

# Tax Memo

## Ontario Corporate Tax Harmonization for Insurance Companies

Ontario's corporate income tax and minimum tax will be administered by the Canada Revenue Agency (CRA), starting with taxation years ending after **December 31, 2008**. This *Tax Memo* addresses Ontario corporate tax harmonization issues that affect insurance companies.

As a result of harmonization, the compliance burden of corporations that are taxable in Ontario will decrease significantly. They will file a single combined tax return, make combined tax payments to the CRA and will also benefit from a streamlined tax system that includes a harmonized corporate income tax base.

Federal tax attributes will replace Ontario tax attributes and differences between the federal and Ontario definitions of taxable income will disappear. Under transitional provisions, a corporation will have a transitional debit (tax liability) or transitional credit (tax relief) to account for the difference between federal and Ontario tax attribute balances. These transitional adjustments will be brought into taxable income over a five-year period.

### Federal and Ontario Balances

Differences in federal and Ontario tax attributes at the end of the last taxation year ending before January 1, 2009, will give rise to either a transitional debit or a transitional credit. Examples of tax attributes that could result in a transitional adjustment for insurance companies are:

- income reserves, including policy reserves;
- undepreciated capital cost;
- cumulative eligible capital;
- capital gains reserves;
- scientific research and experimental development (SR&ED) pool;
- the adjusted cost base of partnership interests; and
- loss pools, including non-capital and net capital loss carryforwards.

These differences between Ontario and federal tax attributes could have arisen over a number of years from the following circumstances (among others):

- corporations may not have claimed full Ontario discretionary deductions, such as capital cost allowance (CCA) or policy reserves, to minimize Corporate Minimum Tax (CMT) or, for life insurance companies only, the Special Additional Tax (SAT);
- CCA may have been claimed in Ontario but not federally, to decrease a corporation's capital tax liability;

- Ontario SR&ED pool balances may be higher, because corporations generally claim federal investment tax credits (ITCs), which are not available in Ontario, before claiming SR&ED;
- a special income inclusion, applicable when management fees or royalties are paid to non-residents, may apply to Ontario taxable income, reducing Ontario loss carry-forward balances; and
- federal and/or Ontario tax audits could have resulted in adjustments to tax attributes that were not applied to both tax jurisdictions.

## Calculation of Transitional Debts or Credits

As noted, on the transition, Ontario tax attributes are generally adjusted to equal the equivalent federal attributes, creating either a transitional debit or a transitional credit.

A **transitional debit** is an amount that is added to the corporation's Ontario tax payable if at the transition time the corporation's federal tax attributes exceed its equivalent Ontario tax attributes. The transitional debit is calculated as:

$$(\text{Federal attributes} - \text{Ontario attributes}) \times 14\% \times \text{Ontario allocation}$$

A **transitional credit** is an amount that is deducted from the corporation's Ontario tax payable if at the transition time the corporation's Ontario tax attributes exceed its equivalent federal tax attributes. The transitional credit is calculated as:

$$(\text{Ontario attributes} - \text{Federal attributes}) \times 14\% \times \text{Ontario allocation}$$

The transitional amounts are pro-rated for the number of days in the five-year period that fall in the taxation year. Therefore, for corporations with a December 31 taxation year end, a transitional debit will be paid pro rata over five years. Similarly, a transitional credit will be available to reduce tax payable over five years.

The transitional credit allocable to a taxation year cannot exceed the amount of Ontario tax payable for that year. Any unused credit can be carried forward to the following taxation year. However, **any unused credit at the end of the five-year period will expire.**

## Implications

Differences in Ontario and federal tax attributes can have significant implications for insurance companies. A company that has a transitional credit risks losing the benefit of the credit if, within five years, it does not have sufficient taxes payable to use it.

In the case of a transitional debit, a company may have to pay tax regardless of whether it has taxable income or not in those years. There may also be significant tax accounting implications as discussed below.

## Tax Accounting

The harmonization rules were substantively enacted under Canadian generally accepted accounting principles (GAAP) on December 13, 2006, and enacted for U.S. GAAP purposes on June 4, 2007. Before the transition date arrives, insurance companies should determine the possible financial statement effect of moving to the harmonized tax system.

For most, any transitional debt or credit arising on the transition date likely will be offset by an equivalent increase or decrease in the financial statement current and future tax adjustment required on transition. However, in two situations a corporation may have an unexpected profit and loss charge:

- **If the corporation has a transitional debit**, it will expect to have an equivalent increase (or decrease) in its future income tax asset (or liability) recorded on its balance sheet.

However, unless that increase (or decrease) meets the relevant GAAP test for recognition, it cannot be recognized in the corporation's financial statements, and the accrual for a transitional debit would be charged to the profit and loss account.

- **If the corporation has a transitional credit**, an equivalent decrease (or increase) in its future income tax asset (or liability) will be recorded on its balance sheet.

However, unless the corporation can demonstrate that it will use the transitional credit within the five-year reference period, it is unlikely to be able to record the credit as an asset on its balance sheet. This would result in the decrease (or increase) in its future income tax asset (or liability) being charged to the profit and loss account.

## Tax Planning Opportunities

Tax planning opportunities may be available to avoid or mitigate any adverse consequences resulting from the Ontario harmonization transitional adjustments. For instance, to manage differences in tax attributes, companies can amend prior-year tax returns. Also, companies with SR&ED pool differences that result in transitional debits can file a special election to extend the period in which the resulting tax liabilities are paid.

However, to minimize improper manipulation of transitional debits and credits, particularly with regard to transactions involving related corporations, Ontario has developed complex anti-avoidance rules. These rules should be carefully considered before any related tax planning is implemented.

## For More Help

Ontario harmonization can have far-reaching effects. Although corporate tax administration will be simplified, some corporations will experience adverse consequences. For more information on how the changes affect your company, and opportunities available to mitigate the effect of Ontario harmonization, please contact your PricewaterhouseCoopers tax adviser or any of the following individuals:

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