Explanatory Notes to Legislative Proposals Relating to Income Tax

Income Tax Act

Section 1

Insurance Corporations

Section 138 of the *Income Tax Act* ("Act") sets out detailed rules relating to the taxation of insurance corporations. Section 138 is amended to modify existing transitional rules for insurers in respect of their life insurance businesses carried on in Canada ("life insurers"). These modifications are as a result of changes ("segregated fund policy changes") to the prescribed rules in Part XIV of the *Income Tax Regulations* ("Regulations") for computing the maximum amount deductible, under subparagraph 138(3)(*a*)(i) of the Act, by a life insurer as a reserve in respect of its life insurance policies in Canada. These changes to the Regulations, announced on ANNOUNCEMENT DATE, would clarify the computation of the maximum allowable reserves in respect of segregated fund policies.

These proposed modifications to the transitional rules in section 138 are generally intended to ensure that any increase or decrease in the reserves of an insurer resulting from the segregated fund policy changes will be taken into account in computing income for tax purposes over a five-year period.

The changes to the Regulations, and these consequential changes to section 138 of the Act, apply to the 2012 and subsequent taxation years.

Definitions

ITA
138(12)

"*transition year*"

The definition "transition year" in subsection 138(12) of the Act provides for two separate transition years of a life insurer. The first relates to accounting changes adopted by the Accounting Standards Board, and effective as of October 1, 2006. The second relates to changes to accounting rules in respect of the International Financial Reporting Standards adopted by the Accounting Standards Board and effective as of January 1, 2011 ("IFRS").

The definition is amended to add a third separate transition year for a life insurer. The third transition year ("segregated fund policy transition year") relates to the segregated fund policy changes and is a life insurer's 2012 taxation year.

As a result of this amendment, a life insurer will be required to compute, in respect of its life insurance business carried on in Canada in its segregated fund policy transition year, its reserve transition amount (as defined in existing subsection 138(12)) in respect of policy reserves arising from the segregated fund policy changes. This computation is independent of the reserve transition amount computed in respect of the 2006 accounting changes and IFRS. In this regard, new subsection 138(26) of the Act provides special rules for applying the related income tax provisions in circumstances where a life insurer has more than one transition year for the same taxation year. For more detail, see the commentary on new subsection 138(26).

Existing subsection 138(16) requires the inclusion, in computing the insurer’s income for its segregated fund policy transition year, of the positive amount, if any, of the insurer's reserve transition amount for its segregated fund policy transition year. Similarly, subsection 138(17) requires the deduction in computing the insurer's income for its segregated fund policy transition year of the absolute value of the negative amount, if any, of the insurer's reserve transition amount for its segregated fund policy transition year. If an insurer has included an amount under subsection 138(16), or deducted an amount under subsection 138(17), subsections 138(18) and (19) will provide for corresponding deductions or inclusions — recognized over a five-year period beginning with its segregated fund policy transition year — in computing the insurer’s income.

Transition Years

ITA
138(26)

New subsection 138(26) of the Act contains rules of application in respect of the determination of a life insurer’s reserve transition amount and the associated application of subsections 138(16), (17), (18) and (19). Those subsections provide for transition in some circumstances where the calculation of a life insurer’s life insurance policy reserves changes.

New paragraph 138(26)(*a*) provides an application rule for purposes of computing the income tax effects in the transitional rules in subsections (16), (17), (18) and (19), and for purposes of the definition “reserve transition amount” in subsection 138(12), where the application of those subsections is relevant to the segregated fund policy changes. For those purposes, that paragraph provides a special rule for computing an insurer’s reserve transition amount for its segregated fund policy transition year. Specifically, variable A in the formula in the definition “reserve transition amount” in subsection (12) is to be read such that it represents the amount that a life insurer would be permitted to claim as a policy reserve in its base year computed as though the amendment to paragraph 1406(*b*) of the Regulations incorporating the segregated fund policy changes applied to that base year.

New paragraphs 138(26)(*b*) and (*c*) both apply if a life insurer has more than one transition year for the same taxation year.

Paragraph 138(26)(*b*) applies specifically where the segregated fund policy transition year and the IFRS transition year are for the same taxation year of the life insurer. In this circumstance, for purposes of the IFRS transition year, the insurer's reserve transition amount, and the associated application of subsections 138(16), (17), (18) and (19), is determined without regard to the segregated fund policy changes.

Paragraph 138(26)(*c*) applies generally where a life insurer has more than one transition year for the same taxation year (note that as a practical matter, under the income tax provisions, including as amended currently, this will only involve, as under paragraph (*b*), where the segregated fund policy transition year and the IFRS transition year are for the same taxation year of the life insurer). In this circumstance, paragraph 138(26)(*c*) clarifies

- that the insurer's reserve transition amount for each of those transition years, and the associated application of subsections 138(16), (17), (18) and (19), is determined separately in respect of each of those transition years, and

- that the amounts determined as described immediately above are to be included or deducted, as the case may be, in computing the insurer's income for the relevant taxation year.

Section 2

Expenditure – Limit for Contingent Amount

ITA
143.4

New section 143.4 of the Act provides a rule that, in general, reduces the amount of a taxpayer's expenditure, that is otherwise deductible for the purposes of the Act or that otherwise forms part of a capital property to the taxpayer, if the taxpayer has a right to reduce or eliminate the amount that the taxpayer is required to pay in respect of the expenditure. This rule responds to the Federal Court of Appeal's decision in *Collins v. The Queen* (2010 FCA 12) in which the Court held that the taxpayers could deduct interest expenses as they accrued even though the taxpayers' had a right to reduce the amount payable in respect of the interest expenses. The Court indicated that it was not the interest amounts payable that were contingent; instead, it was the issue of whether the taxpayers would exercise their right to reduce the amount they were required to pay that was contingent. Further commentary on this new rule is provided below.

Definitions

ITA
143.4(1)

New subsection 143.4(1) of the Act provides four definitions that apply for the purpose of the limitation that may apply in respect of an expenditure under section 143.4. The main rule in respect of this limitation is found in subsection 143.4(2) which provides, in general, that an "expenditure" of a "taxpayer" is reduced to the extent there is, in the year in which the expenditure occurs, a "contingent amount" of the taxpayer – essentially where the taxpayer has a "right to reduce" an amount in respect of the expenditure. These four definitions are more fully described below.

"Contingent amount" of a taxpayer at any time (other than a time at which the taxpayer is a bankrupt) includes an amount to the extent that the taxpayer, or another taxpayer that does not deal at arm's length with the taxpayer, has a right to reduce the amount at that time.

"Expenditure" of a taxpayer means an expense, expenditure or outlay made or incurred by the taxpayer, or a cost or capital cost of property acquired by the taxpayer.

"Right to reduce" in respect of an amount of an expenditure at any time is broadly defined to mean a right to reduce or eliminate the amount. For these purposes a "right to reduce" is defined to include a right that is contingent upon the occurrence of an event, or in any other way, but only if it is reasonable to conclude, having regard to all the circumstances, that the right will become exercisable.

"Taxpayer" includes a partnership.

Limitation of amount of expenditure

ITA
143.4(2)

New subsection 143.4(2) of the Act provides that the amount of a taxpayer's expenditure is the lesser of two amounts. Paragraph (*a*) provides that the first of these two amounts is the amount of the expenditure calculated under the Act without reference to new section 143.4. In general, the second amount in paragraph (*b*) is calculated by reducing the first amount by the amount, if any, that is the total of each contingent amount in respect of the expenditure. The amount computed under paragraph (*b*) is to be reduced by the total of all amounts paid by the taxpayer in order to obtain a right to reduce an amount in respect of the expenditure.

Payment of contingent amount

ITA
143.4(3)

New subsection 143.4(3) of the Act provides, in general, that if an expenditure of a taxpayer has been reduced because of a contingent amount referred to in subsection 143.4(2) and the taxpayer later pays all or a portion of the contingent amount, then the taxpayer is considered to have incurred the previously reduced expenditure to the extent it was paid. In this case, the amount paid is considered to be incurred in the year paid for the same purpose and to have the same character as the expenditure that was reduced under subsection 143.4(2).

Subsequent years – application of paragraph 12(1)(*x*)

ITA
143.4(4)

New subsection 143.4(4) of the Act provides a special rule that, in general, applies if a taxpayer, or a person with whom the taxpayer does not deal at arm's length, has a right to reduce (as defined by subsection 143.4(1)) in respect of an expenditure in a year subsequent to the taxation year in which the expenditure occurred. In such cases, subsection 143.4(4) deems the taxpayer to have received a "subsequent contingent amount" in the course of earning income from a business or property to which paragraph 12(1)(*x*) applies. This rule applies to the extent subsections 143.4(2) and (4) have not previously applied in respect of the expenditure. For this purpose, the amount of a taxpayer's subsequent contingent amount is to be determined under new subsection 143.4(5).

However, subsection 143.4(4) does not apply to a taxpayer's subsequent contingent amount if the special anti-avoidance rule in new subsection (6) applies to deem the amount to be a contingent amount in the previous year in which the expenditure otherwise occurred. In such cases, subsection 143.4(2) applies to reduce the amount of the expenditure in the taxation year in which it otherwise occurred. For more detail see the discussion in respect of the special anti-avoidance rule in subsection 143.4(6)).

Subsequent contingent amount

ITA
143.4(5)

New subsection 143.4(5) of the Act provides in general that a taxpayer's "subsequent contingent amount" is, for the purpose of applying subsection 143.4(4), the amount by which the amount in respect of an expenditure may be reduced under a right to reduce exceeds the amount paid to obtain the right to reduce the amount in respect of the expenditure.

Anti-avoidance

ITA
143.4(6)

New subsection 143.4(6) of the Act provides a special anti-avoidance rule that applies if it is reasonable to conclude that one of the purposes for having a right to reduce an amount in respect of an expenditure after the end of the taxation year in which an expenditure otherwise occurred was to avoid a reduction under subsection 143.4(2) in respect of the expenditure.

In such a case, subsection 143.4(6) deems the right to reduce to exist in the taxation year in which the expenditure otherwise arose. The result of deeming the right to reduce to exist in the year in which the expenditure otherwise occurred is that the limitation in subsection 143.4(2) for a contingent amount in respect of an expenditure applies to reduce the amount of the expenditure in that previous taxation year.

Assessments

ITA
143.4(7)

New subsection 143.4(7) of the Act provides to the Minister of National Revenue the authority to make the assessments, determinations and redeterminations that are necessary to give effect to section 143.4 notwithstanding that the taxation year in question is otherwise statute-barred from assessment.

New section 143.4 applies in respect of taxation years ending on or after Announcement Date.

Section 3

Part XIII - Non-resident withholding tax

Interest

ITA
212(1)(*b*)(i)

Subparagraph 212(1)(*b*)(i) imposes withholding tax on interest payments that a payer resident in Canada makes to a non-resident recipient with whom the payer does not deal at arm's length if the interest is not in respect of certain debt obligations such as Canadian government bonds (referred to as "fully exempt interest").

Subparagraph 212(1)(*b*)(i) is amended to impose withholding tax on interest that, in addition to not being fully exempt interest, is paid or payable to either:

a. a non-resident recipient with whom the payer does not deal at arm's length; or
b. a non-resident recipient (whether arm's length or not) if the interest is paid or payable on a debt obligation owed by the payer to a non-resident with whom the payer does not deal at arm's length.

The amendment applies to interest paid or payable on or after announcement date unless it is interest on an obligation incurred by the payer before announcement date and the recipient acquired the entitlement to the interest before announcement date.

Income Tax Regulations

Section 4

Part XIV
Insurance Business Policy Reserves

Interpretation

ITR
1406

Section 1406 of the Regulations provides rules for the purpose of computing the policy reserves under sections 1404 and 1405 of the Regulations in respect of life insurance policies in Canada.

The Federal Court of Appeal, in *Canada v. National Life Assurance Company of Canada*, 2008 FCA 14 (dismissing the Crown's appeal from the decision in *The National Life Assurance Company of Canada v. The Queen*, 2006 TCC 551), determined that paragraph 1406(*b*) of the Regulations permitted the policy reserves computed under sections 1404 and 1405 to be computed without reference to any liabilities of an insurer in respect of a segregated fund other than liabilities in respect of an obligation on the part of a life insurer to make a guarantee payment.

Paragraph 1406(*b*) of the Regulations is amended, in response to those Court decisions, to ensure that the policy reserves computed under sections 1404 and 1405 are computed excluding only the reserves of the insurer in respect of a benefit that is payable to a policyholder from a segregated fund. In effect, amounts determined under sections 1404 and 1405 of the Regulations will include liabilities in respect of guarantees in respect of the insurer's segregated fund policies, as well as the portion of the insurer's policy reserves that relate to their negative segregated fund policy reserves. This change is intended to ensure that the acquisition expenses associated with such a policy are amortized appropriately over the term of the policy.

This amendment applies to the 2012 and subsequent taxation years