CIAA Tax Update

11 December 2014

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Agenda

1. Income tax update
2. BEPS and transfer pricing update

Break

3. Commodity tax update
4. Industry panel

Income Tax Update

11 December 2014

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Presenters

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Overview

1. Legislative update
2. OSFI Part XIII
3. Loss utilization planning
4. Deduction opportunity for share-settled awards

Legislative update – Bill C-43

- Bill C-43 passed House of Common 2nd reading on November 3, 2014
  - Has been substantively enacted since October 23, 2014

- Contains many new measures including:
  - Insurance swaps
  - Changes to definition of investment business
  - Foreign affiliate dumping rules
  - Back-to-back loan rules
  - Thin capitalization rules

Legislative update – Eligible Capital Property - Federal consultation

- Eligible capital property regime simplification proposed in 2014 Federal budget
  - Suggested elimination of eligible capital property rules in favour of a new CCA class with a 5% rate
  - Existing ECE balance would be transferred to a new CCA class, with special transitional rules anticipated

- Legislative proposals to be released for comments.

Legislative update – Substantively Enacted Rates at November 30, 2014

Province	Dec-13	Dec 14 onwards
	%	%
Federal	15.00	15.00
Newfoundland and Labrador	14.00	14.00
Prince Edward Island	16.00	16.00
Nova Scotia	16.00	16.00
New Brunswick(1)	10.00/12.00	12.00
Quebec	11.90	11.90
Ontario	11.50	11.50
Manitoba	12.00	12.00
Saskatchewan	12.00	12.00
Alberta	10.00	10.00
British Columbia(2)	10.00/11.00	11.00
Northwest Territories	11.50	11.50
Nunavut	12.00	12.00
Yukon	15.00	15.00

1. In New Brunswick's 2013-14 budget tabled on 26 March 2013, the minister proposed to increase the general corporate income tax rate from 10% to 12%, effective 1 July 2013.

2. In British Columbia's 2013-14 budget tabled on 27 June 2013, the minister proposed to increase the general corporate income tax rate from 10% to 11%, effective 1 April 2013.

Quebec 2014 Fall Economic Update: FI compensation tax rates increased

	Taxation years beginning before 3 Dec. 2014	Taxation years ending after 2 Dec. 2014 and beginning before 1 April 2017	Taxation years ending after 31 March 2017 and beginning before 1 April 2019
For amounts paid as wages			
• Banks, loan corporations, trust corporations or corporations trading in securities	2.8%	4.48%	2.8%
• Savings and credit unions	2.2%	3.52%	2.2%
• Other persons	0.9%	1.44%	0.9%
For insurance premiums and amounts established regarding insurance funds	0.3%	0.48%	0.3%

Quebec 2014 Fall Economic Update:

- Automobile insurance premiums tax rate increased:
  - As of January 1, 2015, the 5% automobile insurance premium tax rate will be increased to 9%.
  - As a transitional relief, monthly filers will have until March 31, 2015 to remit the tax to be collected in January 2015 (the same extension will also apply to quarterly filers who have a reporting period ending January 31, 2015).

OSFI Part XIII

- History and background
- Year of transition
- “Insuring in Canada a risk” vs “carrying on an insurance business in Canada”
- Experience with CRA

Loss Utilization Planning

- The Canadian taxation system does not permit a Canadian corporate group to file a consolidated tax return.
  - Instead, CRA's administrative practice is to permit taxpayers to use various loss utilization techniques to use non-capital losses from one entity to offset profits from another entity in the same related group.
- Insurers face unique challenges when considering typical loss utilization techniques due to regulatory restrictions on debt limits .

Loss Utilization Planning

Deduction Opportunity for Share-settled Awards – The Transalta Case

- Canadian tax law denies a corporate deduction where an employer agrees to settle awards using treasury or newly issues shares pursuant to “an agreement to sell or issue securities”.
- In a 2012 decision, the Tax Court of Canada (“TCC”) allowed a deduction for benefit conveyed to employees through the issuance of treasury shares.
- The case turned on the TCC finding that there did not exist “an agreement to sell or issue securities” and accordingly the rule prohibiting the corporate deduction did not apply.

BEPS Update

December 2014

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Presenters

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Agenda

- OECD BEPS project
- Review of 2014 BEPS activity as relevant to insurance companies
- Looking ahead to 2015 BEPS activity – particular issues for banks

OECD BEPS project

Overview of OECD BEPS project

- The OECD's Action Plan on Addressing Base Erosion and Profit Shifting (BEPS) is aimed at government concern about potential for multinational companies (MNCs) to reduce their tax liabilities through shifting of income to no- or low-tax countries
  - Driven by MNC tax issues that have been in the headlines around the world
  - G8 and G20 governments have endorsed OECD's work on BEPS and have committed to individual country action
  - Major non-OECD countries, including China and India, are actively participating in BEPS project
  - Responsive changes over the next several years will differ across countries in specifics and in timing, reflecting each country's particular circumstances
    - Many countries are taking action already, without waiting for OECD recommendations
  - The OECD BEPS agenda is ambitious in both scope and timing, the issues are complex, but there is a real sense of political imperative

OECD BEPS Action Plan

1) Tax challenges of digital economy – *September 2014*
2) Hybrid mismatch arrangements – *September 2014*
3) Controlled foreign corporation (CFC) rules – *September 2015*
4) Deductibility of interest and other financial payments – *September/December 2015*
5) Harmful tax practices – *September 2014 /September 2015/December 2015*
6) Treaty abuse – *September 2014*
7) Artificial avoidance of permanent establishment status – *September 2015*
8) Transfer pricing for intangibles – *September 2014/September 2015*
9) Transfer pricing for risks and capital – *September 2015*
10) Transfer pricing for other high-risk transactions – *September 2015*
11) Development of data on BEPS and actions addressing it – *September 2015*
12) Disclosure of aggressive tax planning arrangements – *September 2015*
13) Transfer pricing documentation – *September 2014*
14) Effectiveness of treaty dispute resolution mechanisms – *September 2015*
15) Development of a multilateral instrument for amending bilateral tax treaties – *September 2014/December 2015*

Review of 2014 BEPS activity

16 September 2014 OECD releases

- On 16 September, the OECD will release recommendations and reports with respect to 7 Actions:
  - Action 1: Digital economy
  - Action 2: Hybrid mismatch arrangements
  - Action 5: Harmful tax practices of countries
  - Action 6: Addressing treaty abuse
  - Action 8: Transfer pricing for intangibles
  - Action 13: CbC reporting and transfer pricing documentation
  - Action 15: Multilateral instrument
- Releases will be endorsed at the 20-21 September G20 Finance Ministers meeting
- The OECD will not have completed work on any of these Actions so work on aspects of each will continue into 2015
- The OECD also will preview upcoming activity with respect to the other Actions which have 2015 target dates for output

Action 13 -- OECD discussion draft on CbC reporting

- Increased information reporting to tax authorities is highest priority BEPS response for OECD and many countries
- OECD will finalize a common template requiring country-based information on income, taxes and economic activity with respect to each country where MNC has entity to be provided to all such countries
- Information to be required for each country will include:
  - Revenue – related party and third party
  - Earnings before income tax
  - Cash taxes paid and current tax accrual
  - Capital and accumulated earnings
  - Number of employees
  - Tangible assets

Content of the CbCR template
Published 16 September 2014

TABLE 1

Tax Jurisdiction	Revenues			Profit (Loss) Before Income Tax	Income Tax Paid (on cash basis)	Income Tax Accrued - Current Year	Stated Capital	Accumulated earnings	Number of Employees	Tangible Assets other than Cash and Cash Equivalents
	Unrelated Party	Related Party	Total							

TABLE 2

Tax Jurisdiction	Constituent Entities resident in the Tax Jurisdiction	Tax Jurisdiction of organisation or incorporation if different from Tax Jurisdiction of Residence	Main business activity(ies)												
			Research and Development	Holding or Managing intellectual property	Purchasing or Procurement	Manufacturing or Production	Sales, Marketing or Distribution	Administrative, Management or Support Services	Provision of Services to unrelated parties	Internal Group Finance	Regulated Financial Services	Insurance	Holding shares or other equity instruments	Dormant	Other
	1.														
	2.														
	3.														
	1.														
	2.														
	3.														

Action 13: TP documentation
Core purposes of documentation

- At least three core purposes of TP documentation:
  - Risk assessment
  - Evidence of appropriate consideration and reporting by taxpayers
  - Information required to conduct a “thorough audit”

- Three tier approach:
  - Master file
  - Local file
  - Country by Country Reporting template

Action 13: TP documentation
Masterfile and local file

- The masterfile: a comprehensive global picture:
  - Group information.
  - The businesses.
  - The group intangibles.
  - The intra-group financial activities.
  - The financial and tax positions of the group, and a country by country employees analysis.
- The local file would focus on detailed transfer pricing analyses related to material transactions between the local and overseas affiliates.

Next steps on Action 13

- CbC reporting template and master/local file framework to be issued on 16 September 2014
- OECD work to continue on implementation issues, most significantly delivery approach for CbC template
- Country actions?
- OECD discussing approach for review of effectiveness of CbC template and master/local file framework by 2020

Action 6 -- OECD discussion draft on preventing treaty abuse

- Proposal for multi–prong approach
- Robust US-style limitation on benefits provision
  - Series of mechanical tests
  - Discretionary relief as catchall
- **Plus** UK-style main purpose test
  - Treaty benefit denied if reasonable to conclude that “obtaining that benefit was one of the main purposes of any arrangement or transaction that resulted directly or indirectly in that benefit”
  - Exception if granting benefit would be in accordance with “object and purpose” of relevant provisions of treaty
- **Plus** specific treaty anti-abuse rules to address particular treaty provisions
- **Plus** new preamble language on purpose of treaties

Country activity with respect to preventing treaty abuse

- Country activity since start of 2014 aimed at preventing treaty abuse has included:
  - **Mexico** – 2014 tax reform included new requirements for eligibility for treaty benefits
  - **Vietnam** – New circular issued to provide that tax treaty benefits will be denied if a main purpose of transaction or arrangement is tax abusive and/or if treaty benefit claimant is not true beneficial owner
  - **Canada** – Consultation initiated on anti-treaty shopping rules and domestic “main purpose” test approach
  - **Russia** – Ministry of Finance letter to tax authorities calling for denial of beneficial ownership status where transaction or series of transactions results in all or nearly all income being paid to party not eligible for treaty benefits
  - **Russia** – Tax reform debate includes discussion of requiring disclosure of information on the ultimate beneficiary of a company

Next steps on Action 6

- Document to be released on 16 September 2014 will include options for addressing treaty abuse
- Proposals for addressing treaty abuse are not to be reflected in 2014 update to OECD Model Treaty and Commentary
- Work on aspects of this Action will continue
  - Consideration of possible “derivative benefits” provision
  - Interactions between Action 6 and several other Actions
  - Potential for incorporation in multilateral instrument contemplated in Action 15
- Country actions?

Action 2 -- OECD discussion drafts on hybrid mismatch arrangements

- Proposal for changes to domestic law to address situations involving deduction in one country and no inclusion in other country or deductions in both countries
  - Also proposed coordination rules to be included in treaties
- Three categories of hybrids addressed:
  - Hybrid financial instruments, including hybrid transfers
  - Hybrid entity payments
  - Reverse hybrids and imported mismatches
- Recommended changes to domestic law
  - No dividend exemption for deductible payments and limit on withholding tax credits
  - Tax filing and information requirements
- Recommended “linking rule” approach
  - Proposed *primary* response generally is denial of deduction in payer or investor country
  - Proposed *defensive* rule generally is income inclusion in payee country

Action 2 -- Country activity with respect to hybrid mismatch arrangements

- Country activity since start of 2014 aimed at addressing hybrid mismatch arrangements has included:
  - **Mexico** – 2014 tax reform included rules targeting interest, royalty and technical services payments to related parties that are not taxed
  - **France** – 2014 finance bill included rules denying deductions for interest payments to related parties that are subject to low tax
  - **Austria** – 2014 tax reform included provision imposing subject-to-tax test with respect to deduction for interest and royalties paid to related parties
  - **Australia** – Bill introduced to deny non portfolio dividend exemption on instruments treated as "debt" under Australian debt / equity rules
  - **Netherlands** – State Secretary announced support for European Commission efforts to address tax mismatches arising from hybrid loans but opposed EC proposal for incorporating GAAR in parent-subsidiary directive
  - **Spain** – Bill to include anti hybrid rules on inbound and outbound transactions
  - **Japan** – Tax System Study Council discussed proposal to exclude from participation exemption dividends that are deductible in subsidiary's country

Next steps on Action 2

- Document to be released on 16 September 2014 will be first phase of output on this Action
  - Specific recommendations for domestic law changes
  - Ordering rules
- OECD work will continue into 2015
  - Specific technical issues
  - Interaction with other Actions
  - Guidance on open issues in form of “commentary” to model legislation
    - Treatment of bank and insurance company regulatory hybrids
    - Treatment of repos in the ordinary course of a banking business
- Country actions?
- OECD discussing approach for ongoing monitoring

Action 1 -- OECD discussion draft on tax challenges of digital economy

- Discussion draft largely devoted to review of development of digital economy and key features of new business models
- Focus on potential BEPS strategies in the digital economy and how these can be addressed in other Actions, including:
  - Hybrid mismatch arrangements
  - Preventing treaty abuse
  - Transfer pricing, including with respect to intangibles
  - Strengthening controlled foreign corporation rules
  - Limiting interest deductions
  - Countering harmful tax practices
  - Preventing artificial avoidance of permanent establishment status
- Also identification of broader tax issues arising in connection with digital economy, with brief summary of potential options for future evaluation

Next steps on Action 1

- Report to be issued on 16 September 2014
- Digital economy implications will be a focus in work on other Actions
- Future consideration of whether digital-economy focused measures are needed
- Country actions?

Action 8 -- OECD revised discussion draft on transfer pricing for intangibles

- Guidance on location savings and other local market characteristics, assembled workforce, and group synergies
- Broad definition of intangibles
  - Rejection of legal and accounting definitions
- Entitlement to intangible return based not on ownership of intangible but rather on contribution to intangible value
  - Performance/control of important functions related to development, enhancement, maintenance and protection of intangibles
  - Provision of funding and other assets
  - Bearing and exercise of control over intangible risks
- Identification/characterization of intangibles transactions
- Guidance on transfer pricing methods and comparability
- Multiple illustrative examples

Next steps on Action 8

- Revised OECD Transfer Pricing Guidelines Chapter 6 to be issued on 16 September 2014
- Section on entitlement to intangibles return will not be considered to be final
  - Most controversial aspect of work
  - Viewed as intertwined with work on transfer pricing for risk and capital
- Connection to be made to work on allocation of risk and capital under Action 9
- Country actions?

Looking ahead to 2015 BEPS activity

2015 OECD BEPS Action Items

1) Tax challenges of digital economy – *September 2014*
2) Hybrid mismatch arrangements – *September 2014*
3) **Controlled foreign corporation (CFC) rules – *September 2015***
4) **Deductibility of interest and other financial payments – *September /December 2015***
5) **Harmful tax practices – *September 2014 /September 2015/December 2015***
6) Treaty abuse – *September 2014*
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Action 3 – CFC rules

- Action 3 focuses on "strengthening" CFC rules
- How will the OECD propose that CFC rules be used to address BEPS issues?
- Key issues for banks:
  - Potential for financial services business income to be inadvertently caught by broad definition of passive income under CFC rules
  - Any potential move toward US-style CFC rules that make it very difficult to qualify financial services entities and their income as being sufficiently "active" and having sufficient local nexus so as to be outside the reach of the CFC regime

Action 4 – Interest deductibility

- Action 4 focuses on the treatment of financing expenses, with the potential for disallowance of interest or other financing expenses to the extent an entity is considered to be over-leveraged.
- Disallowance of interest expense deductions equates to treatment of debt as non-deductible.
- Key issues for insurance companies:
  - Treating debt as non-deductible is equivalent to treating the debt as if it were equity, which represents a reallocation of capital – how will the work in this area be coordinated mesh with Actions 9 and 10, which address transfer pricing for risk and capital and other “high-risk” transactions?
  - Need for recognition of the special circumstances of highly leveraged insurance companies in any rules limiting the deductibility of interest – many countries have special rules or absolute exclusions for financial institutions in their rules restricting interest deductions
  - How will any OECD recommendations regarding interest deduction limitations mesh with countries’ existing laws in this area?

Action 9 – Risk and capital

- The BEPS concern underlying Action 9:
  - *"[M]ultinationals have been able to use and/or misapply [the existing transfer pricing] rules to separate income from the economic activities that produce that income and shift it into low-tax environments. This most often results from transfers of intangibles and other mobile assets for less than full value, the over-capitalisation of lowly taxed group companies and from contractual allocations of risk to low-tax environments in transactions that would be unlikely to occur between unrelated parties."*
- The potential for deviation from the arm's length principle:
  - *[S]pecial measures, either within or beyond the arm's length principle, may be required with respect to intangible assets, risk and over-capitalisation to address [flaws in the current transfer pricing system].*

Action 10 – Transfer Pricing for other high risk transactions

- Action 10 proposes to develop rules to prevent BEPS involving transactions which would not (or would only very rarely) occur between third parties.
- This will involve:
  - Adopting rules to clarify the circumstances in which transactions may be recharacterized;
  - Clarifying the application of transfer pricing methods (profit splits in particular) in the global value chain context; and
  - Providing protection against common types of base-eroding payments such as management fees and head office expenses.
- Expected output is changes to the OECD Transfer Pricing Guidelines and possibly to the OECD Model Treaty.
- Target date is September 2015.

Actions 9 and 10 – Risk and capital

- Key issues for financial institutions:
  - Is it necessary to revisit with Actions 9 and 10 issues that have already been addressed by the OECD in the context of its 2010 report on attribution of profits to a PE?
  - Will the OECD recognize that banks and insurance regulatory requirements drive allocation of risk and capital?
  - Will the OECD recognize that allocation of risk and capital goes hand in hand with the treatment of debt?
  - How will non-regulated financing entities in insurance and banking groups be addressed?
  - Will the OECD recognize that for financial institution groups intercompany transactions of a type that may not commonly occur between unrelated parties may be required to align risk, capital and debt on an entity-by-entity basis?

Transfer Pricing Update

December 2014

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Canadian perspective

Legal framework

- Section 247 of the Income Tax Act
- Organisation for Economic Co-operation and Development's ("OECD") Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations
  - The OECD transfer pricing guidelines were first issued in 1979 and have become internationally respected.
  - They maintain the arm's length principle of treating related enterprises within a multinational group and affirm traditional transaction methods as the preferred way of implementing the principle.
  - The addition of Chapter IX on Business Restructurings should be a particular focus in the context of reinsurance
  - The OECD paper on the Attribution of Profits to Permanent Establishments, Part IX – Insurance Companies
- Transfer pricing laws from other countries

Transfer pricing landscape
Canadian perspective

- Adjustments – Paragraph 247(2)(a) and (c)

  General – If

  (a) terms or conditions of transaction (series) differ from what would have been made between arm's length parties

  Then adjust to the **quantum** or **nature** that would have been determined

  (c) if the terms and conditions had been those that would have been made between arm's length parties

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Transfer pricing landscape
Canadian perspective

- Adjustments – Paragraphs 247(2)(b) and (d)
- Recharacterization – Where

  (b) the transaction or series

  - Would not have been entered into between parties dealing at arm's length, **and**
  - Can *reasonably* be considered not to have been entered into primarily for *bona fide* purposes other than to achieve a tax benefit
- Then adjust to the **quantum** or **nature**

  (d) Of the transaction that would have been entered into by arm's length parties

Transfer pricing landscape
Canadian perspective

- Subsection 247(3) – Penalties
- 10% penalty

(a) Sum of transfer pricing capital and income adjustments

Minus

(b) Sum of transfer pricing capital and income adjustments (and setoffs) for a QCCA or for which the taxpayer made reasonable efforts to determine and use arm's length transfer prices or allocations

But – does not apply if the penalty base is less than $5 million or 10% of taxpayer's gross revenue

- Key requirements for penalty include:
- No "reasonable effort" to determine <u>and use</u> arm's length transfer prices or allocations*
- Not defined

Transfer pricing landscape
Canadian perspective

- Subsection 247(4) – Reasonable Effort

- Failure to meet **<u>any</u>** of the following indicates no reasonable effort

1. Makes or obtains records or documentation on or before the documentation due date
2. For each subsequent year makes or obtains documentation of material changes in the transactions on or before the documentation due date
3. Provides the documentation to the CRA within 3 months of service (personal or registered mail) of a written request for documentation

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Best practices/approaches

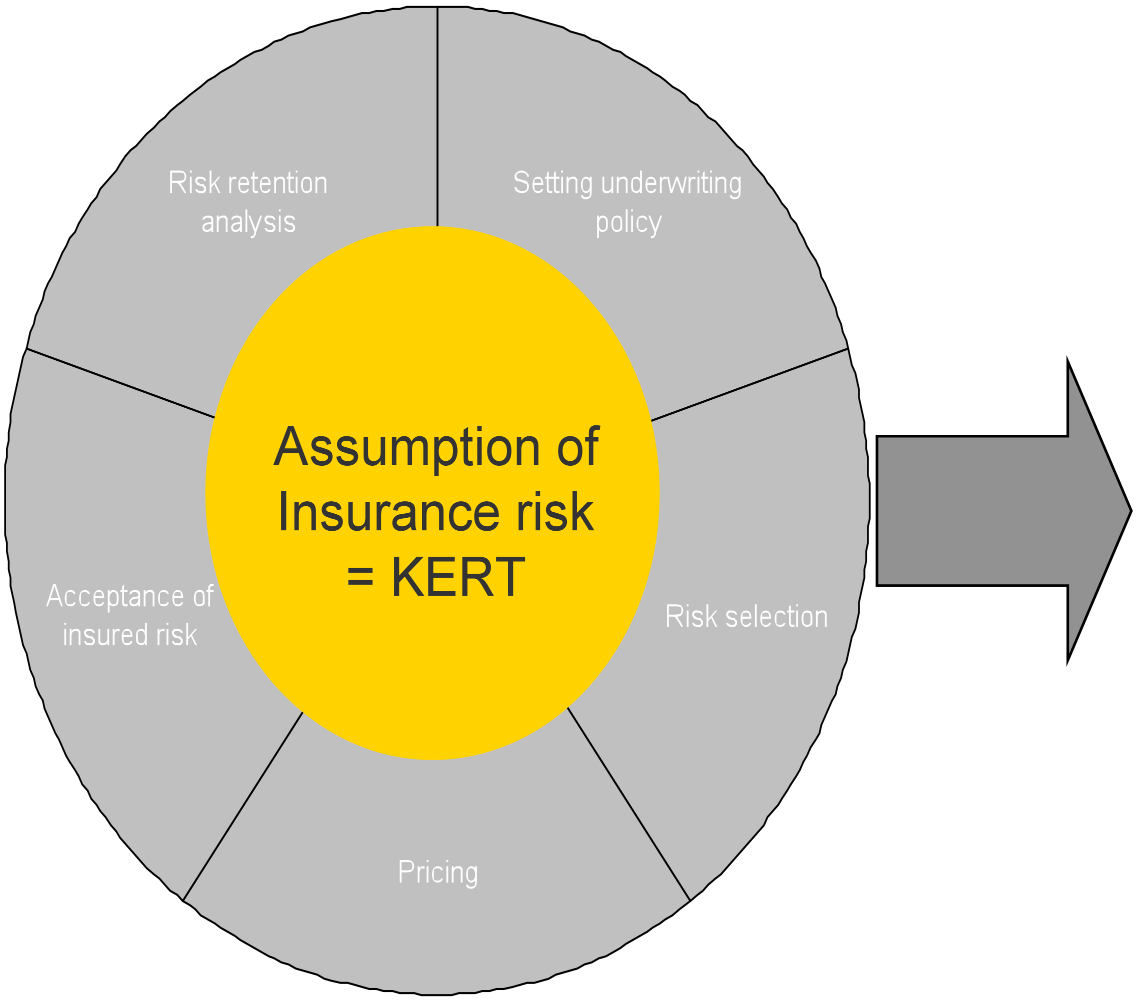
Best practices/approaches

- Insurance is a unique industry requiring specialist transfer pricing considerations
- Main area of difference from other FS transfer pricing is reinsurance transfer pricing. Key points of focus:
  - Substance – recognition of dealings
  - Economics – pricing of reinsurance and ceding commission
- Multi-disciplinary approach may be required

Overview

- Three basic aspects of transfer pricing
  - Functions
    - Underwriting function is what is not shared in proportion by reinsurance company
  - Assets
    - Not capital
    - Typically accounted for in transfer pricing method
  - Risks
    - Contractual arrangement dictates and is generally respected
    - Reinsurance company must have capital and people sufficient to bear such risk

Key Entrepreneurial Risk taking (“KERT”) Function



Importance of functional & factual analysis

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Quota share reinsurance

- Typical related party reinsurance structure
- Determine arm's length ceding commission based on facts and circumstances
  - Expense ratio
  - Combined ratio (net incurred claims + acquisition costs + expenses)/net earned premiums
  - Percent of quota share ceded
  - Benchmarking of proxies for profit commission
- Apply transfer pricing method based on country specific preferences
  - Canada – CUP and return to capital (two-sided approach)
  - US – residual profit split
  - UK – return to capital and residual profit split
  - Japan – return to capital of reinsurance company
- Prepare contemporaneous documentation for country specific and OECD purposes

Branch profit attribution

- Attribute profits to branches (or deemed permanent establishments) based on OECD Guidelines
  - Allocate charges to branches for dealings in support of its operations
  - Allocate as much capital as related to core functions occurring within the location of the branch
  - Allocate as much investment assets as related to core functions occurring with the location of the branch
- Prepare contemporaneous documentation for country specific and OECD purposes

Reinsurance as a business restructuring

Business restructuring - definition

- Cross-border redeployment by a multinational enterprise ('MNE') of functions, assets and / or risks that results in a reallocation of income. Examples:
  - Transfers of intangibles **– customer lists, trade names**
  - Internal reallocation of:
    - Functions **– loan approval / investment management decisions/off-shoring**
    - Assets **– financial assets / premises / IT systems/capital efficiency planning (EU passporting)**
    - Risks **– credit risk / market risk / liquidity risk / operational risk / intra group reinsurance**
  - Conversion of distribution role **– sales and marketing**
  - Rationalisation and/or specialisation of operations **– centralisation of functions such as servicing, portfolio management**

Key considerations

- Overall, OECD Chapter IX emphasizes that transfer pricing rules apply to business restructurings.
- In the case of reinsurance, a business transformation occurs under a reinsurance agreement between related party cedant and reinsurers.
- In particular, the OECD emphasizes the need for economic substance and for the parties to be acting as independent parties would in comparable circumstances when a business transformation occurs.
- Although the OECD explicitly states that “MNEs" are free to organise their business operations as they see fit, tax authorities do, however, have the right to assess the tax consequences of such restructurings and in particular the application of the transfer pricing guidelines" (OECD Chapter IX, 9,163).

Key considerations

- Key concepts which OECD Chapter IX emphasizes are that:
  - The behaviour of the cedant and reinsurers should match the facts and circumstances presented in the contract;
  - Both parties need to have a strong business rationale for entering into the agreement
  - Both parties should have considered the available alternatives and made a decision to enter into the reinsurance agreement given the perceived benefits of doing so;
  - An actual transfer of risk between the cedant and the reinsurer must have occurred;
  - The reinsurer must have the financial capacity to accept the risk it is being transferred; and
  - The reinsurer should have a corresponding control over that risk.
- OECD Chapter IX also reiterates that business restructurings should be undertaken under terms and conditions comparable to that which can be found in the market. The economic analysis should therefore addressed this aspect of Chapter IX and analyze the extent to which the reinsurance agreement is arm’s length, subject to best practices/approaches discussed in the previous section.

Break

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Indirect Tax Update

December 2014

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Topics

- Reinsurance
  - Recap of the issue
  - Department of Finance letter
  - Calculation of Loading
  - Next Steps
- Quebec Sales Tax
- CRA Audit issues
  - Imported services/loading
  - ITC allocation and qualifying institutions
  - Intercompany transactions
  - Documentary requirements
- Compliance issues
  - Quebec implications

Reinsurance – Recap of the issue

- Insurers in Canada required to self-assess on reinsurance premiums paid to a non-resident non-arm's length affiliate to the extent it constitutes "loading"
- Effective 2006
- Statute of limitations extended to 7 years

- What is loading?

Reinsurance – Recap of the issue

- Finance's stated purpose was to create a level playing field
  - Cdn reinsurers incur unrecoverable GST/HST costs
  - Non-resident reinsurers do not incur unrecoverable GST/HST cost (by zero-rating export provisions or no VAT jurisdictions)
- Also to avoid bundling of taxable services (eg management/administrative) into insurance premium
- Definition of loading raised significant concerns

Issue – What is Loading?

- Defined in section 217 as:

  administrative expenses, error or profit margin, business handling costs, commissions, communications expenses, claims handling costs, employee compensation or benefits, execution or clearing costs, management fees, marketing or advertising cost, occupancy or equipment expenses, operating expenses, acquisition costs, premium collection costs, processing costs or any other costs or expenses of the person that makes the supply, other than commissions for a specified financial service or part that is equal to

  > *in the case of an insurance policy, <u>the estimate of **net premium** </u>of the insurance policy*

- What is net premium?

Reinsurance – last 24 months

- CRA started reviewing reinsurance as part of audits of insurers
- Assessments issued on varying basis'
- Inconsistent treatment by CRA and for financial audit purposes
- Representations to CRA and Finance by various industry groups
- Ruling requests to CRA on loading calculation
- CRA communication on treatment of ceding commissions
- Finance letter

Finance letter

- Insurers must self-assess on the administrative component of related party supplies of financial services.
- Components that are fundamentally financial in nature are not taxable.
- Following amounts are not subject to GST/HST:
  - Ceding commissions and expenses
  - Best estimate of losses/expected losses
  - Margin for risk transfer
- Reference to service level agreements ("SLAs")

Finance Letter

- Not binding but persuasive with discussions with the CRA
- To date, no directive issued to CRA auditors
  - auditors may continue to administer the new imported rules inconsistently
- Finance does not comment on calculation of loading

Calculation of Loading

- Quantifying “administrative” portion of the premium
- Methods are not prescribed
- Alternative ways to arrive at the same amount

Examples to calculate loading - deduction

- Quantify the various financial components of the reinsurance premium, for example:
  - ceding commissions
  - expense allowances,
  - expected losses,
  - margin for risk transfer

- Reduce the gross reinsurance premium by the above amounts to arrive at administrative component

Examples to calculate loading - deduction

- Financial components of the reinsurance premium are:
  - Ceding commissions/expense allowances: Reimbursements to Canadian insurer for expenses incurred in Canada (e.g. acquisition costs and other operating costs)
  - Expected losses: Actuarial calculation of the average cost of claims and the probability that the insured event will occur within the coverage period
  - Margin for risk transfer: The cost of capital for the transfer of risk (i.e. the expected rate of return related to reinsurer’s requirement to hold risk-based capital) .

Examples to calculate loading - deduction

- Example
  - Reinsurance Premium: 1,000,000
  - Ceding commission (5%): 50,000
  - Expected Losses (60%): 600,000
  - Margin for risk transfer (10%): 100,000

Examples to calculate loading - deduction

- Calculation of loading component:

Reinsurance Premium	1,000,000
Less: ceding commissions	(50,000)
Less: Expected losses	(600,000)
Less: Margin for risk transfer	(100,000)
Loading	250,000
HST SAM rate	11.10%
HST due	27,750

Examples to calculate loading – “percentage”

- What would the reinsurance premium be if the reinsurer had no costs?
- Based on the % of the gross reinsurance premium that represents the administrative component.
  - likely requires an actuarial breakdown of the premium
- Percentage can then be applied to similar contracts or other years

Examples to calculate loading – “percentage”

- Determine the gross reinsurance premium assuming that reinsurer had no costs
- Determine the difference between the gross reinsurance premium with reinsurer’s cost and gross reinsurance premium without costs
- Divide the difference over the original gross reinsurance premium

Examples to calculate loading – "percentage"

- Example:
  - Original Gross Premium: 2,500,000
  - Gross Premium (assuming no costs) : 2,000,000
- Calculation of Loading

Original Gross Premium	2,500,000
Gross Premium (assuming no costs)	2,000,000
Difference (i.e. admin component)	500,000
Percentage	20%
HST SAM rate	11.10%
HST due	55,500

Next Steps

- If you have already calculated and remitted loading on your GST/HST returns:
  - Review loading calculation in light of Finance/CRA communication
- If you have been assessed by the CRA:
  - Reach out to the CRA if you have filed a notice of objection
  - Ensure Finance's clarifications are included if you are in the process of filing a notice of objection

Next Steps

- If you have not calculated or remitted GST/HST on loading and have not been assessed:
  - Review impact of self-assessment to your business
  - Voluntary Disclosure Program

CRA Audit Issues – Imported Services

- Imported services: Old rules (section 218) vs. New rules (section 218.01)
  - Is CRA assessing under the appropriate provision?
  - CRA applying 218.01 and extended statute of limitations across the board when dealing with FIs
  - Potential savings based on reduced assessment period

CRA Audit Issues – Intercompany Transactions

- Intercompany transactions are constantly reviewed by CRA
- Review section 150 elections to ensure all conditions are met and the election is correctly applied
- For SLFIs, file section 225.2(4) election where section 150 (1) is in place
- Parties to section 150(1) election are deemed financial institutions: GST 111/RC 7291 returns must be filed

CRA Audit Issues – ITC Documentary Requirements

- Complete legal entity must be noted on invoices.
- Ensure that supplier GST/HST registration number is included on the invoice. Handwritten numbers may not be reasonable.
- Documentation requirements still must be met for recurring contracts where supplier does not issue invoices

Compliance Issues

- QST adjustments for GST/HST and QST SLFIs
  - Ensure QST adjustments are separately calculated and reported on RC7294
  - Remember RITR calculation under G adjustments
- GST 111/RC 7291
  - Ensure all boxes are checked to indicate the amounts reported are estimates
  - Ensure ITCs are appropriately categorized and reported as CRA is taking a closer look at these returns

Quebec Sales Tax

- Increase in QST rate on automobile insurance premiums from 5% to 9% effective January 1 2015
- Applies to automobile insurance premium <u>payments</u> made on January 1, 2015 and onwards
- Insurers with reporting periods ending January 31 2015 are required to remit the tax collected by March 31, 2015

Thank you!

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