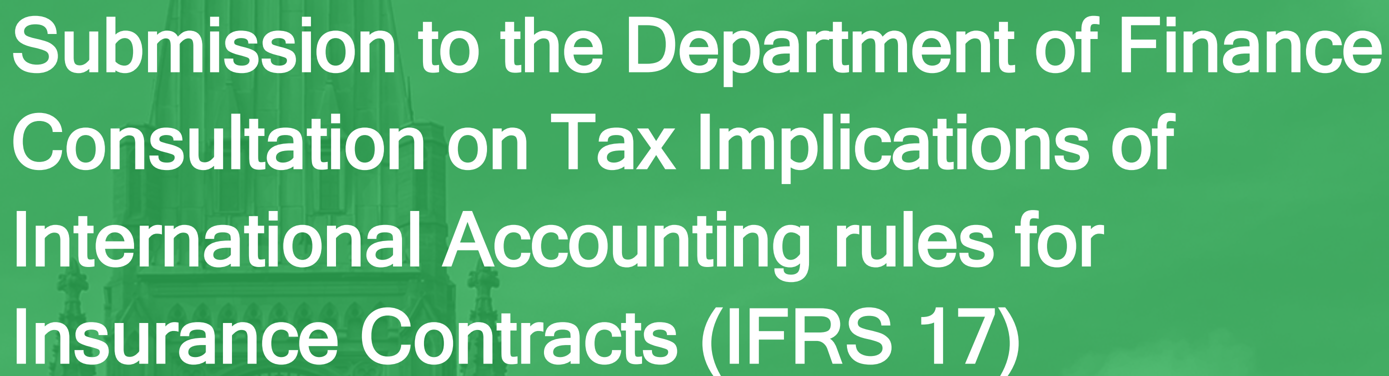

Submission to the Department of Finance Consultation on Tax Implications of International Accounting rules for Insurance Contracts (IFRS 17)

July 2021

Canadian Life & Health Insurance Association
Association canadienne des compagnies d'assurances de personnes

OVERVIEW

The Canadian Life and Health Insurance Association (CLHIA) is pleased to provide its comments to the Department of Finance (Finance) regarding consultation on taxation implications of international accounting rules for insurance contracts (IFRS 17). The life and health insurance industry welcomes the opportunity to provide the Government of Canada our views on the impacts of IFRS 17 on our members.

The life and health insurance industry plays an important role in providing financial security to Canadians, protecting millions of Canadians through a wide variety of life, health, and retirement income products. The industry is also a major contributor to the Canadian economy, by employing 157,000 Canadians and providing an important source of stable capital for the federal government through investments and tax contributions. Three of the Canadian life and health insurers operate internationally in over 20 countries and rank among the top 15 of the global insurers.

$8.3 billion in tax contributions

$1.5 billion in corporate income tax

$1.3 billion in payroll and other taxes

$1.6 billion in premium tax

$3.9 billion in retail sales and payroll taxes collected

Investing in Canada

$950 billion in total invested assets

92% held in long-term investments

Protecting **29 million Canadians**

26 million with drug, dental and other health benefits

22 million with life insurance averaging $222,000 per insured

12 million with disability income protection

$103 billion in payments to Canadians

$53 billion in annuities

$38 billion in health and disability claims

$12 billion in life insurance policies

Canadian life and health insurers welcome the government's consultation on the tax implications of adopting international accounting rules for insurance contracts (IFRS 17) in 2023 as the basis for determining taxable income for insurers, subject to certain adjustments.

The consultation seeks feedback on:

- the Government's intention to maintain the current alignment between the taxation of profits and the timing of income earning activities by taxing the Contractual Service Margin (CSM) at inception of a contract,
- how to best enact IFRS 17 in a way that facilitates implementation by insurance companies and is auditable by the Canada Revenue Agency, and
- other potential taxation issues that could arise from the implementation of, or transition to the new standard.

The CLHIA response will address the following matters:

1. The Government's proposal to deny CSM deductibility.
2. Other potential taxation issues, including transition to the new standard
3. CRA audit considerations under IFRS 17 due to changes in classification, measurement, presentation, and disclosures.

Note items 2 and 3 will be included under a separate cover.

THE GOVERNMENT'S PROPOSAL

The government supports the use of IFRS 17 accounting for income tax purposes but proposes that adjustments be made so that "[taxable income] remains aligned with economic activities."

The consultation articulates the government of Canada's proposal as follows:

> *The government intends to implement changes that will generally support the use of IFRS 17 accounting for income tax purposes. However, adjustments would be made to recognize profits as taxable income so that it remains aligned with economic activities, as under current rules. More specifically, the CSM would not be considered a deductible reserve for tax purposes. The approach would largely preserve the existing tax rules.*
>
> *In the absence of such adjustments, profits from insurance policies – both new policies and policies existing at the time of transition – would no longer be aligned with the timing of economic activity. IFRS 17's CSM would allow insurers to defer the recognition of profits until years following the taxation year in which the economic (income-earning) activities occurred. Deferring the recognition of profits for insurance contracts would result in deferred tax payments, which would raise equity concerns vis-à-vis other sectors of the economy. The proposed asymmetrical treatment between the profits and losses under IFRS 17, would exacerbate this concern.*

THE CLHIA's RESPONSE

The CLHIA strongly disagrees with the government's proposal to tax the CSM by denying a reserve deduction for the CSM as part of the insurer's tax-deductible insurance contract liabilities.

The CLHIA respectfully submits that the government should not proceed with its proposal to deny CSM deductibility for the reasons set out below.

Summary of Our Submissions

The government's proposal to deny tax deductibility of the CSM will result in inappropriate tax consequences and is flawed for the following reasons:

A. The Contractual Service Margin (or CSM) represents unearned profits.

B. The government's proposal to deny CSM deductibility is based on an incorrect characterization of the CSM as being earned profits.

C. The government's proposal conflicts with the IASB's revenue recognition principles.

D. The government's proposal conflicts with long-standing Canadian income tax recognition principles.

E. The government's proposal neither preserves nor approximates the current IFRS 4 / CALM tax regime.

F. The government's proposal cannot be justified, even in part, based upon the treatment of onerous contracts.

G. The government's proposal is expected to have a material financial impact on life insurers in Canada.

A. The Contractual Service Margin Represents Unearned Profits

The nature of the CSM is described, in paragraph 38 of the standard (consistent with its definition in Appendix A of the standard), as follows:

> *The contractual service margin is a component of the asset or liability for the group of insurance contracts that represents the unearned profit the entity will recognise as it provides services in the future.*

Similarly, in paragraph 43 of the standard, it is described as follows:

> *The contractual service margin at the end of a reporting period represents the profit in the group of insurance contracts that has not yet been recognised in profit or loss because it relates to the future service to be provided under the contracts in the group.*

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B. Government's Proposal Conflicts with the Unearned Nature of the CSM

The government's proposal to deny CSM deductibility assumes that all "economic (income-earning) activities" are performed at inception of an insurance contract and that the CSM represents "earned profits". The CLHIA respectfully disagrees for the reasons set out in this submission.

What is meant by "economic (income-earning) activities" is unclear to us but, in our submission, the services that must be performed by the insurer after inception and over the term of the contract (the "insurance contract services" as defined in the IFRS 17 standard) to become entitled to future revenues and profits are the relevant income-earning services.

The government's proposal ignores (or gives no weight to) the insurance contract services that remain to be provided after the inception of the contract. Those services are described in the IFRS 17 standard as follows:

> ***Insurance contract services -*** *The following services that an entity provides to a* ***policyholder*** *of an* ***insurance contract****:*
>
> *(a) coverage for an* ***insured event*** *(insurance coverage);*
>
> *(b) for* ***insurance contracts without direct participation features****, the generation of an investment return for the policyholder, if applicable (investment-return service); and*
>
> *(c) for* ***insurance contracts with direct participation features****, the management of underlying items on behalf of the* ***policyholder*** *(investment-related service).*

It is those insurance contract services—that is, the provision of insurance coverage and the investment-return services and investment-related services—that are the relevant income-earning services because those services must be performed by the insurer over the term of the contract to become entitled to the future premiums and to earn the expected profits captured by the CSM.

The issuance of an insurance contract does not entitle the insurer to the future revenues, nor are those revenues earned or realized: if the insurer does not perform the insurance contract services in the future, it will not maintain its ability to renew and fulfill its obligations under its insurance contracts and will not realize the future revenues and earn the expected profits captured by the CSM.

As will be described below (see section D of this submission), for income tax purposes, those insurance contract services are also the relevant services that must be provided before the future revenues are received or become receivable, and the expected profits captured by the CSM are earned, by the insurer.

The provision of insurance coverage after inception over the term of a contract is itself a service: it requires the insurer to "stand ready" to pay any insurance claim (if, as and when the insurance risks materialize) and to renew and maintain the insurance contracts to realize the future revenues and earn the expected profits captured by the CSM.

"Standing ready" to pay an insurance claim (if, as and when the insurance risks materialize) over the term of an insurance contract requires the insurer to perform many activities after issuance of the insurance contract until the contract terminates. They include the following activities (among others): policy administration, customer service, claims adjudication, management and settlement, and risk and capital management.

Similarly, investment-return services and investment-related services must be performed by the insurer after inception and over the term of a contract to realize the future revenues and earn the expected profits captured by the CSM.

That is why the CSM is amortized over the coverage period based on "coverage units". Those insurance contract services are, therefore, the income-earning activities of the insurer, and they cannot be treated as being non-economic services nor as being insignificant to the income-earning process.

Moreover, the fact that some or most of the costs of those future services are netted out as part of the future cash flows in determining the CSM at inception does not mean that those activities do not have to be performed by the insurer to earn the future revenues.

We are aware of no financial or other sector of the economy where unearned revenues or profits from service transactions are subject to taxation before the services are performed and the revenues or profits are earned.

Accordingly, the CLHIA respectfully disagrees with the government's assertion that all "economic (income-earning) activities" are performed at the outset or inception of the insurance contract. Hence, the CLHIA respectfully submits that, the government's position that the CSM represents "earned profits" is plainly wrong as a factual matter.

C. Government's Proposal Conflicts with the IASB's Revenue Recognition Principles

By erroneously concluding that the CSM represents earned profits, the government's proposal also conflicts with the principles underlying IFRS 17, IFRS 15 (Revenue from Contracts with Customers) and the principles underpinning the IASB's Conceptual Framework for Financial Reporting ("Conceptual Framework") for all international accounting standards.

IFRS 17 uses a fulfilment model to measure both insurance revenue in the insurer's profit or loss and the liability for remaining coverage (or LRC) on the balance sheet. The LRC in its entirety, including the part that is CSM, embodies or represents the obligation to provide insurance contract services in future coverage periods. Under IFRS 17 revenue is recognized in each coverage period as the LRC is reduced by the services rendered in that period, consistent with IFRS 15, IFRS 9 (Financial Instruments) and IFRS 16 (Leases).

The IASB's Insurance Working Group (made up of industry experts, regulators, and academics around the globe) deliberated for many years to deliver an international standard for insurance contracts that better measures, as the government's consultation also notes, "the unique nature of insurance contracts, where premiums are pooled then invested in order to pay claims often years after contracts are sold". More specifically, the IASB stressed that recognizing revenues at the beginning of the coverage period (that is, at inception) is not appropriate because the

insurer has yet to satisfy any of its obligations to the policyholder under the contract, other than a contractual promise to pay an insurance claim in the event the insured risk occurs.

Under IFRS 17, the disparate measurements of insurance contracts followed around the world under IFRS 4 (including CALM in Canada) are no longer acceptable. CALM's focus was to ensure the adequacy of the liability on the balance sheet; there were no explicit or implicit revenue recognition principles in the CALM model. Revenue recognition under IFRS 17 better reflects the timing of insurance contract services, and is consistent with the revenue recognition standard, IFRS 15 (which applies to other Contracts with Customers).

IFRS 17 is intended to be consistent with the principles of revenue recognition (in IFRS 15) that apply to contracts other than insurance contracts. A separate standard applies to insurance contracts because insurance contracts are complex, especially longer-term contracts, and not because the principles of revenue recognition are different. Comparability with other industries was a key objective of IFRS 17.

Contrary to the government's assertion that CSM deductibility "would raise equity concerns vis-à-vis other sectors of the economy", the adoption of IFRS 17 will, in fact, bring consistency to the measurement of revenues and profits between the insurance sector and other sectors of the economy (which was not the case under IFRS 4 and CALM).

This inequity can be demonstrated by way of the following examples. Segregated fund contracts with low guarantees (sold by insurers) and mutual funds, often interchangeable in the eyes of investors or customers. Expected profit included in the pricing of segregated funds is not related to risks, but similar to mutual funds, the income-earning activities are the investment services to be rendered to fund holders after inception. Currently, the fee income on segregated funds is recognized as earned each year, the same as for mutual funds. Under IFRS 17, the present value of the expected future fees will be captured in the CSM and be recognized in income as the services are rendered. Similarly, under IFRS 15, the future fees are not capitalized but are recognized as services are rendered in each future period. Although the earnings of the segregated fund and mutual fund provider will be similar in this example, the government's proposed taxation of segregated funds would significantly disadvantage segregated fund providers.

Another example would be that of a deferred annuity issued by a life insurer, a product that is similar to a deposit GIC issued by a bank or other financial institution. Because the present value of the expected future spreads on the deferred annuity is part of CSM, the life insurer would have to pay tax up-front on that CSM, but the other financial institution would pay tax only as the spreads are earned in the future.

D. Government's Proposal Conflicts with Long-Standing Tax Recognition Principles

The government's rationale for denying CSM deductibility is that a tax-deductible reserve for the CSM "would allow insurers to defer recognition of profit until years following the taxation year in which the economic (income-earning) activities occurred." As noted earlier, we disagree with the factual aspects of that rationale.

In any case, the government's proposal is also contrary to the general recognition principles in the *Income Tax Act* (Canada) with respect to the taxation of services income. As described below, under those long-standing principles, service income is not subject to tax until the revenues are received or are receivable by the service provider.

For the purposes of the *Income Tax Act* (Canada), revenues from the performance of services are generally not subject to tax until the services are rendered and the payment for the services rendered is receivable (even if not due until later). Similarly, amounts received on account of services not yet rendered or that, for any other reason, may be regarded as not having been earned are required to be included in income for tax purposes but a reasonable reserve in respect of services that are reasonably anticipated to be rendered in the future is allowed as an offsetting tax deduction. This regime is laid out in paragraphs 12(1)(a) and (b), and 20(1)(m) of the *Income Tax Act*.

Life insurance premiums are generally paid over the full term of the insurance contract. At inception, the future premiums payable by a policyholder are neither received nor receivable by the insurer until the relevant period in the future when the insurer stands ready to provide, and provides, the insurance coverage. Therefore, the CSM at inception (which is the excess of the present value of those future premiums and other cash inflows over future cash outflows and the risk adjustment) represents the profit margins inherent in those future premiums and other inflows (which are neither received nor receivable at inception). Therefore, denying CSM deductibility at inception is illogical and contrary to the general scheme of the Act (which does not tax service income until the revenues are received or are receivable).

In the case of life insurance business, tax-deductible reserves are prescribed under the *Income Tax Regulations*. Ever since life insurance business became subject to taxation, tax-deductible reserves have not been prescribed separately for insurance and investment risks from the reserves for services to be rendered. Instead, the prescribed reserves were calculated at the insurance contract level for all future obligations under the contract without separately identifying the portions attributable to services to be rendered.

That the CSM is now identified separately under IFRS 17 does not affect its nature as unearned profits—the CSM represents the component of the insurance contract liability for services to be rendered in the future and is not earned profits.

The CLHIA respectfully submits that, the government's proposal overrides the general principles in the *Income Tax Act* (Canada) with respect to the taxation of services income and is based on an incorrect factual understanding of the nature of the CSM and results in inconsistent and inequitable tax treatment of services income between the insurance sector and other sectors of the economy.

E. Government's Proposal neither Preserves nor Approximates Current Tax Rules

Under IFRS 17, the liability excluding CSM is not equivalent to the current CALM liability. For example, the IFRS 17 liabilities include no provision for reinvestment risk (also known as the mismatch or C-3 risk), and the approach to establishing future expected investment returns and discounting is different under IFRS 17. IFRS 17 also considers only "directly attributable expenses" in its future cash flows, and expenses that are not directly attributable to the insurance contracts are only recognized as incurred. IFRS 17 also allows companies to recognize the diversification benefit, which would lead to lower RA, resulting in larger CSM under IFRS 17 than under the CALM IFRS 4 liability.

Therefore, the liabilities deductible for income tax purposes under IFRS 17 will be different than under IFRS 4 and CALM, even if the CSM is not part of the deductible liabilities. Excluding the mismatch risk and expenses that are not directly attributable to the insurance contracts from the fulfilment cash flows has the effect of increasing the CSM at inception. Hence, denying CSM deductibility exacerbates the difference from IFRS 4 and CALM. This is evidenced by the expected financial impact of proceeding with the government's proposal (described below).

We submit that taxing life insurers on components of future revenues represented by expected (but unearned) profits would put the life insurance industry at a competitive disadvantage to other taxpayers, including other financial institutions.

F. Onerous Contracts

The government suggests that the asymmetrical treatment of onerous contracts (as compared to contracts with a positive CSM) under IFRS 17 justifies, in part, its proposal to deny CSM deductibility.

In any case, based on our survey results and the methodology being applied by most of our member companies to measure opening IFRS 17 liabilities, there are unlikely to be any onerous contracts within the insurance contract liabilities at the date of transition to IFRS 17.

Moreover, as in any other business, insurance products are generally priced with an expectation of profit at the time of sale (or inception). However, such contracts may thereafter become onerous if pricing assumptions do not materialize. This is not unique to the insurance industry.

In our view, in these circumstances, the government's proposal to deny CSM deductibility on all insurance contracts, even partly on the basis that onerous contracts result in deductible losses, is unwarranted. There are other ways by which the government can address that asymmetrical treatment if it chooses to do so without taxing unearned profits.

G. Material Financial Impact on Life Insurance Industry

Based on a recent CLHIA survey (encompassing over 85% of the business in Canada), we observed the following:

- The government's proposal to deny CSM deductibility will have adverse financial consequences on all life insurers operating in Canada (those in our survey and others) because they expect to have significant CSM at transition.

- For over two-thirds of the companies surveyed, denying CSM deductibility at transition will result in the deductible component of the IFRS 17 liabilities being significantly lower than the liabilities under IFRS 4 and CALM, and will result in a substantial increase in taxable income in the 2023 taxation year.

- Even if this financial impact were to be spread over the 10 years after transition, there will be a significant increase in cash taxes payable on the business in force at transition. The financial impact will be increased by the denial of CSM deductibility on new business after transition.

The survey and the analysis were restricted to those products or portfolios of life insurance business in Canada for which the life insurers will (or must) apply the general measurement approach (GMA) or the variable fee approach (VFA) under which the insurance contract liabilities include a CSM. Under insurance contracts measured using premium allocation approach (a simplified method offered as a policy choice under IFRS 17 for qualifying insurance contracts), the insurance contract liability does not include a separately identified CSM.

OTHER MATTERS

We understand that the government finds support for its proposal in a paper published by the IFRS 17 CSM Working Party established by the UK's Institute and Faculty of Actuaries. The paper, *The IFRS 17 Contractual Service Margin - A Life Insurance Perspective*, Yousuf et al., British Actuarial Journal (2021), Vol. 26, e2, pp. 1–105; is available at: https://doi.org/10.1017/S1357321721000015.

The paper expressly states that the views expressed in the paper are those of the invited contributors, and that the Institute and Faculty of Actuaries has not endorsed any of the views stated in the paper. Accordingly, the weight to be given to the paper in formulating Canadian tax policy is debatable.

In any case, in our submission, the paper supports our position. Section 6.2 of the paper states that:

> A key feature of the CSM is the effect it has on the smoothing of profits by aligning the release of profit over time with the amount of insurance service provided. This deferral of profit recognition is intended to provide a meaningful measure of annual profitability and is fundamentally different to a purely balance sheet focused approach that capitalises expected economic profits upfront (as would typically be used when assessing economic value).

CONCLUSION

In developing a comprehensive global standard for accounting for insurance contracts, the IASB ensured that the measurement and recognition principles applied were consistent across all businesses to enable comparability, taking into account the complexities and the unique nature of the life insurance contracts. It is important that the Canadian tax policy do the same to ensure that the long-standing tax recognition principles be applied consistently and equitably across all sectors of the Canadian economy. The government's proposal to deny a deduction for the CSM, we respectfully submit, departs from that policy. We urge the government to reconsider this in light of the analysis and factual considerations put forth in this submission and allow a full deduction for both the opening CSM (with some transitional considerations) and the CSM on new business going forward.

Should you have any questions or wish to discuss further, please don't hesitate to contact Noeline Simon, Vice-President, Taxation, Pension and Reporting at nsimon@clhia.ca or 416- 359-2047.

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