# Educational Note

# Implications of Proposed Revisions to Income Tax Legislation

# (November 7, 2007 Department of Finance Proposal)

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*Educational Note*

# Implications of Proposed Revisions to Income Tax Legislation (November 7, 2007 Department of Finance Proposal)

## Committee on Life Insurance Financial Reporting

**January 2008**

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# Memorandum

**To:** All Life Insurance Practitioners

**From:** Jacques Tremblay, Chairperson
Practice Council

Tyrone Faulds, Chairperson
Committee on Life Insurance Financial Reporting

**Date:** January 23, 2008

**Subject:** **Implications of Proposed Revisions to Income Tax Legislation (Nov 7, 2007 Department of Finance Proposal)**

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The Committee on Life Insurance Financial Reporting (CLIFR) had previously issued an educational note (publication 207029) on April 11, 2007, relating to the 2006 Restatement of the Valuation of Policy Liabilities for the Implications of *CICA Handbook* Section 3855 Financial Instruments on Future Income and Alternative Taxes. That guidance had considered the December 28, 2006 proposal of the Department of Finance to revise tax legislation in response to these accounting changes.

CLIFR is now offering the following guidance, in light of the draft legislation proposed by the Department of Finance on November 7, 2007.

In accordance with the Institute's Policy for Due Process for the approval of guidance material other than Standards of Practice, this educational note has been approved by CLIFR, and has received final approval for distribution by the Practice Council on January 16, 2008.

Should you have any questions or comments regarding this educational note, please contact Tyrone Faulds at Ty.Faulds@londonlife.com.

JT, TF

CLIFR published an educational note (Publication 207029) on April 11, 2007 relating to the appropriate treatment of future income and alternate taxes with respect to the accounting changes caused by the implementation of CICA *Handbook* Section 3855. This guidance considered the December 28, 2006 proposal of the Department of Finance regarding changes in the taxation of financial institutions to deal with the effect of these accounting changes.

On November 7, 2007, the Department of Finance followed up on this proposal by issuing draft revisions to the income tax legislation. In most respects, the draft legislation is similar to the original December 28 2006 proposal. One significant change, however, is the proposal to treat tracking property (which may include certain unit trusts and derivative instruments) as mark-to-market properties. Key highlights are summarized in Appendix A, and a link to the draft legislation can be found at http://www.fin.gc.ca/news07/07-086e.html.

CLIFR notes that the November 7, 2007 draft legislation is not considered substantively enacted by December 31, 2007. As such, the guidance offered in the April 2007 educational note continues to be appropriate, but is modified slightly as indicated below.

Under the current tax legislation, the accounting changes caused by CICA 3855 may result in additional tax temporary timing differences. The actuary would recognize that certain tax benefits arising from application of the current tax regulations (specifically those that are the subject of the draft legislation) may not be sustainable, and would exercise caution before reducing liabilities in respect of these benefits, relative to a pre-3855 environment.

The actuary would assess the effect of the draft legislation on its balance sheet. In the assessment, the actuary would treat the legislation as a package and would consider the aggregate effect of all of the proposed changes on its balance sheet, including the new proposed treatment of unit trusts as mark-to-market properties. In doing so, the actuary would recognize that permanent differences associated with unit trusts such as the favourable treatment of the Canadian dividend component of the unit trust returns, as well as any non-recoverable withholding taxes associated with foreign returns will continue to exist.

However, since the legislation is not substantively enacted, the actuary would not reduce liabilities relative to the liabilities that arise in a post-3855 environment in conjunction with current tax rules.

Further guidance can be found in the April 2007 educational note.

# APPENDIX A

## Summary of Draft Legislation

### Tax Treatment of Mark-to-Market Properties

The *Income Tax Act* (Act) has specific rules for mark-to-market properties of financial institutions, which include Specified Debt Obligations (SDOs) held by those financial institutions in circumstances where the financial institution is an investment dealer or the obligation has been carried at market value in the financial statements of the financial institution since the obligation was acquired. Where SDOs are mark-to-market properties, each year's increase or decrease in value of the obligations is included in computing the financial institution's income for the year. Where SDOs are not mark-to-market properties, the gains or losses on the disposition of SDOs (e.g., a bond) are spread over the remaining term of the SDO.

It is proposed that all SDOs held by financial institutions be treated as mark-to-market properties in the case where the SDOs are required by Generally Accepted Accounting Principles (GAAP) to be carried on the financial statements of the financial institution at their fair market value. Financial institutions holding SDOs and that are affected by these changes will be permitted to spread evenly the effect of these changes on their income for tax purposes over a five-year transition period. These changes will apply to all financial institutions as defined under section 142.2 of the Act and be effective for taxation years that begin after October 1, 2006.

It is proposed that all tracking properties held by financial institutions be treated as mark-to-market properties for taxation years that commence after November 7, 2007. The definition of tracking properties is very broad and could include certain investments by financial institutions in derivative financial instrument contracts and unit trusts (e.g., mutual funds, exchange traded funds, and segregated funds), where such properties invest in an investment portfolio that primarily consists of mark-to-market properties (e.g., shares, SDOs or other tracking properties) that are valued in accordance with GAAP, at fair value, on their balance sheets. Unlike the proposed treatment for SDOs, there would be no transition period for the effect of this change on income for tax purposes. Under this proposal, the full amount of any unrealized gain (or loss) on the unit trusts at the end of 2007 (assuming a calendar year taxation year) would effectively become realized and brought into income for tax purposes in 2008.

### Changes in Policy Reserves of Insurance Corporations

Policy reserves of insurance corporations will generally increase as a result of the new accounting standards, as the policy reserves of insurance corporations are generally linked to the yield on assets that support them. This could result in a significant increase in the policy reserves that are deductible under paragraph 20(7)(c) of the Act in the case of property and casualty insurance corporations and under paragraph 138(3)(a) of the Act in the case of life insurance corporations.

The increases or decreases in policy reserves of insurance corporations attributable to the changes in accounting standards will not be permitted in the year in which the accounting changes first take effect. Instead, those increases or decreases will be spread evenly over a five-year period starting in the first year in which the accounting changes take effect. These changes will be effective for taxation years that begin after October 1, 2006.

**Policy Reserves for Life Insurance Policies Issued Before 1996**

Policy reserves deductible by life insurance corporations under paragraph 138(3)(a) of the Act and prescribed by section 1404 of the Income Tax Regulations (Regulations) in respect of life insurance policies issued after 1995 are based on the policy reserves reported on the financial statements of the life insurance corporation. For life insurance policies issued prior to 1996, the policy reserves for tax purposes under paragraph 138(3)(a) are based on the rules set out in section 1401 of the Regulations.

It is proposed that, for life insurance policies issued prior to 1996, the policy reserves be based on the reserves reported on the financial statements. The increases or decreases in reserves resulting from this change will not be included or deducted from income for tax purposes in the year in which these changes are first implemented. Instead, the increases or decreases will be spread evenly over a five-year period starting in the year in which these changes are first implemented. These changes will be effective for taxation years that begin after October 1, 2006.

**Taxable Capital Employed in Canada Under the Minimum Tax**

The minimum tax on financial institutions applies to banks, life insurance corporations, trust companies and mortgage loan companies. As a result of changes proposed in the 2006 budget, the tax will be modified as of July 1, 2006, to a tax of 1.25 percent on taxable capital employed in Canada in excess of $1 billion. The taxable capital employed in Canada generally follows capital and long-term debt reported on the financial statements of financial institutions.

However, life insurance corporations are required to add a "reserve adjustment" to their taxable capital employed in Canada under section 190.11 in Part VI of the *Income Tax Ac*t. This reserve adjustment adds the amount, if any, by which the policy reserves reported on the financial statements exceed the maximum policy reserves reported for tax purposes. This reserve adjustment is no longer required and is being repealed. This change will apply to taxation years of financial institutions that begin after October 1, 2006.