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Insurance

2022 Budget confirms tax treatment for contract service margin set out in IFRS 17

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(April 26, 2022, 3:04 PM EDT) -- On April 7, the federal government released the 2022 Budget (the budget), confirming plans to adopt International Financial Reporting Standard 17 (IFRS 17), the international accounting standard relating to insurance contracts. (See Department of Finance Canada, Budget 2022: A Plan to Grow Our Economy and Make Life More Affordable, Cat No.:1719-7740, p. 210. [Budget 2022]).

IFRS 17 sets out principles for the recognition, measurement, presentation and disclosure of insurance contracts. It replaces IFRS 4, which was adopted in Canada in 2011, and permits the use of a wide variety of accounting practices for insurance contracts. The federal government estimates that implementation of IFRS 17 and the proposed legislative amendments will increase federal revenues by $2.35 billion over the next five years (see Budget 2022, p. 210).

Last year, the Canadian government held consultations with industry stakeholders concerning IFRS 17, looking for input on "how to best enact IFRS 17 in a way that facilitates implementation by insurance companies and that is auditable by the Canada Revenue Agency" (see "Department of Finance launches consultations on tax implications of international accounting rules for insurance contracts," news release, May 28, 2021; see also Department of Finance Canada, Backgrounder — Consultations on tax implications of IFRS 17).

The measures set out in the budget reflect the outcome of these consultations by incorporating "certain relieving modifications and changes to protect the minimum tax base for life insurers" (see Department of Finance Canada, Budget 2022 — Tax Measures: Supplementary Information, p. 30. The budget also proposes certain legislative amendments to ensure income continues to be recognized when key economic activities occur.

New contract service margin to be treated as non-deductible

Generally, IFRS 17 changes the measurement of corporate income from insurance contracts. One of the key changes in IFRS 17 is the introduction of the contract service margin (CSM), a reserve designed to represent the unearned profit from insurance contracts that the insurer will recognize over the life of the contract. Without amendment, the CSM would lead insurers to defer income recognition for income tax purposes.

However, the budget indicates that the CSM would not be considered a deductible reserve for tax purposes, thereby ensuring that such income is recognized when the insurance contract is signed (see Budget 2022 – Supplementary Information, p. 29-30). Because the CSM arises generally for insurance contracts greater than one year, this proposal will mainly impact life insurers, but may also impact property and casualty insurers with multiyear contracts.

However, the budget does propose some modifications which, at least partially, relieve the impact of characterization of the CSM as non-deductible.

In respect of life insurance, the budget proposes that 10 per cent of the CSM associated with life insurance contracts be deductible for tax purposes. This is in recognition of "future so-called non-attributable expenses that are included in deductible reserves at the inception of the contract under current rules" (see Budget 2022 — Supplementary Information, p. 29-30). Additionally, segregated funds associated with life insurance policies will also be fully deductible.

The budget also indicates that 10 per cent of the CSM associated with mortgage and title insurance contracts will be deductible for the same reason as above.

IFRS 17 will be adopted as written for property and casualty insurance contracts (other than mortgage and title insurance contracts) on the basis that the CSM associated with short-term contracts is largely insignificant.

Maintaining the minimum tax base

IFRS 17 also has the effect of reducing the tax base as generated under Part VI of the *Income Tax Act*, which imposes a capital-based tax on large financial institutions. In order to maintain a minimum tax base, the budget proposes to include the non-deductible CSM, together with accumulated other comprehensive income, in the tax base.

Transitional rules to lessen tax impact of IFRS 17

IFRS 17 will apply as of Jan. 1, 2023. However, the budget includes a number of transitional rules that will also be in place as of Jan. 1, 2023 so as to reduce the tax impact of the transition from IFRS 4 to IFRS 17. For instance, there will be a transition period of five years on the non-deductible portion of the CSM for both life insurance and mortgage and title insurance. The budget also proposes transitionary rules relating to deductions for some investment contracts in recognition that certain reserves will be reclassified from insurance contracts under IFRS 4 to investment contracts under IFRS 17.

Key takeaways

- Canadian insurers should be prepared to comply with IFRS 17 starting on Jan. 1, 2023. Insurers may benefit from a number of transitional rules, which may lessen the tax impact.
- With the government's proposal to treat the CSM as non-deductible, life insurers (and some property and casualty insurers) should be prepared for more upfront costs.

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