Canadian Institute of Actuaries
Institut canadien des actuaires

Educational Note

Implications of CICA Handbook Section 3855 – Financial Instruments on Future Income and Alternative Taxes: Update to Fall Letter

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Committee on Life Insurance Financial Reporting

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Seeing Beyond Risk — Canadian Institute of Actuaries / Institut canadien des actuaires — Voir au-delà du risque

Memorandum

To: All Life Insurance Practitioners

From: Tyrone Faulds, Chairperson
Committee on Life Insurance Financial Reporting

John Brierley, Chairperson
Practice Council

Date: April 11, 2007

Subject: **Implications of *CICA Handbook* Section 3855 – Financial Instruments on Future Income and Alternative Taxes: Update to Fall Letter**

The Committee on Life Insurance Financial Reporting (CLIFR) is publishing the attached educational note for 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.

The guidance in this educational note represents a majority view of CLIFR members of appropriate practice consistent with CIA's Standards of Practice (Standards). This educational note has met the requirements of the Policy on Due Process for Approval of Practice-Related Material other than Standards of Practice. However, in accordance with that policy, this educational note is "not binding." It was approved by the Practice Council on April 4, 2007 for distribution to the membership.

As outlined in subsection 1220 of the Standards of Practice,

"The actuary should be familiar with relevant educational notes and other designated educational material. [Effective December 1, 2002]

Educational notes and other designated educational material describe but do not recommend practice in illustrative situations.

A practice which the notes describe for a situation is not necessarily the only accepted practice for that situation and is not necessarily accepted actuarial practice for a different situation.

The educational notes are intended to illustrate the application (but not necessarily the only application) of the standards, so there should be no conflict between them."

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In December 2006, the Committee on Life Insurance Financial Reporting (CLIFR) published guidance for the valuation of the 2006 year-end policy liabilities of life insurers for Canadian Generally Accepted Accounting Principles (GAAP) purposes. Reference was made to the effect of implementation of AcSB Section 3855 for valuations for fiscal years beginning October 1, 2006 or later. Particular reference was made to the potential effects on Future Income and Alternative Taxes (section 10 of the document, which is reproduced below).

As mentioned, "this change may create additional tax timing differences. This accounting standards change is not effective for 2006 year-end statements, however, the opening balance sheet for 2007 reporting would be restated. As of the time of this publication, an industry proposal has been made to the Department of Finance (through the CLHIA) but no formal response has been received. In the case where a formal response has not been received, and the opening balance sheet for the following financial period is required, caution would be used in projecting any favourable tax timing results as a result of the accounting changes."

Subsequent to this guidance, on December 28, 2006 the Department of Finance issued a press release and backgrounder ("Finance proposal") regarding changes in the taxation of financial institutions to deal with the effect of accounting changes under CICA Handbook Section 3855. The backgrounder provides details of the proposed measures that are to be effective for tax years that begin after October 1, 2006, and it is included in Appendix A for reference. CLIFR views this document as a formal response to the industry proposal, but not a substantially enacted (or a virtually definitive) tax change at this time.

CLIFR reminds the actuary that the new accounting standards may require tax-related adjustments to the actuarial liabilities applying to the 2007 opening restated balance sheet. In many cases, a continuation of the current tax regime (*Income Tax Act* and regulations) results in a reduction in the company's tax-related liabilities[1] relative to those established on a pre-3855 basis. For example, future tax assets may be created from new temporary differences in respect of post-1995 business, to the extent that the market value exceeds the book value of assets supporting liabilities.

The actuary would consider that the intent of Finance is to revise the tax regime for insurers on a revenue neutral basis across the industry, as evidenced by the Finance proposal. The actuary would, therefore, consider that certain tax benefits arising from application of the current tax regulations (specifically, those that are the subject of the Finance proposal) may not be sustainable, and would exercise caution before reducing liabilities in respect of these benefits, relative to a pre-3855 environment in conjunction with current tax rules.

The actuary is reminded of the guidance offered in the 2002 Educational Note: Future Income and Alternative Taxes (Document 202065). The actuary determines the total policy-related provision for future tax (discounted future tax liability), and reduces the actuarial liabilities by the amount of policy-related liability already established by the accountant on an undiscounted basis. The actuary would discuss the accounting treatment to be applied with both the accountants and the auditors, and ensure a common understanding. If possible, the actuary would apply a consistent treatment in determining the discounted future tax provision. In any event, the actuary would ensure that tax provisions are not double-counted within the actuarial liabilities. For example, the accountants may establish an undiscounted provision on the basis of a continuation

[1] Including the impact on both the discounted future tax liabilities (DFTP) at the valuation date, as well as the impact on current tax provisions as a result of the 3855 restatement.

of the current tax regime, but may also establish a tax provision to recognize that any resulting benefits will likely be reversed. The actuary would consider all accounting-related provisions in assessing the adjustments required to be made to the actuarial liabilities.

The effect of the adjustment to actuarial liabilities would be that the combination of undiscounted future tax liabilities plus the adjustment to actuarial liabilities would equal the discounted future tax provision determined by the actuary.

The actuary may consider testing the impact of the Finance proposal. CLIFR has the following specific comments about the key elements of the Finance proposal:

1) The Finance proposal would have an impact on temporary differences arising from actuarial liabilities, but would also create new temporary differences arising from existing net deferred gains (or losses) on Specified Debt Obligations (SDOs) at December 31, 2006[2], and from differences between statement and tax values of assets. The actuary would reflect both the asset and liability temporary differences in the discounted future tax provision, and would make appropriate adjustment to the actuarial liabilities to ensure consistency with accounting provisions already established.

2) While existing net deferred gains (or losses) on SDOs at December 31, 2006[2] would be eliminated as at January 1, 2007 from the GAAP financial statements, they would continue to be deferred and amortized for tax purposes. This creates a new temporary difference with a known run-off pattern. To the extent that these support actuarial liabilities, the actuary would reflect these temporary differences in the discounted future tax calculation.

3) Finance is proposing that, for taxation years commencing after October 1, 2006, the maximum tax actuarial reserves (MTARs) for pre-1996 business would be "based on the policy reserves reported on the financial statements." This implies that the MTAR basis for pre-1996 business would become the same as for post-95 business, i.e., the financial statement policy reserves but determined without reference to projected income and capital taxes (other than Investment Income Tax (IIT)). It would appear the intent is that the change in MTARs be determined as at the start of the first taxation year commencing after October 1, 2006[3] and that this change would be spread evenly over a five year period starting at that point.

   This proposal would likely have a significant impact on the discounted future tax provision (DFTP) in respect of pre-1996 business since the reversal period for the existing reserve temporary difference would be significantly shortened (from the term of the liabilities to five years).

4) For post-1995 business, Finance is proposing that the change in MTARs attributable to the changes in accounting standards would be spread evenly over a five-year period starting in the year the accounting changes take effect. This would be coincident with the Finance proposal that SDOs that are required by GAAP to be carried at market value in the financial statements would be treated as mark-to-market property for tax purposes effective for taxation years commencing after October 1, 2006[3], with the change in tax value (from amortized cost to Fair Market Value (FMV)) allowed to be spread evenly

[2] Assuming a calendar year taxation year.
[3] i.e., January 1, 2007 for a calendar year taxation year

over a five-year period. These changes would result in new, but offsetting, temporary differences being created on both the asset and liability side.

5) There will continue to be differences between the financial statement policy liabilities and the allowable tax reserves even after the five-year transition period. There will still be future permanent differences and temporary differences arising from the asset side, e.g., dividends from Canadian stocks, non-deductibility of IIT in Quebec, unit trusts, real estate, run-off of pre-2007 deferred realized gains and losses from SDOs, etc. There will continue to be some temporary differences arising from the liability side, although they will be reduced significantly. Some examples include: Accident and Sickness (A&S) unpaid claim Reserves and Incurred But Not Reported (IBNR) reserves for both life and A&S business which have different liabilities for tax and statement purposes.

APPENDIX A

Summary of Finance Proposal (Backgrounder)

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.

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 Act*. 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.