

Immediate release

Ottawa, October 7, 1996
96-069

DRAFT LEGISLATION ON INSURERS' POLICY RESERVES

Finance Minister Paul Martin today released draft amendments to the Income Tax Act and the Income Tax Regulations dealing with insurers' policy reserves.

The draft amendments are the result of extensive consultations on the reform of the taxation of life insurers. The amendments respond to a number of issues raised during consultations on the draft legislation released to the industry in April this year.

The amendments are primarily concerned with the tax treatment of life insurance policy reserves. In broad terms, the draft legislation provides that an insurer's policy reserves in respect of its policies issued after 1995 will now generally be calculated in the manner in which they are calculated for regulatory purposes. For policies issued before 1996, the insurer will generally continue to calculate policy reserves using the existing rules in Part XIV of the Income Tax Regulations.

It should be noted that the draft amendments also deal with non-life insurance policy reserves and other insurance taxation matters. A detailed description of the amendments is contained in the explanatory notes which are being released with the draft amendments.

The Minister indicated that the draft amendments to the Income Tax Act would be included in the bill containing this year's budget measures, which is expected to be tabled in the fall.

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Legislation

Draft Amendments - Income Tax Act

1.(1) Subsection 12(1) of the Act is amended by adding the following after paragraph (e):

Negative reserves

(e.1) where the taxpayer is an insurer, the amount prescribed in respect of the insurer for the year;

(2) Subsection (1) applies to the 1996 and subsequent taxation years.

2.(1) Paragraph 20(7)(c) of the Act is replaced by the following:

(c) as a reserve in respect of insurance, except that in computing an insurer's income for a taxation year from an insurance business, other than a life insurance business, carried on by it, there may be deducted as a policy reserve any amount that the insurer claims not exceeding the amount prescribed in respect of the insurer for the year.

(2) Section 20 of the Act is amended by adding the following after subsection (21):

Deduction for negative reserves

(22) In computing an insurer's income for a taxation year, there may be deducted the amount included under paragraph 12(1)(e.1) in computing the insurer's income for the preceding taxation year.

(3) Subsections (1) and (2) apply to the 1996 and subsequent taxation years.

3.(1) Subsection 87(2.2) of the Act is replaced by the following:

Amalgamation of insurers

(2.2) Where there has been an amalgamation and one or more of the predecessor corporations was an insurer, the new corporation is, notwithstanding subsection (2), deemed, for the purposes of paragraphs 12(1)(d), (e), (e.1), (i) and (s) and 20(1)(l), (1.1), (p) and (jj) and (7)(c), subsection 20(22), sections 138, 138.1, 140, 142 and 148 and Part XII.3, to be the same corporation as, and a continuation of, each of those predecessor corporations.

(2) Subsection (1) applies to amalgamations occurring after 1995.

4.(1) Subparagraph 88(1)(g)(i) of the Act is replaced by the following:

(i) for the purposes of paragraphs 12(1)(d), (e), (e.1), (i) and (s) and 20(1)(l), (l.1), (p) and (jj) and (7)(c), subsection 20(22), sections 138, 138.1, 140, 142 and 148 and Part XII.3, the parent is deemed to be the same corporation as, and a continuation of, the subsidiary, and

(2) Subsection (1) applies to windings-up that begin after 1995.

5.(1) Subparagraphs 138(3)(a)(i) and (ii) of the Act are replaced by the following:

(i) any amount that the insurer claims as a policy reserve for the year in respect of its life insurance policies, not exceeding the total of amounts allowed the insurer in respect of the policies by regulation,

(ii) any amount that the insurer claims as a reserve in respect of claims that were received by the insurer before the end of the year under its life insurance policies and that are unpaid at the end of the year, not exceeding the total of amounts allowed the insurer in respect of the policies by regulation,

(ii.1) the amount included under paragraph (4)(b) in computing the insurer's income for the taxation year preceding the year,

(2) Subsection 138(4) of the Act is replaced by the following:

Amounts included in computing income

(4) In computing a life insurer's income for a taxation year from carrying on its life insurance business in Canada, there shall be included

(a) each amount deducted under subparagraph (3)(a)(i), (ii) or (iv) in computing the insurer's income for the preceding taxation year;

(b) the amount prescribed in respect of the insurer for the year in respect of its life insurance policies; and

(c) the total of all amounts received by the insurer in the year in respect of the repayment of policy loans or in respect of interest on policy loans.

Life insurance policy

(4.01) For the purposes of subsections (3) and (4), a life insurance policy includes a benefit under a group life insurance policy or a group annuity contract.

(3) Subsection 138(11.5) of the Act is amended by adding the following after paragraph

(j):

(j.1) for the purpose of determining the income of the transferor and the transferee for their taxation years following their taxation years referred to in paragraph (h), amounts included under paragraphs (4)(b) and 12(1)(e.1) in computing the transferor's income for its taxation year referred to in paragraph (h) in respect of the insurance policies of the business referred to in paragraph (a) are deemed to have been included in computing the income of the transferee, and not of the transferor, for their taxation years referred to in paragraph (h),

(4) Subsection 138(11.91) of the Act is amended by adding the following after paragraph (d):

(d.1) for the purposes of subsection 20(22) and subparagraph (3)(a)(ii.1),

(i) the insurer is deemed to have carried on the business referred to in paragraph (a) in Canada in the preceding taxation year referred to in paragraph (c), and

(ii) the amounts, if any, that would have been prescribed in respect of the insurer for the purposes of paragraphs (4)(b) and 12(1)(e.1) for that preceding year in respect of the insurance policies of that business are deemed to have been included in computing its income for that year,

(5) Subsections (1) to (4) apply to the 1996 and subsequent taxation years.

6.(1) Paragraph 149(1)(t) of the Act is replaced by the following:

Farmers' and fishermen's insurer

(t) an insurer that, during the period, is not engaged in any business other than insurance if, in the opinion of the Minister, on the advice of the Superintendent of Financial Institutions or of the superintendent of insurance of the province under the laws of which the insurer is incorporated, not less than 20% of the total of the gross premium income (net of reinsurance ceded) earned in the period by the insurer and, where the insurer is not a prescribed insurer, by all other insurers that

(i) are specified shareholders of the insurer,

(ii) are related to the insurer, or

(iii) where the insurer is a mutual corporation, are part of a group that controls, directly or indirectly in any manner whatever, or are controlled, directly or indirectly in any manner whatever by, the insurer,

is in respect of insurance of property used in farming or fishing or residences of farmers or fishermen;

(2) Subsection 149(4.1) of the Act is replaced by the following:

Income exempt under 149(1)(t)

(4.1) Subject to subsection (4.2), subsection (1) applies to an insurer described in paragraph (1)(t) only in respect of the part of its taxable income for a taxation year determined by the formula

$$\frac{A \times B \times C}{D}$$

where

A is its taxable income for the year;

B is

(a) 1/2, where less than 25% of the total of the gross premium income (net of reinsurance ceded) earned in the year by it and, where it is not a prescribed insurer for the purpose of paragraph (1)(t), by all other insurers that

(i) are specified shareholders of the insurer,

(ii) are related to the insurer, or

(iii) where the insurer is a mutual corporation, are part of a group that controls, directly or indirectly in any manner whatever, or are controlled, directly or indirectly in any manner whatever by, the insurer,

is in respect of insurance of property used in farming or fishing or residences of farmers or fishermen; and

(b) 1 in any other case;

C is the part of the gross premium income (net of reinsurance ceded) earned by it in the year that, in the opinion of the Minister, on the advice of the Superintendent of Financial Institutions or of the superintendent of insurance of the province under the laws of which it is incorporated, is in respect of insurance of property used in farming or fishing or residences of farmers or fishermen; and

D is the gross premium income (net of reinsurance ceded) earned by it in the year.

(3) Subsections (1) and (2) apply to the 1996 and subsequent taxation years.

7.(1) The definitions "life insurance policy" and "life insurance policy in Canada" in subsection 211(1) of the Act are replaced by the following:

"life insurance policy" includes a benefit under

(a) a group life insurance policy, and

(b) a group annuity contract

but does not include

(c) that part of a policy in respect of which the policyholder is deemed by paragraph 138.1(1)(e) to have an interest in a related segregated fund trust, or

(d) a reinsurance arrangement;

"life insurance policy in Canada" means a life insurance policy issued or effected by an insurer on the life of a person resident in Canada at the time the policy was issued or effected;

(2) Subsection (1) applies to the 1996 and subsequent taxation years.

8.(1) Paragraphs (a) and (b) of the description of A in subsection 211.1(3) of the Act are replaced by the following:

(a) the maximum amount that would be determined under paragraph 1401(1)(a), (c) or (d) of the *Income Tax Regulations* (other than an amount that would be determined under subparagraph 1401(1)(d)(ii) of the Regulations in respect of a disabled life) in respect of the insurer for the year in respect of the liability, benefit, risk or guarantee if subsection 1401(1) of those Regulations applied to all life insurance policies and if that amount were determined without reference to any policy loan or reinsurance arrangement, and

(b) the maximum amount that would be determined under paragraph 1401(1)(a), (c) or (d) of the *Income Tax Regulations* (other than an amount that would be determined under subparagraph 1401(1)(d)(ii) of those Regulations in respect of a disabled life) in respect of the insurer for the preceding taxation year in respect of the liability, benefit, risk or guarantee if subsection 1401(1) of those Regulations applied to all life insurance policies and if that amount were determined without reference to any policy loan or reinsurance arrangement;

(2) Paragraphs (a) and (b) of the description of D in subsection 211.1(3) of the Act are replaced by the following:

(a) the maximum amount that would be determined under paragraph 1401(1)(c.1) of the *Income Tax Regulations* in respect of the insurer for the year in respect of the policy if subsection 1401(1) of those Regulations applied to all life insurance policies and if that amount were determined without reference to any policy loan or reinsurance arrangement, and

(b) the maximum amount that would be determined under paragraph 1401(1)(c.1) of the *Income Tax Regulations* in respect of the insurer for the preceding taxation year in respect of the policy if subsection 1401(1) of those Regulations applied to all life insurance policies and if that amount were determined without reference to any policy loan or reinsurance arrangement, and

(3) Subparagraphs (c)(i) and (c)(ii) of the description of E in subsection 211.1(3) of the Act are replaced by the following:

(i) the maximum amount that would be determined under paragraph 1401(1)(c.1) of the *Income Tax Regulations* in respect of the insurer for the year in respect of the policy if subsection 1401(1) of those Regulations applied to all life insurance policies and if that amount were determined without reference to any policy loan or reinsurance arrangement

exceeds

(ii) the maximum amount that would be determined under paragraph 1401(1)(c.1) of the *Income Tax Regulations* in respect of the insurer for its last 1989 taxation year in respect of the policy if subsection 1401(1) of those Regulations applied to all life insurance policies and if that amount were determined without reference to any policy loan or reinsurance arrangement; and

(4) Subsections (1) to (3) apply to the 1996 and subsequent taxation years.

Draft Amendments - Income Tax Regulations

1.(1) The heading before section 1400 of the *Income Tax Regulations* is replaced by the following:

DIVISION I
POLICY RESERVES
Non-Life Insurance Business

(2) Section 1400 of the Regulations is replaced by the following:

1400.(1) For the purpose of paragraph 20(7)(c) of the Act, the amount prescribed in respect of an insurer for a taxation year is

- (a) the amount determined under subsection (3) in respect of the insurer for the year, where that amount is greater than nil, and
- (b) nil, in any other case.

(2) For the purpose of paragraph 12(1)(e.1) of the Act, the amount prescribed in respect of an insurer for a taxation year is

- (a) the absolute value of the amount determined under subsection (3) in respect of the insurer for the year, where that amount is less than nil, and
- (b) nil, in any other case.

(3) For the purposes of paragraphs (1)(a) and (2)(a), the amount determined under this subsection in respect of an insurer for a taxation year is the amount, which may be positive or negative, determined by the formula

$$A + B + C + D + E + F + G + H + I + J + K$$

where

A is the total of all amounts each of which is the unearned portion at the end of the year of the net premium for a policy, (other than a policy that insures a risk in respect of

- (a) a financial loss of a lender on a loan made on the security of real property,
- (b) a home warranty,
- (c) a lease guarantee, or

(d) an extended motor vehicle warranty),

determined by apportioning the net premium equally over the period to which that premium relates;

B is the total of all amounts each of which is an amount determined in respect of a policy referred to in paragraph (a), (b), (c) or (d) of the description of A equal to the lesser of

(a) the amount of the reported reserve of the insurer at the end of the year in respect of the unearned portion at the end of the year of the net premium for the policy, and

(b) a reasonable amount as a reserve determined as at the end of the year in respect of the unearned portion at the end of the year of the net premium for the policy;

C is the total of all amounts each of which is the amount in respect of a policy, where all or a portion of a risk under the policy was reinsured, equal to the unearned portion at the end of the year of a reinsurance commission in respect of the policy determined by apportioning the reinsurance commission equally over the period to which it relates;

D is the total of all amounts each of which is the amount determined by the formula

$$V \times W$$

in respect of a policy under which a claim was reported to the insurer before the end of the year and in respect of which the insurer is, or may be, required to make a payment or incur an expense after the year, where

V is

(a) where the claim is in respect of damages for personal injury or death and the insurer has agreed to a structured settlement of the claim, 100 per cent, and

(b) in any other case, 95 per cent, and

W is the lesser of

(a) the amount of the reported reserve of the insurer at the end of the year in respect of the claim, and

(b) the amount of the claim liability of the insurer at the end of the year in respect of the claim;

E is the amount, in respect of policies under which there may be claims incurred before the end of the year that have not been reported to the insurer before the end of the year, equal to 95% of the lesser of

(a) the total of the reported reserves of the insurer at the end of the year in respect of the possibility that there are such claims, and

(b) the total of the claim liabilities of the insurer at the end of the year in respect of the possibility that there are such claims;

F is an additional amount in respect of policies that insure

(a) a fidelity risk,

(b) a surety risk,

(c) a nuclear risk, or

(d) a risk related to a financial loss of a lender on a loan made on the security of real property,

equal to the lesser of

(e) the total of the reported reserves of the insurer at the end of the year in respect of such risks (other than an amount included in determining the value of A, B, C, D, E, G, H, I, J or K), and

(f) a reasonable amount as a reserve determined as at the end of the year in respect of such risks (other than an amount included in determining the value of A, B, C, D, E, G, H, I, J or K);

G is the amount of a guarantee fund at the end of the year provided for under an agreement in writing between the insurer and Her Majesty in right of Canada under which Her Majesty has agreed to guarantee the obligations of the insurer under a policy that insures a risk related to a financial loss of a lender on a loan made on the security of real property;

H is the amount in respect of risks under pre-1996 non-cancellable or guaranteed renewable accident and sickness policies equal to

(a) where the amounts determined under subparagraphs (i) and (ii) are greater than nil, the lesser of

(i) the total of the reported reserves of the insurer at the end of the year in respect of such risks (other than an amount included in determining the value of A, B, C, D, E, F, G, I, J or K), and

(ii) a reasonable amount as a reserve determined as at the end of the year in respect of such risks (other than an amount included in determining the value of A, B, C, D, E, F, G, I, J or K); and

(b) nil, in any other case;

I is, subject to subsection (5), the amount in respect of risks under non-cancellable or guaranteed renewable accident and sickness policies that are not pre-1996 non-cancellable or guaranteed renewable accident and sickness policies, equal to the lesser of

(a) the total of the reported reserves of the insurer at the end of the year in respect of such risks (other than an amount included in determining the value of A, B, C, D, E, F, G, H, J or K), and

(b) the total of the policy liabilities of the insurer at the end of the year in respect of such risks (other than an amount included in determining the value of A, B, C, D, E, F, G, H, J or K);

J is the total of all amounts (other than an amount deductible under subsection 140(1) of the Act) each of which is the amount that is the least of

P, Q and R

in respect of a dividend, refund of premiums or refund of premium deposits provided for under the terms of a group accident and sickness insurance policy that will be

(a) used by the insurer to reduce or eliminate a future adverse claims experience under the policy,

(b) paid or unconditionally credited to the policyholder by the insurer, or

(c) applied in discharge, in whole or in part, of a liability of the policyholder to pay premiums to the insurer under the policy,

where

P is a reasonable amount as a reserve determined as at the end of the year in respect of the dividend, refund of premiums or refund of premium deposits,

Q is 25 per cent of the amount of the premium payable under the terms of the policy for the 12-month period ending

(i) if the policy is terminated in the year, on the day the policy is terminated, and

(ii) in any other case, at the end of the year, and

R is the reported reserve of the insurer at the end of the year in respect of the dividend, refund of premiums or refund of premium deposits;

K is the total of all amounts each of which is the amount, in respect of a policy under which a portion of the amount paid or payable by the policyholder for the policy before the end of the year is deducted under paragraph 1408(4)(b), equal to the portion of that amount that the insurer has determined will, after the end of the year, be returned to, or credited to the account of, the policyholder on the termination of the policy.

(4) Where the relevant authority does not require an insurer to determine its liabilities in respect of claims referred to in the description of D or E in subsection (3) in accordance with actuarial principles,

(a) the value of W in subsection (3) is deemed to be the amount determined under paragraph (a) of the description of W in that subsection, and

(b) the value of E in subsection (3) is deemed to be the amount determined under paragraph (a) of the description of E in that subsection.

2.(1) The heading before section 1401 of the Regulations is replaced by the following:

DIVISION II
POLICY RESERVES FOR PRE-1996 POLICIES
Life Insurance Business

(2) The portion of subsection 1401(1) of the Regulations before paragraph (a) is replaced by the following:

1401.(1) For the purpose of subparagraph 138(3)(a)(i) of the Act, in computing a life insurer's income for a taxation year from carrying on its life insurance business in Canada, there may be deducted in respect of

(3) Clause 1401(1)(c)(ii)(B) of the Regulations is replaced by the following:

(B) the present value at the end of the year of any future modified net premiums in respect of the policy, and

(4) Section 1401 of the Regulations is amended by adding the following after subsection (1):

(1.1) An amount may be deducted because of subsection (1) only in respect of a life insurance policy in Canada that is a pre-1996 life insurance policy.

(5) Subsection 1401(4) of the Regulations is replaced by the following:

(4) For the purpose of subparagraph 138(3)(a)(ii) of the Act, there may be deducted, in computing a life insurer's income for a taxation year, the amount it claims as a reserve in respect of unpaid claims received by it before the end of the year under life insurance policies in Canada that are pre-1996 life insurance policies, not exceeding the present value at the end of the year, computed using a rate of interest that is reasonable in the circumstances, of a reasonable amount in respect of those unpaid claims.

3.(1) The heading before section 1402 of the Regulations is replaced by the following:

SPECIAL RULES
Non-Life and Life Insurance Businesses

(2) Section 1402 of the Regulations is replaced by the following:

1402. Any amount determined under section 1400 or 1401 shall be determined on a net of reinsurance ceded basis.

4. Part XIV of the Regulations is amended by adding the following after section 1402:

1402.1 For greater certainty, any amount referred to or determined under section 1400 may be equal to, or less than, nil.

5. Sections 1404 to 1406 of the Regulations and the heading before section 1404 are replaced by the following:

DIVISION III
POLICY RESERVES FOR POST-1995 POLICIES
Life Insurance Business

1404.(1) For the purpose of subparagraph 138(3)(a)(i) of the Act, there may be deducted in computing a life insurer's income from carrying on its life insurance business in Canada for a taxation year in respect of its life insurance policies in Canada that are post-1995 life insurance policies, the amount the insurer claims, not exceeding

- (a) the amount determined under subsection (3) in respect of the insurer for the year, where that amount is greater than nil, and
- (b) nil, in any other case.

(2) For the purpose of paragraph 138(4)(b) of the Act, the amount prescribed in respect of an insurer for a taxation year, in respect of its life insurance policies in Canada that are post-1995 life insurance policies, is

- (a) the absolute value of the amount determined under subsection (3) in respect of the insurer for the year, where that amount is less than nil, and
- (b) nil, in any other case.

(3) For the purposes of paragraphs (1)(a) and (2)(a), the amount determined under this subsection in respect of an insurer for a taxation year, in respect of its life insurance policies in Canada that are post-1995 life insurance policies, is the amount, which may be positive or negative, determined by the formula

$$A + B + C + D - M$$

where

A is the amount (except to the extent the amount is determined in respect of a policy, claim, premium, dividend or refund in respect of which an amount is included in determining the value of B, C or D), in respect of the insurer's life insurance policies in Canada that are post-1995 life insurance policies, equal to the lesser of

- (a) the total of the reported reserves of the insurer at the end of the year in respect of those policies, and

(b) the total of the policy liabilities of the insurer at the end of the year in respect of those policies;

B is the amount, in respect of the insurer's life insurance policies in Canada that are post-1995 life insurance policies under which there may be claims incurred before the end of the year that have not been reported to the insurer before the end of the year, equal to 95% of the lesser of

(a) the total of the reported reserves of the insurer at the end of the year in respect of the possibility that there are such claims, and

(b) the total of the policy liabilities of the insurer at the end of the year in respect of the possibility that there are such claims;

C is the total of all amounts each of which is the unearned portion at the end of the year of the net premium for the policy where the policy is a group term life insurance policy that

(a) provides coverage for a period that does not exceed 12 months,

(b) is a life insurance policy in Canada, and

(c) is a post-1995 life insurance policy,

determined by apportioning the net premium equally over the period to which that premium relates;

D is the total of all amounts (other than an amount deductible under subsection 138(3)(a)(v) of the Act) each of which is the amount that is the least of

P, Q and R

in respect of a dividend, refund of premiums or refund of premium deposits provided for under the terms of a group life insurance policy that is a life insurance policy in Canada that is a post-1995 life insurance policy that will be

(a) used by the insurer to reduce or eliminate a future adverse claims experience under the policy,

(b) paid or unconditionally credited to the policyholder by the insurer, or

(c) applied in discharge, in whole or in part, of a liability of the policyholder to pay premiums to the insurer under the policy,

where

P is a reasonable amount as a reserve as at the end of the year in respect of the dividend, refund of premiums or refund of premium deposits provided for under the terms of the policy,

Q is 25 per cent of the amount of the premium under the terms of the policy for the 12-month period ending

(i) on the day the policy is terminated, if the policy is terminated in the year, and

(ii) at the end of the year, in any other case, and

R is the amount of the reported reserve of the insurer at the end of the year in respect of the dividend, refund of premiums or refund of premium deposits provided for under the terms of the policy; and

M is the total of all amounts determined in respect of a life insurance policy in Canada that is a post-1995 life insurance policy each of which is

(a) an amount payable in respect of a policy loan under the policy, or

(b) interest that has accrued to the insurer to the end of the year in respect of a policy loan under the policy.

(4) Notwithstanding subsection (3), the amount determined under that subsection in respect of an insurer for a taxation year that ends before 2001 is deemed to be the amount determined by the formula

$$A + (B \times (C - D))$$

where

A is the amount that would, but for this subsection, be the amount determined under subsection (3) in respect of the insurer for the year;

B is, where the year ends in

(a) 1996, 100%,

(b) 1997, 80%,

(c) 1998, 60%,

(d) 1999, 40%, and

(e) 2000, 20%;

C is the total of all amounts each of which is the absolute value of any amount that is less than nil and that is used in computing

(a) the amount that is the lesser of the totals determined for the year under the description of I in subsection 1400(3), in respect of a risk under a non-cancellable or guaranteed renewable accident and sickness policy of the insurer that is a post-1995 non-cancellable or guaranteed renewable accident and sickness policy, or

(b) the amount that is the lesser of the totals determined for the year under the description of A in subsection (3), in respect of a liability or risk under a life insurance policy in Canada of the insurer that is a post-1995 life insurance policy; and

D is the lesser of

(a) 5% of the total of all amounts each of which is a premium received by the insurer in the year or any preceding taxation year ending after 1995 in respect of

(i) a non-cancellable or guaranteed renewable accident and sickness policy, or

(ii) a life insurance policy in Canada, and

(b) the value of C.

1405. For the purpose of subparagraph 138(3)(a)(ii) of the Act, there may be deducted in computing a life insurer's income for a taxation year the amount it claims as a reserve in respect of an unpaid claim received by the insurer before the end of the year under a life insurance policy in Canada that is a post-1995 life insurance policy, not exceeding the lesser of

(a) the reported reserve of the insurer at the end of the year in respect of the claim; and

(b) the policy liability of the insurer at the end of the year in respect of the claim.

1406. Any amount determined under section 1404 or 1405 shall be determined

(a) on a net of reinsurance ceded basis; and

(b) without reference to any liability in respect of a segregated fund (other than a liability in respect of a guarantee in respect of a segregated fund policy).

1407. For greater certainty, any amount referred to or determined under section 1404 or 1405 may be equal to, or less than, nil.

DIVISION IV
INTERPRETATION
Insurance Businesses

1408.(1) The definitions in this subsection apply in this Part.

"acquisition costs" of a policy means

(a) 5 per cent of the premium paid by the policyholder for the policy where the policy is

(i) a group policy,

(ii) a policy that insures a risk in respect of a financial loss of a lender on a loan made on the security of real property,

(iii) a policy issued under an arrangement with a person (other than an insurer or an insurance agent or broker) with whom the insurer does not deal at arm's length whereby a customer of the person is referred to the insurer,

(iv) a policy issued to a member of a credit union as a consequence of an arrangement with a credit union, where

(A) the insurer was established primarily to provide insurance to members of credit unions,

(B) the policyholder was referred to the insurer, and

(C) the principal business of the insurer is the provision of insurance to members of credit unions, or

(v) a policy issued to a policyholder that is a corporation with which the insurer does not deal at arm's length, and

(b) in any other case, 20 per cent of the premium paid by the policyholder for the policy.

"amount payable", in respect of a policy loan at a particular time, means the amount of the policy loan and the interest thereon that is outstanding at that time.

"benefit" in respect of a policy includes

(a) a policy dividend (other than a policy dividend in respect of a policy described in paragraph 1403(1)(c)) in respect of the policy to the extent that the dividend was specifically treated as a benefit by the insurer in determining a premium for the policy, and

(b) an expense of maintaining the policy after all premiums in respect of the policy have been paid to the extent that the expense was specifically provided for by the insurer in determining a premium for the policy,

but does not include

(c) a policy loan,

(d) interest on funds left on deposit with the insurer under the terms of the policy, and

(e) any other amount under the policy that was not specifically provided for by the insurer in determining a premium for the policy.

"capital tax" means a tax imposed under Part I.3 or VI of the Act or a similar tax imposed under an Act of the legislature of a province.

"cash surrender value" has the meaning assigned by subsection 148(9) of the Act.

"claim liability" of an insurer at the end of a taxation year means

(a) in respect of a claim reported to the insurer before that time under an insurance policy, the amount, if any, by which

(i) the present value at that time, computed using a rate of interest that is reasonable in the circumstances, of a reasonable estimate, determined in

accordance with accepted actuarial practice, of the insurer's future payments and claim adjustment expenses in respect of the claim

exceeds

(ii) the present value at that time, computed using a rate of interest that is reasonable in the circumstances, of a reasonable estimate, determined in accordance with accepted actuarial practice, of the amounts that the insurer will recover after that time in respect of the claim because of salvage, subrogation or any other reason, and

(b) in respect of the possibility that there are claims under an insurance policy incurred before that time that have not been reported to the insurer before that time, the amount, if any, by which

(i) the present value at that time, computed using a rate of interest that is reasonable in the circumstances, of a reasonable estimate, determined in accordance with accepted actuarial practice, of the insurer's payments and claim adjustment expenses in respect of those claims

exceeds

(ii) the present value at that time, computed using a rate of interest that is reasonable in the circumstances, of a reasonable estimate, determined in accordance with accepted actuarial practice, of the amounts that the insurer will recover in respect of those claims because of salvage, subrogation or any other reason.

"extended motor vehicle warranty" means an agreement (referred to in this definition as the "extended warranty") under which a person agrees to provide goods or render services in respect of the repair or maintenance of a motor vehicle manufactured by the person or a corporation related to the person where

(a) the extended warranty is in addition to a basic or limited warranty in respect of the vehicle,

(b) the basic or limited warranty has a term of 3 or more years, although it may expire before the end of such term upon the vehicle's odometer registering a specified number of kilometres or miles,

(c) more than 50 per cent of the expenses to be incurred under the extended warranty are reasonably expected to be incurred after the expiry of the basic or limited warranty, and

(d) the person's risk under the extended warranty is insured by an insurer that is subject to the supervision of a relevant authority.

"general amending provision" of an insurance policy means a provision of the policy that allows it to be amended with the consent of the policyholder.

"interest", in relation to a policy loan, has the meaning assigned by subsection 138(12).

"lapse-supported policy" means a life insurance policy that would require materially higher premiums if premiums were determined using policy lapse rates that are zero after the fifth policy year.

"life insurance policy" includes a benefit under a group life insurance policy or a group annuity contract.

"life insurance policy in Canada" means a life insurance policy issued or effected by an insurer on the life of a person resident in Canada at the time the policy was issued or effected.

"modified net premium", in respect of a premium under a policy (other than a prepaid premium under a policy that cannot be refunded except on termination of the policy), means

(a) where all benefits (other than policy dividends) and premiums (other than the frequency of payment of premiums) in respect of the policy are determined at the date of issue of the policy, the amount determined by the formula

$$A \times \frac{(B + C)}{(D + E)}$$

where

A is the amount of the premium,

B is the present value, at the date of the issue of the policy, of the amount of the benefits to be provided under the terms of the policy after the day that is one year after the date of the issue of the policy,

C is the present value, at the date of the issue of the policy, of the amount of the benefits to be provided under the terms of the policy after the day that is two years after the date of the issue of the policy,

- D is the present value, at the date of the issue of the policy, of the amount of the premiums payable under the terms of the policy on or after the day that is one year after the date of the issue of the policy, and
- E is the present value, at the date of the issue of the policy, of the amount of the premiums payable under the terms of the policy on or after the day that is two years after the date of the issue of the policy,

except that the amount determined by the formula in respect of the premium for the second year of a policy is deemed to be the amount that is 1/2 of the total of

- (i) the amount that would otherwise be determined under the formula, and
- (ii) the amount of a one-year term insurance premium (determined without regard to the frequency of payment of the premium) that would be payable under the policy, and

(b) in any other case, the amount that would be determined under paragraph (a) if that paragraph applied and the amount were adjusted in a manner that is reasonable in the circumstances.

"net premium for the policy" means the amount by which the premium paid by the policyholder for the policy exceeds the acquisition costs of the policy.

"non-cancellable or guaranteed renewable accident and sickness policy" includes a benefit under a group non-cancellable or guaranteed renewable accident and sickness policy.

"participating life insurance policy" has the meaning assigned by subsection 138(12) of the Act.

"policy liability" of an insurer at the end of the taxation year in respect of an insurance policy or a claim, possible claim or risk under an insurance policy means the positive or negative amount of the insurer's reserve in respect of its potential liability in respect of the policy, claim, possible claim or risk at the end of the year determined in accordance with accepted actuarial practice, but without reference to projected income and capital taxes (other than the tax payable under Part XII.3 of the Act).

"policy loan" has the meaning assigned by subsection 138(12) of the Act.

"post-1995 life insurance policy" means a life insurance policy that is not a pre-1996 life insurance policy.

"post-1995 non-cancellable or guaranteed renewable accident and sickness policy" means a non-cancellable or guaranteed renewable accident and sickness policy that is not a pre-1996 non-cancellable or guaranteed renewable accident and sickness policy.

"pre-1996 life insurance policy", at any time, means a life insurance policy where

- (a) the policy was issued before 1996; and
- (b) before that time and after 1995 there has been no change, except in accordance with the provisions (other than a general amending provision) of the policy as they existed on December 31, 1995, to
 - (i) the amount of any benefit under the policy,
 - (ii) the amount of any premium or other amount payable under the policy, or
 - (iii) the number of premium or other payments under the policy.

"pre-1996 non-cancellable or guaranteed renewable accident and sickness policy", at any time, means a non-cancellable or guaranteed renewable accident and sickness policy where

- (a) the policy was issued before 1996; and
- (b) before that time and after 1995 there has been no change, except in accordance with the provisions (other than a general amending provision) of the policy as they existed on December 31, 1995, to
 - (i) the amount of any benefit under the policy,
 - (ii) the amount of any premium or other amount payable under the policy, or
 - (iii) the number of premium or other payments under the policy.

"qualified annuity" means an annuity contract issued before 1982, other than a deposit administration fund policy or a policy referred to in paragraph 1403(7)(c),

- (a) in respect of which regular periodic annuity payments have commenced,
- (b) in respect of which a contract or certificate has been issued that provides for regular periodic annuity payments to commence within one year from the date of issue of the contract or certificate,

(c) that is not issued as or under a registered retirement savings plan, registered pension plan or deferred profit sharing plan and that

(i) does not provide for a guaranteed cash surrender value at any time, and

(ii) provides for regular periodic annuity payments to commence not later than the attainment of age 71 by the annuitant, or

(d) that is issued as or under a registered retirement savings plan, registered pension plan or deferred profit sharing plan, if the interest rate is guaranteed for at least 10 years and the plan does not provide for any participation in profits, directly or indirectly.

"reinsurance commission" in respect of a policy means

(a) where the risk under the policy is fully reinsured, the amount, if any, by which

(i) the net premium for the policy

exceeds

(ii) the consideration payable by the insurer in respect of the reinsurance of the risk, and

(b) where the risk under the policy is not fully reinsured, the amount, if any, by which

(i) the portion of the net premium for the policy that may reasonably be considered to be in respect of the portion of the risk that is reinsured with a particular reinsurer

exceeds

(ii) the consideration payable by the insurer to the particular reinsurer in respect of the risk assumed by the reinsurer.

"relevant authority" of an insurer means

(a) the Superintendent of Financial Institutions, if the insurer is required by law to report to the Superintendent of Financial Institutions, and

(b) in any other case, the Superintendent of Insurance or other similar officer or authority of the province under whose laws the insurer is incorporated.

"reported reserve" of an insurer at the end of a taxation year in respect of an insurance policy or a claim, possible claim, risk, dividend, refund of premiums or refund of premium deposits under an insurance policy means the amount equal to

(a) where the insurer is required to file an annual report with its relevant authority for a period ending coincidentally with the year, the positive or negative amount of the reserve that would be reported in that report in respect of the insurer's potential liability under the policy if the reserve were determined without reference to projected income and capital taxes (other than the tax payable under Part XII.3 of the Act),

(b) where the insurer is, throughout the year, subject to the supervision of its relevant authority and paragraph (a) does not apply, the positive or negative amount of the reserve that would be reported in its financial statements for the year in respect of the insurer's potential liability under the policy if

(i) those statements were prepared in accordance with generally accepted accounting principles, and

(ii) the reserve were determined without reference to projected income and capital taxes (other than the tax payable under Part XII.3 of the Act),

(c) where the insurer is the Canada Mortgage and Housing Corporation or a foreign affiliate of a taxpayer resident in Canada, the positive or negative amount of the reserve that would be reported in its financial statements for the year in respect of the insurer's potential liability under the policy if

(i) those statements were prepared in accordance with generally accepted accounting principles, and

(ii) the reserve were determined without reference to projected income and capital taxes (other than the tax payable under Part XII.3 of the Act), and

(d) in any other case, nil.

"segregated fund" has the meaning given that expression in subsection 138.1(1).

"segregated fund policy" has the meaning given that expression in subsection 138.1(1).

(2) The definition "group term life insurance policy" in subsection 248(1) of the Act does not apply to this Part.

(3) For the purpose of the definition "modified net premium" in subsection (1), it may be assumed that premiums are payable annually in advance.

(4) For the purposes of this Part,

(a) a reference to a "premium paid by the policyholder" shall, depending on the method regularly following by the insurer in computing its income, be read as a reference to a "premium paid or payable by the policyholder"; and

(b) in determining the premium paid by a policyholder for a policy, there may be deducted by the insurer the portion, if any, of the premium that

(i) can reasonably be considered, at the time the policy is issued, to be a deposit that, pursuant to the terms of the policy or the by-laws of the insurer, will be returned to the policyholder, or credited to the account of the policyholder, by the insurer on the termination of the policy, and

(ii) was not otherwise deducted under section 140 of the Act.

(5) For the purposes of this Part, any rider that is attached to a life insurance policy and that provides for additional life insurance or for an annuity is a separate life insurance policy.

(6) For the purposes of this Part, any rider that is attached to a non-cancellable or guaranteed renewable accident and sickness policy that provides for additional non-cancellable or guaranteed renewable accident and sickness insurance, as the case may be, is a separate non-cancellable or guaranteed renewable accident and sickness policy.

(7) For the purposes of the definitions "pre-1996 life insurance policy" and "pre-1996 non-cancellable or guaranteed renewable accident and sickness policy" in subsection (1), a change in the amount of any benefit or in the amount or number of any premiums or other amounts payable under a policy is deemed not to have occurred where the change results from

(a) a change in underwriting class;

(b) a change in frequency of premium payments within a year that does not alter the present value, at the beginning of the year, of the total premiums to be paid under the policy in the year;

(c) the deletion of a rider;

- (d) the correction of erroneous information;
- (e) the reinstatement of the policy after its lapse, if the reinstatement occurs not later than 60 days after the end of the calendar year in which the lapse occurred;
- (f) the redating of the policy for policy loan indebtedness; or
- (g) an increase in the amount of a benefit under the policy that is granted by the insurer on a class basis, where
 - (i) no consideration was payable by the policyholder or any other person for the increase, and
 - (ii) the increase was not made because of the terms or conditions of the policy or any other policy or contract to which the insurer is a party.

6. Sections 1 to 5 apply to the 1996 and subsequent taxation years.

Explanatory Notes

Draft Amendments - Income Tax Act

Clause 1

ITA

12(1)(e.1)

New paragraph 12(1)(e.1) of the Act requires an insurer to include in computing its income under Part I for a taxation year a prescribed amount for "negative reserves" arising in respect of its insurance policies other than life insurance policies. Section 1400 of the Income Tax Regulations prescribes the amount of negative policy reserves that must be included in income under new paragraph 12(1)(e.1). New subsection 20(22) provides the insurer with a deduction from income for the amount of negative policy reserves included in income in the preceding taxation year. In general terms, negative policy reserves arise where the present value of future premiums exceeds the present value of future estimated benefits and expenses in respect of the insurer's policies.

New paragraph 12(1)(e.1) applies to the 1996 and subsequent taxation years.

Clause 2

Section 20 of the Act permits certain deductions in computing a taxpayer's income for a taxation year from a business or property as are wholly applicable to that source or as may be reasonably regarded as applicable thereto.

Subclause 2(1)

ITA

20(7)(c)

Paragraph 20(7)(c) of the Act provides that an insurer may deduct a prescribed amount as a policy reserve in respect of its other than life insurance businesses. Section 1400 of the Income Tax Regulations prescribes the amount that may be deducted under paragraph 20(7)(c). The amendments to this paragraph are strictly consequential on the amendments to section 1400 of the Regulations and ensure that the wording of these provisions corresponds.

Amended paragraph 20(7)(c) applies for the 1996 and subsequent taxation years.

Subclause 2(2)

ITA

20(22)

New subsection 20(22) of the Act provides that an insurer may deduct, in computing its income from an insurance business other than a life insurance business, any amount included in income in the preceding year as a negative policy reserve pursuant to new paragraph 12(1)(e.1). In general terms, negative policy reserves arise where the present value of future premiums exceeds the present value of future estimated benefits and expenses in respect of the insurer's policies.

New subsection 20(26.1) applies to the 1996 and subsequent taxation years.

Clause 3

ITA
87(2.2)

Subsection 87(2.2) of the Act deals with the amalgamation of two or more corporations where one or more of the predecessor corporations was an insurer. Where this occurs, the resulting corporation is treated as a continuation of each of the predecessor insurance corporations for the purposes of section 138 of the Act and certain other provisions of the Act relating to insurers that are listed in subsection 87(2.2). This subsection is amended to add references to new paragraph 12(1)(e.1) and new subsection 20(22) dealing with an insurer's negative policy reserves in respect of its other than life insurance businesses.

Amended subsection 87(2.2) applies to amalgamations occurring after 1995.

Clause 4

ITA
88(1)(g)(i)

Paragraph 88(1)(g) deals with the winding-up of a corporation that is a subsidiary into its parent. Subparagraph 88(1)(g)(i) will treat the parent corporation as a continuation of a subsidiary that is an insurance corporation for the purposes of certain provisions relating to insurers listed in subparagraph 88(1)(g)(i). This subparagraph is amended to add references to proposed new paragraph 12(1)(e.1) and new subsection 20(22) dealing with an insurer's negative policy reserves in respect of its other than life insurance businesses.

Amended subparagraph 88(1)(g)(i) applies to windings-up that begin after 1995.

Clause 5

Section 138 of the Act provides rules for the purpose of computing the income of a life insurer.

Subclause 5(1)

ITA

138(3)(a)(i)

Subparagraph 138(3)(a)(i) of the Act permits a life insurer to deduct in computing its income for a taxation year such amount as is allowed by regulation as a policy reserve in respect of its life insurance policies of a particular class. Subparagraph 138(3)(a)(i) is amended to ensure that it provides a life insurer with the authority to claim a deduction for policy reserves in an amount up to (but not exceeding) the amount allowed by regulation. It should also be noted that subparagraph 138(3)(a)(i) applies in respect of both "pre-1996 life insurance policies" and "post-1995 life insurance policies".

Amended subparagraph 138(3)(a)(i) applies to the 1996 and subsequent taxation years.

ITA

138(3)(a)(ii)

Subparagraph 138(3)(a)(ii) of the Act permits a life insurer to deduct in computing its income for a taxation year a prescribed amount as a reserve in respect of claims under life insurance policies that were received by it before the end of the year and that are unpaid at the end of the year. Subparagraph 138(3)(a)(ii) is amended to ensure that it provides a life insurer with the authority to claim a deduction for unpaid claims under its life insurance policies in amounts up to (but not exceeding) the amounts allowed by regulation. It should also be noted that subparagraph 138(3)(a)(ii) applies in respect of both "pre-1996 life insurance policies" and "post-1995 life insurance policies".

Amended subparagraph 138(3)(a)(ii) applies to the 1996 and subsequent taxation years.

ITA

138(3)(a)(ii.1)

New subparagraph 138(3)(a)(ii.1) of the Act will permit a life insurer to claim a deduction in respect of negative policy reserves that were included in the insurer's income in the preceding year pursuant to new paragraph 138(4)(b) of the Act and the regulations thereunder. In general terms, negative policy reserves arise where the present value of future premiums exceeds the present value of future estimated benefits and expenses in respect of the insurer's policies.

New subparagraph 138(3)(a)(ii.1) applies to the 1996 and subsequent taxation years.

Subclause 5(2)

ITA

138(4)

Subsection 138(4) of the Act requires a life insurer to include certain amounts in computing its income under Part I for a taxation year. Subsection 138(4) is amended to require a life insurer to include in income the amount prescribed by new subsection 1404(2) of the Income Tax Regulations to be the "negative policy reserves" in respect of the insurer's life insurance policies that are post-1995 life insurance policies. In general terms, negative policy reserves arise where the present value of future premiums exceeds the present value of future estimated benefits and expenses in respect of the insurer's policies.

Amended subsection 138(4) applies to the 1996 and subsequent taxation years.

ITA
138(4.01)

New subsection 138(4.01) of the Act extends the meaning of life insurance policy, for the purposes of subsections 138(3) and (4) and the regulations made thereunder, to include benefits under, both, group life insurance policies and group annuity contracts. This extended definition of life insurance policy was previously found in section 1404 of the Income Tax Regulations. New subsection 138(4.01) applies to the 1996 and subsequent taxation years.

Subclause 5(3)

ITA
138(11.5)(j.1)

Subsection 138(11.5) of the Act provides rules which allow a non-resident insurer (the "transferor") to transfer, on a tax-deferred basis, an insurance business carried on in Canada to a qualified related corporation (the "transferee") within the meaning assigned by subsection 219(8) of the Act. Paragraph 138(11.5)(j) provides that insurance reserves claimed by the transferor are deemed to have been deducted by the transferee for the taxation years deemed by paragraph 138(11.5)(h) to have ended before the transfer. Consequently, the transferee must include such amounts in computing its income for the following year. Similarly, new paragraph 138(11.5)(j.1) provides that negative policy reserves included in the transferor's income under new paragraphs 12(1)(e.1) and 138(4)(b) for the taxation year deemed to have ended before the transfer are deemed to have been included in the transferee's income for such year. This will enable the transferee to claim a deduction for such amounts in the following year pursuant to new subsection 20(22) or new subparagraph 138(3)(a)(ii.1).

New paragraph 138(11.5)(j.1) applies to the 1996 and subsequent taxation years.

Subclause 5(4)

ITA
138(11.91)(d.1)

Subsection 138(11.91) of the Act provides rules for the purpose of computing the income of a non-resident insurer that commences to carry on a business in Canada or that ceases to be exempt from tax under Part I in a particular taxation year. Paragraph 138(11.91)(d) treats the insurer as having claimed the maximum insurance reserves for the year deemed by paragraph 138(11.91)(c) to have ended immediately before the beginning of the particular taxation year. Accordingly, the non-resident insurer must include such amounts in computing its income in Canada for the following year. Similarly, new paragraph 138(11.91)(d.1) deems the non-resident insurer to have carried on business in Canada in the year deemed to have ended immediately before the beginning of the particular taxation year and to have included in income the amount of negative policy reserves that would have been prescribed in respect of the insurer for the purposes of new paragraphs 12(1)(e.1) and 138(4)(b) and the regulations thereunder. This will enable the non-resident insurer to claim a deduction for such amounts in the particular year pursuant to new subsection 20(22) or new subparagraph 138(3)(a)(ii.1).

New paragraph 138(11.91)(d.1) applies to the 1996 and subsequent taxation years.

Clause 6

Section 149 of the Act provides an exemption from Part I tax for the taxable income of certain persons.

Subclause 6(1)

ITA

149(1)(t)

Paragraph 149(1)(t) of the Act provides a tax exemption in respect of the taxable income of an insurer for a period in which the insurer was engaged solely in the business of insurance, and in which not less than 25% of the gross premium income (net of reinsurance ceded) earned by the insurer and certain other insurers that are grouped for this purpose was from the insurance of residences of farmers and fishermen, farm property and property used in fishing ("farm risks"). Paragraph 149(1)(t) is amended, applicable to the 1996 and subsequent years, to expand the exemption to include insurers in respect of which not less than 20% of such premium income is from the insurance of farm risks. The extent of the exemption is described in the commentary on subsection 149(4.1). This expansion is to provide some transitional relief for insurers that fall below the current 25% threshold, but remain above the new 20% threshold. Paragraph 149(1)(t) is also amended to clarify that property must be used in farming in order for the premium income arising from the insurance of such property to be counted towards the 20% threshold.

Subclause 6(2)

ITA
149(4.1)

Subsection 149(4.1) of the Act limits the tax exemption provided under paragraph 149(1)(t). More specifically, the exemption is limited to that portion of the insurer's taxable income for a taxation year that the insurer's gross premium income (net of reinsurance ceded) earned for the year from the insurance of residences of farmers and fishermen, farm property and property used in fishing is of its total gross premium income (net of reinsurance ceded) for the year.

Subsection 149(4.1) is amended as a consequence of the expansion of the exemption under paragraph 149(1)(t) to include certain insurers where not less than 20% of their gross premium income (net of reinsurance ceded) is from the insurance of residences of farmers and fishermen or property used in farming or fishing ("farm risks"). New subsection 149(4.1) effectively provides that where between 20 and 25 per cent of the total gross premium income (net of reinsurance ceded) of the insurer and certain other insurers that are grouped for this purpose is from the insurance of farm risks, one-half of the insurer's taxable income attributable to premium income arising from such risks is eligible for the exemption under paragraph 149(1)(t). The scope of the exemption is otherwise unchanged.

New subsection 149(4.1) applies to the 1996 and subsequent taxation years.

Clause 7

ITA
211(1)

Subsection 211(1) of the Act provides definitions for the purpose of the tax on the taxable life investment income of a life insurer under Part XII.3. There are two amendments to this subsection: the definition "life insurance policy" is extended to include benefits under, both, group life insurance policies and group annuity contracts, and the definition "life insurance policy in Canada" in subsection 138(12) has been repeated. These amendments apply to the 1996 and subsequent taxation years.

Clause 8

ITA
211.1(3)

Section 211.1 of the Act levies a tax at the rate of 15% on the taxable Canadian life investment income of a life insurer. A life insurer's taxable Canadian life investment income is equal to the excess of its Canadian life investment income for a taxation year over the total of the insurer's unused Canadian life investment losses from the seven preceding years. Subsection 211.1(3) provides for the determination of an insurer's Canadian life investment income or loss for a

taxation year for these purposes. The amendments to paragraphs (a) and (b) of the descriptions of A and D as well as subparagraphs (c)(i) and (ii) of the description of E in subsection 211.1(3) are strictly consequential on the amendment to subsection 1401(1) of the Income Tax Regulations restricting the application of that Regulation, for the 1996 and following years, to life insurance policies in Canada that are "pre-1996 life insurance policies". These amendments ensure that the Canadian life investment income of the life insurer is determined in respect of all its life insurance policies.

These amendments apply to the 1996 and subsequent taxation years.

Draft Amendments - Income Tax Regulations

Clause 1

ITR

Part XIV

Part XIV of the Income Tax Regulations provides rules for determining the amount that may be deducted by an insurer in computing its income for a taxation year under Part I of the Act as a reserve in respect of liabilities under insurance policies. Part XIV is modified by the creation of four separate divisions. Division I of Part XIV will provide for the determination of the policy reserves for insurance policies other than life insurance policies. Division II will provide for the determination of the policy reserves for life insurance policies that are "pre-1996 life insurance policies". Division III will provide for the determination of the policy reserves for life insurance policies that are post-1995 life insurance policies. Division IV will provide definitions and rules of interpretation for the purposes of Divisions I to III.

ITR

1400

Section 1400 of the Regulations establishes the amount an insurer may deduct under paragraph 20(7)(c) of the Act as policy reserves in respect of insurance policies other than life insurance policies. Section 1400 is replaced by four new subsections.

New subsection 1400(1) provides that, for the purposes of paragraph 20(7)(c) of the Act, the amount prescribed in respect of an insurer's other than life businesses is the amount determined under subsection 1400(3), where that amount is a positive number. Where, however, that amount is equal to or less than nil, the prescribed amount is nil.

New subsection 1400(2) provides that, for the purposes of new paragraph 12(1)(e.1) of the Act, the amount prescribed in respect of an insurer's other than life businesses is the absolute value of the amount determined under subsection 1400(3), where that amount is less than nil. Where, however, the amount determined under subsection 1400(3) is equal to or greater than nil, the prescribed amount is nil.

Therefore, where the amount determined under subsection 1400(3) is positive, that is the amount prescribed for the purposes of paragraph 20(7)(c) of the Act. According to paragraph 20(7)(c), an amount not exceeding such prescribed amount may be deducted as a policy reserve in respect of an insurer's other than life businesses. Where, however, the amount determined under subsection 1400(3) is negative, then the absolute value of that amount is the amount prescribed for the purpose of paragraph 12(1)(e.1) of the Act. This "negative policy reserve" must be included in computing the insurer's income from its other than life businesses pursuant to new paragraph 12(1)(e.1), and may be deducted in the following taxation year pursuant to new subsection 20(22) of the Act.

New subsection 1400(3) of the Regulations sets out a formula for determining the amount prescribed for the purposes of subsections 1400(1) and (2) of the Regulations. The total amount determined under this formula in subsection 1400(3), as well as the individual amounts determined under each of the components of the formula, may be equal to, greater or less than, nil (see new section 1402.1 of the Regulations).

The description of A in new subsection 1400(3) replaces existing paragraph 1400(a) of the Regulations. In general terms, "A" is equal to the total unearned premiums at the end of the taxation year in respect of insurance policies other than those listed in paragraphs (a), (b), (c) and (d) of the description of A.

The description of B in new subsection 1400(3) replaces existing paragraph 1400(b) of the Regulations. Paragraph 1400(b) provides a reserve for unearned premiums in respect of policies excluded from the application of paragraph 1400(a). Similarly, the description of B provides a reserve for unearned premiums in respect of policies excluded from the description of A, namely, policies that insure a risk in respect of mortgages, home warranties, lease guarantees and extended motor vehicle warranties. "B" is, in general terms, equal to the lesser of the insurer's reported reserve in respect of the unearned portion at the end of the year of the net premium for the policy and a reasonable amount in respect of such unearned premiums.

A "reported reserve" of an insurer at the end of a taxation year in respect of an insurance policy or a claim, possible claim or risk under an insurance policy is defined in new subsection 1408(1). Where the insurer is subject to the supervision of the "relevant authority" throughout a taxation year, it is defined as the positive or negative amount of the reserve that would have been reported in the insurer's annual report for the year to the "relevant authority" in respect of that policy, claim, possible claim or risk if the reserve has been determined without reference to projected income and capital taxes of the insurer (other than the tax payable under Part XII.3 of the Act). Where the insurer is subject to the supervision of the relevant authority throughout its taxation year but is not required to file a report for a period ending coincidentally with the year, or the insurer is the Canada Mortgage and Housing Corporation (CMHC) or a foreign affiliate of a taxpayer resident in Canada, it is the amount of the reserve that would have been reported in the insurer's financial statements if they had been prepared in accordance with generally accepted accounting principles (GAAP) and without reference to income and capital taxes (other than the tax payable under Part XII.3 of the Act). In any other case, the reported reserve is nil.

The description of C in new subsection 1400(3) replaces existing paragraphs 1400(c) and (d) of the Regulations. Paragraph 1400(c) provides a reserve for the unearned portion of reinsurance commissions in respect of policies where all or a portion of the risk under the policies has been reinsured. Similarly, paragraph 1400(d) provides a reserve for the unearned portion of reinsurance commissions in respect of policies where all or a portion of the risk under the policies was assumed by the insurer and all or a portion of the risk assumed was subsequently reinsured. No substantive changes have been made to these reserves.

The description of D in new subsection 1400(3) replaces existing paragraph 1400(e) of the Regulations. Paragraph 1400(e) provides for a reserve in respect of an insurer's unpaid claims. In general terms, the reserve is equal to 95% of the lesser of the insurer's reported reserve for unpaid claims and the insurer's actuarial liability in respect of such claims. The description of E modifies this reserve by making it 95% of the lesser of the insurer's reported reserve and the insurer's claim liability in respect of such claims. Where the insurer has agreed to a structured settlement of a claim that is in respect of personal injury or death, the reserve remains at 100% of the claim.

A "reported reserve" of an insurer at the end of a taxation year in respect of an insurance policy or a claim, possible claim or risk under an insurance policy is defined in new subsection 1408(1). Where the insurer is subject to the supervision of the "relevant authority" throughout a taxation year, it is defined as the positive or negative amount of the reserve that would have been reported in the insurer's annual report for the year to the relevant authority in respect of that policy, claim, possible claim or risk if the reserve had been determined without reference to projected income and capital taxes of the insurer (other than the tax payable under Part XII.3 of the Act). Where the insurer is subject to the supervision of the relevant authority throughout its taxation year but is not required to file a report for a period ending coincidentally with the year, or the insurer is the CMHC or a foreign affiliate of a taxpayer resident in Canada, it is the amount of the reserve that would have been reported in the insurer's financial statements if they had been prepared in accordance with GAAP and without reference to income and capital taxes (other than the tax payable under Part XII.3 of the Act). In any other case, the reported reserve is nil.

New subsection 1408(1) defines the "claim liability" (which term has been substituted for the term "actuarial liability") of an insurer at the end of a taxation year in respect of an unpaid claim as a reasonable estimate, determined in accordance with accepted actuarial practice, of the present value of future payments and claims adjustment expenses in respect of the claim, over the present value of amounts to be recovered in respect of the claim because of salvage, subrogation or any other reason.

The description of E in new subsection 1400(3) replaces existing paragraph 1400(e.1) of the Regulations. Paragraph 1400(e.1) provides a reserve in respect of the possibility that claims have been incurred under a policy before the end of a taxation year but not reported to the insurer. In general terms, the reserve is 95% of the lesser of the insurer's actuarial liability for incurred but not reported (IBNR) claims and its reported reserve for IBNR claims. The description of E modifies this reserve by making it 95% of the lesser of the insurer's reported reserve and the insurer's claim liability in respect of the possibility that there are such claims. The terms "reported reserve" and "claim liability" are defined in new subsection 1408(1) of the Regulations and described in the commentary therefor.

The description of F in new subsection 1400(3) replaces existing paragraph 1400(f) of the Regulations. Paragraph 1400(f) provides a supplementary reserve for policies insuring a risk listed in that paragraph, such as a fidelity risk. Under the description of F, the new reserve in respect of such policies becomes the lesser of the insurer's reported reserve and a reasonable

amount in respect of that reserve. The term "reported reserve" is defined in new subsection 1408(1) of the Regulations and described in the commentary therefor.

The description of G in new subsection 1400(3) replaces existing paragraph 1400(f.1) of the Regulations. This reserve is currently under review by the Department.

The description of H in new subsection 1400(3) replaces existing paragraph 1400(g) of the Regulations. Paragraph 1400(g) provides for a reserve in respect of a risk under non-cancellable or guaranteed renewable accident and sickness policies. The reserve under the description of H may only be claimed in respect of non-cancellable or guaranteed renewable accident and sickness policies that are "pre-1996 non-cancellable or guaranteed accident and sickness policies". Otherwise, the reserve is essentially unchanged. Non-cancellable or guaranteed renewable accident and sickness policies that are "post-1995 non-cancellable or guaranteed renewable accident and sickness policies" are governed by the description of I.

A "pre-1996 non-cancellable or guaranteed renewable accident and sickness policy" is defined by new subsection 1408(1) to mean a non-cancellable or guaranteed renewable accident and sickness policy that was issued before 1996 and in respect of which there has been no change to the amount or number of premium payments or the amount of benefits under the policy after 1995 except in accordance with the provisions of the policy as they existed on December 31, 1995. However, if such a change occurred pursuant to a "general amending provision" of the policy, it will lose its status as a pre-1996 policy. The term "general amending provision" is defined in new subsection 1408(1) as a provision of a policy that allows it to be amended with the consent of the policyholder.

The description of I provides a reserve in respect of risks under non-cancellable or guaranteed renewable accident and sickness policies that are post-1995 non-cancellable or guaranteed renewable accident and sickness policies, that is, non-cancellable or guaranteed renewable accident and sickness policies that are not pre-1996 non-cancellable or guaranteed renewable accident and sickness policies. The reserve is the lesser of the reported reserve and the policy liability of the insurer in respect of such risks. The terms "reported reserve" and "policy liability" are defined in new subsection 1408(1) of the Regulations and described in the commentary therefor.

The description of J in new subsection 1400(3) replaces existing paragraph 1400(g.1) of the Regulations. In general terms, paragraph 1400(g.1) provides a reserve for future adverse claims experience under group accident and sickness insurance policies. This reserve is essentially unchanged.

Existing paragraph 1400(h) of the Regulations is repealed. Paragraph 1400(h) is a transitional provision applicable in respect of the 1977 to 1986 taxation years of an insurer. It effectively provides an insurer with a ten-year period in which to include in income the amount of any contingency reserve claimed by the insurer for its 1977 taxation year, which was the last year in respect of which such a reserve could be claimed.

The description of K in new subsection 1400(3) replaces existing paragraph 1400(i) of the Regulations. Paragraph 1400(i) provides a reserve, in lieu of the reserve under paragraph 1400(a) for unearned premiums, in respect of amounts deposited under a policy that will be returned to the policyholder upon termination of the policy. This reserve is essentially unchanged.

New subsection 1400(4) provides a special rule where the relevant authority does not require an insurer to determine its reserves in respect of unpaid claims in accordance with actuarial principles. The unpaid claim reserves under the descriptions of D or E of subsection 1400(3), in such cases, will simply be the reported reserve under those descriptions. This rule is intended to relieve small property and casualty insurers from having to seek an "outside" opinion as to the reasonableness of their reserves for unpaid claims.

New subsections 1400(1) to (4) of the Regulations apply to the 1996 and subsequent taxation years.

Clause 2

ITR

1401(1) and (1.1)
and 1401(1)(c)(ii)(B)

Amended subsection 1401(1) of the Regulations establishes the amount which an insurer is permitted to deduct as a policy reserve under subparagraph 138(3)(a)(i) of the Act in respect of its life insurance policies. New subsection 1401(1.1) is added in order to restrict the application of subsection 1401(1) to life insurance policies in Canada that are "pre-1996 life insurance policies". Life insurance policies in Canada that are "post-1995 life insurance policies" will be subject to the new policy reserve rules in Division III of Part XIV of the Regulations.

Subsection 1408(1) of the Regulations defines "pre-1996 life insurance policy" to mean a life insurance policy that was issued before 1996 and in respect of which there has been no change to the amount or number of premiums payments or the amount of benefits under the policy after 1995 except in accordance with the provisions of the policy as they existed on December 31, 1995. However, if such a change occurs pursuant to a "general amending provision" of the policy, it will lose its status as a pre-1996 policy. The term "general amending provision" is defined in new subsection 1408(1) as a provision of a policy that allows it to be amended with the consent of the policyholder. New subsection 1408(7) of the Regulations provides that, for the purpose of the definition "pre-1996 life insurance policy" in subsection 1408(1), changes in the amount of any benefit or in the amount or number of any premiums payable under a life insurance policy are deemed not to have occurred where they have resulted from:

- a change in underwriting class,
- a change in frequency of premium payments within a year that does not alter the present value, at the beginning of the year, of the total premiums to be paid under the policy in the year,
- the deletion of a rider,
- the correction of erroneous information,
- the reinstatement of the policy after its lapse, provided the policy is reinstated not later than 60 days after end of the calendar year in which the lapse occurred,
- the redating of the policy for policy loan indebtedness, and
- an increase in a benefit under the policy granted by the insurer on a class basis without consideration and not pursuant to any term of the policy.

To summarize, an existing life insurance policy will not lose its status as a pre-1996 life insurance policy, and, therefore, will continue to be governed by section 1401 of the Regulations, where the change in its benefits or premiums results from a transaction or event that is either pre-determined or set out in new subsection 1408(7). However, where such a change is the result of any other transaction or event, the policy will no longer be a pre-1996 life insurance policy, and, accordingly, will be subject to the new policy reserve rules in respect of post-1995 life insurance policies set out in Division III of Part XIV of the Regulations.

A minor amendment has also been made to clause 1401(1)(c)(ii)(B) of the Act in order to avoid any confusion that could result from the use of the term "net premiums for the policy" in that clause.

Amended subsection 1401(1), new subsection 1401(1.1) and amended clause 1401(1)(c)(ii)(B) of the Regulations apply to the 1996 and subsequent taxation years.

ITR 1401(4)

Subsection 1401(4) of the Regulations sets out the basis for determining the amount an insurer is permitted to deduct pursuant to subparagraph 138(3)(a)(ii) of the Act as a reserve in respect of its reported unpaid claims under its life insurance policies in Canada. Subsection 1401(4) is amended in order to limit its application to life insurance policies that are "pre-1996 life insurance policies". Policies that are not pre-1996 life insurance policies, that is, "post-1995 life insurance policies", will be subject to the rules regarding unpaid claims reserves in new Division III of Part XIV of the Regulations. The terms "post-1995 life insurance policy" and "pre-1996 life insurance policy" are

defined in subsection 1408(1) of the Regulations. Amended subsection 1401(4) is applicable to the 1996 and subsequent taxation years.

Clause 3

Clause 3 simply changes the heading before section 1402 of the Regulations.

Clause 4

ITR 1402

Existing subsection 1402(1) of the Regulations ensures that the reserves claimed under sections 1400 and 1401 are net of any reinsurance ceded by the insurer. Subsection 1402(2) is intended to provide an insurer that is a foreign affiliate of a taxpayer resident in Canada with the authority to claim reserves of a reasonable amount in respect of its insurance business that is deemed to be carried on in Canada under the Foreign Accrual Property Income (FAPI) rules in subdivision i of the Act. Where an insurer that is a foreign affiliate carries on a business that is subject to the FAPI rules, it must compute the income from that business in accordance with the rules of the Act (see paragraph 95(2)(k)), including the rules respecting policy reserves in paragraph 20(7)(c) and section 138 of the Act and the regulations made thereunder. Because of the existence of paragraph 95(2)(k) of the Act and the definition of reported reserve in new subsection 1408(1), subsection 1402(2) of the Regulations is considered to be unnecessary and is therefore repealed.

Amended section 1402 of the Regulations applies to the 1996 and subsequent taxation years.

Clause 5

ITR 1402.1

New section 1402.1 of the Regulations provides, for greater certainty, that amounts referred to or determined under section 1400 of the Regulations may be negative. New section 1402.1 is to apply to the 1996 and subsequent taxation years.

Clause 6

ITR 1404(1)

New section 1404 of the Regulations establishes the basis for determining the amount an insurer may deduct under subparagraph 138(3)(a)(i) of the Act as a policy reserve in respect of its life

insurance policies that are post-1995 life insurance policies. A "post-1995 life insurance policy" is defined by subsection 1408(1) of the Regulations. Section 1404 is divided into four subsections.

New subsection 1404(1) of the Regulations provides that, for the purpose of subparagraph 138(3)(a)(i) of the Act, the amount that may be deducted by an insurer as a policy reserve in respect of its life insurance policies in Canada that are post-1995 life insurance policies is the amount determined under the formula in subsection 1404(3) of the Regulations. Where that amount is a positive number, new subsection 1404(1) provides that that amount is the deductible amount; however, where that amount is equal to or less than nil, the amount deductible is nil.

New subsection 1404(2) of the Regulations provides that, for the purposes of paragraph 138(4)(b) of the Act, the amount prescribed in respect of life insurance policies that are post-1995 life insurance policies is the absolute value of the amount determined under the formula in subsection 1404(3) of the Regulations, where that amount is less than nil. Where, however, the amount determined under subsection 1404(3) is equal to or greater than nil, the prescribed amount is nil.

To summarize, where the amount determined under subsection 1404(3) is positive, that is the amount deductible under subparagraph 138(3)(a)(i) of the Act. Under subparagraph 138(3)(a)(i) of the Act, an amount not exceeding such prescribed amount may be deducted as a policy reserve in respect of an insurer's life insurance policies that are post-1995 life insurance policies. Where, however, the amount determined under subsection 1404(3) is negative, then the absolute value of that "negative reserve" is (subject to the transitional relief provided in new subsection 1404(4)) the prescribed amount for the purpose of paragraph 138(4)(b) of the Act.

New subsection 1404(3) of the Regulations sets out a formula for determining the amount prescribed for the purposes of subsections 1404(1) and (2) of the Regulations. The total amount determined under this formula in subsection 1404(3), as well as the individual amounts determined under each of the components of the formula, may be equal to, greater or less than, nil (see new section 1407 of the Regulations).

The general policy reserve in respect of life insurance policies that are post-1995 life insurance policies is found in the description for A of the formula in subsection 1404(3) of the Regulations. This reserve replaces the existing reserves for such policies contained in paragraphs (a), (c) and (d) of subsection 1401(1) of the Regulations, the application of which, for the 1996 and subsequent taxation years, is limited to pre-1996 life insurance policies. The reserves contained in paragraphs (a), (c) and (d) of subsection 1401(1) are for, respectively, deposit administration fund policies, actuarial liabilities in respect of policies other than deposit administration fund policies and group term life policies with a term of up to 12 months, and policies that provide for certain additional benefits and guarantees under life insurance policies.

In general terms, the amount of the reserve determined under the description of A is equal to the lesser of two amounts: (1) the total of the reported reserves of the insurer at the end of the year

in respect of post-1995 life insurance policies and (2) the total of the policy liabilities of the insurer at the end of the year in respect of such policies.

The terms "reported reserve" and "policy liability" are defined in new subsection 1408(1) of the Regulations.

Where an insurer is subject to the supervision of the "relevant authority" throughout a taxation year, the "reported reserve" of the insurer at the end of that year in respect of a life insurance policy or a claim, possible claim or risk under a life insurance policy means the positive or negative amount of the reserve that would have been reported in the insurer's annual report to the "relevant authority" in respect of that policy, claim, possible claim or risk if the reserve had been determined without reference to projected income and capital taxes of the insurer (other than the tax payable under Part XII.3 of the Act). Where the insurer is subject to the supervision of the relevant authority throughout its taxation year but is not required to file a report for a period ending coincidentally with the year, or the insurer is the CMHC or a foreign affiliate of a taxpayer resident in Canada, it is the amount of the reserve that would have been reported in the insurer's financial statements if they had been prepared in accordance with GAAP and without reference to income and capital taxes (other than the tax payable under Part XII.3 of the Act). In any other case, the reported reserve is nil.

The "policy liability" of an insurer at the end of a taxation year in respect of a life insurance policy or a claim, possible claim or risk under a life insurance policy means the positive or negative amount of the reserve in respect of the insurer's liability in respect of the policy, claim, possible claim or risk determined in accordance with accepted actuarial practice, but without reference to income and capital taxes (other than the tax payable under Part XII.3 of the Act).

The description of B in new subsection 1404(3) of the Regulations provides a reserve in respect of the possibility that there may be claims under post-1995 life insurance policies that have not been reported to the insurer. Existing paragraphs 1401(1)(d.1) and (d.2) of the Regulations provide a reserve for such incurred but not reported claims in respect of pre-1996 life insurance policies.

The reserve under "B" in respect of a life insurance policy is equal to 95% of the lesser of two amounts: (1) the total of the insurer's reported reserves in respect of possible claims under the policy and (2) the total of the insurer's policy liabilities in respect of such claims. The terms "reported reserve" and "policy liability" are defined in new subsection 1408(1) of the Regulations and described in the commentary therefor.

The description of C in new subsection 1404(3) of the Regulations provides for the determination of a reserve amount for unearned premiums in respect of group term life insurance policies that provide coverage for a period of up to 12 months. The description of C parallels the reserve in paragraph 1401(1)(b) of the Regulations, the application of which, for the 1996 and subsequent

taxation years, is restricted to group term life insurance policies that are pre-1996 life insurance policies.

The description of D in new subsection 1404(3) of the Regulations provides for the determination of a reserve amount for, in general terms, future adverse claims experience in respect of group life insurance policies that are post-1995 life insurance policies. The description of D parallels the reserve in paragraph 1401(1)(c.1) of the Regulations, the application of which, for the 1996 and subsequent taxation years, is restricted to group life insurance policies that are pre-1996 life insurance policies.

The additional reserve provided under paragraph 1401(1)(e) of the Regulations in respect of qualified annuities of an insurer has no corollary under the new policy reserve rules in Division III of Part XIV, as these rules are solely applicable to life insurance policies that are not pre-1996 life insurance policies, that is, post-1995 life insurance policies.

The description of M in new subsection 1404(3) of the Regulations provides a deduction for outstanding policy loans and interest accrued thereon in the computation of the reserve amount under that subsection. This is in keeping with the view that policy loans represent a pre-payment of benefits.

New subsections 1404(1) to (3) apply to the 1996 and subsequent taxation years.

ITR 1404(4)

New subsection 1404(4) of the Regulations is a transitional measure which provides relief, in certain circumstances, for negative reserves arising under the description of I in new subsection 1400(3) or the description of A in new subsection 1404(3). Those provisions provide for reserves in respect of an insurer's non-cancellable or guaranteed renewable accident and sickness policies that are post-1995 non-cancellable or guaranteed renewable accident and sickness policies and in respect of its life insurance policies in Canada that are post-1995 life insurance policies. More specifically, new subsection 1404(4) may operate to increase a life insurer's total policy reserve (or, if such a reserve is negative, decrease the amount by which it is negative) otherwise determined under subsection 1404(3), for its taxation years ending after 1995 and before 2001, by a decreasing percentage of an amount. That amount is the amount, if any, by which the absolute value of the total of the negative reserves used in the computation of the reserve amount under the descriptions of I or A in, respectively, subsection 1400(3) or 1404(3) for the year, exceeds 5% of the total of the premiums received by the insurer in each of those years in respect of its non-cancellable or guaranteed renewable accident and sickness policies and its life insurance policies in Canada (including "pre-1996" policies). The following example illustrates the mechanics of the rule.

Assume that a life insurer with a December 31 year-end issues insurance policies in 1996 and 1997. Certain of these policies (the "I policies") are subject to the reserve rules under the description of I in subsection 1400(3), while the rest (the "A policies") are subject to the rules under the description of A in subsection 1404(3). Assume further that no other reserves may be claimed in respect of the policies. The total amount of premiums received by the insurer in respect of all policies (including "pre-1996" policies) is \$10,000 in 1996 and \$14,000 in 1997. The following reserves, both positive and negative, were computed in respect of the A and I policies for those years:

Policies	A Policies		I Policies	
	1996	1997	1996	1997
Reserves				
Reported reserves	(\$)	(\$)	(\$)	(\$)
- positive	1000	1200	0	0
- negative	(800)	(600)	(200)	(100)
- net	200	600	(200)	(100)
Policy liabilities				
- positive	1200	1400	100	100
- negative	(800)	(600)	(200)	(100)
- net	400	800	(100)	0

Therefore, the lesser of the totals determined under the descriptions of A in subsection 1404(3) and I in subsection 1400(3) in respect of the A and I policies for the insurer's 1996 taxation year, is the total of the reported reserves for those policies. Given the above, the amount deemed by subsection 1404(4) to be the insurer's policy reserve under subsection 1404(3) for its 1996 taxation year is computed as follows:

$$A + (B \times (C - D)) \quad [\text{with the term } (C - D) \text{ never less than zero}]$$

where

- A is 200, that is, the total of the reported reserves in respect of the A policies for the insurer's 1996 taxation year;
- B is 100%, as the insurer's taxation year ends in 1996;
- C is 1,000, that is, the absolute value of the negative amounts (800 + 200), determined on a policy-by-policy basis, used in computing the insurer's reported reserves (as the total reported reserves is the least of the totals determined under

the descriptions of A in subsection 1404(3) and I in subsection 1400(3)) in respect of the A and I policies for the insurer's 1996 taxation year; and

- D is 500 or 5% of the \$10,000 premiums received by the insurer in its 1996 taxation year in respect of all policies.

$$200 + (100\% \times (1,000 - 500)) = 700$$

Therefore, the insurer's policy reserve under subsection 1404(3) for its 1996 taxation year is \$700.

For the insurer's 1997 taxation year, the amount deemed by subsection 1404(4) to be the insurer's policy reserve under subsection 1404(3) is computed as follows:

$$A + (B \times (C - D)) \quad \text{[with the term (C-D) never less than zero]}$$

where

- A is 600, that is, the total of the reported reserves in respect of the A policies for the insurer's 1997 taxation year;
- B is 80%, as the insurer's taxation year ends in 1997;
- C is 700, that is, the total of all amounts each of which is the absolute value of the negative amounts used in computing the reported reserves for 1997 (600) in respect of the A policies, and the reported reserves for 1997 (100) in respect of the I policies; and
- D is the lesser of 1,200 (5% x (\$10,000 premiums received in 1996 + \$14,000 premiums received in 1997)), and (in order to avoid a negative amount) the value of C or 700.

$$600 + (80\% \times (700 - 700)) = 600$$

Therefore, the insurer's policy reserve under subsection 1404(3) for its 1997 taxation year is \$600.

New subsection 1404(4) applies to the 1996 and subsequent taxation years.

ITR
1405

New section 1405 of the Regulations sets out the basis for determining the amount an insurer is permitted to deduct pursuant to subparagraph 138(3)(a)(ii) of the Act as a reserve in respect of its reported unpaid claims at the end of a taxation year under its life insurance policies in Canada that are post-1995 life insurance policies. Policies that are pre-1996 life insurance policies will continue to be governed by the rules in subsection 1401(4) of the Regulations.

The reserve under section 1405 is equal to the lesser of two amounts: (1) the insurer's reported reserve in respect of a reported unpaid claim and (2) the insurer's policy liability in respect of that claim. The terms "reported reserve" and "policy liability" are defined in new subsection 1408(1) of the Regulations and described in the commentary therefor.

New section 1405 applies for the 1996 and subsequent taxation years.

ITR
1406 and 1407

New sections 1406 and 1407 of the Regulations provide rules for the purpose of computing the policy reserves under new sections 1404 and 1405 of the Regulations in respect of life insurance policies that are post-1995 life insurance policies.

New section 1406 provides that any amounts determined under sections 1404 and 1405 shall be determined

- on a net of reinsurance ceded basis, and
- without reference to a liability in respect of a segregated fund.

New section 1407 of the Regulations clarifies that any amounts referred to or determined under sections 1404 and 1405 of the Regulations, in connection with an insurer's reserves in respect of its life insurance policies that are post-1995 life insurance policies, may be negative amounts. A parallel rule is provided in new section 1402.1 of the Regulations for the purposes of the existing reserve provisions in section 1400 of the Regulations.

New sections 1406 and 1407 apply to the 1996 and subsequent taxation years.

Division IV
 ITR
 1408

New section 1408 of Division IV of Part XIV of the Regulations provides a number of definitions and interpretative rules (some of which were previously found in section 1404) for the purposes of the rules in Divisions I, II and III of Part XIV of the Regulations dealing with the determination of insurance reserves. Those definitions and rules which are new or that have undergone significant amendments are dealt with below.

The term "acquisition costs" of a policy for a taxation year is amended in order to delete the transitional provisions in subparagraphs 1404(2)(a)(v) and (vi) of that definition.

"Capital tax" means the tax imposed under Part I.3 or VI of the Act or a similar tax imposed by a province.

The "claim liability" of an insurer at the end of a taxation year in respect of an unpaid claim is defined as a reasonable estimate, determined in accordance with accepted actuarial practice, of the present value of future payments and claim adjustment expenses in respect of the claim, over the present value of amounts to be recovered in respect of the claim because of salvage, subrogation or any other reason.

The "claim liability" of an insurer at the end of a taxation year in respect of the possibility that there are claims that have been incurred before that time but not reported, is defined as a reasonable estimate, determined in accordance with accepted actuarial practice, of the present value at that time of future payments and claim adjustment expenses that it will incur in respect of such claims, over the present value at that time of amounts to be recovered in respect of the claim because of salvage, subrogation or any other reason.

The term "extended motor vehicle warranty" is defined as a warranty agreement issued by a person in respect of a motor vehicle it or a corporation related to it manufactured where

- there exists a basic or limited warranty in respect of the vehicle,
- the basic warranty is for a term of at least 3 years, although it may expire earlier if the vehicle registers a certain distance before that time,
- it is reasonable to expect that more than 50% of the expenses under the warranty will be incurred after the basic warranty expires, and
- the company insuring the manufacturer's risk under the warranty is a regulated insurer.

A "general amending provision" is a provision of an insurance policy that allows the policy to be amended with the consent of the policyholder.

The terms "interest" and "life insurance policy in Canada" in subsection 138(12) of the Act have been added to the list of definitions that were in former section 1404 of the Regulations.

A "non-cancellable or guaranteed renewable accident and sickness policy" is defined to include a benefit under a group non-cancellable or guaranteed renewable accident and sickness policy. A parallel rule exists for life insurance policies.

"Policy liability" of an insurer at the end of the taxation year in respect of an insurance policy or claim, possible claim or risk under an insurance policy means the positive or negative amount of the reserve in respect of the insurer's liability in respect of the policy, claim, possible claim or risk determined in accordance with accepted actuarial practice, but without reference to income and capital taxes (other than the tax payable under Part XII.3 of the Act).

A "post-1995 life insurance policy" is simply defined as a life insurance policy that is not a "pre-1996 life insurance policy".

A "post-1995 non-cancellable or guaranteed renewable accident and sickness policy" is simply defined as a non-cancellable or guaranteed renewable accident and sickness policy that is not a "pre-1996 non-cancellable or guaranteed renewable accident and sickness policy".

A "pre-1996 life insurance policy" is a life insurance policy that was issued before 1996 and in respect of which there has been no change to the amount or number of premium payments or the amount of benefits under the policy after 1995 except in accordance with the provisions of the policy as they existed on December 31, 1995. However, if such a change occurs pursuant to a "general amending provision" of the policy, it will lose its status as a pre-1996 policy. The term "general amending provision" is defined in new subsection 1408(1) and described in the commentary therefor.

A "pre-1996 non-cancellable or guaranteed renewable accident and sickness policy" means a non-cancellable or guaranteed renewable accident and sickness policy, which, for this purpose, includes a benefit under a group policy, that was issued before 1996 and in respect of which there has been no change to the amount or number of premium payments or the amount of benefits under the policy after 1995 except in accordance with the provisions of the policy as they existed on December 31, 1995. However, if such a change occurs pursuant to a "general amending provision" of the policy, it will lose its status as a pre-1996 policy. The term "general amending provision" is defined in subsection 1408(1) and described in the commentary therefor.

Where an insurer is subject to the supervision of the "relevant authority" throughout a taxation year, the "reported reserve" of the insurer at the end of that year in respect of an insurance policy or a claim, possible claim or risk under an insurance policy means the positive or negative amount

of the reserve that would have been reported in the insurer's annual report to the relevant authority in respect of that policy, claim, possible claim or risk if the reserve had been determined without reference to income and capital taxes (other than the tax payable under Part XII.3 of the Act). Where the insurer is subject to the supervision of the relevant authority throughout its taxation year but is not required to file a report for a period ending coincidentally with the year, or the insurer is the CMHC or a foreign affiliate of a taxpayer resident in Canada, it is the amount of the reserve that would have been reported in the insurer's financial statements if they had been prepared in accordance with GAAP and without reference to income and capital taxes (other than the tax payable under Part XII.3 of the Act). In any other case, the reported reserve is nil.

The terms "segregated fund" and "segregated fund policy" have been added to the list of definitions in former section 1404 of the Regulations, and have the meanings given those expressions in subsection 138.1(1) of the Act.

ITR
1408(6)

New subsection 1408(6) provides that a rider attached to a non-cancellable or guaranteed renewable accident and sickness policy that provides for additional non-cancellable or guaranteed renewable accident and sickness insurance, as the case may be, is a separate policy. This will ensure that such a rider issued after 1995 will not, in and of itself, cause a non-cancellable or guaranteed renewable accident and sickness policy to lose its status as a "pre-1996" policy. A parallel rule is provided in subsection 1408(5) with respect to life insurance policies.

ITR
1408(7)

New subsection 1408(7) of the Regulations provides that, for the purposes of the definitions "pre-1996 life insurance policy" and "pre-1996 non-cancellable or guaranteed renewable accident and sickness policy" in subsection 1408(1), a change in the amount of any benefit or in the amount or number of any premiums payable under a life insurance policy resulting from certain listed transactions or events in respect of the policy, is deemed not to have occurred.

New section 1408 of the Regulations applies to the 1996 and subsequent taxation years.