GST/HST Notice

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CRA Administrative Positions on the Application of the Import Rules for Financial Institutions to Reinsurance Contracts

Technical Information Bulletin B-095, *The Self-Assessment Provisions of Section 218.01 and Subsection 218.1(1.2) for Financial Institutions (Import Rules)* provides general information on the interpretation and application of the import rules to cross-border transactions and should be read in conjunction with this notice.

The purpose of this notice is to provide the Canada Revenue Agency's (CRA) administrative positions which are based on Finance Canada's (Finance) clarification of the policy intent with respect to the application of the import rules to reinsurance premiums paid by insurers that are qualifying taxpayers under the import rules to non-resident reinsurers with whom they are not dealing at arm's length. Finance has indicated that the policy clarification applies to primary insurers and their reinsurers as well as to reinsurers and their retrocessionaires and is retroactive to the date of introduction of the import rules in 2005. However, the CRA cannot pay any rebate claims in respect of these matters based on the current legislation.

All references in this notice are to the *Excise Tax Act* unless otherwise indicated. Further, all references to an insurer are with respect to an insurer that is a qualifying taxpayer pursuant to subsection 217.1(1), and all references to a reinsurer are with respect to a non-resident reinsurer with whom the insurer does not deal at arm's length.

All references to tax are to the GST/HST, and all references to the import rules are to the self-assessment provisions of section 218.01 and subsection 218.1(1.2) for financial institutions.

Generally, under the import rules, a financial institution is required to self-assess tax in respect of certain cross-border transactions. For example a qualifying taxpayer is required to self-assess tax on the non-financial ("loading") part of the consideration for an imported financial service where the parties are not dealing at arm's length. Loading is defined as that part of the consideration for a financial service that is attributable to administrative expenses, profit and error margins, employee compensation, and other similar amounts. As a result, where a reinsurance premium is paid by an insurer that is a qualifying taxpayer to a non-resident reinsurer in a non-arm's length transaction, a portion of the reinsurance premium may be subject to tax by self-assessment.

Finance policy intent regarding administrative expenses

It is the policy intent of the import rules that financial institutions be required to self-assess tax on the portion of a related-party supply of a financial service that is largely administrative in nature subject to the Finance policy intent concerning service level agreements that meet the criteria described below.

CRA administrative position

Subject to the position concerning service level agreements that meet the criteria described below, the amount representing that part of the reinsurance premium that may reasonably be allocated to administrative expenses, i.e., loading, including any error or profit margin specific to those expenses, is subject to tax under the import rules.

La version française de la présente publication est intitulée *Positions administratives de l'ARC sur l'application aux contrats de réassurance des règles sur l'importation pour les institutions financières*.

Finance policy intent regarding the margin for risk transfer

It is not the policy intent of the import rules that financial institutions be required to self-assess tax on the portion of a related-party supply of a financial service that is clearly and fundamentally financial in nature.

In the case of the amount that the insurance industry refers to as the "margin for risk transfer" portion of the reinsurance premium, the industry has stated that this amount exclusively represents the compensation paid by the primary insurer to the reinsurer over and above the "best estimate of losses" to reflect the transfer of risk to the reinsurer for potential future insurance claims under the insurance/reinsurance policy/contract, and that some or all of this amount could become profit of the reinsurer. If the margin for risk transfer is as described by the insurance industry, it is not intended to be taxed as part of "loading".

CRA administrative position

The amount in the reinsurance premium described above as the margin for risk transfer is not considered to be included in loading as defined in section 217. As a result, the amount is not excluded from paragraph (k) of the definition of permitted deduction in section 217 and is not subject to tax.

Finance policy intent regarding ceding commissions and expense allowances

On the issue of the GST/HST treatment of an amount payable by a reinsurer to a primary insurer to compensate the primary insurer for certain property and services acquired or performed by the primary insurer exclusively in Canada (amounts referred to as ceding commissions and expense allowances), it is not the policy intent to impose tax on these amounts under the import rules as these amounts reflect reimbursement of expenses incurred in Canada.

CRA administrative position

The ceding commission or expense allowance that compensates the primary insurer for certain property or services acquired or performed by the primary insurer exclusively in Canada is not subject to tax under the import rules.

Finance policy intent where there is a service level agreement

The industry indicated that primary insurers obtaining reinsurance from related parties typically have service level agreements or documented head office allocation charges (SLAs) with them and/or with other affiliate(s) (i.e., persons not dealing at arm's length with the primary insurer). Further, to the extent that the reinsurer and/or other affiliates charges the primary insurer for providing property or services relating to reinsurance, that charge would be covered under these SLAs. The information in this regard would be made available to the CRA by the insurer upon audit. The industry indicated that all cross-border related party transactions would be subject to transfer pricing rules under the *Income Tax Act*.

Criteria

For the purposes of providing clarity and certainty to the industry, the import rules are not intended to impose GST/HST on the reinsurance premium charged by a reinsurer to a primary insurer in respect of a reinsurance policy or contract between the primary insurer and the reinsurer where:

1. the reinsurance policy or contract is recognized as an insurance contract under federal and provincial laws and the guidelines issued by the Office of the Superintendent of Financial Institutions Canada, or other similar regulatory authority, with respect to sound reinsurance practices and procedures;

2. the primary insurer pays to the reinsurer and/or affiliates amounts, each of which is an amount (referred herein to as a "fee") under an SLA that is allowed as a deduction, an allowance or an allocation for a reserve under the *Income Tax Act*;

3. the total of these fees represents exclusively, or almost exclusively, the total of all of the amounts payable for imported property and services provided by the reinsurer and/or affiliates, which includes the administration of the reinsurance policy or contract, other than amounts attributable to best estimate of losses, ceding commissions/expense allowances and compensation paid by the primary insurer to the reinsurer over and above the "best estimate of losses" to reflect the transfer of risk to the reinsurer for potential future insurance claims;

4. each fee charged by the reinsurer or an affiliate is commensurate with arm's length pricing for the property and services provided by the reinsurer or the affiliate, as the case may be; and

5. the primary insurer is charged, or self-assesses, GST/HST on each of these fees.

CRA administrative position

The reinsurance premium paid by the insurer to the reinsurer is not subject to tax under the import rules where all the criteria stated above are met.

Example 1

InsurerCan, a Canadian licensed property and casualty insurer, had a 50% quota share treaty (property insurance) in place with ReinsurerUS, a related non-resident reinsurer. For 2013, ReinsurerUS was paid a $10 million reinsurance premium (50% of $20 million policy premiums) priced and based on the arm's length principle. The reinsurance policy is recognized as an insurance contract under federal and provincial laws and the guidelines issued by the Office of the Superintendent of Financial Institutions Canada. A 25% ceding commission of $2.5 million was paid by ReinsurerUS to InsurerCan to compensate for certain property and services acquired or performed by InsurerCan exclusively in Canada in 2013.

For 2013, there were related party SLAs in place between InsurerCan and ServiceCo (a foreign affiliate) and between InsurerCan and ReinsurerUS for imported property and services. InsurerCan paid ServiceCo and ReinsurerUS a total of $1 million under these agreements. The amount represented exclusively, or almost exclusively, the total of all of the amounts payable for imported property and services provided by ReinsurerUS and ServiceCo, including the administration of the reinsurance contract, other than amounts attributable to best estimate of losses, ceding commissions/expense allowances and compensation paid by the primary insurer to the reinsurer over and above the best estimate of losses to reflect the transfer of risk to the reinsurer for potential future insurance claims. The amount was deducted under the *Income Tax Act* and was commensurate with arm's length pricing for the property and services provided by ReinsurerUS and ServiceCo. InsurerCan self-assessed tax on the $1 million under section 218 and subsection 218.1(1) of the imported taxable supplies rules.

Since all of the criteria set out above are met, the reinsurance premium of $10 million is not subject to tax under the import rules. As a result, InsurerCan is not required to self-assess tax under section 218.01 and subsection 218.1(1.2) on the reinsurance premium it paid to ReinsurerUS.

Finance policy intent where there is no SLA or the SLA does not meet the criteria

Where SLAs have not been entered into between the reinsurer or its affiliates and the primary insurer, or where all the SLAs in respect of a reinsurance policy or contract between the reinsurer and the primary insurer do not meet all the above criteria, the policy intent with respect to administrative expenses, the margin for risk transfer, and ceding commissions and expense allowances would still apply. In such a case, the parties would be required to provide satisfactory documentary evidence for a reasonable allocation of administrative expenses (including any error or profit margin specific to those administrative expenses) being recharged to the primary insurer either through the reinsurance premium or through other charges, to allow the CRA to establish the "loading" amount, if any, that would be subject to GST/HST under the import rules.

CRA administrative position

Where SLAs have not been entered into between the primary insurer and the reinsurer or affiliates, or where the SLA does not meet the above criteria, then the insurer is required to determine the amount that is loading as defined in section 217 and that amount is subject to tax by self-assessment as required under the import rules. The parties would be required to provide satisfactory documentary evidence for a reasonable allocation of administrative expenses (including any error or profit margin specific to those administrative expenses) being charged to the primary insurer either through the reinsurance premium or through other charges. This will allow the CRA to establish the "loading" amount that would be subject to tax under the import rules.

However, the component of the premium referred to above as the margin for risk transfer is not considered to be included in loading and is not subject to tax under the import rules. Further, amounts received by the insurer as ceding commission or expense allowances from the related non-resident reinsurer are not subject to tax under the import rules.

Example 2

InsurerCan, a Canadian licensed property and casualty insurer, had a 50% quota share treaty (property insurance) in place with ReinsurerUS, a related foreign reinsurer. For 2013, ReinsurerUS was paid a $10 million reinsurance premium (50% of $20 million policy premiums) priced and based on the arm's length principle. A 25% ceding commission of $2.5 million was payable by ReinsurerUS to InsurerCan to compensate for certain property and services acquired or performed by InsurerCan exclusively in Canada in 2013. Documentary evidence indicated that a reasonable allocation of the administrative expenses incurred by ReinsurerUS for the reinsurance policy with InsurerCan was $500,000.

No SLAs were in place between InsurerCan and ReinsurerUS or another affiliate.

The reinsurance premium is subject to tax on the amount determined for loading under section 217. As a result, InsurerCan is required to self-assess tax under section 218.01 and subsection 218.1(1.2) on the amount of $500,000 (the amount that may reasonably be allocated for administrative expenses).

Further information

All GST/HST technical publications are available on the CRA website at www.cra.gc.ca/gsthsttech.

To make an enquiry on the GST/HST by telephone, call one of the following numbers:

- for general enquiries, call the Business Enquiries line at 1-800-959-5525;
- for technical enquiries, call 1-800-959-8287.

If you are located in Quebec, contact Revenu Québec at 1-800-567-4692 or visit their website at www.revenuquebec.ca.
If you are a selected listed financial institution (whether or not you are located in Quebec) and require information on the GST/HST or QST, call one of the following numbers:

- for general enquiries, call 1-800-959-5525;
- for technical enquiries, call 1-855-666-5166.