Draft Income Tax Regulations and Explanatory Notes

Insurance companies

Published by
The Honourable Paul Martin, P.C., M.P.
Minister of Finance

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Draft Income Tax Regulations

DRAFT *INCOME TAX REGULATIONS*

1. Section 804 of the *Income Tax Regulations* is replaced by the following:

Interpretation

804. In this Part, "registered non-resident insurer" means a non-resident corporation approved to carry on business in Canada under the *Insurance Companies Act*.

2. Sections 2400 and 2401 of the Regulations are replaced by the following:

Definitions

2400. (1) The definitions in this subsection apply in this Part and in subsection 219(7) of the Act.

"attributed surplus"

"attributed surplus" of a non-resident insurer for a taxation year is the total of

(*a*) the insurer's property and casualty surplus for the year;

(*b*) where the insurer elects for the year in prescribed form and manner, 1/2 of the total of

(i) the amount that would have been determined at the end of the year in respect of the insurer under subparagraph (*a*)(iii) of the definition "Canadian investment fund", and

(ii) the amount that would have been determined at the end of the preceding taxation year in respect of the insurer under subparagraph (*a*)(iii) of the definition "Canadian investment fund"

if, throughout the year and the preceding taxation year, the insurer had been a life insurer resident in Canada and had not carried on any insurance business other than a life insurance business or an accident and sickness insurance business; and

(*c*) where the insurer does not elect under paragraph (b) for the year, 120 per cent of the total of all amounts each of which is 1/2 of the amount determined by regulations or guidelines made under Part XIII of the Insurance Companies Act to be the margin of assets in Canada over liabilities in Canada required to be maintained by the insurer as at the end of the year or as at the end of the preceding taxation year in respect of an insurance business carried on in Canada (other than a property and casualty insurance business).

"Canadian business property"

"Canadian business property" of an insurer for a taxation year in respect of an insurance business means

(*a*) where the insurer was resident in Canada throughout the year and did not carry on an insurance business outside Canada in the year, the property used or held by it in the year in the course of carrying on the business in Canada; and

(*b*) in any other case, the designated insurance property of the insurer for the year in respect of the business.

"Canadian equity property"

"Canadian equity property" of a person or partnership (in this definition referred to as the "taxpayer") at any time means property of the taxpayer that is

(*a*) a share of the capital stock of, or an income bond, income debenture, small business development bond or small business bond issued by, a person (other than a corporation affiliated with the taxpayer) resident in Canada or a Canadian partnership; or

(*b*) that proportion of shares owned by the taxpayer of the capital stock of a corporation affiliated with the taxpayer, or of the taxpayer's interest in a partnership or trust, that

(i) the total value for the year that includes that time of Canadian equity property owned by the corporation, partnership or trust, as the case may be,

is of

(ii) the total value for the year that includes that time of all property owned by the corporation, partnership or trust, as the case may be.

"Canadian investment fund"

"Canadian investment fund" of an insurer at the end of a taxation year means

(*a*) in the case of a life insurer resident in Canada, the total of

(i) the amount, if any, by which the insurer's Canadian reserve liabilities as at the end of the year exceeds the insurer's Canadian outstanding premiums and policy loans as at the end of the year (to the extent the policy loans were not otherwise deducted in computing the insurer's Canadian reserve liabilities as at the end of the year),

(ii) the amount, if any, by which

(A) the total of all amounts each of which is an amount in respect of an insurance business carried on by the insurer in Canada that is reported as a liability of the insurer as at the end of the year other than

(I) a liability to the extent that it is included in subparagraph (i),

(II) a liability in respect of an amount payable out of a segregated fund, or

(III) a debt that was incurred or assumed by the insurer to acquire a property

exceeds the total of

(B) the total value for the year of the insurer's non-segregated property (other than investment property, or a share of the capital stock of, or a debt owing by, a financial institution to the extent that its value for the year is included in the insurer's financial institution allowance for the year) used or held by it in the year in the course of carrying on its insurance business in Canada,

(C) the insurer's deferred tax debit balance as at the end of the year in respect of its insurance business carried on in Canada, and

(D) an amount equal to that proportion of

(I) the insurer's financial institution allowance for the year that

(II) the amount that would be determined under this subparagraph if it were read without this clause

is of

(III) the total of the amount determined under subclause (II) and the amount determined under subclause (iii)(B)(II), and

(iii) the amount, if any, by which

(A) the amount equal to that proportion of

(I) the amount of the insurer's total policyholders' and shareholders' equity as at the end of the year (to the extent that that amount is not included as a liability under subparagraph (ii))

that

(II) the insurer's weighted Canadian liabilities as at the end of the year

is of

(III) the insurer's weighted total liabilities as at the end of the year

exceeds

(B) an amount equal to that proportion of

(I) the insurer's financial institution allowance for the year

that

(II) the amount determined under clause (A)

is of

(III) the total of the amount determined under subclause (II) and the amount determined under subclause (ii)(D)(II); and

(b) in the case of a non-resident insurer, the total of

(i) the amount, if any, by which

(A) the insurer's Canadian reserve liabilities as at the end of the year

exceeds the total of

(B) the insurer's Canadian outstanding premiums and policy loans as at the end of the year (to the extent the policy loans were not otherwise deducted in computing the insurer's Canadian reserve liabilities as at the end of the year), and

(C) the insurer's deferred acquisition expenses as at the end of the year in respect of its property and casualty insurance business carried on in Canada,

(ii) the amount, if any, by which

(A) the total of all amounts each of which is an amount in respect of an insurance business carried on by the insurer in Canada that is reported as a liability of the insurer as at the end of the year other than

(I) a liability to the extent that it is included in subparagraph (i),

(II) a liability in respect of an amount payable out of a segregated fund, or

(III) a debt that was incurred or assumed by the insurer to acquire a property

exceeds the total of

(B) the total value for the year of the insurer's non-segregated property (other than investment property) used or held by it in the year in the course of carrying on an insurance business in Canada, and

(C) the insurer's deferred tax debit balance as at the end of the year in respect of its insurance business carried on in Canada, and

(iii) the greater of

(A) the amount, if any, by which the total of

(I) the insurer's surplus funds derived from operations as at the end of its preceding taxation year, and

(II) the total of all amounts in respect of which the insurer made an election under subsection 219(4) or (5.2) of the Act, each of which is an amount included in the total determined in respect of the insurer under subparagraph 219(4)(*a*)(i.1) of the Act as at the end of its preceding taxation year

exceeds

(III) the total of amounts determined in respect of the insurer under subparagraphs 219(4)(*a*)(ii), (iii), (iv) and (v) of the Act, as at the end of the taxation year, and

(B) the insurer's attributed surplus for the year.

"Canadian investment property"

"Canadian investment property" of an insurer for a taxation year means an investment property owned by the insurer (other than, where the insurer is non-resident, property established by the insurer as not being effectively connected with its Canadian insurance businesses) that is

(*a*) real property situated in Canada;

(*b*) depreciable property situated in Canada or leased to a person resident in Canada for use inside and outside of Canada;

(*c*) a mortgage, a hypothec, an agreement of sale or any other form of indebtedness in respect of property described in paragraph (*a*) or (*b*);

(*d*) a Canadian equity property;

(*e*) a Canadian resource property;

(*f*) a deposit balance of the insurer that is in Canadian currency;

(*g*) a bond, debenture or other form of indebtedness, in Canadian currency, issued by

(i) a person resident in Canada or a Canadian partnership, or

(ii) the government of Canada, a province or any political subdivision thereof; or

(*h*) a property that is

(i) a share of the capital stock of a corporation resident in Canada that is affiliated with the insurer, or

(ii) an interest in a Canadian partnership, or a trust resident in Canada

where not less than 75 per cent of the total value for the year of all property of the corporation, partnership or trust, as the case may be, is attributable to property that would be Canadian investment property if it were owned by an insurer.

"Canadian outstanding premiums"

"Canadian outstanding premiums" of an insurer at any time means the total of all amounts each of which is the amount of an outstanding premium of the insurer with respect to an insurance policy at that time, to the extent of the amount of the premium included in the insurer's Canadian reserve liabilities as at that time.

"Canadian reserve liabilities"

"Canadian reserve liabilities" of an insurer as at the end of a taxation year means the total of all amounts as at that time each of which is the amount of a liability (other than a liability in respect of a segregated fund) of the insurer in respect of

(*a*) a life insurance policy in Canada;

(*b*) a fire insurance policy issued or effected upon property situated in Canada; or

(*c*) an insurance policy of any other class covering risks ordinarily within Canada at the time the policy was issued or effected.

"deposit balance"

"deposit balance" of an insurer means an amount standing to the insurer's credit as or on account of amounts deposited with a corporation authorized to accept deposits or to carry on the business of offering to the public its services as a trustee.

"equity limit"

"equity limit" of an insurer for a taxation year means

(*a*) in respect of a life insurer resident in Canada, that proportion of the total of all amounts each of which is the value for the year of an equity property of the insurer that

(A) the insurer's weighted Canadian liabilities as at the end of the year

is of

(B) the insurer's weighted total liabilities as at the end of the year;

(*b*) in respect of a non-resident insurer (other than a life insurer), 1/4 of the total of

(i) the amount, if any, by which

(A) the insurer's mean Canadian reserve liabilities for the year

exceeds

(B) 1/2 of the total of its deferred acquisition expenses and premiums receivable as at the end of the year and its deferred acquisition expenses and premiums receivable as at the end of its preceding taxation year to the extent that those amounts were included in the insurer's Canadian reserve liabilities for the year or the preceding year, as the case may be, in respect of the insurer's business in Canada, and

(ii) the insurer's property and casualty surplus for the year; and

(*c*) in respect of a non-resident life insurer, the total of

(i) where the insurer makes an election referred to in paragraph (*b*) of the definition "attributed surplus" for the year, the greater of

(A) that proportion of the total of all amounts each of which is the value for the year of an equity property of the insurer that

(I) the insurer's weighted Canadian liabilities as at the end of the year

is of

(II) the insurer’s weighted total liabilities as at the end of year, and

(B) 8 per cent of the insurer’s mean Canadian investment fund for the year,

(ii) where the insurer does not make an election referred to in paragraph (*b*) of the definition "attributed surplus" for the year, 8 per cent of the insurer’s mean Canadian investment fund for the year,

(iii) 1/4 of the amount, if any, by which

(A) the insurer’s mean Canadian reserve liabilities for the year (determined on the assumption that the only insurance business carried on in Canada by the insurer was a property and casualty insurance business)

exceeds

(B) 1/2 of the total of its deferred acquisition expenses and premiums receivable as at the end of the year and its deferred acquisition expenses and premiums receivable as at the end of its preceding taxation year to the extent that those amounts were included in the insurer’s Canadian reserve liabilities for the year or the preceding year, as the case may be, (determined on the assumption that the only insurance business carried on in Canada by the insurer was a property and casualty insurance business), and

(iv) 1/4 of the insurer’s property and casualty surplus for the year.

"equity property"

"equity property" of a person or partnership (in this definition referred to as the "taxpayer") for a taxation year or fiscal period means property of the taxpayer that is

(*a*) a share of the capital stock of, or an income bond, income debenture, small business development bond or small business bond issued by, a person (other than a corporation affiliated with the taxpayer) or partnership; or

(*b*) that proportion of shares owned by the taxpayer of the capital stock of a corporation affiliated with the taxpayer or of the taxpayer’s interest in a partnership or trust that

(i) the total value for the year or period of equity property owned by the corporation, partnership or trust, as the case may be,

is of

(ii) the total value for the year or period of all property owned by the corporation, partnership or trust, as the case may be.

"financial institution"

"financial institution" means a corporation that is

(*a*) a corporation described in any of paragraphs (*a*) to (*e*) of the definition "restricted financial institution" in subsection 248(1) of the Act; or

(*b*) a corporation all or substantially all of the value for a taxation year of the assets of which is attributable to shares or indebtedness of one or more financial institutions.

"financial institution allowance"

"financial institution allowance" of an insurer for a taxation year means the amount equal to that proportion of

(*a*) the total of all amounts each of which is the amount that would be the value for the year of a property of the insurer that is a share of the capital stock of, or a debt owing to the insurer by, a corporation if the insurer owned the property only during those days in the year during which the insurer owned the property and the corporation was a financial institution affiliated with the insurer

that

(*b*) the insurer’s weighted Canadian liabilities as at the end of the year

is of

(*c*) the insurer's weighted total liabilities as at the end of the year.

"foreign policy loan"

"foreign policy loan" means an amount advanced by an insurer to a policyholder in accordance with the terms and conditions of a life insurance policy, other than a life insurance policy in Canada.

"gross Canadian life investment income"

"gross Canadian life investment income" of a life insurer for a taxation year means the amount, if any, by which the total of all amounts each of which is

(*a*) the insurer's gross investment revenue for the year, to the extent that the revenue is from Canadian business property of the insurer for the year in respect of the insurer's life insurance business,

(*b*) the amount included in computing the insurer's income for the year under paragraph 138(9)(*b*) of the Act,

(*c*) the portion of the amount deducted under paragraph 20(1)(*l*) of the Act in computing the insurer's income for its preceding taxation year that was in respect of Canadian business property of the insurer for that year in respect of the insurer's life insurance business,

(*d*) the amount included under section 142.4 of the Act in computing the insurer's income for the year in respect of a property disposed of by the insurer that was, in the taxation year of disposition, a Canadian business property of the insurer for that year in respect of the insurer's life insurance business,

(*e*) the insurer's gain for the year from the disposition of a Canadian business property of the insurer for the year in respect of the insurer's life insurance business, other than a capital property or a property in respect of which section 142.4 of the Act applies, or

(*f*) the insurer's taxable capital gain for the year from the disposition of a Canadian business property of the insurer for the year in respect of the insurer's life insurance business

exceeds the total of all amounts each of which is (*g*) the portion of the amount deducted under paragraph 20(1)(*l*) of the Act in computing the insurer’s income for the year that is in respect of debt obligations that are Canadian business property of the insurer for the year in respect of the insurer’s life insurance business,

(*h*) the amount deductible under section 142.4 of the Act in computing the insurer’s income for the year in respect of a property disposed of by the insurer that was, in the taxation year of disposition, a Canadian business property of the insurer for that year in respect of the insurer’s life insurance business,

(*i*) the insurer’s loss for the year from the disposition of a Canadian business property of the insurer for the year in respect of the insurer’s life insurance business, other than a capital property or a property in respect of which section 142.4 of the Act applies, or

(*j*) the insurer’s allowable capital loss for the year from the disposition of a Canadian business property of the insurer for the year in respect of the insurer’s life insurance business.

"investment property"

"investment property" of an insurer for a taxation year means non-segregated property that is

(*a*) property acquired by the insurer for the purpose of earning gross investment revenue in the year, other than property that is

(i) property, a portion of which is investment property because of paragraph (*b*),

(ii) a share of the capital stock of, or a debt owing to the insurer by, a corporation affiliated with the insurer, or

(iii) an interest in a partnership or trust;

(*b*) the portion, if any, of property of the insurer that is land, depreciable property or property that would have been depreciable property if it had been situated in Canada and used or held by it in the year in the course of carrying on an insurance business in Canada, that

(i) the use made of the property in the year for the purpose of earning gross investment revenue therefrom

is of

(ii) the whole use made of the property in the year;

(*c*) where the insurer is a life insurer, property described in any of paragraphs 138(4.4)(*a*) to (*d*) of the Act; or

(*d*) property of the insurer that is

(i) a share of the capital stock of, or a debt owing to the insurer by, a corporation (other than a financial institution) affiliated with the insurer, or

(ii) an interest in a partnership or trust

if the total value for the year of all investment property of the corporation, partnership or trust, as the case may be, is not less than 75 per cent of the total value for the year of all its property, and for the purpose of this paragraph (other than for the purpose of determining whether it is a financial institution) every corporation, partnership and trust is deemed to be an insurer.

"mean Canadian investment fund"

"mean Canadian investment fund" of an insurer has the meaning assigned by section 2412.

"mean Canadian outstanding premiums"

"mean Canadian outstanding premiums" of an insurer for a taxation year means 1/2 of the total of

(*a*) its Canadian outstanding premiums as at the end of the year; and

(*b*) its Canadian outstanding premiums as at the end of its preceding taxation year.

"mean Canadian reserve liabilities"

"mean Canadian reserve liabilities" of an insurer for a taxation year means 1/2 of the total of

(*a*) its Canadian reserve liabilities as at the end of the year; and (*b*) its Canadian reserve liabilities as at the end of its preceding taxation year.

"mean maximum tax actuarial reserve"

"mean maximum tax actuarial reserve" in respect of a particular class of life insurance policies of an insurer for a taxation year means 1/2 of the total of

(*a*) its maximum tax actuarial reserve for that class of policies for the year; and

(*b*) its maximum tax actuarial reserve for that class of policies for its preceding taxation year.

"mean policy loans"

"mean policy loans" of an insurer for a taxation year means 1/2 of the total of

(*a*) its policy loans as at the end of the year; and

(*b*) its policy loans as at the end of its preceding taxation year.

"outstanding premiums"

"outstanding premiums" of an insurer with respect to an insurance policy at any time means premiums due to the insurer under the policy at that time but unpaid.

"property and casualty surplus"

"property and casualty surplus" of an insurer for a taxation year means the total of

(*a*) 7 1/2 per cent of the total of

(i) its unearned premium reserve as at the end of the year,

(ii) its unearned premium reserve as at the end of its preceding taxation year,

(iii) its provision for unpaid claims and adjustment expenses as at the end of the year, and

(iv) its provision for unpaid claims and adjustment expenses as at the end of its preceding taxation year,

in respect of its property and casualty insurance business; and

(*b*) 1/2 of the total of

(i) its investment valuation reserve as at the end of the year, and

(ii) its investment valuation reserve as at the end of its preceding taxation year,

in respect of its property and casualty insurance business.

"segregated fund"

"segregated fund" has the meaning assigned by subsection 138.1(1) of the Act.

"segregated fund policies"

"segregated fund policies" has the meaning assigned by subsection 138.1(1) of the Act.

"value"

"value" for a taxation year of a property of a person or partnership (in this definition referred to as the "owner") means

(*a*) in the case of a property that is a mortgage, hypothec or an agreement of sale or an investment property that is a deposit balance, the amount, if any, by which

(i) the amount obtained when the gross investment revenue for the year from the property is divided by the average rate of interest earned by the owner (expressed as an annual rate) on the amortized cost of the property during the year

exceeds

(ii) the amount obtained when the interest payable for the year on debt incurred for the purpose of acquiring the property is divided by the average rate of interest payable by the owner (expressed as an annual rate) on the debt for the year;

(*b*) in the case of a property (other than a property referred to in paragraph (*a*)) that was not owned by the owner throughout the year, the amount, if any, by which

(i) that proportion of

(A) the carrying value of the property as at the end of the preceding taxation year, where the property was owned by the owner at that time,

(B) the carrying value of the property as at the end of the year, where the property was owned by the owner at that time and not at the end of the preceding taxation year, and

(C) in any other case, the cost of the property to the owner when it was acquired

that

(D) the number of days, at the end of which the owner owned the property, that are in the year

is of

(E) the number of days in the year

exceeds

(ii) the amount obtained when the interest payable for the year on debt assumed or incurred for the purpose of acquiring the property is divided by the average rate of interest payable by the owner (expressed as an annual rate) on the debt for the year; and

(*c*) in the case of any other property, the amount, if any, by which

(i) 1/2 of the total of

(A) the carrying value of the property as at the end of the year, and

(B) the carrying value of the property as at the end of the preceding taxation year

exceeds

(ii) the amount obtained when the interest payable for the year on debt assumed or incurred for the purpose of acquiring the property is divided by the average rate of interest payable by the owner (expressed as an annual rate) on the debt for the year.

"weighted Canadian liabilities"

"weighted Canadian liabilities" of an insurer as at the end of a taxation year means the total of

(*a*) 3 times the amount, if any, by which the total of all amounts each of which is an amount in respect of an insurance business carried on by the insurer in Canada that is reported as a liability (other than a liability in respect of an amount payable out of a segregated fund) of the insurer in respect of a life insurance policy in Canada (other than an annuity) or an accident and sickness insurance policy as at the end of the year exceeds its policy loans as at the end of the year, and

(*b*) the total of all amounts each of which is an amount in respect of an insurance business carried on by the insurer in Canada that is reported as a liability of the insurer as at the end of the year other than

(i) an amount to the extent that it is reported as a liability in respect of an insurance policy (other than an annuity) included in paragraph (*a*),

(ii) a liability in respect of an amount payable out of a segregated fund, or

(iii) a debt incurred or assumed to acquire a property of the insurer.

"weighted total liabilities"

"weighted total liabilities" of an insurer as at the end of a taxation year means the total of

(*a*) 3 times the amount, if any, by which the total of all amounts each of which is an amount in respect of an insurance business carried on by the insurer that is reported as a liability (other than a liability in respect of an amount payable out of a segregated fund) of the insurer in respect of a life insurance policy (other than an annuity) or an accident and sickness insurance policy exceeds the total of its policy loans and foreign policy loans as at the end of the year; and (*b*) the total of all amounts each of which is an amount in respect of an insurance business carried on by the insurer that is reported as a liability of the insurer as at the end of the year other than

(i) an amount to the extent it is reported as a liability of the insurer in respect of an insurance policy (other than an annuity) included in paragraph (*a*),

(ii) a liability in respect of an amount payable out of a segregated fund, or

(iii) a debt incurred or assumed to acquire a property of the insurer.

Determining values and amounts

(2) For the purposes of determining the carrying value of a taxpayer's property or any other amount under this Part in respect of a taxation year of the taxpayer, except as otherwise provided in this Part,

(*a*) where the taxpayer is an insurer, the amounts reflected in the taxpayer's non-consolidated balance sheet as at the end of the year accepted (or, if that non-consolidated balance sheet was not prepared, the taxpayer's balance sheet as at the end of the year that would have been accepted) by the Superintendent of Financial Institutions, in the case of an insurer that is required under the *Insurance Companies Act* to report to the Superintendent, or by the superintendent of insurance or other similar officer or authority of the province under the laws of which the corporation is incorporated or otherwise formed, in the case of an insurer that is required by law to report to that officer or authority, and

(*b*) in any other case, the amounts that would be reflected in the taxpayer's balance sheet as at the end of the year if that balance sheet were prepared in accordance with generally accepted accounting principles

shall be used.

Liabilities

(3) A reference in this Part to an amount reported as a liability of a taxpayer as at the end of a taxation year means an amount that is reported as a liability in the taxpayer's non-consolidated balance sheet as at the end of the year accepted (or, if that non-consolidated balance sheet was not prepared, the taxpayer's balance sheet as at the end of the year that would have been accepted) by the Superintendent of Financial Institutions, in the case of an insurer that is required under the *Insurance*

Companies Act to report to the Superintendent, or by the superintendent of insurance or other similar officer or authority of the province under the laws of which the corporation is incorporated or otherwise formed, in the case of an insurer that is required by law to report to that officer or authority.

Definitions

(4) For the purposes of subsection 138(14) of the Act, the expressions "Canadian investment fund for a taxation year", "specified Canadian assets" and "value for the taxation year" have the meanings prescribed therefor by subsection 2404(1) as it read in its application to the 1977 taxation year.

Designated insurance property

2401. (1) For the purposes of section 138 of the Act, "designated insurance property" of an insurer for a taxation year means property that is designated by the insurer under this section for the year, in its return of income under Part I of the Act for the year, in respect of an insurance business carried on in Canada.

Designation rules

(2) For the purposes of subsection (1),

(*a*) the insurer shall designate investment property owned by it at any time in the year with a total value for the year equal to the amount, if any, by which the insurer’s mean Canadian reserve liabilities for the year in respect of its life insurance business in Canada exceeds the insurer’s mean Canadian outstanding premiums and mean policy loans for the year (to the extent that the amount of the mean policy loans was not otherwise deducted in computing the insurer’s Canadian reserve liabilities for the year);

(*b*) the insurer shall designate investment property owned by it at any time in the year with a total value for the year equal to the insurer’s mean Canadian reserve liabilities for the year in respect of its accident and sickness insurance business in Canada;

(*c*) the insurer shall designate in respect of its insurance business in Canada (other than a life insurance business or an accident and sickness insurance business) investment property owned by it at any time in the year with a total value for the year equal to the amount, if any, by which

(i) the insurer's mean Canadian reserve liabilities for the year in respect of the business

exceeds

(ii) 1/2 of the total of all amounts each of which is the amount, at the end of the year or at the end of its preceding taxation year, of a deferred acquisition expense or a premium receivable (to the extent included in the insurer's Canadian reserve liabilities) of the insurer in respect of the business;

(*d*) where

(i) the insurer's mean Canadian investment fund for the year

exceeds

(ii) the total value for the year of all property required to be designated by the insurer under paragraph (*a*), (*b*) or (*c*)

the insurer shall designate in respect of a particular insurance business it carries on in Canada investment property owned by it at any time in the year with a total value for the year equal to that excess;

(*e*) a particular property can only be designated once for the year;

(*f*) the insurer may designate for a taxation year a portion of a particular property where the designation of the entire property would result in a designation of property with a total value for the year exceeding that required to be designated by the insurer under paragraphs (*a*) to (*d*); and

(*g*) where in the opinion of the Minister the insurer has failed to designate property for the year in accordance with this section,

(i) subject to subparagraph (ii), any designation of property by the insurer for the year that is selected by the Minister is deemed not to have been made, and

(ii) property owned by the insurer at any time in the year may be designated by the Minister in accordance with this subsection and subsections (3) and (4), and the property so designated is deemed to have been designated by the insurer for the year.

Order of property

(3) For the purpose of subsection (2), investment property of an insurer shall be designated for a taxation year in respect of the insurer's insurance businesses in Canada in the following order:

(*a*) Canadian investment property owned by the insurer at the beginning of the year that was designated insurance property of the insurer for its preceding taxation year except that such property shall be designated in the following order:

(i) real and depreciable property,

(ii) mortgages, hypothecs, agreements of sale and other forms of indebtedness in respect of real property situated in Canada or depreciable property situated in Canada or depreciable property leased to a person resident in Canada for use inside and outside of Canada, and

(iii) other property;

(*b*) property (other than Canadian investment property) owned by the insurer at the beginning of the year that was designated insurance property of the insurer for its preceding taxation year;

(*c*) Canadian investment property (other than property included in paragraph (*a*)) in the order set out in subparagraphs (*a*)(i) to (iii); and

(*d*) other property.

Equity limit for the year

(4) Notwithstanding subsections (2) and (3),

(*a*) the total value for the year of Canadian equity property that may be designated in respect of an insurer's insurance businesses for a taxation year shall not exceed the insurer's equity limit for the year; and

(*b*) the insurer may designate for a taxation year a portion of a particular Canadian equity property where the designation of the entire property would result in a designation of Canadian equity property with a total value for the year exceeding that allowed to be designated under paragraph (*a*).

Exchanged property

(5) For the purposes of subsection (3) and this subsection, property acquired by an insurer in a particular taxation year by reason of

(*a*) a transaction described in section 51, 51.1, 85.1 or 86 of the Act,

(*b*) a transaction in respect of which an election was made under subsection 85(1) or (2) of the Act,

(*c*) an amalgamation of two or more corporations (within the meaning assigned by subsection 87(1) of the Act), or

(*d*) a winding-up of a corporation to which subsection 88(1) of the Act applied,

as consideration for or in exchange for property of the insurer that was designated insurance property of the insurer in respect of a particular insurance business for its preceding taxation year is deemed to be designated insurance property in respect of the particular business of the insurer for that preceding year and to have been owned by the insurer at the beginning of the particular year.

Non-investment property

(6) Non-segregated property (other than investment property) owned by an insurer at any time in a taxation year that is used or held by the insurer in the year in the course of carrying on an insurance business in Canada is deemed to be designated insurance property of the insurer for the year in respect of the business.

3. Paragraph 2403(2)(*a*) of the Regulations is replaced by the following:

(*a*) whether paragraphs 219(5.2)(*a*) and (*b*) of the Act apply; and

4. Sections 2404 to 2406 of the Regulations are replaced by the following:

Prescribed amount

2404. For the purpose of subparagraph 138(5)(*b*)(iv) of the Act, the prescribed amount in respect of an insurer for a taxation year is that proportion of the total of all amounts each of which is an amount of interest described in paragraph 20(1)(*c*) of the Act that is payable by the insurer in respect of the year on borrowed money (other than borrowed money used to acquire property or used or held by a segregated fund) used by the insurer for the purpose of earning income from an insurance business carried on by it in Canada or an amount otherwise deductible under paragraph 20(1)(*d*) of the Act for the year that is paid in the year on such interest, that

(*a*) the total of the amount described in subparagraph (*a*)(ii) or (*b*)(ii), as the case may be, of the definition "Canadian investment fund" in subsection 2400(1) in respect of the insurer as at the end of the year and the amount so described as at the end of its preceding taxation year

is of

(*b*) the total of the amount described in clause (*a*)(ii)(A) or clause (*b*)(ii)(A), as the case may be, of the definition "Canadian investment fund" in subsection 2400(1) in respect of the insurer as at the end of the year and the amount so described as at the end of its preceding taxation year.

Policy loans

2405. Notwithstanding any other provision in this Part, a designated insurance property or an investment property of an insurer does not include a policy loan payable to the insurer.

5. (1) The portion of subsection 2410(1) of the Regulations before the description of A is replaced by the following:

Prescribed amount

2410. For the purpose of subsection 138(4.4) of the Act, the amount prescribed in respect of a property for a period in a taxation year is the amount determined by the formula

$$[(A \times B) \times C/365] - D$$

where

(2) The descriptions C to F in subsection 2410(1) of the Regulations are replaced by the following:

C is the number of days in the period; and

D is the income derived from the property in the period by the person or partnership that owned the property.

(3) Subsection 2410(2) of the Regulations is repealed.

6. (1) The description of B in subsection 2411(1) of the Regulations is replaced by the following:

B is the positive or negative amount, as the case may be, determined in respect of the insurer for the year under subsection (4) in respect of the insurer's investment property that is designated insurance property for the year;

(2) the description of B.1 in subsection 2411(1) of the Regulations is replaced by the following:

B.1 is the positive or negative amount, as the case may be, determined in respect of the insurer for the year under subsection (4.1) in respect of property disposed of by the insurer in a taxation year for which it was designated insurance property of the insurer; and

(3) The portion of subsection 2411(3) of the Regulations before the description of A is replaced by the following:

(3) The positive or negative amount, as the case may be, determined under this subsection in respect of an insurer for a taxation year shall be the amount determined by the formula

$$\left[\frac{(A + A.1)}{B} \times C\right] + \frac{(D \times F)}{E} + \left[\frac{(G + G.1)}{H} \times J\right]$$

or, where the value for the year of the insurer's foreign investment property that is designated insurance property for the year is not greater than 5 per cent of the amount of the insurer's mean Canadian investment fund for the year and the insurer so elects in its return of income under Part I for the year, the amount determined by the formula

$$\left[\frac{(A + A.1)}{B} \times (C + J)\right] + \frac{(D \times F)}{E}$$

(4) The description of C in subsection 2411(3) of the Regulations is replaced by the following:

C is the total value for the year of the insurer's Canadian investment property (other than Canadian equity property) that is designated insurance property of the insurer for the year;

(5) The description of F in subsection 2411(3) of the Regulations is replaced by the following:

F is the total value for the year of the insurer's Canadian investment property that is Canadian equity property that is designated insurance property of the insurer for the year;

(6) The description of J in subsection 2411(3) of the Regulations is replaced by the following:

J is the total value for the year of the insurer's foreign investment property that is designated insurance property of the insurer for the year.

(7) The portion of the description of A in subsection 2411(4) of the Regulations before paragraph (*a*) is replaced by the following:

A is the total of the following amounts determined in respect of the property for the year, or that would be determined in respect of the property for the year if the property were designated insurance property of the insurer in respect of an insurance business in Canada for each taxation year in which it was held by the insurer:

(8) The descriptions of A and B in subsection 2411(4.1) of the Regulations are replaced by the following:

A is the total of the amounts included under paragraphs 142.4(4)(*a*) and (*c*) of the Act in the insurer's income for the year in respect of the property, or that would be so included if the property were designated insurance property of the insurer in respect of an insurance business in Canada for each taxation year in which it was held by the insurer; and

B is the total of the amounts deductible under paragraphs 142.4(4)(*b*) and (*d*) of the Act in respect of the property in computing the insurer's income for the year, or that would be so deductible if the property were designated insurance property of the insurer in respect of an insurance business in Canada for each taxation year in which it was held by the insurer.

(9) Subsection 2411(7) of the Regulations is repealed.

7. Subsection 2412 of the Regulations is replaced by the following:

Mean Canadian investment fund

2412. (1) The mean Canadian investment fund of an insurer for a particular taxation year is the total of

(*a*) 1/2 of the total of

(i) its Canadian investment fund at the end of the particular year,

(ii) where the insurer is resident in Canada, its Canadian investment fund at the end of its preceding taxation year, and

(iii) where the insurer is non-resident, its Canadian investment fund at the end of its preceding taxation year determined as if its attributed surplus for that preceding year were its attributed surplus for the particular year; and

(*b*) the insurer's cash-flow adjustment for the particular year.

Cash-flow adjustment

(2) An insurer's cash-flow adjustment for a taxation year is the total of

(*a*) where the year ended 6 months or more after it began, the positive or negative amount determined by the formula

$$1/2 \left[A - \frac{(B + 3C + 5D + 7E)}{F} \right]$$

where

A is the total of B, C, D and E;

B is the amount determined under subsection (3) in respect of the insurer for the first 3-month period in the year;

C is the amount determined under subsection (3) in respect of the insurer for the second 3-month period in the year;

D is the amount determined under subsection (3) in respect of the insurer for the third 3-month period in the year;

E is the amount determined under subsection (3) in respect of the insurer for the fourth 3-month period in the year; and

F is the number of consecutive 3-month periods in the year; and

(*b*) the amount determined under subsection (4) in respect of the insurer for the year.

Amounts paid and received

(3) The amount determined in respect of an insurer for a particular 3-month period in a taxation year is the positive or negative amount determined by the formula

$$G - H$$

where

G is the total of all amounts (other than an amount included in subsection (4)) each of which is

(*a*) the amount of a premium or consideration received by the insurer in the period in respect of a contract of insurance (including a settlement annuity) entered into in the course of carrying on its insurance businesses in Canada,

(*b*) an amount received by the insurer in the period in respect of interest on or a repayment in respect of a policy loan made under a life insurance policy in Canada, or

(*c*) an amount received by the insurer in the period in respect of reinsurance (other than reinsurance undertaken to effect a transfer of a business in respect of which subsection 138(11.5), (11.92) or (11.94) of the Act applies) arising in the course of carrying on its insurance businesses in Canada; and

H is the total of all amounts (other than an amount included in subsection (4)) each of which is

(*a*) the amount of a claim or benefit (including a payment under an annuity or settlement annuity, a payment of a policy dividend and an amount paid on a lapsed or terminated policy), a refund of premiums, a premium or a commission paid by the insurer in the period under a contract of insurance in the course of carrying on its insurance businesses in Canada,

(*b*) the amount of a policy loan made by the insurer in the period under a life insurance policy in Canada, or

(*c*) an amount paid by the insurer in the period in respect of reinsurance (other than reinsurance undertaken to effect a transfer of a business in respect of which subsection 138(11.5), (11.92) or (11.94) of the Act applies) in the course of carrying on its insurance businesses in Canada.

Daily adjustment

(4) The amount determined under this subsection in respect of an insurer for a taxation year is the positive or negative amount determined by the formula

$$\frac{(I - J)}{2} - (K - L)$$

where

I is the total of all amounts each of which is an amount described in any of paragraphs (*a*) to (*c*) of the description of K;

J is the total of all amounts each of which is an amount described in any of paragraphs (*a*) to (*c*) of the description of L;

K is the total of all amounts each of which is the amount determined in respect of a day in the year equal to that proportion of the total of all amounts each of which is

(*a*) where the total of all amounts each of which is an amount received by the insurer in the year from a particular person or partnership or from a person affiliated with the particular person or partnership in respect of one or more contracts of insurance (other than reinsurance undertaken to effect a transfer of a business in respect of which subsection 138(11.5), (11.92) or (11.94) of the Act applies) entered into in the course of carrying on an insurance business in Canada exceeds $1,000,000, any such amount received by the insurer on the day,

(*b*) an amount received by the insurer on the day in respect of any indebtedness incurred or assumed for the purpose of carrying on an insurance business in Canada (other than indebtedness incurred or assumed to acquire a particular property) represented by bonds, debentures, notes, mortgages, bankers' acceptances, or similar obligations issued or assumed by the insurer or by any loan or advance made to the insurer, or

(*c*) where the insurer is resident in Canada in the year, that proportion of the total of all amounts each of which is the amount received by the insurer on the day in respect of the issuance of a share of the capital stock of the insurer that

(i) the total of the insurer's weighted Canadian liabilities as at the end of the year and its weighted Canadian liabilities as at the end of its preceding taxation year

is of

(ii) the total of the insurer’s weighted total liabilities as at the end of the year and its weighted total liabilities as at the end of its preceding taxation year

that

(*d*) the number of days in the year before that day

is of

(*e*) the number of days in the year; and

L is the total of all amounts each of which is the amount determined in respect of a day in the year equal to that proportion of the total of all amounts each of which is

(*a*) where the total of all amounts each of which is an amount paid by the insurer in the year to a particular person or partnership or to a person affiliated with the particular person or partnership in respect of one or more contracts of insurance (other than reinsurance undertaken to effect a transfer of a business in respect of which subsection 138(11.5), (11.92) or (11.94) of the Act applies) entered into in the course of carrying on an insurance business in Canada exceeds $1,000,000 and an amount in respect of the contract was included in paragraph (*a*) of the description of K in any taxation year, any such amount paid by the insurer on the day,

(*b*) an amount paid (other than interest) by the insurer on the day in respect of any indebtedness incurred or assumed for the purpose of carrying on an insurance business in Canada (other than indebtedness incurred or assumed to acquire a particular property) represented by bonds, debentures, notes, mortgages, bankers’ acceptances, or similar obligation issued or assumed by the insurer or by any loan or advance made to the insurer, or

(*c*) where the insurer is resident in Canada in the year, that proportion of the total of all amounts each of which is an amount paid on the day by the insurer to a shareholder of the insurer in respect of the redemption or cancellation of a share of the insurer’s capital stock that

(i) the total of the insurer’s weighted Canadian liabilities as at the end of the year and its weighted Canadian liabilities as at the end of its preceding taxation year

is of

(ii) the total of the insurer’s weighted total liabilities as at the end of the year and its weighted total liabilities as at the end of its preceding taxation year

that

(*d*) the number of days in the year before that day

is of

(*e*) the number of days in the year.

8. The portion of section 8201 of the Regulations before paragraph (*a*) is replaced by the following:

Permanent Establishments

8201. For the purposes of the definition "outstanding debts to specified non-residents" in subsection 18(5), subsections 16.1(1), 34.2(6), 112(2) and 125.4(1), the definition "taxable supplier" in subsection 127(9) and paragraph 260(5)(*a*) of the Act, a "permanent establishment" of a person or partnership (referred to in this section as the "person") means a fixed place of business of the person, including an office, a branch, a mine, an oil well, a farm, a timberland, a factory, a workshop or a warehouse and, where the person does not have any fixed place of business, the principal place at which the person’s business is conducted, and

9. The definitions "attributed surplus", "Canadian reserve liabilities" and "total reserve liabilities" in section 8600 of the Regulations are replaced by the following:

"attributed surplus"

"attributed surplus" of a non-resident insurer for a taxation year has the meaning assigned by subsection 2400(1);

"Canadian reserve liabilities"

"Canadian reserve liabilities" of an insurer as at the end of a taxation year has the meaning assigned by subsection 2400(1);

"total reserve liabilities"

"total reserve liabilities" of an insurer as at the end of a taxation year means the total amount as at the end of the year of the insurer's liabilities and reserves (other than liabilities and reserves in respect of a segregated fund) in respect of all its insurance policies, as determined for the purposes of the Superintendent of Financial Institutions, if the insurer is required by law to report to the Superintendent of Financial Institutions, or in any other case, the Superintendent of Insurance or other similar officer or authority of the province under the laws of which the insurer is incorporated.

10. Subsection 8605(3) of the Regulations is replaced by the following:

(3) For the purposes of subclause 181.3(1)(*c*)(ii)(A)(V) and clause 190.11(*b*)(i)(E) of the Act, the amount prescribed in respect of a particular corporation for a taxation year ending at a particular time means the total of all amounts each of which would be the total reserve liabilities of a foreign insurance subsidiary of the particular corporation as at the end of the subsidiary's last taxation year ending at or before the particular time if the subsidiary were required by law to report to the Superintendent of Financial Institutions for that year.

11. (1) Section 1 applies after December 12, 1991.

(2) Sections 2 to 10 apply to the 1997 and subsequent taxation years.

Explanatory Notes

PREFACE

These explanatory notes relate to proposed amendments to the Income Tax Regulations. These notes describe these proposed amendments, clause by clause, for the assistance of Members of Parliament, taxpayers and their professional advisors.

The Honourable Paul Martin
Minister of Finance

These explanatory notes are provided to assist in an understanding of proposed amendments to the Income Tax Regulations. These notes are intended for information purposes only and should not be construed as an official interpretation of the provisions they describe.

EXPLANATORY NOTES

DRAFT INCOME TAX REGULATIONS

ITR
804

Interpretation

Section 804 defines the term "registered non-resident insurer" as a non-resident corporation registered to carry on business in Canada under Part VIII of the *Canadian and British Insurance Companies Act* or under the *Foreign Insurance Companies Act*. Those Acts have been replaced by the *Insurance Companies Act*. The reference to those Acts is replaced with a reference to the *Insurance Companies Act*, and the terminology has been changed to refer to a company "approved", rather than "registered", under the new Act.

This amendment applies after December 12, 1991 to coincide with the coming-into-force of the *Insurance Companies Act*.

ITR
Part XXIV

Insurance companies

Part XXIV of the Income Tax Regulations sets out special rules for the computation of an insurer's income. The amendments to Part XXIV apply to the 1997 and subsequent taxation years.

ITR
2400

Existing section 2400 of the Regulations provides rules for determining the investment property of multinational resident life insurers and non-resident insurers that is considered to be used or held in support of the insurer's Canadian insurance business. The rules in section 2400 have been extensively modified and moved to new section 2401.

In essence, amended section 2400 replaces the definitions and rules which are set out in existing section 2405. Amended subsections 2400(1) and (4) contain definitions for terms and expressions used in Part XXIV of the Regulations. Many of these terms and expressions were previously set out in subsections 2405(1), (2) and (3). Amended subsection 2400(2) sets out rules for determining the carrying value of a property or any other amount under Part XXIV of the Regulations. Amended subsection 2400(3) provides a rule for determining the liabilities of a taxpayer.

ITR
2400(1)

Definitions

"attributed surplus"

In general terms, the attributed surplus for the year of a non-resident insurer is a notional calculation of its surplus in respect of its Canadian property and casualty insurance business and Canadian life insurance and accident and sickness insurance businesses.

Under the existing definition, a non-resident insurer's "attributed surplus for the year" is made up of the following two components:

1. surplus in respect of its Canadian property and casualty insurance business, and

2. surplus in respect of its other Canadian insurance businesses. An insurer's other insurance businesses are usually its life insurance and accident and sickness insurance businesses (in this note an insurer's other insurance businesses will be simply referred to as the insurer's life insurance business).

The amount in 1. above is determined by the rules in the definition of "property and casualty surplus" found in subsection 2405(3) of the existing Regulations (now found in subsection 2400(1); for further details see the commentary to that definition, below).

The amount in 2. above is equal to the insurer’s *life surplus factor* (which is a percentage) multiplied by the total amount of its reserves and liabilities in respect of its Canadian life insurance business. An insurer’s *life surplus factor* is determined under the definition of *"life surplus factor"* (in subsection 2405(3) of the existing Regulations) as one of the following expressed as a percentage:

(*a*) where the insurer makes an election under section 2401, the surplus the insurer would have been considered to have it if had been a life insurer resident in Canada;

(*b*) where the insurer made an election under section 2401 in one of the four preceding years, its surplus and liabilities) for the most recent year in which an election was made; or

(*c*) 10%.

Section 2401 of the existing Regulations sets out the administrative requirements for making an election to determine its surplus as if the non-resident where a life insurer resident in Canada. In essence, an election under section 2401 allowed a non-resident insurer to calculate its surplus as if it were life insurer resident in Canada. Accordingly, where an election is made, the non-resident’s Canadian investment fund may be similar to the Canadian investment fund that it would have had if it were a Canadian resident (because attributed surplus is a component of the Canadian investment fund).

The definition of *"attributed surplus for the year"* is renamed simply *"attributed surplus"* and is amended with respect to the computation of an insurer’s surplus in respect of its Canadian life insurance and accident and sickness insurance businesses. Paragraph (*a*) of the amended definition retains the property and casualty surplus component of attributed surplus, while the existing *"life surplus factor"* calculation is replaced by new rules in paragraphs (*b*) and (*c*) of the amended definition.

New paragraph (*c*) of the amended definition of *"attributed surplus"* contains the general rule for determining surplus is Canada in respect of an insurer’s life insurance and accident and sickness insurance businesses in Canada. Under this paragraph an insurer’s attributed surplus is 120% of the average of the current year’s and the immediately preceding year’s margin of assets over liabilities which are required to be maintained by the insurer under the *Insurance Companies Act* in respect of its Canadian life insurance and accident and sickness insurance businesses.

New paragraph (*b*) is applicable only where the insurer elects in prescribed form and manner to calculate its surplus using the rules which apply to resident life insurers. As explained in more detail in the commentary to that definition of *"Canadian investment fund"*, subparagraph (*a*)(iii) of that definition sets out the Canadian portion of a resident life insurer's surplus in respect of its life and accident and sickness insurance businesses carried on in Canada. Under that subparagraph an insurer prorates its policyholders' and shareholders' equity (as reported to the Office of the Superintendent of Financial Institutions) using the ratio of the insurer's Canadian liabilities to its world-wide liabilities. To make use of this election, the non-resident insurer must compute its policyholders' and shareholders' equity, and its world-wide liabilities as if it were a life insurer resident in Canada. Once the equity and world-wide liability amounts are determined, the non-resident insurer can use the proration formula in subparagraph (*a*)(iii) of the amended definition of *"Canadian investment fund"* to compute its Canadian surplus.

The form and manner of making the election under new paragraph (*b*) of the definition of *"attributed surplus"* will be prescribed by the Department of National Revenue; accordingly, the existing rules in section 2401 for making an election are repealed.

"Canadian business property"

The expression "Canadian business property" is used in the definition of "gross Canadian life investment income" which is also contained in amended subsection 2400(1). These definitions are relevant only for the purpose of computing a life insurer's income from its participating life insurance business under section 2402.

The definition of "Canadian business property is amended in three respects. First, paragraph (*a*) is amended by removing the reference to a insurer that <u>did not</u> carry on a life insurance business in Canada in the year: as noted above, these definitions are redundant for insurers that do not carry on a life insurance business. Second, the phrase *"property used by it in the year in, or held by it in the year in the* *course of*" (which means property that is factually used in an insurance business) is simplified to *"property used or held by it in the year"*. This latter change is not intended to effect any substantive change to the definition.

Third, paragraph (*b*), which applies to multinational resident life insurers, is amended by replacing the reference to "property used by it in the year in, or held by it in the year in the course of" with the new expression "designated insurance property".

"Canadian equity property"

The definition of *"Canadian equity property"* is relevant for the purposes of the equity limit in subsection 2400(4), the transitional rule in section 2409 and the minimum net revenue test in section 2411 of the Regulations.

Under the existing definition of the term (found in subsection 2405(3)), Canadian equity property means

- a share, an income bond or debenture, or small business development or small business bond issued by a person or partnership resident in Canada, or

- a share of a designated corporation or an interest in a partnership or trust, based on the amount of equity property owned by such corporation, partnership or trust.

Currently, where an insurer owns shares of a "designated corporation" (formerly defined in subsection 2405(3) as a corporation in respect of which the insurer or non-arm’s length persons held shares that represented 30% or more of the common shares of the corporation) only that proportion of the shares that the designated corporation’s Canadian equity property is of all its property is considered to be Canadian investment property.

The definition is amended as a consequence of the replacement of the designated corporation definition with the affiliated person concept (as set out in section 251.1 of the Act). The definition is also amended so that paragraph (*a*) applies only where the partnership is a Canadian partnership. The amended definition continues to be relevant for the equity limit in amended subsection 2400(4), the rules in section 2409 and amended section 2411.

"Canadian investment fund"

Current rules:

An insurer's Canadian investment fund ("CIF") at the end of a taxation year represents the quantum of investment property considered to be used in the insurer's Canadian insurance business as of the end of the year. For a resident life insurer, its CIF at the end of a year is currently determined by pro-rating the value of the insurer's world-wide investment property using the ratio of its Canadian reserve liabilities to its total reserve liabilities at year-end. The amount of investment property pro-rated is adjusted by the insurer's policy loans and general indebtedness.

A non-resident insurer's CIF at the end of a year is equal to the total of

- its maximum tax actuarial reserves,
- its policy dividend reserves on a tax basis,
- its reserves in respect of its property and casualty insurance business in Canada (as reported to the Office of the Superintendent of Financial Institutions ("OSFI")), and
- the greater of:

  (*a*) its "surplus funds from operations" computed at the end of the preceding year, and

  (*b*) its "attributed surplus" for the year

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- the value of all its non-investment property which is factually used in carrying on its insurance businesses in Canada, and

- its deferred acquisition expenses in respect of its property and casualty insurance business in Canada.

In general terms, a non-resident insurer’s surplus funds from operations is its post-1968 income and gains from the disposition of property considered to have been used in an insurance business in Canada, less its post-1968 business losses and losses from property considered to have been used in an insurance business in Canada. A non-resident insurer’s attributed surplus is the total of the insurer’s surplus in respect of its insurance businesses in Canada less the amount of non-investment property that is considered to be used in respect of those business. (For further details see the commentary, above, on the definition of "attributed surplus".)

Proposed changes:

Under paragraph (*a*) of the amended CIF definition, a resident insurer’s CIF at the end of a year is equal to the total of:

- its Canadian reserve liabilities (less policy loans and outstanding premiums in respect of Canadian policies)

- its other liabilities in respect of its Canadian insurance businesses to the extent that those liabilities exceed: (*a*) the value of the insurer’s non-investment property (other than shares and debt of affiliated financial institutions) which is factually used in its Canadian insurance businesses; (*b*) the part of the insurer’s financial institution allowance that, based on the relationship between the amount of its general Canadian liabilities and Canadian equity, may be considered to have been funded from those liabilities; and (*c*) its deferred tax debit balance

- its policyholders’ and shareholders’ equity, less the value of its shares or debt of affiliated financial institutions multiplied by the ratio of weighted Canadian liabilities to weighted total liabilities (For further details, see the commentary on the definitions of "weighted total liabilities" and "total weighted liabilities" below.) This equity amount is eligible to be reduced by the part of the insurer’s financial institution allowance that, based on the relationship between the amount of its Canadian general liabilities and Canadian equity, may be considered to have been funded from that equity.

Conceptually, the new CIF for a resident insurer is determining by dividing the right hand side of the insurer's regulatory balance sheet into Canadian and foreign components. The liabilities which relate to the Canadian insurance business will be included in the insurer's CIF. The remaining part of the right hand side of the balance and, correspondingly, the rest of the insurer's CIF, will be composed of the insurer's capital and surplus accounts. A factual allocation of these accounts to Canada is not practical because most multinational life insurers' capital and surplus is considered to be held in support of its world-wide operations - not only those in Canada. The new resident CIF uses the ratio of weighted Canadian liabilities to weighted total liabilities to establish the Canadian portion of an insurer's capital and surplus accounts.

The amended non-resident CIF is similar to the resident life insurer's CIF with respect to the computation of its liability accounts. However, because non-resident insurers are not, generally, required to compute their total liabilities in accordance with a Canadian regulatory authority it would generally be impractical to use the weighted CL/weighted TL ratio for apportioning capital. The non-resident's capital and surplus components are equal to the greater of its surplus funds from operations and attributed surplus.

More specifically, under paragraph (*b*) of the amended definition of CIF, a non-resident insurer's CIF is equal to:

- its Canadian reserve liabilities as at the end of the year less policy loans and outstanding premiums in respect of Canadian policies, and deferred acquisition expenses, at the end of the year; and

- its other liabilities in respect of an insurance business carried on in Canada that is reported to OSFI as a liability (excluding Canadian reserve liabilities, liabilities in respect of a segregated fund or debts in respect of the acquisition of a specific property of the insurer)

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- the total of the insurer’s non-investment property that is factually used in the course of carrying on an insurance business in Canada and its deferred tax debit balance at year-end; and

- the greater of:

  (A) the insurer’s surplus funds from operations computed at the end of the preceding year (adjusted for the amount of Part XIV branch tax paid), and

  (B) the insurer’s attributed surplus for the year. (For further details see the commentary on the amended definition of "attributed surplus" above.)

"Canadian investment property"

Canadian investment property is defined in subsection 2405(3) of the existing Regulations as investment property of an insurer that is

(*a*) land or depreciable property in Canada;

(*b*) Canadian equity property;

(*c*) Canadian resource property;

(*d*) mortgage or other forms of indebtedness in respect of land or depreciable property;

(*e*) Canadian currency deposits with Canadian financial institutions;

(*f*) Canadian currency government debt of a Canadian government; and

(*g*) shares of a designated corporation in Canada, interest in a partnership or trust where not less than 75% of the value of the corporation’s, partnership’s or trust’s assets is Canadian investment property.

The definition of "Canadian investment property" is used in the ordering rule for the designation of property (currently found in subsection 2400(6) and to be replaced with new subsection 2401(3)), and the minimum net revenue test for investment property in section 2411.

An insurer must designate its investment property in the following order:

1. property which was designated in the preceding year;

2. Canadian investment property in the following order:

   - land and depreciable property in Canada,

   - mortgages, agreements of sale and other forms of indebtedness in respect of land and depreciable property in Canada, and

   - other Canadian investment property; and

3. other investment property.

Section 2411 sets out the basis for determining the prescribed amount for the purpose of paragraph 138(9)(*b*) of the Act. This amount ensures that the insurer's net investment revenue from its designated property is not less than the net investment revenue that would be determined if the average rate of return on its designated assets were equal to the average rate of return on all its investment property. Under this net investment revenue test, the average rate of return is determined in respect of three classes of property: Canadian investment property, Canadian equity property and foreign investment property. This rule is intended to prevent an insurer from understating its Canadian investment income by only designating assets with low investment returns.

The definition of "Canadian investment property" is amended in several ways. First, the definition is reworded to make it easier to read. Second, the new definition of "deposit balance" is used to replace the wording in paragraph (*e*). Third, the look-through rule for shares of corporations is amended to change the reference from *designated* corporation to corporation *affiliated* with the insurer who owns the shares. The affiliation rules are set out in section 251.1 of the Act.

The definition continues to be relevant for the designation of property ordering rule in amended subsection 2401(3) and the minimum revenue test in amended section 2411.

"Canadian outstanding premiums"

The "Canadian outstanding premiums" of an insurer at any time means the total of all amounts each of which is the amount of an outstanding premium of the insurer in respect of an insurance policy at that time, to the extent that the amount of the premium is included in the insurer's Canadian reserve liabilities at that time.

"Canadian reserve liabilities"

An insurer's "Canadian reserve liabilities" is defined as an insurer's liabilities and reserves (excluding those in respect of segregated funds) in respect of its insurance policies in Canada as determined for the purposes of the relevant authority. An insurance policy in Canada is defined in subsection 2405(3) of the existing Regulations as a life insurance policy in Canada, a fire insurance policy issued or effected upon property in Canada, and a policy where the risks covered by the policy were ordinarily in Canada. The relevant authority is defined in subsection 2405(3) as the Superintendent of Financial Institutions or the Superintendent of Insurance or other similar officer or authority of the province in which the insurer is incorporated.

The definition of "Canadian reserve liabilities" is amended as a consequence of the repeal of the definitions of "insurance policy in Canada" and "relevant authority". The definition of "insurance policy in Canada" is incorporated into the amended definition of "Canadian reserve liabilities". The reference to "relevant authority" is removed because amended subsection 2400(2) provides rules for determining any amount in the amended rules. (For further details see the commentary to amended subsection 2400(2) below.)

"deposit balance"

A "deposit balance" is an amount standing to an insurer’s credit on account of amounts deposited with a deposit-taking institution or a trust company.

The definition replaces the existing references to "a balance standing to the insurer’s credit as or on account of amounts deposited with a corporation authorized to accept deposits or to carry on the business of offering to the public its services as a trustee." The definition is used in subsection 2410(1) and the amended definitions of "Canadian investment property" and "value" in amended subsection 2400(1).

"equity limit"

Subsection 2400(4) of the existing Regulations provides that an insurer cannot designate for a taxation year Canadian equity property in excess of its equity limit for the year. The limit is necessary to ensure that an insurer cannot fill its Canadian investment fund with Canadian equity property on which it receives tax-free dividend income. The existing definition of *"equity limit for the year"*, found in subsection 2405(3) of the Regulations, provides a different limit for resident life insurers, non-resident non-life insurers and non-resident life insurers.

Paragraph (*a*) of the definition provides that the equity limit for resident life insurers is the greater of

- the total value for the year of all the insurer’s equity property multiplied by the ratio of the insurer’s mean Canadian reserve liabilities (less policy loans and outstanding premiums in respect of Canadian policies) to the insurer’s mean total reserve liabilities (less all policy loans and outstanding premiums), and

- 8% of the insurer’s Canadian investment fund for the year.

Paragraph (*a*) is amended by removing the 8% limit and replacing the ratio of mean Canadian reserve liabilities to mean total reserve liabilities with the ratio of weighted Canadian liabilities to weighted total liabilities (For further details see the new definitions of "weighted Canadian liabilities" and "weighted total liabilities" below.)

Paragraph (*b*) of the definition currently provides that a non-resident, non-life insurer's equity limit is 1/4 of the total of

- the amount by which its mean Canadian reserve liabilities for the year exceeds its average deferred acquisition expenses and premiums receivable for the year as determined for the purposes of the relevant authority, and

- its *property and casualty surplus for the year*.

The definition of *"property and casualty surplus"* is currently set out in subsection 2405(3) and is reproduced in amended subsection 2400(1).

Paragraph (*b*) is amended by reorganizing subparagraph (*b*)(i) into 2 separate clauses and removing the reference to *"relevant authority"*, which is to be repealed.

Paragraph (*c*) of the definition currently provides that a non-resident life insurer's *equity limit* is the total of

- its *life equity limit* for the year, and

- the amount that would be determined under paragraph (*b*) if the insurer carried on only a property and casualty business in Canada.

An insurer's *"life equity limit"* for a year is defined in subsection 2405(3) as one of the following:

- where the insurer elects under the definition *"life surplus factor"* for the year, the amount that would have been its equity limit if the insurer were a life insurer resident in Canada,

- where the insurer does not make an election but had made one in one of the four preceding taxation years, the amount determined under that preceding election, or

- in any other case, 8% of the insurer's *Canadian investment fund* for the year.

Paragraph (*c*) is amended as a consequence of the repeal of the definitions *"life equity limit"* and *"life surplus factor"*, and the addition of the new definitions *"mean Canadian investment fund"*, *"weighted Canadian liabilities"* and *"weighted total liabilities"*. Amended paragraph (*c*) provides that a non-resident life insurer's equity limit is the total of

- where the insurer elects under paragraph (*b*) of the amended definition *"attributed surplus"*, the greater of (*a*) 8% of the insurer's mean Canadian investment fund for the year; and (*b*) the total *value for the year* of all the insurer's *equity property* multiplied by the ratio *weighted Canadian liabilities* to *weighted total liabilities*;

- where the insurer does not make the above election, 8% of the insurer's *mean Canadian investment fund* for the year;

- 1/4 of the insurer's *property and casualty surplus* for the year; and

- 1/4 of the insurer's *mean Canadian reserve liabilities* in respect of its property and casualty insurance business (less its deferred acquisition expenses and premiums receivable in respect of that business for the current and preceding year).

"equity property"

The *"equity property"* of an insurer is currently defined in subsection 2405(3) of the Regulations as

- a share, income bond or debenture, small business development bond or small business bond issued by a person (other than a designated corporation) or partnership; or

- the shares of a designated corporation or an interest in a partnership or trust multiplied by the ratio of the value of the equity property owned by the designated corporation, partnership or trust to the value of all the property owned by the designated corporation, partnership or trust.

The definition of *"equity property"* is amended (and relocated to subsection 2400(1)) to ensure that it operates properly where the equities are held through multiple tiers of corporations, partnerships or trusts. The definition is also amended by replacing the reference to the designated corporation, which has been repealed, with a reference to *affiliated corporation* (as defined in section 251.1 of the Act).

"financial institution"

The new definition of "financial institution" provides that a corporation is a financial institution if it is a corporation described in any of paragraphs (*a*) to (*e*) of the definition of *"restricted financial institution"* (as defined in subsection 248(1) of the Act) or a corporation all or substantially all of the value of which is attributable to assets that are shares or debt of one or more financial institutions.

"foreign policy loan"

The definition of *"foreign policy loan"* means an amount advanced to a policy holder under a life insurance policy that is not a life insurance policy in Canada. The expression *life insurance policy in Canada"* is defined in subsection 138(12) of the Act.

"financial institution allowance"

The amount of an insurer's "financial institution allowance" is deducted, on a proportionate basis, from its Canadian reserve liabilities and its general liabilities in computing its Canadian investment fund. In general terms, an insurer's financial institution allowance is equal to the total value for the year of shares of, or debts owing to the insurer by, financial institutions affiliated with the insurer.

"gross Canadian life investment income"

The expression "gross Canadian life investment income" is defined for the purpose of section 2402, which contains the rules for determining an insurer's income for a year from carrying on its participating life insurance business in Canada. The changes to this definition merely update some of the wording.

"investment property"

Resident life insurers and non-resident insurers are required to include in their income from carrying on an insurance business in Canada the *gross investment revenue* from *investment property* that the insurer designates as being used in that business. An insurer must designate investment property equal to its *mean Canadian investment fund* for the taxation year. (For further information on the *Canadian investment fund* see the commentary to the amended definition of *Canadian investment fund* and amended subsection 2401 and amended section 2412.)

Only non-segregated property can be considered *investment property*. Non-segregated property is defined under subsection 138(12) of the Act as property not held in respect of a segregated fund. Such funds are taxed as trusts which are separate from the other activities of the insurer that administers the fund.

Paragraphs (*a*) to (*d*) of the definition of *"investment property"* set out the types of property that are considered to be investment property. Paragraph (*a*) currently refers to property acquired by the insurer for the purpose of earning *gross investment revenue* except property that is a portion of property which is treated as investment property by reason of paragraph (*b*), a share or debt of a *designated corporation*, or an interest in a partnership or trust. The structure of paragraph (*a*) is reorganized and the reference to *designated corporation* is replaced with a reference to a *corporation affiliated* (within the meaning assigned by section 251.1 of the Act) with an insurer.

Paragraph (*b*) currently includes as investment the portion of land or depreciable property of an insurer that is factually used or held by the insurer in the course of carrying on an insurance business in Canada. Only the portion of the property which is used in the year in for the purpose of earning *gross investment revenue* is considered to be investment property. The amendment to the paragraph attempts to simplify the wording and the structure of paragraph (*b*).

Existing paragraph (*c*) captures as investment property land or depreciable property that is vacant, held for resale or development in a year and is not used for the purpose of earning gross investment revenue in the year. New paragraph (*c*) provides that where an insurer is a life insurer, property described in paragraphs 138(4.4)(*a*) to (*d*) of the Act will be treated as investment property. Amended subsection 138(4.4) of the Act includes a prescribed amount in computing a life insurer's income in respect of vacant real property or real property under development. The amendment to paragraph (*c*) of the definition of *"investment property"* is intended to ensure that non-income producing real property will only be considered investment property when a prescribed amount of income is considered to have been earned on the property.

Paragraph (*d*) of the current definition of *"investment property"* provides that a share or debt of a *designated corporation*, an interest in a partnership or trust is investment property if

- 75% or more of the corporation's, partnership's or trust's property is investment property; and

- 90% or more of the gross revenue of the corporation, partnership or trust is derived from investment property.

Paragraph (*d*) is amended in three ways. First, the term *designated corporation*, which is repealed, is replaced with the expression corporation (other than a financial institution) *affiliated* with the insurer. For the purpose of determining whether a corporation is *affiliated* section 251.1 of the Act will apply. Second, the 90% gross revenue test in subparagraph (*d*)(v) has been deleted. Finally, the post-amble to paragraph (*d*) is amended so that every corporation, partnership and trust is deemed to be an insurer for the purpose of applying the paragraph. This last change is intended to ensure that the definitions in Regulation 2400 will apply to the corporation, partnership or trust which owns the investment property and that paragraph (*d*) will work even if the property is held in a multi-tier corporate, partnership or trust structure.

"mean Canadian investment fund"

The new definition *"mean Canadian investment fund"* is relevant for the purpose of determining what amount of investment property an insurer must designate in respect of its Canadian insurance businesses. The expression has the meaning assigned by section 2412. (For further details see the commentary on amended section 2412, below.)

"mean Canadian outstanding premiums"

The "mean Canadian outstanding premiums" of an insurer for a taxation year means the average of the insurer's Canadian outstanding premiums as at the end of the current taxation year and the immediately preceding taxation year.

"mean Canadian reserve liabilities"

The expression *"mean Canadian reserve liabilities"* for a taxation year means the average of an insurer's Canadian reserve liabilities at the end of the year and at the end of it preceding taxation year. The definition is not amended in substance, but the wording is up-dated. The definition is used in determining a non-resident's *equity limit* for the year and in the new designation of property rules in amended section 2401.

"mean maximum tax actuarial reserve"

The definition of *"mean maximum tax actuarial reserve"* for a taxation year means the average of an insurer's maximum tax actuarial reserve for the year and for the preceding year. The definition is not substantively amended, but the wording is up-dated. The definition is relevant in calculating an insurer's income from a participating life insurance business under section 2402.

"mean policy loans"

The definition of *"mean policy loans"* of an insurer for a taxation year means the average of an insurer's policy loans at the end of the year and at the end of the preceding year. The definition is not substantively amended, but the wording is up-dated. The definition is used in determining an insurer's *attributed surplus*, *Canadian investment fund* and its *equity limit*.

"outstanding premiums"

The "outstanding premiums" of an insurer with respect to an insurance policy at a particular time means the premiums due to the insurer under the policy at that time but unpaid.

"property and casualty surplus"

An insurer's *"property and casualty surplus"* is equal to the total of 7 1/2% of the average of the insurer's unearned premium reserve at the end of the year and at the end of its preceding year; 7 1/2% of its average provision for unpaid claims and adjustment expenses at the end of the year and the end of its preceding year; and its average investment valuation reserve at the end of the year and its preceding year. The definition of *"property and casualty surplus"* is relevant only in respect of a non-resident's property and casualty insurance business and is used in determining a non-resident's *Canadian investment fund* and *equity limit* for the year. The definition is not substantively amended, but the structure and wording are up-dated.

"segregated fund" and "segregated fund policies"

The expressions *segregated fund* and *segregated fund policies* have the meaning assigned by subsection 138.1(1) of the Act. The existing definition defines both expressions. Under the amended Regulations, each expression is defined separately. The definition of *"segregated fund policies"* is relevant only for the 1977 Carryforward Deduction set out in section 2408.

"value"

The definition *"value for the year"* is replaced by the definition of *"value"*.

Paragraph (*a*) of the definition of *"value"* currently provides that the value for a taxation year of a mortgage, hypothec, agreement of sale or an investment property that is a bank deposit is the gross investment revenue for the year earned on the property divided by the average interest rate earned on the property during the year. Paragraph (*a*) is amended by adding a reference to the new definition *"deposit balance"* and simplifying the wording by removing the references to interest expressed as a fraction.

Paragraph (*b*) of the existing definition applies to property, other than property described in paragraph (*a*), that is not owned throughout a taxation year. Where the property was owned at the end of the preceding taxation year, subparagraph (*b*)(i) provides that its value is its *valuation* at the end of the preceding taxation year prorated by the number of days the property was owned in the current taxation year. A similar rule in subparagraph (*b*)(ii) applies where the property is acquired during the taxation year. Depending on the type of property in question, its *valuation* under the existing Regulations may be based on its cost, undepreciated capital cost, or book value for purposes of the insurer's regulatory authority. Paragraph (*b*) is amended consequential on the repeal of the definition *"valuation"*, and as amended provides that the value of property is

- where the property is owned at the end of the preceding taxation year, its carrying value at that year-end;

- where the property is owned at the end of the current taxation year, its value, its carrying value at that year-end; and

- in any case where the property was acquired during the year and was not owned at the end of the year, its cost when it was acquired.

To determine the value of a property to an insurer, its carrying value or cost is pro-rated for the number of days that the property is owned by the insurer in the year, and reduced by the average amount of debt incurred by the insurer to acquire the property. Under amended subsection 2400(2) the carrying value of a property is its value as accepted on the insurer's balance sheet by the Superintendent of Financial Institutions or a province's superintendent of insurance if the insurer is provincially incorporated. In general, where the property is not owned by someone other than an insurer, its carrying value is equal to the value that is reflected in the owner's year-end balance sheet. (For more details see the commentary to amended subsection 2400(2).)

Paragraph (*c*) of the existing definition *"value for the year"* provides that the value for a taxation year of a property owned throughout the year is equal to the average of its valuation at the end of the taxation year and its valuation at the end of its preceding taxation year. As a consequence of the repeal of the definition of *"valuation"*, paragraph (*c*) of the definition *"value"* refers to the carrying value of a property. Amended paragraph (*c*) also requires that in computing a property's value that the property's average carrying value is reduced by the average amount of debt incurred to acquire the property.

"weighted Canadian liabilities"

The new definition *"weighted Canadian liabilities"* is relevant for the purposes of the amended definitions *"Canadian investment fund"* and *"equity limit"*. The definition of *"weighted Canadian liabilities"* is also important for determining an insurer's daily cash-flow adjustment under amended subsection 2412(4).

An insurer's *weighted Canadian liabilities* is the total of its weighted Canadian life insurance and accident and sickness insurance policy liabilities (to the extent they exceed its policy loans) and its other non-weighted Canadian insurance liabilities (excluding those in respect of a segregated fund or a debt incurred or assumed to acquire a particular property). Weighting life and accident and sickness insurance policy liabilities by a factor of 3 recognizes the fact that an insurer must maintain more reserves in respect of such policies than in respect of other types of insurance products.

"weighted total liabilities"

The new definition *"weighted Canadian liabilities"* is relevant for the purposes of the amended definitions *"Canadian investment fund"* and *"equity limit"*. The definition of *"weighted Canadian liabilities"* is also important for determining an insurer's daily cash-flow adjustment under amended subsection 2412(4).

An insurers *weighted total liabilities* is similar to its *weighted Canadian liabilities* except that the former includes an insurer's world-wide insurance liabilities rather than only its Canadian insurance liabilities. (For further details see the above commentary to the definition of *"weighted Canadian liabilities"*.)

ITR
2400(2)

Determining values and amounts

Existing subsection 2400(2) provides rules relating to the designation of property. These rules are modified and moved to amended section 2401.

For the purposes of Part XXIV of the Regulations, amended subsection 2400(2) provides rules for determining the carrying value of any property owned by a taxpayer and any other amount in respect of a taxpayer. Where the taxpayer is an insurer, paragraph 2400(2)(*a*) provides that the carrying value or other amount is the amount reflected on the insurer's year-end balance sheet as accepted by the Superintendent of Financial Institutions or, where the insurer is incorporated under province's law, the balance sheet accepted by that province's superintendent of insurance. Where the taxpayer is not an insurer, paragraph 2400(2)(*b*) provides that the carrying value or other amount is the amount that would be reflected in the taxpayer's year-end balance sheet if the balance sheet was prepared in accordance with generally accepted accounting principles.

ITR
2400(3)

Liabilities

Existing subsection 2400(3) provides rules that apply when designated property is exchanged for other property under various rollover transactions. An amended version of this rule is contained in amended subsection 2401(5).

Amended subsection 2400(3) provides that any reference in Part XXIV of the Regulations to an amount reported as a liability of an insurer is to be construed as a reference to the amount that is reported as a liability in the taxpayer’s year-end balance sheet accepted by the Superintendent of Financial Institutions or, where the taxpayer is incorporated under a province’s law, the amount reported as a liability on the year-end balance sheet accepted by that province’s superintendent of insurance or similar officer.

ITR
2400(4)

Definitions

Existing subsection 2400(4) sets out the restriction on the ability of insurers to designate Canadian equity property up to the insurer’s equity limit. This equity limit rule has been moved as part of these changes to subsection 2401(4).

Amended subsection 2400(4) reproduces existing subsection 2405(2) which applies for the purposes of subsection 138(14) of the Act. Subsection 138(14) is a transitional rule which applies for the purposes of determining an insurer’s tax basis or amortized cost of a debt obligation under subsection 138(13) of the Act. For the purposes of subsection 138(14) the expressions "Canadian investment fund for a taxation year", "specified Canadian assets" and "value for the taxation year" have the meanings set out in subsection 2404(1) of the Regulations as it read in its application to the 1977 taxation year.

ITR
2401

Existing section 2401 sets out the rules for a non-resident to file an election to calculate its *life surplus factor* in accordance with the rules applicable to resident life insurers. The rules in existing section 2401 are deleted as a consequence of the repeal of the definition of *"life surplus factor"* and the amendments to the definition of *"attributed surplus"*. In effect, the amended definition of *"attributed surplus"* states that an election to use the resident life insurer rules must be made in the form and manner prescribed by the Department of National Revenue.

Amended section 2401 replaces existing section 2400 which sets out the rules that apply for the type, amount, and nature of investment property that must be designated by an insurer in respect of a taxation year.

ITR
2401(1)

Designated insurance property

Amended subsection 2401(1) provides that for the purposes of section 138 of the Act, designated insurance property of an insurer is property that is designated by the insurer in its Part I income tax return and in accordance with section 2401.

ITR
2401(2)

Designation rules

Amended subsection 2401(2) replaces the designation rules in existing subsection 2400(1). Amended subsection 2401(2) sets out rules that an insurer is required to follow in designating investment property for a taxation year in respect of its insurance businesses carried on in Canada in the year.

Paragraph 2401(2)(*a*) provides that an insurer shall designate in respect of its Canadian life insurance business, investment property with a total *value* (as defined in amended subsection 2400(1)) equal to the amount by which the insurer's *mean Canadian reserve liabilities* (as defined in amended subsection 2400(1)) exceeds its *mean policy loans* and mean Canadian outstanding premiums (as defined in amended subsection 2400(1)) in respect of that business. Paragraph 2401(2)(*b*) provides a similar rule for an insurer's accident and sickness insurance business carried on in Canada.

Paragraph 2401(2)(*c*) provides that an insurer shall designate in respect of its non-life and non-accident and sickness insurance business, investment property with a total *value* equal to the amount by which the insurer's *mean Canadian reserve liabilities* in respect of that business exceeds the insurer's average deferred acquisition expenses or premiums receivable in respect of that business.

Where the insurer's *mean Canadian investment fund* for a year exceeds the value of the property that is designated in accordance with paragraphs 2401(2)(*a*) to (*c*), the insurer is required to designate additional investment property so that the total value of the designated property equals that *mean Canadian investment fund*. The insurer must designate the additional investment property in respect of a particular Canadian insurance business.

Paragraph 2401(2)(*e*) is similar to existing paragraph 2400(2)(*b*) and prohibits an insurer from designating the same property twice.

Paragraph 2401(2)(*f*) is similar to existing subsection 2400(7) and provides that an insurer may designate a portion of a particular property where a designation of the entire property would result in exceeding the value of the property required to be designated under amended paragraphs 2401(2)(*a*) to (*d*).

Paragraph 2401(2)(*g*) permits the Minister of National Revenue to determine whether an insurer has made appropriate designations and to designate property where the insurer has not followed the designation rules. Where the Minister designates property, the property is considered to have been designated by the insurer. The amended paragraph refines the powers which the Minister currently has under existing paragraph 2400(1)(*f*).

ITR
2401(3)

Order of property

Amended subsection 2401(3) replaces the existing rule in subsection 2400(6). Amended subsection 2401(3) mandates that property be designated by an insurer in a particular order. Before designating any other property, amended paragraph 2401(3)(*a*) requires an insurer to designate *Canadian investment property* that was *designated insurance property* in the preceding taxation year in the following order:

- real and depreciable property;
- mortgages, hypothecs, agreements of sale or other debts in respect of real or depreciable property; and
- other *Canadian investment property*.

Next, an insurer must designate previously *designated insurance property* that is not *Canadian investment property*. After that, the insurer must designate *Canadian investment property* that was not designated in the preceding taxation year in the order set out in amended paragraph 2401(3)(*a*). Finally, an insurer may designate its other (non-Canadian) investment property.

Canadian investment property is designated before other investment property on the basis that *Canadian investment property* can reasonably be expected to have a closer relationship to an insurer's Canadian insurance businesses than its foreign insurance businesses.

ITR
2401(4)

Equity limit for the year

Amended subsection 2401(4) replaces the existing equity limit rule in existing subsection 2400(4). Amended paragraph 2401(4)(*a*) provides that an insurer cannot designate *Canadian equity property* with a total value for the year which exceeds the insurer's *equity limit* for the year. The amended definitions of *"Canadian equity property"* and *"equity limit"* are contained in amended subsection 2400(1).

Amended paragraph 2401(4)(*b*) adds a rule which provides that an insurer may designate a portion of a *Canadian equity property* where a designation of the entire property would result in exceeding the insurer's *equity limit* for the year.

ITR
2401(5)

Exchanged property

Amended subsection 2401(5) is very similar to the exchanged property rule in existing subsection 2400(3). Both subsections provide that property acquired in exchange for *designated insurance property* under certain rollover transactions is considered to be *designated insurance property*. Amended subsection 2401(5) merely updates the wording that is used in existing subsection 2400(3).

ITR
2401(6)

Non-investment property

Amended subsection 2401(6) replaces existing paragraph 2400(1)(*e*), which stated that an insurer's non-investment property which was factually used or held in carrying on an insurance business in Canada is deemed to have been designated by the insurer. This designation rule is relevant for the definition of "outstanding debts to specified non-residents" in subsection 18(5), the definition of "eligible property" in subsection 85(1.1), subparagraph 115(1)(*b*)(ii.1), section 138, paragraph 219(4)(i.1), and subsection 219(5.1) of the Act. The property designated under this rule is not, however, relevant for determining an insurer's gross investment revenue because such property is not investment property.

Amended paragraph 2401(6) uses the new term *designated insurance property* and simplifies the wording of existing paragraph 2400(1)(*e*) by replacing the phrase "used by it in the year in, or held by it in the year in the course of carrying on an insurance business" with "property used or held by the insurer".

ITR
2403(2)(*a*)

Subsection 2403(2) sets out the mechanism for making an election under subsection 219(5.2) of the Act. Subsection 219(5.2) permits a non-resident insurer to elect to defer the branch tax arising under subsection 219(5.1) of the Act when the insurer transfers a Canadian insurance business to a qualified related corporation.
Paragraph 2403(2)(*a*) requires the insurer and the qualified related corporation to jointly sign a letter seeking the election and include the letter in its Part I income tax return. That paragraph states that the letter must indicate whether paragraph 219(5.2)(*a*) or (*b*) of the Act is applicable to the transfer. Amended paragraph 2403(2)(*a*) requires that the letter state whether paragraph 219(5.2)(*a*) and (*b*) of the Act apply.

ITR
2404 & 2405

Prescribed amount
Policy Loans

Existing section 2404 provides that where an amount is determined in foreign currency, the amount must be converted to Canadian currency on the date on which is amount is determined. This rule is considered unnecessary because under the Income Tax Act amounts in foreign currency must (in the absence of any specific rule to the contrary) be converted into Canadian currency.

Amended section 2404, which is unrelated to existing section 2404, sets out the amount of interest which an insurer is permitted to deduct under amended subparagraph 138(5)(*b*)(iv) of the Act. Subsection 138(5) of the Act prohibits resident multinational life insurers and non-resident insurers from deducting any interest expense in computing their income from carrying on a Canadian insurance business except in limited circumstances. Interest deductibility is currently permitted under subparagraph 138(5)(*b*)(i) where the interest is payable on borrowed money used to acquire designated insurance property and under subparagraph 138(5)(*b*)(ii) on amounts payable for designated insurance property. New subparagraph 138(5)(*b*)(iv) allows insurers to deduct interest not in excess of a prescribed amount: amended section 2404 sets out that amount.

More specifically, the prescribed amount is equal to the amount of interest which would otherwise be deductible (but for the restrictions in subsection 138(5) of the Act) by the insurer under paragraph 20(1)(*c*) or 20(1)(*d*) of the Act multiplied by the ratio A/B where

A is the amount of the insurer's balance sheet liabilities, in respect of its Canadian insurance business, which do not relate to insurance policies, a segregated fund or a debt incurred to acquire a property (the amount being referred to in these notes as its a "general liabilities"), less

- the value for the year of the insurer's non-investment property that is factually used in carrying on an insurance business in Canada,

- where the insurer is a Canadian resident, the amount deductible from its general liabilities in computing its Canadian investment fund on account of its financial institution allowance, and

- the insurer's year-end balance sheet deferred tax debit balance in respect of an insurance business carried on in Canada; and

B is the insurer's general liabilities.

In general terms, amended section 2404 is intended to determine the amount of an insurer's interest expense which is attributable to its general borrowing and other non-specific liabilities to the extent that the borrowing or liability is used in carrying on a Canadian insurance business and is not held in respect of a segregated fund. As noted above, the only interest expense which can be included in the amount prescribed by regulation 2404 is interest which meets the criteria for deductibility under paragraph 20(1)(*c*) or (*d*) of the Act.

Amended section 2405 (which is, essentially, existing section 2406) provides that a policy loan payable to an insurer cannot be investment property or *"property used by it in the year in, or held by it in the year in the course of"* (as defined in subsection 138(12) of the Act) carrying on an insurance business. As a consequence of the repeal of the definition of *"property used by it in the year in, or held by it in the year in the course of"*, the reference to that definition is replaced with a reference to the new definition "designated insurance property".

ITR
2410

Prescribed amount

Section 2410 sets out the rules for determining the prescribed amount for the purposes of subsection 138(4.4) of the Act. Subsection 138(4.4) of the Act applies where a life insurer owns vacant real property or real property under development and the property is designated by the insurer as property used or held by it in the year in the course of carrying on an insurance business in Canada or is factually used or held in such a business.

Subsection 138(4.4) has been amended by replacing the reference to property *"used by it in the year, or held by it in the year in the course of"* with a reference to the new definition *"designated insurance property"*, and to clarify that an amount is prescribed in respect of each property which is subject to the rule. The amount prescribed for this purpose continues to be determined under amended section 2410.

Existing subsection 2410(1) provides that the prescribed amount is the specified percentage (as set out in subsection 2410(2)) of the amount determined by the formula

$$[(A \times B) \times C/D \times E/365] - F$$

where

A is the average annual interest rate (as set out in Regulation 4301) for the period while the property was vacant or undeveloped

B is the average cost or capital cost of the property (net of the average amount of debt on the property)

C is the insurer's Canadian reserve liabilities less policy loans and premiums receivable

D is either:

(i) the value of the insurer's investment property less the insurer's indebtedness where the life insurer is resident in Canada but does not carry any insurance business outside Canada, or

(ii) the insurer's Canadian investment fund where the life insurer carries on an insurance business outside Canada

E is the number of days in the period

F is the insurer's net income earned on the property

Consistent with the amendments to subsection 138(4.4) of the Act, subsection 2410(1) is amended so that a prescribed amount is determined in respect of each property which is subject to subsection 138(4.4). Subsection 2410(1) is also simplified by deleting the portion of the formula which prorates the imputed interest. Accordingly, the formula is simplified to

$$[(A \times B) \times C/365] - D$$

where

A is existing A

B is existing B

C (which is existing E) is the number of days in the relevant period, and

D (which is existing F) is the net income actually earned on the property in the period

Subsection 2410(2) was intended to phase-in the effect of subsection 138(4.4) of the Act and subsection 2410(1) when they were introduced in 1987. Subsection 2410(2) provides that an amount determined under subsection 2410(1) is included only on the basis of 20%, 40%, 60%, 80% and 100% of the amount for the 1988, 1989, 1990, 1991 and 1992 years. Subsection 2410(2) is now redundant and is being repealed. The repeal of subsection 2410(2) means that subsection 2410(1) becomes simply section 2410.

ITR
2411

Minimum net revenue test

Section 2411 sets out the rules for determining the prescribed amount which is required to be included in an insurer's income under paragraph 138(9)(*b*) of the Act.

Paragraph 138(9)(*a*) of the Act requires multinational life insurers and non-resident insurers to include in computing income for a year from a Canadian insurance business the gross investment revenue that is derived from property which is considered, under a set of prescribed rules, to be used in that insurance business. Paragraph 138(9)(*b*) requires such insurers to also include in their income from carrying on an insurance business in Canada the amount prescribed in section 2411 of the Regulations.

Section 2411 is intended to restrict the ability of a multinational insurer to reduce its taxable income by having only the revenue from its low-yielding assets included in computing its Canadian income. Under Part XXIV of the Regulations, an insurer is required to choose (a process referred to as the designation of property), from among all of its investment assets, those assets which can be considered to be used in carrying on the Canadian portion of its insurance businesses. The value of its assets which must be designated in respect of a taxation year cannot be less than its Canadian investment fund for the year (for further details see the commentary on amended subsection 2401, above). Absent paragraph 138(9)(*b*) of the Act and section 2411, an insurer could fill its Canadian investment fund with its lowest-yielding assets thereby failing to provide a reasonable representation of its income from its Canadian insurance operations.

Subsection 2411(1) prescribes the amount for the purposes of paragraph 138(9)(*b*). The amount is the difference between the insurer's average net investment revenue for the year (as determined under subsection 2411(3)) and the insurer's net investment revenue earned on its designated property (as determined under subsection 2411(4)). The amount may be reduced if the insurer has a carryover amount from its cumulative excess account. The cumulative excess account is made up of amounts in the seven preceding taxation years where the insurer's actual revenue in a preceding taxation year exceeded the minimum revenue, as determined under section 2411, for that preceding year.

Subsection 2411(3) sets out the computation of the minimum amount of net investment revenue that must be reported by an insurer for a taxation year. In general terms, the minimum net investment revenue is determined by multiplying the net investment revenue earned on the insurer's designated property by the ratio that the insurer's net investment revenue on all its investment property is to the value for the year of all its investment property. That ratio represents the average yield on the insurer's investment property. Multiplying the ratio by the value of the designated insurance property produces the average yield which should be earned on the insurer's investment property. The actual computation in subsection 2411(3) measures the average yield for assets in each of the following groups of property:

- Canadian equity property,
- other Canadian investment property, and
- foreign investment property.

Subsection 2411(4) sets out the rules for determining an insurer's net investment revenue for the purposes of computing the insurer's minimum net revenue in subsection 2411(1) and (3). Subsection 2411(4.1) serves the same function as subsection 2411(4), but in respect of certain specified debt obligations which are disposed of by an insurer.

Subsections 2411(1), (3), (4) and (4.1) are amended strictly as a consequence of the replacement of the definition *"property used by it in the year in, or held by it in the year in the course of"* in subsection 138(12) of the Act with the definition *"designated insurance property"*.

Subsection 2411(7) provides that subsection 2411(3) applies only to the extent that investment property must be designated by an insurer in accordance with the rules in paragraphs 2400(1)(*a*) to (*d*). Those paragraphs permitted an insurer to designate investment property with a total value in excess of that required to be designated for the year. The amended designation rules (for further details see the commentary on amended section 2401, above) do not allow such excess designations and, therefore, subsection 2411(7) is to be repealed.

ITR
2412

Cash Flow Adjustment

The cash flow adjustment (the "CFA") is designed to take account of the actual receipts and payments of an insurer throughout a taxation year in order to achieve a more accurate determination of the year-end Canadian investment fund (CIF) when the insurer’s business does not grow or shrink uniformly during the year. This adjustment is necessary because the CIF for the year is simply the mean of the insurer’s opening and closing CIFs for the year, but the value attributed to the property that is designated to fill this mean CIF is based on the number days in the year that the property was owned. Without the CFA, investment income earned on an investment property will be understated when the property is acquired in the first half of the year and overstated where the property is acquired in the second half of the year.

<u>*Example*</u>

Assume the following:

- *opening CIF $100*

- *closing CIF $200*

- *mean CIF for the year 1/2($100 + $200) = $150*

- *The increase in the CIF over the year corresponded to the receipt of premium revenue, an increase in the insurer's reserve liabilities in respect of the premium, and acquisition of an investment property, with a carrying value equal to $100, at the very beginning of the year.*

For designation purposes, the value for the year of the property is $100. Because the increase in the mean CIF for the year is only $50, however, only 1/2 of the value of the investment property need be designated to fill the increase in the mean CIF. Accordingly, only the investment revenue generated from $50 worth of the investment property will be included in the insurer's income.

In these circumstances the cash flow adjustment is designed to increase the insurer's CIF for the year by $50 to reflect the acquisition of the investment property at the beginning of the year.

The existing CFA increases or decreases the mean CIF based on the insurer's quarterly cash flows of the following items:

- premiums or consideration in respect of insurance contracts or annuities

- amounts in respect of interest on policy loans or repayments in respect of policy loans

- amounts in respect of reinsurance

- amounts in respect of claims, benefits, and refunds of premiums.

Because the cash flow is only measured quarterly, amounts in respect of contracts (such as cash annuities) which are outstanding for less than 90 days may not be included in the CFA (subject to the application of the anti-avoidance rule in section 245 of the Act, where the timing of the obligations is deliberately manipulated to over-weight redemptions prior to the end of a quarter) although the insurer could have earned investment income for 89 days on the amount received on the contract.

To address the above problems, a new daily CFA will apply a daily-weighting to amounts received or paid by an insurer in the following transactions:

- certain large life insurance, reinsurance and annuity contracts;
- an insurer’s borrowing and debt instrument financing; and
- an insurer’s equity financing.

The existing quarterly CFA will continue to apply except in respect of amounts which are included in the daily CFA.

ITR
8201

Permanent establishments

Section 8201 sets out the criteria for determining whether a person who is not resident in Canada has a "permanent establishment" for various provisions of the Act. The section is amended by extending its application to the definition "outstanding debts to specified non-residents" in subsection 18(5) of the Act.

This amendment applies to the 1997 and subsequent taxation years.

ITR
8600

Definitions

Section 8600 contains several definitions which apply for the purposes of determining a corporation’s taxable capital employed in Canada.

The definitions of "attributed surplus" and "Canadian reserve liabilities" are amended by changing the cross-reference from subsection 2405(3) to amended subsection 2400(1). These amendments are strictly consequential on the re-location of those definitions within Part XXIV of the Regulations.

The existing term "total reserve liabilities", which is relevant in determining the taxable capital employed in Canada of insurance corporations that carry on a life insurance business, has the meaning assigned by existing subsection 2405(3). Because that definition has been repealed in subsection 2405(3), the full definition of "total reserve liabilities" is being moved to section 8600. The definition is also amended to replace the reference to "relevant authority" with references to the Superintendent of Financial Institutions, superintendent of insurance of a province or other similar officer of a province.

These amendments apply to the 1997 and subsequent taxation years.

ITR
8605(3)

Prescribed amount

Subsection 8605(3) of the Regulations sets out the amount in respect of foreign insurance subsidiaries under subclause 181.3(1)(*c*)(ii)(A)(V) and clause 190.11(*b*)(i)(E) of the Act. Subsection 8605(3) is amended strictly as a consequence of the addition of the definition "total reserve liabilities" to subsection 8600. This amendment applies to the 1997 and subsequent taxation years.