpose of determining the amount of the Policy Reserve Deduction that the taxpayer was permitted to claim in respect of the UltraFlex policies for the 1997 and 1998 taxation years.

[29] Hershfield J. concluded that while the intended outcome of the application of the Actuarial Reserve Formula is to derive a liability of the taxpayer, it does not necessarily follow that each component of the Actuarial Reserve Formula is, itself, a liability. Accordingly, he found that the sub-component (ii) amount cannot, for that reason, be excluded from the calculation of the component A amount. He nonetheless concluded that, whether or not it is itself a liability, the sub-component (ii) amount, or alternatively its core elements, are calculated with reference to liabilities

in respect of a Segregated Fund, and on that basis, the sub-component (ii) amount is to be excluded from the calculation of the component A amount. This result flowed from the broad language of paragraph 1406(b), which provides that the component A amount must be determined without reference to any liability in respect of a Segregated Fund, which includes any policyholder liability in addition to any life insurer liability in respect of a Segregated Fund. Accordingly, he allowed the appeal.

STATUTORY PROVISION

[30] The principal statutory provision that is relevant to this appeal is paragraph 1406(b) which reads as follows:

1406. Any amount determined under section 1404 or 1405 shall be determined

(b) without reference to any liability in respect of a segregated fund (other than a liability in respect of a guarantee in respect of a segregated fund policy).

1406. Les montants déterminés selon les articles 1404 et 1405 sont calculés comme suit :

b) compte non tenu du passif relatif à un fonds réservé, sauf le passif relatif à une garantie au titre d'une police à fonds réservé.

ISSUE

[31] The issue in this appeal is the application of paragraph 1406(b) to the determination of the Policy Reserve Deduction that the taxpayer is entitled to deduct in its 1997 and 1998 taxation years in respect of the Segregated Fund portion of the UltraFlex policies.

ANALYSIS

General

[32] The determination of the Policy Reserve Deduction to which the taxpayer is entitled in respect of its life insurance policies in the taxation years under appeal requires the aggregation of each amount that is determined to be a component A amount in respect of each of those policies.

[33] The starting point in the determination of the component A amount in respect of the UltraFlex policies for the taxation years in question is the determination of the Reported Reserves and the Policy Liabilities in respect of those policies for those years. Once determined, those amounts must be adjusted in accordance with paragraph 1406(b) to produce the actual component A amount in respect of those policies for those years.

[34] The Reported Reserves and Policy Liabilities in respect of the UltraFlex policies of the taxpayer for the taxation years under consideration are the same amount. The parties agree that such amount must be the subject of an adjustment under paragraph 1406(b) but they disagree as to the basis upon which the adjustment must be made.

[35] The parties approached the question of the adjustment of the component A amount that is mandated by paragraph 1406(b) by reference to the sub-components of the Actuarial Reserve Formula. They agreed that the sub-component (i) amount should be excluded from the determination of the adjusted component A amount. The taxpayer contended that the sub-component (ii) amount should also be excluded from that determination, while the Crown argued

that it should not. While I am not inclined to say that focusing on the sub-components of the Actuarial Reserve Formula is misguided, as will be seen, I have chosen a somewhat different approach to the determination of the appropriate amount of the Policy Reserve Deduction in respect of the Segregated Fund portion of the UltraFlex policies for the taxation years under consideration.

Illustration

[36] The practical effect of the contentions of the parties can be observed by reference to the application of the Actuarial Reserve Formula to the Segregated Fund portion of the UltraFlex policies for 1997, as depicted in the following table.

UltraFlex Policies 1997	
Guaranteed Accounts *	N/A
Segregated Fund	
• sub-component (i)	\$ 283,498,000
• sub-component (ii)	- 9,794,000
• sub-component (iii)	<u>489,000</u>
Total Actuarial Liability	\$ 274,193,000

* The parties agreed that the Guaranteed Accounts portion of the UltraFlex policies were not in issue in this appeal.

Assuming, for the purposes of illustration, that the Segregated Fund portions of those UltraFlex policies were the only life insurance policies of the taxpayer for 1997, the amount determined under the Actuarial Reserve Formula for 1997 in respect of those policies would be \$274,193,000. That amount would then become the component A amount in respect of those policies, before the application of paragraph 1406(b).

[37] Under the Crown's contention, in the assumed circumstances, the application of paragraph 1406(b) to exclude only the sub-component (i) amount would result in the component A amount being -\$9,305,000 for 1997. In other words, according to the Crown, the taxpayer would not be permitted to deduct any amount as a Policy Reserve Deduction for 1997, and would actually have an income inclusion, by virtue of paragraph 12(1)(e.1), of \$9,305,000 for that year.

[38] Under the taxpayer's contention, the application of paragraph 1406(b) to exclude both the sub-component (i) amount and the sub-component (ii) amount would result in the component A amount being \$489,000 for 1997. That amount would then be the amount of the Policy Reserve Deduction that the taxpayer would be permitted to claim in that year in respect of the Segregated Fund portion of the UltraFlex policies.

Interpretation of Paragraph 1406(b)

[39] The text of paragraph 1406(b) of the ITR is relatively short and bears repetition:

1406. Any amount determined under section 1404 or 1405 shall be determined

1406 Les montants déterminés selon les articles 1404 et 1405 sont calculés comme suit :

(b) without reference to any liability in respect of a segregated fund (other than a liability in respect of a guarantee in respect of a segregated fund policy).

b) compte non tenu du passif relatif à un fonds réservé, sauf le passif relatif à une garantie au titre d'une police à fonds réservé.

[40] In the circumstances of this appeal, the opening words of section 1406 contemplate that it is the component A amount in respect of the Segregated Fund portion of the UltraFlex policies that

must be determined in accordance with the directions contained in paragraph 1406(b). That provision directs that the component A amount must be determined without reference to “any *liability* in respect of a segregated fund” but then goes on to require that such amount be determined having regard to “a *liability* in respect of a guarantee in respect of a segregated fund policy”.

[41] Some assistance in the discernment of the appropriate interpretation of the term “liability” in paragraph 1406(b) can be found by reference to the statutory context of that provision, as well as its purpose.

[42] Paragraph 1406(b) plays a part in the ascertainment of the Policy Reserve Deduction that a life insurer may claim in respect of its future payment obligations under each of its Segregated Fund Policies. The ascertainment of the amount of that deduction has essentially been left to the actuarial profession, having regard to the definitions of Reported Reserves and Policy Liabilities, which underpin the determination of the component A amount. Accordingly, a contextual consideration of the term “liability” in paragraph 1406(b) indicates that it should be given a meaning that is consistent with the actuarial interpretation of that term and therefore should be interpreted to mean a liability as determined under actuarial principles.

[43] The broad purpose of paragraph 1406(b) is to reconcile the different regulatory and income tax treatments of life insurers in respect of their obligation to make Variable Benefit Payments under Segregated Fund Policies, whether or not such policies also contain an obligation to make a

Minimum Guaranteed Benefit Payment. In the circumstances under consideration, the taxpayer was obligated to make both types of benefit payments under the UltraFlex policies.

[44] For regulatory and legal purposes, the obligations to make Variable Benefit Payments and a Minimum Guaranteed Benefit Payment under a Segregated Fund Policy are obligations of the life insurer. However, for income tax purposes, only the obligation to make a Minimum Guaranteed Benefit Payment rests with the life insurer. By virtue of paragraph 138.1(1)(j), the obligation to make Variable Benefit Payments is deemed to be the obligation of the Related Segregated Fund Trust, and not the life insurer.

[45] As a result, it would be inappropriate to permit a life insurer to claim a Policy Reserve Deduction in respect of an obligation to make Variable Benefit Payments when the life insurer is deemed, for the purposes of Part I of the ITA, not to have that obligation. The purpose of paragraph 1406(b) is to provide the necessary reconciliation by reducing the component A amount, and therefore the Policy Reserve Deduction that a life insurer may claim in respect of the Segregated Fund portion of a Segregated Fund Policy, to the extent that the component A amount includes an amount in respect of the obligation of the life insurer to make Variable Benefit Payments.

[46] Paragraph 1406(b) uses the term “liability” twice. It refers to a liability in respect of a Segregated Fund and to a liability in respect of a guarantee in respect of a Segregated Fund Policy. In my view, the initial use corresponds to the actuarial liability of a life insurer in respect of its obligation to make Variable Benefit Payments under such a policy and the second use corresponds

to the actuarial liability of the life insurer in respect of its obligation to make a Minimum Guaranteed Benefit Payment under such a policy. Furthermore, I interpret that provision as mandating a reduction in the component A amount of a life insurer in respect of the Segregated Fund portion of a Segregated Fund Policy, for a particular taxation year, by an amount equal to the actuarially determined liability of the life insurer in respect of its obligation to make Variable Benefit Payments under such portion of such a policy for that year. It is apparent from the bracketed words in paragraph 1406(b) that this mandated reduction does not extend to any actuarially determined liability of the life insurer in respect of its obligation to make a Minimum Guaranteed Benefit Payment under such portion of such a policy in that year.

Application

[47] The single amount that is determined by the application of the Actuarial Reserve Formula to the Segregated Fund portion of the UltraFlex policies represents the aggregation of the actuarial liabilities of the taxpayer in respect of its obligations to make Variable Benefit Payments and the Minimum Guaranteed Benefit Payment under those policies. That single amount is the component A amount in respect of those policies. In my view, the language of paragraph 1406(b) requires the component A amount to be reduced by the full amount determined under the Actuarial Reserve Formula excluding only the amount determined to be the actuarial liability of the taxpayer in respect of its obligation to make the Minimum Guaranteed Benefit Payment under the UltraFlex policies.

[48] The actuarial liability of the taxpayer in respect of its obligation to make a Minimum Guaranteed Benefit Payment under the UltraFlex policies has been determined. It is the sub-

component (iii) amount that appears in the Actuarial Reserve Formula. Accordingly, the determination of the amount of the reduction in the component A amount in respect of the Segregated Fund portion of those policies that is mandated by paragraph 1406(b) becomes a simple matter of subtraction.

[49] Reverting to the illustration in paragraph 35, if the component A amount is \$274,193,000 and the actuarial liability in respect of the obligation to make the Minimum Guaranteed Benefit Payment is \$489,000, then the amount of the reduction of the component A amount would be $\$274,193,000 - \$489,000$ or \$273,704,000. As a result, the adjusted component A amount would be \$489,000, which would then be the Policy Reserve Deduction in the assumed circumstances.

[50] The effect of this conclusion is that the sub-component (ii) amount may be considered to relate to the obligation of the taxpayer to make Variable Benefit Payments under the Segregated Fund portion of the UltraFlex policies (i.e. the sub-component (i) amount). The Crown argues that this approach is incorrect on the basis that the sub-component (ii) amount should be considered to relate to the obligation of the taxpayer to make the Minimum Guaranteed Benefit Payment under the UltraFlex policies (i.e. the sub-component (iii) amount). With respect, I cannot agree. The flaw in the Crown's argument is apparent when one considers that a given Segregated Fund Policy may not in fact contain an obligation on the part of the life insurer to make a Minimum Guaranteed Benefit Payment. The Actuarial Reserve Formula that would be applied to determine the actuarial liability of the life insurer under such a policy would nonetheless contain a sub-component (ii) amount, even though there would be no sub-component (iii) amount (i.e. no amount in respect of an

obligation to make a Minimum Guaranteed Benefit Payment). The sub-component (ii) amount cannot relate to an obligation to make a Minimum Guaranteed Benefit Payment that does not exist under a Segregated Fund Policy. This supports the conclusion that the sub-component (ii) amount relates to the obligation to make Variable Benefit Payments under a Segregated Fund Policy and, therefore, that such amount must not be excluded in the determination of the adjusted component A amount in respect of such a policy in accordance with paragraph 1406(b).

[51] My conclusion is essentially the same as that reached by Hershfield J., although I reached my conclusion using a somewhat different approach. Accordingly, except to the limited extent referred to below, I would dismiss the appeal.

DISPOSITION

[52] The parties agreed that Hershfield J. erred to the extent that he stated that the result of the reassessment of the 1998 taxation year of the taxpayer in respect of the issue under consideration in this appeal was an increase in the taxable income of the taxpayer for that year of \$15,770,000. The parties agree that the amount of that increase was \$7,848,000. To that extent only, I would allow the appeal. Otherwise, I would affirm the judgment of Hershfield J. and would award costs to the taxpayer.

“C. Michael Ryer”

J.A.

“I agree.
Robert Décary J.A.”

“I agree.
J.D. Denis Pelletier J.A.”

5.3.2.3 Summary of Liabilities held for Segregated Fund Policies

Fund	Amount of Reserves (\$'000)				Basis of Valuation	Basis of Investment Management Fee
	Liabilities carried in the Segregated Fund	Reserves for Guaranteed Benefits carried in the life General Fund	PPM Reserves for Future Expenses less Future Management Fee	Total Liabilities		
<i>National Equities Fund</i>						
Individual Annuities	105,505	182	-3,552	102,165	See 5.3.2.2	See 5.3.2.1
Others	66,236	0	0	66,326	N/A	N/A
Subtotal:	171,831	182	-3,552	168,491		
<i>National Fixed Income Fund</i>						
Individual Annuities	33,317	59	-1,142	32,234	See 5.3.2.2	See 5.3.2.1
Other	22,781	0	0	22,781	N/A	N/A
Subtotal:	56,098	59	-1,142	55,015		
<i>National of Canada Fund</i>						
Individual Annuities	389	0	0	389	N/A	N/A
Other	0	0	0	0	N/A	N/A
Subtotal:	389	0	0	389		
<i>National Money Market Fund</i>						
Individual Annuities	8,278	0	-325	7,953	N/A	N/A
Other	2,718	0	0	2,718	N/A	N/A
Subtotal:	10,996	0	-325	10,671		
<i>National Balanced Fund</i>						
Individual Annuities	94,615	172	-3,338	91,449	See 5.3.2.2	See 5.3.2.1
Others	64,615	0	0	64,615	N/A	N/A
Subtotal:	159,230	172	-3,338	156,064		
<i>National Global Equity Fund</i>						
Individual Annuities	41,783	76	-1467	40,392	See 5.3.2.2	See 5.3.2.1
Others	23,892	0	0	23,892	N/A	N/A
Subtotal:	65,675	76	-1467	64,284		
<i>Other Funds</i>						
Individual Annuities	0	0	0	0	N/A	N/A
Others	1,878	0	0	1,878	N/A	N/A
Subtotal:	1,878	0	0	1,878		
Total	466,097	489	-9,794	456,792		

5.3.2.4 Summary of Liabilities held for Segregated Fund Policies

Fund	Amount of Reserves (\$'000)				Basis of Valuation	Basis of Investment Management Fee
	Liabilities carried in the Segregated Fund	Reserves for Guaranteed Benefits carried in the Life General Fund	PPM Reserves for Future Expenses Less Future Management Fees	Total Liabilities		
<i>National Equities Fund</i>						
Individual Annuities	126,839	3,441	-6,133	124,147	See 5.3.2.1	See 5.3.2.2
Others	64,594	0	0	64,594	N/A	N/A
Subtotal:	191,433	3,441	-6,133	188,741		
<i>National Fixed Income Fund</i>						
Individual Annuities	47,832	132	-1,727	46,237	See 5.3.2.1	See 5.3.2.2
Other	27,582	0	0	27,582	N/A	N/A
Subtotal:	75,414	132	-1,727	73,819		
<i>National of Canada Fund</i>						
Individual Annuities	130	0	0	130	N/A	N/A
Other	0	0	0	0	N/A	N/A
Subtotal:	130	0	0	130		
<i>National Money Market Fund</i>						
Individual Annuities	8,732	13	-267	8,478	See 5.3.2.1	See 5.3.2.2
Other	3,507	0	0	3,507	N/A	N/A
Subtotal:	12,239	13	-267	11,985		
<i>National Balanced Fund</i>						
Individual Annuities	146,571	2,051	-7,232	141,390	See 5.3.2.1	See 5.3.2.2
Others	76,826	0	0	76,826	N/A	N/A
Subtotal:	223,397	2,051	-7,232	218,216		
<i>National Global Equities Fund</i>						
Individual Annuities	55,208	648	-2,204	53,652	See 5.3.2.1	See 5.3.2.2
Others	17,413	0	0	17,413	N/A	N/A
Subtotal:	72,621	648	-2,204	71,065		

FEDERAL COURT OF APPEAL

NAMES OF COUNSEL AND SOLICITORS OF RECORD

DOCKET: A-490-06

**(AN APPEAL TO THE FEDERAL COURT OF APPEAL, FROM THE JUDGMENT OF
HERSHFIELD J., DATED OCTOBER 13, 2006, WHEREBY THE TAX COURT OF CANADA
ALLOWED, WITH COSTS, THE RESPONDENT'S APPEAL).**

STYLE OF CAUSE: HER MAJESTY THE QUEEN
Appellant
and
THE NATIONAL LIFE ASSURANCE
COMPANY OF CANADA
Respondent

PLACE OF HEARING: Toronto, Ontario

DATE OF HEARING: November 8, 2007

REASONS FOR JUDGMENT BY: Ryer J.A.

CONCURRED IN BY: Décary J.A.
Pelletier J.A.

DATED: January 15, 2008

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