

HST & Other Indirect Tax Developments Impact on the P&C Industry

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CIAA Annual Tax Update

December 6, 2011



Agenda

- Harmonized Sales Tax (HST) in Ontario (ON) and British Columbia (BC)
 - Background
 - Focus on insurance providers
- Recent developments with BC and Quebec (QU) regarding harmonization
- Other Goods and Services Tax (GST) changes impacting insurance providers
 - Input tax credit (ITC) methodologies
 - Application of GST/HST to employee pension plans
 - Rules for self-assessment on expenses incurred and outlays made outside Canada
 - Annual Information Return
 - Amendments to the definition of “financial service”
- Possible review by the Department of Finance (Finance) on the application of GST/HST to financial services
 - Considerations for P&C insurance

HST in ON and BC

Background

- Trending towards more reliance on value added taxes by the governments
 - Nova Scotia (NS), New Brunswick (NB) and Newfoundland (ND) harmonized in 1997
 - ON and BC harmonized effective July 1, 2010
 - NS increased HST rate effective July 1, 2010 to 15% from 13%
 - Quebec Sales Tax (QST) rate increased to 8.5% January 1, 2011 and then increasing to 9.5% January 1, 2012
 - QU “harmonizing” on January 1, 2013
 - **BUT**, BC will “de-harmonize” sometime in 2013

HST in ON and BC Background

How does Canada compare on the global VAT/GST map?

	BC	ONT	NB	NS	NL	QC
VAT/ GST Rate	12%	13%	13%	15%	13%	14.975%*

	UK	FRA	GER	SWE	MEX	JAPN	INDIA	AUST	NZ
VAT/ GST Rate	17.5%	19.6%	19%	25%	15%	5%	12.5%	10%	12.5%

*Effective January 1, 2012

NOTE: These only include value added taxes. They do not include any other transaction taxes, such as premium taxes or retail sales taxes.

HST in ON and BC

Background

Current application of GST/HST to P&C insurance

- P&C insurance exempt for GST/HST purposes
- Some taxable activity – e.g., salvage
- For the most part, GST/HST paid on costs (operating & claims) by insurers not recoverable – becomes a factor in establishing premiums
- Significant compliance for insurers (e.g., ITC methodologies, Annual Information Return, self-assessment obligations, etc.)

HST in ON and BC

Background

- HST poses special problems for financial institutions (FIs)
- Absent special rules, there would be an incentive for an FI to source inputs from outside the “harmonized zone”
- Issues are addressed with special “net tax” accounting rules
- These rules were developed in 1997 in the context of harmonization in NS, NB and ND
- With ON and BC harmonization, the current HST rules are proposed to be refined

HST in ON and BC Background

- Relevant releases to date by Finance regarding changes to the rules
 - May 19, 2010 Backgrounder
 - June 30, 2010 Backgrounder
 - Draft SLFI Regulations released June 30, 2010
 - January 28, 2011 Backgrounder including draft legislation changes to the ***Excise Tax Act*** (ETA)
 - Revised draft SLFI Regulations released January 28, 2011
- So changes to the rules in context to ON and BC harmonized not yet official law or regulations

HST in ON and BC

Focus on insurance providers

- A “selected listed financial institution” (SLFI) must follow special approach to determine its HST liability
- A person is a SLFI if it is a:
 - Listed financial institution (LFI) under ETA 149(1)(a)(i) to (x) (excludes “s. 150 LFIs”); and
 - Prescribed financial institution under the draft regulations
- Under ETA 149(1)(a)(v), an LFI includes “an insurer or any other person whose principal business is providing insurance under insurance policies”
 - Therefore, P&C insurers are LFIs

HST in ON and BC

Focus on insurance providers

Prescribed financial institution; s.11 draft regs

- Among other things, a “prescribed financial institution” is a LFI that has a permanent establishment (PE) in a participating province and a PE in any other province
- PE test looks to:
 - PE for income tax purposes; and
 - Deemed PE depending on the business of the LFI (**NEW**)

HST in ON and BC

Focus on insurance providers

Prescribed financial institution; s.11 draft regs (cont'd)

- Actual PE – [PE definition – s. 1 of the draft regs]
 - Corporation: income tax PE per ss 400(2) of the IT Regs (fixed place of business)
- Deemed PE – [PE in a province – s.4 of the draft regs]
 - For insurance corporations it is the location of property or persons in respect of risks covered
- Therefore, most P&C companies are:
 - “prescribed financial institutions”
 - SLFIs

HST in ON and BC

Focus on insurance providers

- SLFIs follow special rules:
 - Cannot claim ITCs for the provincial component of HST (PVAT)
 - Not generally required to self-assess PVAT on goods, intangible property or services brought into a HST province
 - Use the special attribution method (SAM) under ETA 225.2(2) for determining liability for PVAT and allowing full recovery of PVAT paid to suppliers
- Non-SLFIs follow “default” rules

HST in ON and BC

Focus on insurance providers

SAM (ETA 225.2(2))

$$(A-B) \times C \times D/E - F +/- G$$

A = GST (currently 5%) paid/payable

B = ITCs claimed on GST

C = Provincial attribution percentage (PAP) of the participating province

D = PVAT rate of the participating province

E = GST rate (currently 5%)

F = Actual PVAT paid for the participating province

G = Various adjustments

HST in ON and BC

Focus on insurance providers

Simple SAM example (SAM formula = [(A-B) x C x D/E] – F+/-G)

Facts:

- Consideration paid on purchases = \$2 million
- Ontario HST paid @ 13% = \$260,000 (federal - \$100k; provincial - \$160k)
- No ITCs claimed
- Provincial attribution percentage (PAP) = BC 25%; ON 50%; NS 5%; NB 5%; ND 5%

Province	GST Paid \$ (A)	ITC (B)	Provincial Attribution % (C)	PVAT rate (D)	GST rate (E)	PVAT liability (A-B) x C x D/E	PVAT paid \$ (F)	Net Tax Adj.*
BC	100K	-	25%	7%	5%	35K		35K
ON	100K	-	50%	8%	5%	80K	(160K)	(80K)
NS	100K	-	5%	10%	5%	10K		10K
NB	100K	-	5%	8%	5%	8K		8K
ND	100K	-	5%	8%	5%	8K		8K
Total						141K	(160K)	(19K)

* Subject to "G" adjustments

HST in ON and BC

Focus on insurance providers

ETA 225.2(4) election for SLFIs – (Impacts elements A, B, F in the SAM)

- SLFI makes this election with a closely-related company with whom it has a s. 150 election
- Proposed amendment – includes supplier who is also a SLFI
- Avoids applying higher notional 5% GST on intercompany supplies to SAM calculation (essentially only include GST on taxable inputs of closely related supplier)
- Election ***must*** be filed with the Minister
- ***NOTE: There is likely no situation where it does not make sense to make this election***

HST in ON and BC

Focus on insurance providers

225.2(4) election for SLFIs

SLFI SUPPLIER		SLFI RECIPIENT
With 225.2(4)	Actual GST paid – A Actual PVAT paid – F Reversal of actual GST paid – G2 Reversal of actual PVAT paid – G1	Notional GST on cost – A Notional ITC on cost – B Actual PVAT paid by SLFI supplier – F
Without 225.2(4)	Actual GST paid – A Actual PVAT paid – F Notional ITC on actual GST paid – G8	Notional GST on charge – A Notional ITC on charge – B
NON-SLFI SUPPLIER		SLFI RECIPIENT
With 225.2(4)	SAM impact n/a	Notional GST on cost – A Notional ITC on cost – B Actual PVAT paid by SLFI supplier – F
Without 225.2(4)	SAM impact n/a	Notional GST on charge – A Notional ITC on charge – B

HST in ON and BC

Focus on insurance providers

Without 225.2(4) election

Additional facts from previous simple SAM example:

- s. 150 supplies made to SLFI = \$4 million
- No ss. 225.2(4) election made
- Notional GST to be added to “A” for SLFI recipient = \$200,000
(\$4,000,000 x 5%)

Province	GST Paid \$ (A)	ITC (B)	Provincial Attribution % (C)	PVAT rate (D)	GST rate (E)	PVAT liability (A-B) x C x D/E	PVAT paid \$ (F)	Net Tax Adj.*
BC	300K	-	25%	7%	5%	105K		105K
ON	300K	-	50%	8%	5%	240K	(160K)	80K
NS	300K	-	5%	10%	5%	30K		30K
NB	300K	-	5%	8%	5%	24K		24K
ND	300K	-	5%	8%	5%	24K		24K
Total						423K	(160K)	263K

HST in ON and BC

Focus on insurance providers

With 225.2(4) election

Additional facts from previous simple SAM example:

- Notional GST on costs of supplier related to the s. 150 supplies made to the SLFI = \$50,000 (to be added to “A” component)
- Ontario PVAT paid by supplier on those costs = \$80,000 (to be added to “F” component)

Province	GST Paid \$ (A)	ITC (B)	Provincial Attribution % (C)	PVAT rate (D)	GST rate (E)	PVAT liability (A-B) x C x D/E	PVAT paid \$ (F)	Net Tax Adj.*
BC	150K	-	25%	7%	5%	52.5K		52.5K
ON	150K	-	50%	8%	5%	120K	(240K)	(120K)
NS	150K	-	5%	10%	5%	15K		15K
NB	150K	-	5%	8%	5%	12K		12K
ND	150K	-	5%	8%	5%	12K		12K
Total						211.5K	(240K)	(28.5K)

HST in ON and BC

Focus on insurance providers

- Prescribed amounts of tax excluded from elements A, B and F in the SAM, include:
 - The GST/HST paid or payable by an insurer in respect of property or a service acquired, imported or brought into a participating province exclusively and directly for consumption, use or supply in the course of investigating, settling or defending an insurance claim, other than a claim in respect of accident and sickness or life insurance.
- Therefore, for purposes of the SAM, no need to track the GST/HST paid on these costs

HST in ON and BC

Focus on insurance providers

PAP calculations (element C) for insurance corporations

A/B

where

A is *net premiums* in respect of the insurance of risk in respect of *property situated in the province* and of its net premiums in respect of the insurance of risk in respect of *persons resident in that province*, that are included in computing its income under the *Income Tax Act*; and

B is *net premiums* in respect of the insurance of risk in respect of *property situated in Canada* and of its net premiums in respect of the insurance of risk in respect of *persons resident in Canada*, that are included in computing its income under the *Income Tax Act*.

HST in ON and BC

Focus on insurance providers

PAP calculations (element C) for insurance corporations (cont'd)

- Determined for each participating province
- **Net premiums** equals gross premiums less:
 - premiums paid for reinsurance,
 - dividends or rebates paid or credited to policy-holders; and
 - rebates or returned premiums paid in respect of the cancellation of policies
- Excludes non-Canadian risks in the denominator since those should be zero-rated allowing for ITCs (i.e., reduces “A minus B” component of SAM)

HST in ON and BC

Focus on insurance providers

Prescribed amounts under element G: s. 49 draft regs

- Five groups of adjustments under element g which adjust liability determined under same portions a to f
 - i. Refunds, adjustments, rebates and credits; 49(a)
 - ii. Deemed supplies and recapture ITCs; 49(b)
 - iii. Transitional rules for SLFIs; 49(c)
 - iv. Recapture of the provincial component of ITCs (RITC-SLFI rule); 49(d)
 - v. Effect of general transition rules on SLFI rules (NS/NB/ND); 49(e)

Recent developments in BC and QU

BC

- Following the results of the referendum in BC, the BC PVAT will be repealed
- During the 18 month transition period
 - BC PVAT will remain at 7%
 - BC will provide quarterly progress updates

Recent developments with BC and QU

BC

- What does this mean for insurance corporations that are SLFIs?
 - BC will no longer be a participating province
 - Wait to see if any transitional rules impacting PAP, etc.
 - BC retail sales tax registration (as applicable)
 - Reinstatement of prior process and systems to accommodate retail sales tax with possible changes to reflect any administrative/legislative changes
 - System and process changes required
- GST/HST tax cost for insurance providers likely will be less when BC “de-harmonizes” (need to compare BC PVAT cost with BC retail sales tax cost)
- Stay tuned for updates as to the changes and timing

Recent developments with BC and QU

QU

- Quebec announced in its Mar 2011 budget Quebec's desire to be "just as harmonized as the provincial component of the HST in participating provinces" and in particular:
 - To withdraw the GST from the QST base
 - To gradually eliminate input tax refund restrictions over eight years (as with ON and BC)
 - To "complete" harmonization for financial services
- Federal government announced in its June 2011 budget that a provision has been made in 2011-12 for \$2.2 billion in support of the conclusion of a satisfactory agreement between Canada and Quebec on harmonization
- Sep 30, 2011 QU and Federal governments signed *Memorandum of Agreement Regarding Sales Tax Harmonization with a View to Concluding a Canada-Quebec Comprehensive Integrated Tax Coordination Agreement*

Recent developments with BC and QU

Proposed “harmonization” of QST with GST

- Implementation date set for January 1, 2013
- Withdraw GST from the QST base
- Combined rate of 14.975% (5% GST and 9.975% QST)
- Financial services will become exempt (currently zero-rated)
 - Will not be entitled to “input tax refunds” (ITRs) related to financial services supplies
 - PVAT liability calculation for SLFIs – QU will be treated as a “participating province”
 - Gradual elimination of compensatory tax
- Insurance providers with business in QU likely will incur increased tax costs (compare reduction of compensatory tax with loss of ITRs)

Recent developments with BC and QU

Gradual elimination of compensatory tax for insurance corporations

- Compensation tax will be repealed as of January 1, 2013
- However, the temporary rate increases introduced in the March 2010 budget will be maintained until April 1, 2014
- For example, prior to March 30, 2010, an insurance corporation paid compensation tax of 0.35% of premiums
- On March 30, 2010, the compensation tax was increased to 0.55%
- Consequently, as of January 1, 2013, an insurance corporation will no longer pay 0.35% but will continue to pay 0.20% of premiums (*i.e.*, the March 2010 rate increase) until April 1, 2014

Other GST changes impacting insurance providers

- Since 2005, various changes to the GST rules have made a significant impact on financial services providers, including insurance providers
- These changes deal with:
 - ITC methodologies employed
 - Application of GST/HST to employee pension plans
 - Self-assessment of GST/HST on expenses incurred and outlays made outside Canada
 - Requirement to file an Annual Information Return in addition to the GST/HST return
 - Narrowing the exemption for intermediary financial services
- Passed into law in July 2010, but most have retroactive application
- Focus will be on new developments with respect to these changes

Other GST changes impacting insurance providers

- Application of GST/HST to employee pension plans
 - Considerable lobbying/representations made to Finance regarding the complexity of the rules
 - Particularly with respect to “actual” and “deemed” supplies made by employers and the need to use “tax adjustment notes” to eliminate the double taxation
 - Shortcuts could lead to exposures, even if rebates for the pension entities are small
 - Finance has indicated that they are exploring ways to simplify the rules
 - Watch for developments here

Other GST changes impacting insurance providers

- Self-assessment of GST/HST on expenses incurred and outlays made outside Canada
 - Insurance industry is impacted specifically as it relates to cross-border non-arm's length reinsurance arrangements where self-assessment of GST applies to “loading” element of premiums paid
 - Concerns:
 1. Difficulty in determining “loading” element of reinsurance premiums paid
 2. Components of “loading” too broad
 3. Discrimination against related party scenarios
 4. Potential for double taxation
 - Finance is open to understanding these concerns and it is likely that industry will be making representation on these points
 - Watch for developments here

Other GST changes impacting insurance providers

- Requirement to file an Annual Information Return in addition to the GST/HST return
 - Affects all registered financial institutions (FIs) with annual revenue in excess of \$1,000,000
 - Effective for fiscal years commencing after 2007
 - Significantly more information to be reported and tracked by FIs which in some cases was not previously tracked
 - e.g., GST/HST paid by P&C insurers on claims costs
 - P&C industry has asked for relief from reporting the GST/HST on claims costs
 - Passage into law of the rules in July 2010 resulted in penalties applying only in respect of fiscal years commencing after 2009
 - Given the amount of information required to be reported and penalties are referenced to each of the amounts to be reported, penalties for non-compliance can be significant

Other GST changes impacting insurance providers

- Narrowing the exemption for intermediary financial services
 - “Arranging for”, paragraph (l) in the definition of “financial service”
 - Key events since release of Finance backgrounder on December 14, 2009
 - CRA Notice 250 (February 11, 2010) published
 - March 4, 2010 NWMM tabled with Federal budget
 - NWMM tabled on March 22, 2010 (Bill C-9)
 - March 26th announcement by Minister of Finance “...not imposing new taxes”.
 - Finance published revised Explanatory Notes on June 29, 2010
 - Revised CRA Notice 250 (June 30, 2010) published
 - Bill C-9 received Royal Assent on July 12, 2010
 - TIB-105 published and officially replaces Notice 250, P-239, and P-119 (February 9, 2011)

Other GST changes impacting insurance providers

- Narrowing the exemption for intermediary financial services
 - TIB-105 contains 2 examples specifically related to insurance – examples 11 and 12
 - Whether or not brokerage or other arranging for functions in relation to insurance is exempt depends on the facts and seemingly whether the intermediary is in the business of principally being a broker or salesperson of, financial instruments (such as insurance policies) (see example 11)
 - Telemarketing of insurance likely taxable per the CRA (see example 12)
 - Meaning of “arranging for” now unclear - if unclear, consider obtaining a ruling
 - What is certain is that the scope of the exemption is narrower – rule changes increasing the tax cost of intermediary services in relation to selling insurance

Possible review by Finance on the application of GST/HST to financial services

Why might there be a review?

- Changes to the definition of “financial service” effective December 2009; HST in ON and BC July 1, 2010; QU “harmonization” January 1, 2013
 - Extensive industry lobbying has put possible review of the application of GST/HST to financial services on Government’s “radar”
- University of Calgary School of Public Policy GST Policy Conference in November 2011
 - GST on financial services was one of 5 topics
- Financial services industry associations thinking ahead to understand possible alternatives

Possible review by Finance on the application of GST/HST to financial services

Why might there be a review?

- VAT “101”
 - Tax paid on “final consumption” of goods and services
 - Applied throughout the distribution chain on each “value add”
- In theory, financial services should be treated the same as other goods and services
- **But** not that easy in practice to apply VAT to the “value add” of financial intermediation
- What other countries do

Possible review by Finance on the application of GST/HST to financial services

Considerations for P&C insurance

- P&C insurance exempt for GST/HST purposes
- GST/HST paid on costs (operating & claims) by insurers not recoverable – becomes a factor in establishing premiums
- Compliance is significant
- Current application leads to indirect taxation of insureds and tax cascading for many insured businesses and public service bodies

Possible review by Finance on the application of GST/HST to financial services

Considerations for P&C insurance

- Provincial premium taxes (PTs) (ON = 3.5%, BC = 4.4%)
- 8% ON Retail Sales Tax applied to non-auto P&C insurance
 - Quite perverse given HST in Ontario – results in double taxation
- QU current status
 - P&C insurance zero-rated under QST Title I – exempt effective January 1, 2013
 - P&C insurance taxable under QST Title III (i.e., provincial sales tax) (9%/5%)
 - Compensatory tax (CT = 0.55%) applied to P&C insurers
- Overall tax burden significant compared to other financial services

Possible review by Finance on the application of GST/HST to financial services

Considerations for P&C insurance

- Should be fairly easy to tax P&C insurance premiums
- But need to consider impact on:
 - Individual insureds
 - Business insureds
 - Government revenues
 - Other taxes that could be eliminated/reduced
- Other realistic alternatives include zero-rating with a compensatory tax or hybrid methods that look to eliminate tax cascading on B to B

Possible review by Finance on the application of GST/HST to financial services

What next?

- Finance likely to do a review
- Industry and consultants will be consulted
 - Some are being pro-active and have met/corresponded with Finance in anticipation of a review
- Watch for developments on this

The new foreign affiliate proposals and recent case of interest

Paul Vienneau

CIAA Annual Tax Update

December 6, 2011



Agenda

1. Recent Case – Imperial Tobacco
2. The new foreign affiliate proposals – selected topics
 - a) Background
 - b) Hybrid Surplus
 - c) Upstream Loans
 - d) Foreign Affiliate Distributions
 - e) Q & A

Imperial Tobacco Canada Limited v. The Queen

Imperial Tobacco Canada v. The Queen

Background

- Taxpayer appeal from Tax Court of Canada
- Are payments made to employees to surrender share options deductible?

Imperial Tobacco Canada v. The Queen

Facts

- Imasco had an employee stock option plan
- Vesting occurred 2 years after grant
- Holder had right to surrender for cash
- In 1999, British American Tobacco (BAT) approached Imasco with proposal to go private
- Under proposal, vesting of stock options was accelerated
- BAT was in position to acquire all Imasco shares
- Surrender payments - \$118 million

Imperial Tobacco Canada v. The Queen

Statutory Provisions

- Subsection 9(1) of the Income Tax Act
- Meaning of “profit”
- Treatment for accounting
- Paragraph 18(1)(b)
 - capital versus income

Imperial Tobacco Canada v. The Queen

Taxpayer's Argument

- Payments were employee compensation

Crown's Argument

- Payments are on account of capital

The New Foreign Affiliate Proposals – Selected Topics

Background

Background

- Final package of FA proposals released on August 19, 2011
- Advisory Panel recommendation for territorial system rejected
 - Stated reason: incentive to sign TIEAs
- Unworkable surplus suspension rules abandoned
- However, new restrictions impair ability to repatriate taxable surplus without additional Canadian tax, including “upstream loan” rule

Hybrid Surplus

Hybrid Surplus

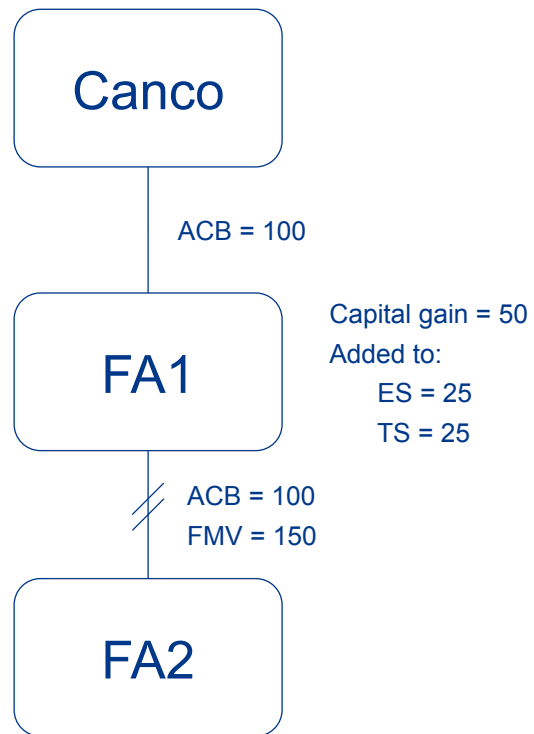
- New category of surplus (in addition to the traditional exempt and taxable surplus pools)
 - Tracks capital gains and losses on the disposition of FA shares and partnership interests that are not relevant in computing FAPI (i.e., excluded property)
 - Capital gains continue to be half exempt and half taxable; however, it is no longer possible to distribute the exempt portion as a dividend while deferring the distribution of the taxable portion

Hybrid Surplus

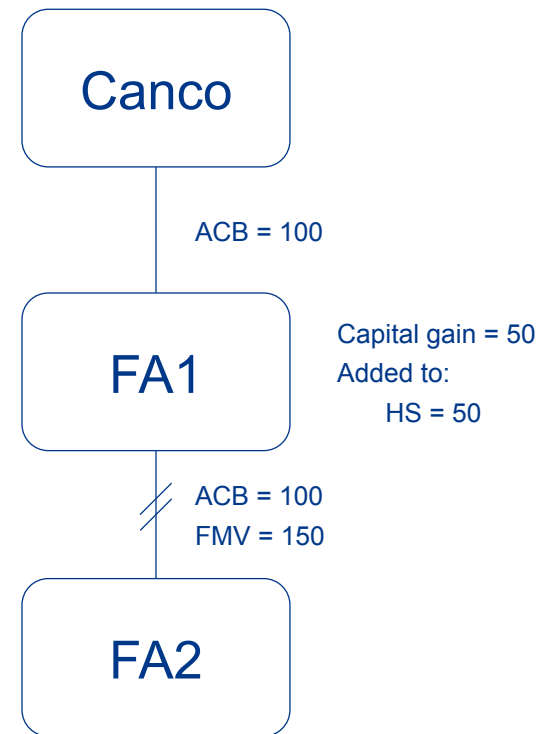
- Proposed paragraph 113(1)(a.1) provides a deduction for FA dividends paid from hybrid surplus:
 - One half is exempt
 - One half is eligible for a deduction based on grossed-up hybrid underlying tax (HUT) and foreign withholding tax
- Cannot repatriate hybrid surplus to Canada via a loan because of the new “upstream loan” rules

Hybrid Surplus

Existing Rules



New Rules



Hybrid Surplus

- Coming into force:
 - Applies to internal dispositions occurring after August 19, 2011
 - Applies to third party dispositions occurring after 2012

Upstream Loans

Upstream Loans

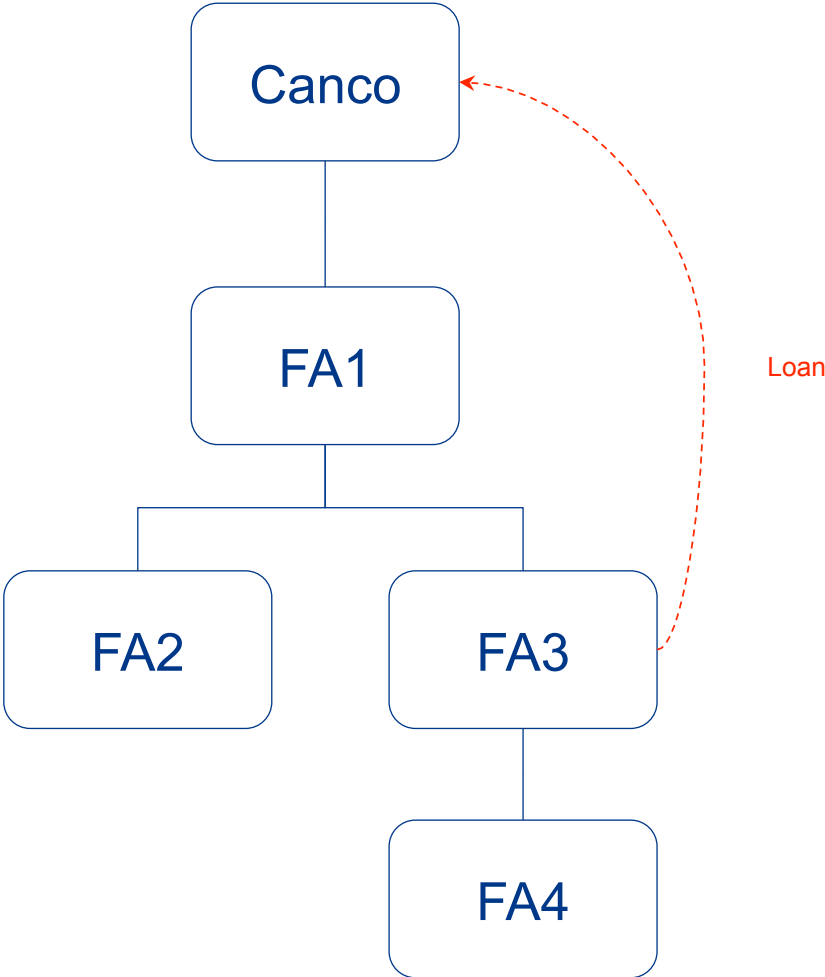
- New anti-avoidance rule
 - Designed to prevent the deferral of Canadian tax in situations where low-taxed taxable surplus or hybrid surplus is repatriated via upstream loan
 - Runs counter to at least 13 years of CRA rulings
 - Disincentive to reinvest cash in Canada
 - Explicitly modeled on existing subsection 15(2) which deems a loan to certain shareholders (e.g. non-resident Parent co) to be a dividend if outstanding for 2 year ends
 - Applies where a Canadian taxpayer or another non-arm's length person (other than a FA controlled by Canadian shareholders) receives a loan from or becomes indebted to a FA of the taxpayer, and the amount remains outstanding for 2 years

Upstream Loans

- Results in an income inclusion for the Canadian taxpayer equal to “specified amount” of the loan or indebtedness
- Reserve mechanism available to the extent of “good surplus” at the time the loan is made or indebtedness arises, but quite restrictive
 - Does not take into account outside basis
 - Not available if any dividends paid to Canada by a “relevant FA” during the year
 - Only takes into account dividends that would be “fully deductible”
- Deduction available in the year the loan or indebtedness is repaid, provided it is not part of a series of loans and repayments

Upstream Loans

Typical upstream loan



Upstream Loans

- Coming into force
 - Effective August 19, 2011
 - No grandfathering for existing loans or indebtedness
 - Deemed made on August 19, 2011
 - Loans made before the lender became a FA?
- Planning options?
- F/X implications of unwinding

Tax Accounting Implications

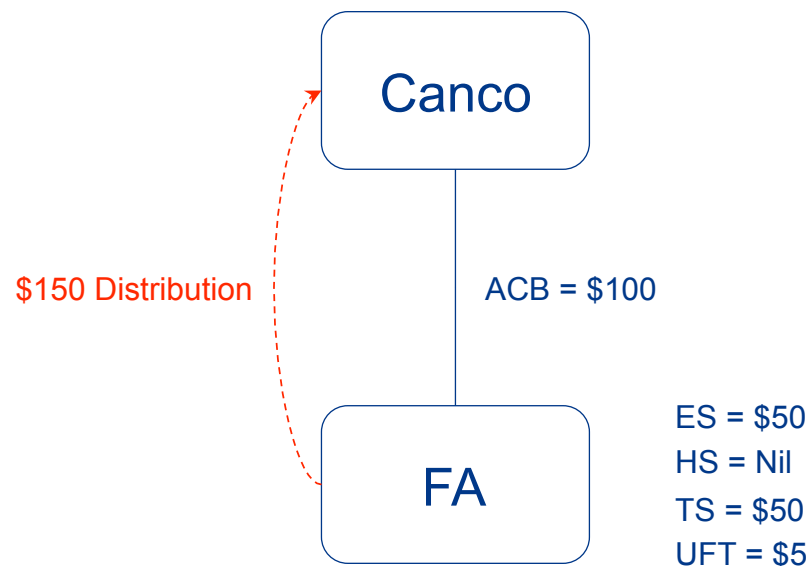
- In a typical upstream loan scenario, Canadian companies often consider the upstream loan to be part of their net investment in a foreign operation
 - Foreign exchange and deferred tax not recognized in the P&L
- Substantive enactment is the “triggering event”
- Pressure on the foreseeable future assertion
 - Is it still probable that the upstream loan will not be repaid in the foreseeable future?
- Is there a tax liability to be recorded due to subsection 90(4)?
 - Is it reasonable to conclude the loan will be repaid within 2 years?
- Consistency of the financial statement assertions

Foreign Affiliate Distributions

FA Distributions

- Under current rules, the characterization of FA distributions is based on foreign commercial law (dividend, return of paid-up capital, other)
 - Potential for section 15 taxable benefits for distributions of contributed surplus or share premium
- Under new rules, all *pro rata* distributions (other than liquidating distributions and redemptions) will be deemed to be dividends
 - Canadian corporate shareholders can elect to access pre-acquisition surplus (tax basis) first
 - Election is not available if any shares of the FA are held by a partnership
 - Election is not available for individuals and trusts

FA Distributions



Current Law

Undertake two separate distributions:

- \$100 return of paid-up capital
- \$50 dividend

Proposed Law

Regardless of legal characterization, deemed to be a \$150 dividend

- Elect to access pre-acquisition surplus first
- Forced 93(1) election

FA Distributions

- Coming into force
 - Generally effective after August 19, 2011
 - However, taxpayers may elect that the rules apply to dividends paid after February 27, 2004

IFRS Tax Update

Impact on the P&C Industry

Arthur Driedger

CIAA Annual Tax Update

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Agenda

- Mark to Market Properties
- Pension
- Stock Option Benefit
- Business Combinations
- Note Disclosure Requirements

Mark to Market Properties

Financial Instruments: Available Classifications

Category	Definition
Fair Value Through Profit and Loss	Includes: <ul style="list-style-type: none"> • Financial assets or liabilities classified as HFT (acquired or incurred principally for the purpose of selling or repurchasing it in the near term, managed as part of portfolio, or derivative) • All derivatives that are not designated in hedging relationships • When can demonstrate the ability to reduce an accounting mismatch or when its performance is managed on a FV basis
Held to Maturity	Non-derivative financial assets with fixed or determinable payments and fixed maturity that an entity has the positive intention and ability to hold to maturity
Available for Sale	Non-derivative financial assets that are designated as available for sale or are not classified as (a) loans and receivables, (b) held-to-maturity investments or (c) financial assets at fair value through profit or loss.
Loans and Receivables	Non-derivative financial assets with fixed or determinable payments that are not quoted in an active market other than HFT, AFS or impaired financial assets
Other liabilities	A financial liability not classified as FVTPL

Financial Instruments: Measurement

- The measurement of a financial instrument and the recognition of associated gains and losses is determined by the financial instrument classification category)

Category	Classification	Measurement	Gains and Losses
Financial Assets	Fair Value Through Profit and Loss	Fair value	Recognized in net income in the current period
	Held to Maturity Loans and Receivables	Amortized cost	Recognized in net income in the period that the asset is derecognized or impaired
	Available for sale	Fair value	Recognized in other comprehensive income until realized through disposal or impaired
Financial Liabilities	Fair Value Through Profit and Loss	Fair value	Recognized in net income in the current period
	Other liabilities **	Amortized cost	Recognized in net income in the period that the liability is derecognized

Mark to Market Properties – Fair value to Amortized Cost

- For tax, the properties will change from mark-to-market properties to specified debt obligations that are not mark-to-market properties.
- Fair value should be equal to amortized cost at opening balance sheet date
 - 2010 financial statement balances are restated under IFRS for comparative purposes only;
 - Canadian GAAP financial statements used for 2010 tax return filing purposes
 - For tax purposes, bonds are still considered to be a mark-to-market property

Mark to Market Properties – FV to Amortized Cost (cont'd)

- Temporary difference created on January 1, 2011
 - Opening retained earnings adjustment is not included in computation of 2011 taxable income
 - CRA guidance is that an adjustment should be made to taxable income in the year of transition to ensure all income is taxed and to prevent double taxation
 - The fair market value at January 1, 2011 is the new tax cost base
 - Temporary difference reverse when bond matures or disposed
- Any realized gain/loss
 - amortized over the remaining term to maturity
 - Will result in a deferred tax asset or liability.

Example

Assumptions:

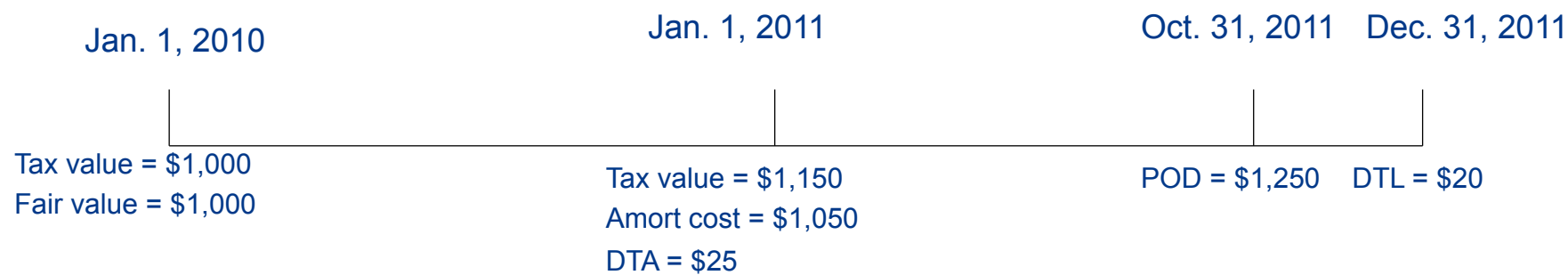
Under IFRS Company A is required to reclassify its bond from held for trading to held to maturity. The value of the bond are as follows.

- January 1, 2010
 - Fair value/Amortized cost = 1,000
 - Face value = 1,300
- January 1, 2011
 - Fair value = 1,150
 - Amortized cost = 1,050
 - Future tax rate = 25%
- December 31, 2011
 - Future tax rate = 25%

On October 31, 2011, the bond is disposed of for \$1,250. The original maturity date of the bond is October 31, 2015.

What are the tax and tax accounting implications?

Example (cont'd)



- Jan 1, 2010 – Both tax and accounting were at fair value. No Opening Balance Sheet adjustment on transition to IFRS as fair value and amortized cost is the same.
- Fiscal 2010 – Tax followed CGAAP, accounting followed IFRS. Need to account for the change in tax base of the bond that triggered tax with no change in IFRS accounting amounts
- Jan 1, 2011 – Tax Return Adjustment? The tax base of the bond is its MTM value at Dec 31, 2010. Now the accounting is no longer fair value accounting. Thus switch back to the “old” SDO rules

Example (cont'd)

- On October 31, 2011 the temporary difference of \$100 recorded as at January 1, 2011 is reversed.
 - Tax gain on disposition is \$100 (\$1,250 - \$1,150)
 - Accounting gain is \$200 (\$1,250 - \$1,050)
- For tax purposes the bond is considered to be a specified debt obligation that is not a mark-to-market property.
 - Tax gain is deferred and amortized into income over original term to maturity (5 years).

Net Income before tax	\$1,000
Less: accounting gain	(\$200)
Add: 1/5 of tax gain	<u>\$20</u>
Taxable income	\$820

- \$100 of the accounting gain is “paid” by the use of the \$25 DTA. The remaining \$100 accounting gain that = the \$100 tax gain has \$80 deferred. A taxable temporary difference of \$80 arises which results in deferred income tax liability of \$20.

Tracking Property

- Changes in the measurement of the underlying assets
 - Can change from being carried at cost to fair value
 - Results in a change from a tracking property that is not a mark-to-market to a tracking property that is a mark-to-market property
 - Mark to market rules applies
- Example: Partnership interest

Partnership Interest

- Previously carried at cost
 - Capital property
 - Suspended loss rules under subsection 40(3.3)/40(3.4)
- Now carried at fair value
 - No longer considered a capital property
 - Suspended loss rules under subsection 18(13)/40(3.3)/40(3.4) no longer apply
- Losses will be converted from capital loss to non-capital loss
 - Maybe affect the recoverability of any existing capital loss carryforwards
- Fair Value gains will be taxed immediately

Mark to Market Properties – Amortized Cost to Fair Value

Result in a transition amount at January 1, 2011

- Generally considered to be immediately taxable

No deferred tax asset/liability should result from the change in measurement

Pension

Pension

- For accounting purposes, pension cost are recognized as service is provided by the employees.
- For tax purposes, the deduction occurs either when contributions are made to the pension plan.
- A deductible temporary difference arises when the plan is underfunded (i.e. a pension liability is recorded) and a taxable temporary difference arises when the pension plan is in a surplus position.

Defined Benefit Pension Plan

- Current service cost and finance income/expense relating to plan assets are recognized in profit and loss.
- Company can choose to account for actuarial gains/losses:
 - In profit or loss; or
 - In other comprehensive income
- IAS 12 requires recognizing current and deferred tax outside profit or loss if the tax relates to items recognized outside profit or loss.

Classification of the Tax Expense

- Classification issue of the current and deferred tax if entity choose to recognize actuarial gains/loss in other comprehensive income
- Often not possible to determine whether contributions relate to past or current service costs recognized in profit or loss, or to actuarial gains and losses.
- Where there is no clear relationship between the pension expense recognized in the financial statement and the tax deduction received in the period reasonable allocation method may be used as long it is applied on a consistent basis.

Example

	Defined benefit liability	Current year expense/ (deduction) (30%)	Deferred tax asset (30%)
Opening balance	\$(200)		\$60
Contribution paid/ deduction received	\$70	\$(21)	(\$21)
Income statement – net pension cost	\$(50)	\$15 (\$50 * 30%)	\$15
Other comprehensive income (actuarial loss)	\$(30)	\$9	\$9
Current year activity	\$80	\$3	\$3
Ending balance	\$(210)		\$63

Summary

<i>Income statement – pension expense</i>	\$15
<i>Current year deduction in P&L</i>	<u>(\$15)</u>
Tax expense(recovery) in P&L	\$ 0
Remaining deduction recorded in OCI	\$ (6)
OCI tax – Actuarial loss	\$ 9
Net OCI tax	\$ 3
Deferred tax recovery	\$ 3
Net tax expense recorded in the FS	\$ 0

Stock Options Benefit

Stock Based Compensation

IAS 12	CICA Section 3465
<p data-bbox="205 495 953 711">Deferred tax is calculated based on tax deduction for the share-based payment under the applicable tax law (intrinsic value).</p> <p data-bbox="205 836 911 1166">The current or deferred tax associate to the excess of the tax deduction over the amount of the related cumulative remuneration expense should be recognized directly in equity</p>	<p data-bbox="1024 495 1772 651">Canadian GAAP does not address treatment of deductible stock-based compensation.</p>

Stock Based Compensation

- IAS 12 paragraph 68A through 68C discuss Current and Deferred Tax Arising from Share-based Payment transactions.
- Recording is based on the intrinsic value; that is the difference between:
 - The tax base of employee services received to date (i.e. the amount estimated to be deductible for tax purposes in the future), and
 - The carrying amount.
- The amount allowed by the taxing authorities for deduction should be estimated based on the information available at the end of the period and may differ from the related cumulative remuneration expense.
- If the tax deduction exceeds the related cumulative remuneration expense, the excess of the tax benefit should be recognized directly in equity.

Example

Assumptions:

- The difference between the exercise price and the stock value at the time of exercise is deductible for tax purposes
- All options vest at the end of year 3
- Exercise price \$100
- FMV at end of year 1 \$100
- FMV at end of year 2 \$115
- FMV at end of year 3 \$180 (exercise price)
- FMV at grant date \$ 60
(per the corporate finance group)
- Corporate tax rate 30%

Stock Based Compensation and Deferred Taxes (*cont'd*)

	<u>P&L Remuneration Expense</u>	<u>“Expected” Tax benefit in P&L @ Statutory rate</u>	<u>Intrinsic Value * Percentage of Services Received</u>	<u>Deferred Tax Asset</u>	<u>Tax Benefit in P&L for the year</u>	<u>Tax benefit in equity for the year</u>
Year 1	\$20	\$6	ⓧ	ⓧ	ⓧ	ⓧ
Year 2	\$20	\$6	$\$15 \times 2/3 = 10$	\$3	\$3	\$0
Year 3	\$20	\$6	\$60	\$24	\$15	\$6

Other considerations

- Calculation of deferred tax asset needs to be completed separately for each award granted
 - Allocation of the tax between P&L and equity should also be considered separately.
- Reduction of the deferred tax asset as a result of a fall in the share price need to be analyzed in order to determine the allocation of the expense between P&L and equity.

Business Combination

Definition of a “Business Combination”

- IFRS 3(2008) defines a “business combination” as follows:

“A transaction or other event in which an acquirer obtains control of one or more businesses. Transactions sometimes referred to as “true mergers” or “merger of equals” are also classified business combinations.”

- Determination of a business combination performed by audit team
- IFRS 1 allows for an exemption for the retroactive application of transactions identified as business combinations under IFRS 3

Initial Recognition Exception

Initial Recognition Exception	
IAS 12	CICA 3465
<p>IAS 12.15 and .24: Initial recognition exception prohibits recognition of deferred taxes for temporary differences that arise upon initial recognition of:</p> <ul style="list-style-type: none">• Goodwill, or• An asset/liability that is not a business combination and affects neither accounting nor taxable profit	<p>CICA 3465 does not contain a similar requirement</p> <ul style="list-style-type: none">• Par 22 prohibits the recognition of a taxable temporary difference arising from goodwill that is not deductible for tax purposes

- Very important provision within IAS 12 that should be kept in mind when analyzing acquisition transactions

Acquisition of Intangible Assets as a Business Combination

- Are there any differences in tax accounting for intangible assets acquired in an acquisition of a group of assets that constitute a business under IFRS and CGAAP?
- IFRS
 - IAS 12.7: The tax base of an asset is the amount that will be deductible for tax purposes against any economic benefits that will flow to an entity when it recovers the carrying amount of the asset
 - IAS 12.18(d): Temporary differences can arise when the tax base of an asset on initial recognition differs from its initial carrying amount
 - IAS 12.22(a): A temporary difference may arise on initial recognition of an asset if part or all the cost of an asset will not be deductible for tax purposes
 - IAS 12.51: An entity measures DTA/L using the tax base that is consistent with the expected manner of recovery (either sale or use)

Acquisition of Intangible Assets Accounted for as a Business Combination

- IFRS (continued)
 - On initial recognition of intangible asset acquired through an asset purchase which qualifies as a business combination, and where it is management's intent to utilize the assets in the normal course of business, a temporary difference would arise – corresponds to 25% of the carrying value of the intangible asset
 - If the intangible asset is not amortized under IAS 38, then the method of recovery may be on "sale" basis
 - In some jurisdictions, the intangible asset may have no tax base for either method of recovery – usually the case where the asset was internally generated by an entity that was later acquired
- CGAAP
 - CICA 3465.14(f): The tax basis of intangible assets would be the balance in the cumulative eligible capital pool plus 25% of the carrying amount
 - On initial recognition of the intangible asset on the balance sheet, no temporary difference would occur and no future income tax would need to be recognized at that point in time

Example: Acquisition of Intangible Assets as a Business Combination – Initial Recognition

- Assume the following:
 - Intangible asset was acquired as part of a group of assets that constituted a business
 - On acquisition date, its carrying value is \$1,000
 - For tax purposes, the intangible asset qualifies as being eligible capital expenditures and therefore, 75% of the costs are tax-deductible
 - Intangible asset will be recovered through use
 - Considered a business combination under CGAAP and IFRS

Initial Recognition	IFRS	CGAAP
Carrying value	\$1,000	\$1,000
Tax basis	\$750	\$1,000
Temporary difference	\$250	\$0
DTL (tax rate = 30%)	\$75	\$0

IFRS: Tax basis = \$1,000 x 75% = \$750

CGAAP: Tax basis = \$1,000 x 75% + \$1,000 x 25% = \$1,000

Consolidation Tax Adjustments

- Deferred tax treatment can be different at legal entity and consolidated levels
- Example:
 - If the initial recognition exemption applied to an acquiree's own F/S (i.e. deferred taxes on temporary differences related to some assets/liabilities are not recognized), the initial recognition exemption does not apply when the assets/liabilities are initially recognized in the new consolidated F/S
 - Deferred taxes should be recognized on temporary differences on these assets/liabilities since they are acquired in a business combination
 - Consolidation adjustment is required

Consolidation Tax Adjustments

- Deferred tax treatment can be different at legal entity and consolidated levels
- Example:
 - Co A acquires net assets in a business combination and subsequently transfers one or more of the assets to another related entity, Co B, within the group
 - Co B's Legal entity F/S: As the transaction is unlikely to be a business combination, the recognition exemption is applied to any temporary difference arising from the initial recognition of the asset(s) transferred; no deferred taxes is recognized
 - Consolidated F/S: Initial recognition exemption would not apply and deferred taxes would be recognized on any temporary differences arising on the date of acquisition; consolidation adjustment is required

Note Disclosure

Disclosure Requirements

- More detailed disclosures than under CGAAP
- Outlined in IAS 12.79-88

Disclosure Requirements - IAS 12.79 – 12.88

IAS 12.81

The following needs to be disclosed *separately*:

- (a) Current and deferred tax charged directly to equity
- (ab) Income tax relating to each component of OCI
- (c) Explanation of relationship between tax expense and accounting profit (tax rate reconciliation disclosing the basis of calculation of the “applicable tax rate”)
- (d) Explanation of changes in tax rate from previous period
- (e) Amount and expiry date of deductible temporary differences, unused tax losses/credits for which no DTA is recognized
- (f) Total temporary differences from investments in subsidiaries, branches and JV’s for which DTL’s have not been recognized

Disclosure Requirements - IAS 12.79 – 12.88

IAS 12.81 (cont'd)

- (g) For each temporary difference and unused tax loss/credit:
 - (i) Amount of DTA and DTL recognized
 - (ii) Amount of deferred tax income or expense recognized
- (h) Tax expense relating to discontinued operations (distinguish tax expense related to gain/loss)
- (i) Any tax on dividends declared before issuance of Financial Statements not recognized as a liability
- (j) Any change in the acquiror's pre-acquisition DTA as a result of a business combination
- (k) Description of the event or change that caused a previously unrecognized deferred tax benefit (acquired in a business combination) to now be recognized.

IAS12.81(a), (g) – Deferred Tax Balances

2010	Opening balance CU'000	Recognised in profit or loss CU'000	Recognised in other comprehensive income CU'000	Recognised directly in equity CU'000	Reclassified from equity to profit or loss CU'000	Acquisitions /disposals CU'000	Other [Describe] CU'000	Closing balance CU'000
Deferred tax (liabilities)/assets in relation to:								
Cash flow hedges	(119)	-	(131)	-	114	-	-	(136)
Net investment hedges	-	-	4	-	-	-	-	4
Associates	(1,268)	(356)	-	-	-	-	-	(1,624)
Property, plant & equipment	(3,165)	(1,517)	-	-	-	458	430	(3,794)
Investment property	(90)	(9)	-	-	-	-	-	(99)
Finance leases	(22)	18	-	-	-	-	-	(4)
Intangible assets	(572)	196	-	-	-	-	-	(376)
FVTPL financial assets	(48)	(6)	-	-	-	-	-	(54)
FVTOCI financial assets	(178)	-	(22)	-	-	-	-	(200)
Deferred revenue	34	12	-	-	-	-	-	46
Convertible notes	-	9	-	(242)	-	-	-	(233)
Exchange difference on foreign operations	(14)	-	(22)	-	36	-	-	-
Provisions	1,672	42	-	-	-	-	-	1,714
Doubtful debts	251	(8)	-	-	-	(4)	-	239
Other financial liabilities	5	2	-	-	-	-	-	7
Unclaimed share issue and buy-back costs	-	-	-	75	-	-	-	75
Other [describe]	(181)	(32)	-	-	-	-	-	(213)
	(3,695)	(1,649)	(171)	(167)	150	454	430	(4,648)
Tax losses	-	-	-	-	-	-	-	-
Other	2	-	-	-	-	-	-	2
	2	-	-	-	-	-	-	2
	(3,693)	(1,649)	(171)	(167)	150	454	430	(4,646)

Disclosure under IAS 12.81(f)

- Paragraph IAS 12.81(f) requires an enterprise to disclose, *“the aggregate amount of temporary differences associated with investments in subsidiaries, branches and associates and interests in joint ventures, for which deferred tax liabilities have not been recognized”*
- Paragraph 39 provides an exception to the general rule of recording a deferred tax liability on outside basis temporary differences.
- Paragraph IAS 12.7 applies to deem tax basis to equal the asset’s carrying value in certain circumstances
 - 112(2.1)
 - Surplus pools calculation
 - Withholding tax considerations

Example of a IAS12.81(f) disclosure

- As at December 31, 2010 the Corporation had temporary differences of \$1,085 associated with investments in subsidiaries, associated entities and interests in joint ventures for which no deferred tax liabilities have been recognized, as the Corporation is able to control the timing of the reversal of these temporary differences and it is not probable that these temporary differences will reverse in the foreseeable future.

Deloitte.