Consolidation in the Financial Services Sector: Tax Implications to Stakeholders

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Introduction

Some 40 years ago, Canada's financial services sector drifted toward regulatory protectionism. In 1957, the Royal Commission on Canada's Economic Prospects (the Gordon commission)[1] considered, inter alia, the effects of foreign investment and control of Canadian enterprises in the economy. With respect to Canada's financial institutions, the Gordon commission concluded that it was "most important that Canadian control be maintained of our principal financial institutions—the chartered banks and life insurance companies which are incorporated in Canada."[2] The Gordon commission recommended that Canadian control of Canada's chartered banks and life insurance enterprises be strengthened and in 1957 the federal government passed a bill allowing for the "mutualization" of existing stock life insurers' companies. Regulatory protection was also extended for banks in the form of rigid ownership restrictions for schedule I banks.[3]

The policy rationale behind these proposals was to encourage wider Canadian ownership of the financial institutions and hence guard against

[1] The commission was chaired by Walter Gordon, senior partner of Clarkson Gordon, later Ernst & Young.

[2] Canada, Royal Commission on Canada's Economic Prospects, *Final Report* (Ottawa: Queen's Printer, 1957), at 397.

[3] While many of Canada's trading partners permit the foreign purchase of an indigenous bank, certain countries impose prior approvals. With respect to the schedule I Canadian banks, Canada would appear to have the tightest restrictions, since no ministerial discretion is allowed at present.

foreign takeovers.[4] Much has happened in the four decades since the report of the Gordon commission, and the recommendations have served Canada well.[5] However, the pace of change in technology and globalization has meant that while Canada's financial institutions have grown and remain strong, they may be losing ground to potential global competitors and financial innovators. Only now are regulators paying attention to both global and domestic issues.[6]

Until the mid-1980s, Canada's financial services operated through four channels: banking, brokerage, trust, and insurance (the four pillars). Deregulation and economic events in the late 1980s led to the immersion of Canada's retail and institutional brokerage firms into the big five banks. The recession and real estate meltdown at the beginning of 1990 saw many trust and loan companies disappear or become subsumed by the big five banks. However, while many countries have readied their financial service sectors for change and positioned themselves as jurisdictions of choice for global mega-bancassurance providers, 1997 marked the year in which Canada began to play catch-up.

Sectoral Environment

In Canada, the most significant remaining regulatory barriers to consolidation (at least in the traditional lines of business) are between the banking and insurance sectors. The banking sector is mainly composed of widely held institutions with relatively easy access to the capital markets. Banks have been actively pressing for entry into the insurance market. By contrast, the insurance sector does not have wide access to capital markets, and for the most part has not directly sought entry to the banking sector.[7] Keep in mind that the policies restricting bank mergers and the fact that the large insurers are mutuals have stalled the pace of consolidation and modernization in Canada. The one remaining trust company, Canada Trust (which acts much like a bank), is not itself widely held, nor is the only tier-1 stock life insurer (Great West Life). Both sectors are themselves under pressure from unexpected competitors who are able to lever technology and information to gain access to the Canadian

[4] Some of the pressures toward mutualization and retaining control of the financial institutions is summed up in Joseph Schull, *The Century of the Sun: The First Hundred Years of Sun Life Assurance Company of Canada* (Toronto: Macmillan of Canada, 1971).

[5] "The Canadian financial system has been, and continues to be, well-developed and efficient." See Itzhak Swary and Barry Topf, *Global Financial Deregulation: Commercial Banking at the Crossroads* (Cambridge, Mass.: Blackwell, 1992), at 229.

[6] See Task Force on the Future of the Canadian Financial Services Sector, *Discussion Paper* (Ottawa: the task force, June 1997), at 22.

[7] Some insurers did try with limited success to enter banking. Insurers would, however, like to have access to the payments system.

marketplace.[8] Technological growth, falling trade barriers, and customer-driven change have brought new players into the sector and spurred other changes. Traditional distinctions between banks, insurance companies, and brokerage firms are falling away as they all compete for the same assets with increasingly similar products and services. This is not a trend confined to Canada:

> For example, in the U.S., $2.2 trillion in invested household assets are at stake. During the past 20 years, the distribution of those assets has flowed dramatically out of banks and into asset management firms. In 1976, banks held 25% of the U.S. invested assets; today, their share has dwindled by nearly half, to just 13%. During this same 20-year period, assets held by asset managers have ballooned from 38% to 66%, at the expense of banks and other traditional institutions. No ambiguity there: banks are losing ground. Brokerage firms and insurance companies, too, are being challenged by newer mutual fund companies and discount brokers.[9]

Segmentation of the marketplace has enabled non-bank financial service providers to capture an increasing proportion of the market while direct barriers to entry and the inability to merge and demutualize have significantly constrained consolidation in the sector among the Canadian financial service providers.[10] The rapid pace of technological growth, including telephone banking, data warehousing, PC banking, debit cards, and other "smart" card technologies is also changing the industry and increasing pressure on traditional financial service providers. Internet-based technologies are also having an impact on marketing and access to financial services.

New players have entered or are seeking to enter the Canadian marketplace: ING is selling itself as an alternative to the traditional branch network, while Wells Fargo is attempting to run a lending operation from the United States to western Canada. Other potential entrants are MBNA, which is considering entering solely in the credit card market. Meanwhile, the bank-owned brokerages are increasingly facing competition from larger international operations while undergoing their own technological transformation (for example, the creation of the electronic trading floor).

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[8] Non-bank financial institutions would include players such as captive credit corporations for the automobile industry and others such as GE Capital. One view is that financial services are increasingly about access to and ability to lever information flows.

[9] Ernst & Young LLP, *Managing the Value Network—1997 Special Report on Technology in Banking and Financial Services.*

[10] See, for example, the recent acquisition of AT & T Capital by Newcourt Credit Group, with an anticipated market capitalization in excess of US$4.5 billion. See also the anticipated megamergers of US banks in "Shopping for the Big Day" (September 1997), no. 341 *Euromoney* 130-34.

The current regulatory framework (formal and informal) has created artificial barriers to consolidation and change in the industry by not enabling demutualization of the mutual insurers, by blocking access of the banks to certain sectors, and by not allowing large financial institutions to merge. Ownership requirements are also an impediment to change. Some argue that these barriers will have to go as the federal government recognizes the inevitability of a single financial services marketplace.[11]

After blocking the banks from selling insurance and offering leasing products through their branch network in the 1996 Bank Act review, Finance Minister Paul Martin announced the establishment of the Task Force on the Future of Canada's Financial Services Sector("the task force") to inquire into public policies affecting the financial services sector and to make recommendations to enhance the sector's contribution to job creation capacity and economic growth, competitiveness (domestic and international), efficiency, and innovation, and the contribution of the sector to the best interests of Canadian consumers.

The market, however, seems increasingly impatient with the lumbering pace of the regulatory change, and if transactions in 1997 are any indication, 1998 will be a watershed year. This paper looks at some of the tax consequences that flow from the 1997 transactions and highlights certain regulatory changes that will drive tax considerations in the future.

Current Constraints on Consolidation in the Financial Services Sector

Among its identified objectives, the task force will be looking to strengthen consumer protection, rationalize the regulatory burden, and ensure that the sector's legislation evolves with current trends.[12] This will entail dealing with the current restrictions on consolidation in the sector.[13]

For schedule I banks, there is a 10 percent ownership restriction such that no investor may own more than 10 percent of any class of shares of a schedule I bank. To move beyond the 10 percent requirement would require a legislative change. By contrast, the 10 percent restriction applicable to insurers may be waived by the minister. The banks are, however, able to amalgamate with ministerial approval. Thus, only the "big shall not buy big" policy stands in the way of any potential consolidation within the banks. The banks also face a commercial links restriction, which is a policy that the regulated financial sector should not be directly linked with

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[11] See, for example, G. Frank Mathewson and Neil C. Quigley, "Reforming the Bank Act: Regulation, Public Policy and the Market" (September 1997), 29 *Canadian Business Law Journal* 1-16.

[12] Supra footnote 6.

[13] See also recommendations 79-85 of the *Australian Financial System Inquiry Final Report* (the Wallis report) in March 1997, specifically the recommendation to remove Australia's "six pillars" policy, which has prevented the four large banks and the two large insurers from merging.

commercial enterprises, particularly with respect to downstream investments. Finally, the banks are unable to sell insurance or carry on certain types of businesses (for example, automobile leasing) through branches.

For mutual insurers, a clear impediment to consolidation is a lack of access to the capital markets and "acquisition currency" in the form of common shares. Further, there is no clear regulatory framework for demutualization or post-demutualization. Finally, insurers lack the ability post-demutualization to issue stock options to senior managerial staff.

The informal "big shall not buy big" policy applies to all large financial institutions. The policy has no legislative basis, and simply refers to the minister's current view on when the minister is willing to exercise discretion to allow mergers and acquisitions in the sector.

The following list is a chronology of recent events of interest in the sector, including some of the changes that will affect the current regulatory framework.

- *March 1996*: The minister of finance states in a mini-budget that banks will not be allowed to finance automobile leasing or sell insurance in their branches.

- *June 1996*: The federal government introduces a white paper as required under the five-year sunset clause in the 1992 legislation. The white paper, entitled *1997 Review of Financial Sector Legislation: Proposals for Change*, proposes technical changes to be made in 1997, with major policy issues to be studied by an appointed task force. The task force is entrusted with reporting on structural reform by the end of September 1998.

- *February 1997*: The secretary of state for international financial institutions announces that foreign banks will be allowed to operate in Canada through branches subject to conditions, including that the branches not fund themselves via retail deposits, a new regulatory regime, and reserves requirements on Canadian activities. Further, foreign companies which are near banks or otherwise deemed to be banks are freed of limitations on their Canadian financial service subsidiaries if they are not regulated as banks in their home jurisdiction.

- *February 1997*: The government introduces Bill C-82 to take effect on June 30, 1997, with portions taking effect on August 1, 1997 (including the changes on foreign banks and near-banks).

- *June 1997*: The task force's discussion paper lists issues to be addressed, and requests submissions.

- *June 1997*: The World Trade Organization (WTO) negotiations on financial services state that negotiations should be concluded by the end of 1997.

- *July 1997*: The task force responds to an urgent request from the secretary of state on appropriate criteria in reviewing particular transactions and concludes, inter alia, that "big may be allowed to buy big" on a case-by-case basis subject to competition review and concerns, but with no specific comments on bank mergers.

• *July 1997*: The Department of Finance begins review of demutualization regulations.

Some Recent Changes to Financial Services Legislation

Bill C-82 ("the bill"), which became law on April 25, 1997, changed financial services sector legislation in some areas, and may indicate where the government is heading in terms of change.

Demutualization for Insurers

The bill amended the demutualization provisions of the Insurance Companies Act.[14] Previously, only small mutuals (those with assets up to $7.5 billion) were permitted to demutualize. Now large mutual companies are permitted to demutualize with OSFI's permission. That is, the superintendent is now empowered to exempt an insurer from any of the requirements under the regulations governing demutualization,[15] which are currently under review by the Department of Finance. A small mutual company will be exempt from the requirement that the company be widely held after demutualization.[16] The changes recognize the need for flexibility in corporate governance of mutual insurers subsequent to the Confederation Life insolvency. The minister of finance may now exempt any insurer from the provisions of the ICA or regulations where that insurer is in financial difficulty.[17]

Participating Shares for Insurers

Since the 1992 legislative reforms, mutual insurers could raise capital through the issue of certain types of shares, but could not issue voting shares or shares with a right to property on dissolution. Participating shareholders are entitled to share in annual earnings and to receive dividends. Mutual insurers are now permitted to issue participating shares, which confer a right on the holder of such shares to receive the remaining property of the insurer on a dissolution.[18] The authority to issue participating shares and the shareholder's rights are to be defined in the company's bylaws.[19] Participating shareholders may vote in circumstances relating

[14] Insurance Companies Act, SC 1991, c. 47, as amended, section 237 (herein referred to as "ICA"). See new section 224, new sections 237(3) and (4), and new section 237.1.

[15] See the Mutual Company Conversion Regulations, PC 1993-771, SOR/93-205 (1993), vol. 127, no. 9 *Canada Gazette Part II* 2181-93.

[16] ICA sections 407(4) and (5), based on its assets as prescribed.

[17] See ICA section 237(4).

[18] ICA section 490(1), "participating share."

[19] ICA section 238(2.1).

specifically to their rights—for example, certain fundamental changes such as amalgamations. If provided for in the company's bylaws, such shareholders may elect up to one-third of the insurer's board of directors.[20]

Other Changes Related to Insurers

With ministerial approval, life insurers, trusts, and loan companies may directly provide specialized business management, venture capital, or advisory services with respect to small business financing. A specialized financing corporate subsidiary for these activities will no longer be required. In addition, such companies may now engage in the activities of an information services corporation with the minister's prior written approval.[21] Also, a life insurer will now be able to own its own shares or those of its parent in market-indexed segregated funds, subject to regulatory approval.

Bank Opting Out of Canada Deposit Insurance

Some banks may now opt out of the deposit insurance requirement through Canada Deposit Insurance Corporation (CDIC) membership. Previously, all banks had to carry deposit insurance as a condition of doing business in Canada. To be able to opt out, a bank cannot be affiliated with any other member of CDIC.[22] In addition, retail deposits at an eligible bank in Canada for amounts under $150,000 must make up less than 1 percent of the bank's total deposits payable in Canada. Finally, all depositors must be notified by the bank that it has applied to opt out of CDIC, which, if such application is granted, means that deposits with it are not covered by CDIC insurance. The legislation also contemplates the posting of notices to inform the public that the bank is not a CDIC member.

Loosening Restrictions on Foreign Banks[23]

Previously, a foreign bank entering Canada was required (that is, foreign banks formed a subsidiary under schedule II to the Bank Act) to bring all their other Canadian financial service operations, including any insurers, trusts, and securities dealers, under that schedule II bank in a vertical corporate structure. This requirement is now in the process of being removed.

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[20] ICA sections 238(2.1) and (2.2).

[21] Previously, companies could only conduct these activities outside Canada, subject to some restrictions.

[22] See the definition of "affiliate" in section 1 and section 6 and "control" in section 3 of the Bank Act, SC 1991, c. 46, as amended.

[23] See various consultation papers released by the Department of Finance on foreign bank entry, including *Foreign Bank Entry Policy: Consultation Papers 1 and 2* (September 1997), where the department observes that it "is currently developing a framework for taxing foreign bank branches in light of the proposed regulatory framework outlined in this paper."

Owning Unregulated Canadian Financial Service Entities

The bill allows any foreign bank to expand its Canadian financial service operations by an acquisition or startup of an unregulated entity without further consent. However, if the acquisition target is a defined "Canadian financial institution," then the new rules do not apply. The minister of finance may, after consulting with OSFI, designate any foreign bank regulated as a bank in its home jurisdiction as ineligible for the exception. In July 1997, foreign banks received letters from OSFI telling them whether they would be designated and were so designated on August 1, 1997.

Those with Cabinet's sanction must sign an undertaking to make regular information filings with OSFI. The foreign bank must agree that failure to comply with the new undertaking may mean an order to dispose of its Canadian businesses after having agreed in advance to comply with any such order. Further, non-bank affiliates may now borrow on a parent's guarantee without discretionary consent of the minister of finance. The lender must be apprised by the borrower that it is not a CDIC member, the borrower is not a deposit taker, and the borrower is not a regulated Canadian financial institution. A sophisticated-lender exception exists for where the amount borrowed exceeds $100,000 or where the borrowing takes place outside Canada.

Foreign Banks Operating as Branches

Foreign banks will be allowed to operate branches in Canada subject to certain terms and conditions. Those banks that take retail deposits will not qualify for this treatment, while banks (commercial operations) that do not take retail deposits will qualify (most foreign banks in Canada do not take retail deposits).[24] Deemed banks and near-banks not regulated as banks in their home jurisdictions will be allowed to operate in Canada without being regulated as financial institutions, provided they are not deposit-taking institutions. Further, their assets must be below $200 million in Canadian currency. To operate as a branch, the foreign bank must meet certain requirements.[25]

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[24] There has not yet been a formal announcement of what constitutes retail deposits.

[25] These include: regulated on a consolidated basis to international standards with the foreign regulator to cooperate with OSFI; subject to reporting, auditing and taxation requirements; cannot take retail deposits; must have at least $25 billion in worldwide assets; must maintain a "capital equivalency deposit" of 5 percent of branch liabilities; must be deposited in Canada with a third-party financial institution; upon liquidation, OSFI is empowered to seize all the assets of the foreign bank in Canada to satisfy the obligation of Canadian branches; and OSFI may require assets to be lodged in Canada (with a third-party financial institution).

The Canadian Payments Association (CPA)

A quiet but crucial reform that is under way is the review by Finance of access to the payments network in the Canadian payments system in conjunction with the Bank of Canada. This review has been necessitated by a number of factors, including the new large-value transfer system (LVTS),[26] the new Interac Association agreement, and the new Payments and Clearing Settlement Act.[27]

Competition in the Financial Services Sector and the CPA[28]

Some financial services providers have argued that exclusion from direct access to clearing and settlement networks is a competitive disadvantage in providing payment acquisition services and as suppliers of related financial services. A broader range of financial institutions and near-financial institutions in the CPA networks may mean some tradeoffs between efficiency and safety of the payments system. Broader access to the payments system may broaden competitiveness in the financial services sector, as non-bank financial institutions could directly access the payments system, assuming that the regulatory restraints on the banks and insurers do not create an unlevel playing field for the banks and insurers. One further issue is how the federal government will deal with the specified definitions and exemptions under the Income Tax Act[29] and the Excise Tax Act[30] if membership in the CPA is broadened.

Recent Transactions

The financial services sector globally continued to witness significant consolidation in 1997. Transactions in many countries and crossing many borders saw global financial service providers playing out strategies to create in some cases broader global reach and economies of scale, and in other cases to gain access to new delivery channels and more customers

[26] The LVTS is an electronic credit transfer system for large-value payments which settles in real-time multilateral net accounting for settlement balances with certainty of final settlement on an item-by-item basis in real time, but with deferred settlement on the accounts of the direct participating group at the Bank of Canada subject to risk containment measures.

[27] The Payment Clearing and Settlement Act, 1996, SC 1996, c. 6. See also Bradley Crawford, "The Payment Clearing and Settlement Act, 1996" (February 1997), 28 *Canadian Business Law Journal* 1-21.

[28] See Bank of Canada and Department of Finance, "Access to Payment Networks in the Canadian Payments System," paper no. 3 (July 1997).

[29] Except as otherwise noted, tax comments are based on the provisions of the Income Tax Act, RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act"). Provincial laws may vary and should be consulted separately.

[30] Parts VIII and IX and schedules V through VII of the Excise Tax Act, RSC 1985, c. E-15, as amended (herein referred to as "the ETA").

or to expand monoline operations. Examples include Switzerland's Zurich Group acquiring Scudder Funds, Credit Suisse First Boston acquiring the Swiss-based global insurer Winterthur, the United Kingdom's General Accident acquiring Canadian General, AON's acquisitions of brokerage operators in all parts of the world, and UBS and SBC Warburg announcing plans to merge to form the world's largest financial group. The successful demutualization of the Norwich Union Life Insurance Society in the United Kingdom and policyholder approval for a similar transaction in Australia for the Australian Mutual Provident Society marked the launch of new organizations that would be able to vie for capital and grow, possibly through acquisitions with their newly minted acquisition currency, "common shares."

Many of these transactions are the consequence of global deregulation over the past 10 years, which in many countries has meant the removal of restrictions on geographic expansion and reduced protection from foreign competitors. Countries that early adopted the reforms necessary to provide the framework for consolidation are further along the curve in fostering a financial services sector that can compete internationally.

Consolidation, in all of its forms, is driven by the need to become more efficient in the use of capital and the resources deployed in service delivery to customers and returns to investors. Transactions to consolidate the financial services sector will cover the full gamut of possibilities, including takeovers (by cash or shares), mergers, joint ventures, and strategic alliances as well as asset-based transactions. The form of the transaction will, as in any sector, be influenced by the strategic intentions of the parties, the tax profiles of the parties, and other commercial imperatives such as cost of capital. The financial services sector will, however, produce additional complexities and uncertainty due to the regulatory constraints and need for regulatory approvals. The form, timing, and degree of success of transactions will be heavily influenced by the direction taken by the task force in September 1998.

Recent Signs of Consolidation in Canada

A number of public Canadian transactions this year provided the first signs that industry consolidation was also on the march in Canada. First off the mark was the Royal Bank Financial Group's bid for all of the common shares of London Insurance Group. This $2.4 billion bid was later successfully trumped by a competing bid by Power Corporation's Great West Life (GWL) group of companies. Next came the Bank of Nova Scotia's bid for all of the common shares of National Trustco Limited. These transactions alone pushed the financial services sector to the front of the federal government's agenda. The demutualization of Norwich Union provided a firsthand look for over 100,000 Canadians at windfalls that Canadian policyholders could experience in the future if the Canadian mutual life insurers were at some time in the future to announce flotation plans.

The Royal Bank Bid for London Insurance

The Royal Bank's bid for London Insurance (LIG) represented a first attempt to bring the final leg of Canada's financial services pillar (insurance) under one financial services group to create a European-style bancassurance provider in Canada. The $2.4 billion transaction was structured to accommodate the commercial needs of the major shareholder, Trilon Financial Corporation (TFC). Both LIG and TFC entered into support and lockup agreements respectively with the Royal Bank. The lockup agreement allowed Trilon to tender the LIG shares to a higher-value unsolicited qualifying competing bid by a third party, subject to a $70 million termination fee payable to the Royal Bank. Accordingly, when GWL and its affiliates put an additional half-billion dollars on the table and Royal decided not to match it, LIG was finally sold to GWL after over six months of waiting.

For each common share of LIG, the Royal's bid allowed LIG shareholders the choice of

1) $27.50 cash, or

2) $16.50 cash, 0.055 of a series L first preferred share, and 0.09 of a Royal Bank common share, or

3) $16.50 cash, 0.22 of a series M first preferred share, and 0.09 of a Royal Bank common share.

The series L first preferred share had a stated capital of $100 per share, entitled the holder to a quarterly non-cumulative preferential cash dividend of $1.30, and was not to be listed on the stock exchange. However, it was exchangeable, at the option of the holder, into four series M first preferred shares, which were expected to be listed on the exchange. The series M first preferred shares had a stated capital of $25 and entitled the holder to a quarterly non-cumulative preferential cash dividend of $0.325 per share.

To accommodate the Bank Act ownership restrictions that no shareholder may own more than 10 percent of a class of shares of a schedule I bank, the bid limited the entitlement of any one shareholder to no more than 10 percent of the first preferred shares in the aggregate. Individual shareholders were only permitted to elect one of the three options.

In addition, consistent with many other recent transactions in the past several years, shareholders were allowed to tender a holding company that held shares of LIG rather than tendering the LIG shares directly. The surprise tax issue in the Royal's bid was that, unlike previous transactions providing the holding company alternative, the Royal's bid did not allow the holding company alternative for less than 10 percent of shareholders. The technical tax reasons for this are described below and are specific to situations where the acquiror is a financial institution for purposes of the mark-to-market rules. While this raised potential collateral benefit issues under securities law, the situation is not without precedent (for example, see the 1994 acquisition of Lawson Mardon Group Inc.). There seems to have evolved support for the premise that consideration offered will not be considered of greater value when measured on an after-tax basis.

The compulsory acquisition set out in the bid provided an interesting venue for tax-deferred transfers using the identical-property rules.[31]

The Great West Bid for LIG

Within a month of the Royal Bank's circular hitting the street, Great West Lifeco Inc. (Lifeco) announced its bid of $33.50, or $2.9 billion, for all of the outstanding shares of LIG. In stark contrast to the Royal Bank's strategy of building a full-service financial service provider, Lifeco's bid represented a further consolidation of the insurance sector from within the insurance sector itself—a clear case of scale versus scope. The sheer size of the transaction necessitated Lifeco soliciting the participation in the bid of Investors Group Inc., also of Winnipeg, both companies being under the common control of the Power Financial Group.

Since the GWL bid was structured as a competing bid to the Royal Bank's bid, it had many of the same features but with added complexity as a consequence of the joint bid by both Lifeco and its substantially owned subsidiary, GWL. GWL-Lifeco's initial bid for each common share of LIG allowed LIG shareholders the choice of:

1) $33.50[32] cash, or

2) 1.0625 common shares of Lifeco, or

3) a combination of $16.50[33] or more in cash and the balance in Lifeco common shares, totalling a value of $33.50 or 1.0625 Lifeco common shares, or

4) a combination of $16.50 or more in cash and the balance in Lifeco class A preferred shares and/or series L GWL preferred shares.

It was a significant challenge for shareholders just to complete the share transmittal forms, let alone decide which consideration to take. In any event, the GWL-Lifeco bid also included the Holdco alternative mentioned previously. Although GWL is a financial institution for the purposes of the mark-to-market rules, Lifeco was not, and therefore the Holdco alternative was opened up potentially to a wider group of shareholders, so long as the shareholders opted for an option that included Lifeco common or preferred shares.

An additional feature of the GWL-Lifeco bid was the limitations on the numbers of common and preferred shares available and the rules for

[31] See, for example, Robert Couzin, "Going Private," in *Report of Proceedings of the Forty-Seventh Tax Conference*, 1995 Conference Report (Toronto: Canadian Tax Foundation, 1996), 24:1-27.

[32] Later increased to $34.00.

[33] Later increased to $17.50.

prorating the consideration where demand exceeded supply. This proration feature created shareholder uncertainty about the ultimate tax consequences of the consideration and the administrative tax filings required.

Towards the end of the summer, GWL-Lifeco enhanced its offer by an additional $0.50 and convinced LIG to terminate its support agreement with the Royal Bank. As a consequence, LIG paid a $70 million termination fee to the Royal Bank and withdrew its recommendation of the Royal Bank's offer. LIG then entered into a new support agreement in favour of the GWL bid. Trilon then entered into an irrevocable lockup agreement with GWL, and the transaction closed in November 1997, shortly after regulatory approval was received, with more than 99 percent of the LIG shares having been tendered to GWL-Lifeco's bid. The transaction closed and the integration of LIG GWL-Lifeco began.

The BNS Bid for National Trustco Limited

At the same time all of this was playing itself out, the Bank of Nova Scotia (BNS) was in the process of bidding for National Trustco Limited, the holding company for National Trustco. BNS's bid for National Trustco represented the attempt to consolidate one of the remaining self-standing trust companies of significant size in Canada. The BNS offer included the option of the Holdco alternative, except, as in the case of the Royal Bank offer, the mark-to-market rules applicable to BNS as a financial institution would create an undesirable tax result for shareholders owning less than 10 percent of the National Trustco shares. This indirectly limited the Holdco alternative to shareholders owning more than 10 percent of National Trustco shares.

The BNS offer consisted of $26.475 cash and 0.125 of a common share of BNS. The high cash component of the initial BNS bid meant that limited tax deferral would be available to long-time shareholders who would be unable to access safe income as a consequence of the unavailable Holdco alternative. BNS later varied the offer to increase the common share portion. Interestingly, neither the Royal Bank bid nor the BNS bid included a dividend option for shareholders.

The Demutualization of Norwich Union Life Insurance Society

The mutual form of carrying on commercial or other activities operates on the basis of groups of persons coming together for a common purpose and making contributions to a common fund to achieve that purpose. Typically, such enterprises operate in entities incorporated without share capital. While we refer to a mutual as though it were a legal form of doing business, like joint stock companies or partnerships, mutuals are not legal forms but, typically, corporations without share capital. Many organizations operate on a mutual basis, including building societies, automobile associations, credit unions, caisses populaires, property and casualty companies, and other clubs and benevolent societies. One common characteristic of mutuals is that they typically have no tradable property rights, but rather offer their constituents membership or other rights of "belonging."

In the insurance industry, a significant number of companies operate as mutuals, and as they have expanded into less traditional forms of their root businesses the pressure to convert these enterprises into quoted companies has increased. A recent study on the efficiency of the mutual and stock organizational forms observes that "mutual insurers should be relatively successful in lines of business with relatively good actuarial tables and lines where underwriting procedures and reinsurance decisions are relatively uncomplicated. In general, mutuals also should engage in fewer lines of business and operate over narrower geographical areas than stock insurers, because the cost of monitoring and controlling management varies directly with the scope of an insurer's operations."[34]

Norwich Union is the most recent example of the demutualization phenomenon, and, as a consequence of Norwich's sizable Canadian operations, Canadians witnessed what could become a path for Canadian insurers in similar circumstances in the future.

The demutualization process pursued by Norwich Union culminated in the £3.0 billion flotation in June 1997. Broadly speaking, qualifying members of the Norwich Union were entitled to receive a fixed allocation of 150 shares plus an additional allocation of a minimum 150 shares dependent upon the size of the qualifying member's "with profits" (i.e., participating) policy. In addition, qualifying members could acquire additional shares of NU PLC at a discount to other investors.

The Norwich transaction included a transfer of all of its trade, undertaking, and assets to a newly formed company, Norwich Union PLC, pursuant to section 49 and schedule 2C to the Insurance Companies Act 1992 ("the scheme"). The scheme allows a British insurance company, with consent from the High Court of England, to transfer its long-term business to a new company, in this case Norwich Union PLC. Because Norwich Union carried on business in many jurisdictions and in subsidiaries and branches in different locations throughout the world, the transaction included a complete and thorough restructuring of all of its operations to deal with the many commercial, regulatory, and tax constraints in each jurisdiction.

In Canada, Norwich Union carried on its principal activities through a branch. Regulatory requirements required a separate scheme in which the Canadian branch was transferred to a new federally incorporated company under the ICA. The transaction presented a number of tax issues in Canada, both at the enterprise level and for the many qualifying members who would be eligible to receive stock in the new company.

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[34] J.D. Cummins, M.A. Weiss, and H. Zi, "Organizational Form and Efficiency: An Analysis of Stock and Mutual Property-Liability Insurers," The Wharton School, Financial Institutions Center, 97-02, December 1996.

Forms of Consideration

Obviously, whenever a bid is made for a public company a widely held shareholder base will mean that the tax implications will vary substantially for different classes of shareholders. A transaction structured to yield proceeds of disposition and hence possible capital treatment will appeal to shareholders who have high outside cost basis or who can shelter a capital gain, either through available capital losses or treaty/home country exemptions. Low-income individuals may prefer to receive dividends in order to take advantage of the dividend tax credit. Certain corporations may prefer a transaction that would give rise to a dividend in order to access any available safe income. Finally, financial institutions will generally prefer to receive dividends that can be deducted under one of the intercorporate dividend exemptions contained in the Act. Appendix 2 summarizes the preferences for various types of shareholders and the possible Canadian tax implications of either a transaction giving rise to proceeds of disposition or a transaction giving rise to a dividend depending on the level of ownership. It is not intended that the tax implications of different forms of consideration be dealt with in this paper; rather, readers are referred to the circulars, which contain detailed tax commodity entries sufficient for this purpose.

Tax Issues on a Takeover or Merger Involving Financial Institutions

The current regulatory constraints described at the beginning of this paper limit for the time being the circumstances in which large financial service providers can consolidate in any meaningful way. However, the early-stage consolidation transactions in 1997 illustrate that more interesting Canadian transactions in the sector are not beyond the realm of possibility and are already taking place in other jurisdictions. The 1997 Canadian transactic ns illustrated many tax issues that had not been considered in depth for the financial services sector in the past. This section explores everyday tax issues that have a certain twist when applied to a financial services setting.

Income Earned or Realized (Safe Income)

Subsection 55(2) of the Act recharacterizes as a capital gain certain intercorporate dividends received in anticipation of, or as part of, an arm's-length sale of shares that could reasonably be considered to be attributable to anything other than "income earned or realized" by any corporation after 1971. Income earned (safe income) or realized by a corporation is determined according to the general rules for the calculation of income for tax purposes under the Act.[35] Safe income is the aggregate of income less losses earned after 1971 and before the transaction to which subsection

[35] Paragraphs 55(5)(a), (b), and (c) of the Act.

55(2) applies. Safe income cannot be a negative amount. However, a loss within one corporation can in certain circumstances reduce the extent to which safe income contributes to the overall gain on a share.

Safe income is essentially a target's after-tax income that at the time of sale is contributing to a corporate vendor's gain in the shares of the target—in effect, the undistributed after-tax income earned while the corporate vendor held the target's shares. It is not necessary to cover in great detail safe income and its component parts, since this is well covered elsewhere.[36] However, a number of issues arise in computing the safe income of financial institutions. Comments on the peculiarities that need to be resolved in a financial services environment are worthwhile.

Subsection 55(5) sets out the specific determinants in calculating safe income, and the courts have become more willing to explore the components of safe income[37] and apply the technical rules to resolving areas of uncertainty previously resolved on the basis of Revenue Canada's administrative guidelines. The process of compiling safe income is essentially as follows:

1) Aggregate the net incomes for tax purposes of all the companies in a corporate group (that are part of the group at the end of the period) for the period commencing after 1971 since the acquisition of the share to the "safe income determination time,"[38] which in most cases will be immediately before the payment of the dividend.

2) Add the excess of the non-taxable portion of capital gains over the non-deductible portion of capital losses for the period. Any non-deductible portion of "net capital losses" on hand at the end of the period is not deducted at this stage, but could affect the determination of "safe income on hand."

3) Add the non-taxable portion of net eligible capital amounts received during the period.

4) Add the undistributed exempt surplus for the period of foreign affiliates owned at the end of the period.

The sum of the above four items represents the safe income earned during the holding period (or safe income). Having calculated safe income, the next step is to determine how much of the gain on a share is attributable to that safe income. This requires a calculation of how much of the safe income remains "on hand" and available to be paid out on the

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36 Kirsten Richter, "The Removal of Accrued Gains in Capital Stock Holdings Through the Use of 'Safe Income,'" Personal Tax Planning feature (1991), vol. 39, no. 5 *Canadian Tax Journal* 1349-72; and Michael A. Denega, "Divisive Reorganizations: Back to the Future," in *Report of Proceedings of the Forty-Eighth Tax Conference*, 1996 Conference Report, vol. 1 (Toronto: Canadian Tax Foundation, 1997), 16:1-12.

37 See, for example, *Gestion Jean-Paul Champagne Inc. v. MNR*, 97 DTC 155 (TCC), and *Deuce Holdings Limited v. The Queen*, 97 DTC 921 (TCC).

38 See the definition in subsection 55(1).

date the dividend is paid. At this stage, certain items need to be considered and assessed as to whether they reduce the safe income or whether they reduce the portion of the gain that is attributable to something other than safe income.

This reduced amount is generally referred to as safe income on hand (SIOH). Items that would typically be applied to reduce safe income to determine the SIOH are as follows:

- income and other non-deductible taxes paid or payable;
- dividends paid out of safe income;
- non-deductible expenditures; and
- realized non-capital and capital losses that have not already been deducted in the determination of income earned or realized for the period.

A number of specific computational issues arise when determining the income earned or realized or the SIOH of a financial institution, generally as a consequence of rules unique to financial institutions.

Timing Issues

The safe income determination time is the end of the safe income holding period. It occurs at the earlier of the time a safe income dividend is paid and the time at which unrelated persons have a significant increase in their holdings in the target. Since a deemed year-end occurs immediately preceding the time of acquisition, it may be important to ensure that both dates are in proximity to maximize the safe income.

As background, a financial institution must annually recognize its profit or loss on certain securities, specifically mark-to-market properties. Such securities are deemed disposed of at the end of the taxation year. However, if the safe income determination time precedes the end of the taxation year, how much of the mark-to-market profit or loss should be included in the safe income? Paragraph 55(5)(a) precludes the recognition of any mark-to-market adjustment, since such amounts would constitute what is referred to as "income expected to be earned." Such income is deemed to be "a portion of the gain that is attributable to anything other than income earned or realized." Whether this is consistent with the approach that Revenue Canada applies to such things as capital cost allowance, which is also only computed at the last day of the year, is unclear. It would seem appropriate to allow a proration of the annual mark-to-market gains, perhaps on a daily basis.

On a positive note, a strict interpretation under paragraph 55(5)(a) can be beneficial in certain cases. "Income" under the Act is typically computed on a net basis and, unless otherwise indicated, is generally computed on an aggregate basis. Accordingly, it should be possible to apply any "expected losses" (contingencies, for example), to reduce any "expected income" in order to determine the portion of the gain that is attributable to anything other than safe income. This approach will have the effect of ensuring that income earned or realized is not eroded by contingencies. This interpretation provides a determination of SIOH that is consistent with Revenue Canada's views on the application of accounting provisions and their effect on SIOH.[39]

With respect to specified debt obligations (SDO), the rules hold that, except where the SDO matures within two years of the end of the year in which the bond is disposed of, the purchaser must defer and amortize the gain or loss over the remaining term to maturity of the bond. Thus, the purchaser may have a gain or loss to recognize in the years beyond the safe income determination time. For safe income purposes, only the gains or losses amortized into income prior to the safe income determination time, including the transition amount, are included in safe income.

As a further example of differences in accounting and tax amounts, consider the reserves of an insurer. Such reserves are computed under specific rules contained in the regulations. In many cases, the reserves for tax purposes have been more generous than the required accounting reserves. Accordingly, insurers need not claim the full amount of their reserves available to them at the end of a particular taxation period to bring their taxable income to zero. The issue is whether such unclaimed tax reserves need be claimed to the maximum extent possible in order to determine the safe income or the SIOH. Since the reserves are discretionary in nature, they clearly do not reduce the income earned or realized until such time as they are claimed. Whether they should be applied as a reduction to SIOH requires a more thorough analysis. Revenue Canada has indicated in the past that there should be no artificial creation of safe income by not claiming discretionary allowances.[40] However, in the case of reserves that are not created out of surpluses but rather as a consequence of balance sheet events, the appropriate analysis would be to examine whether the claiming of the reserve reduces the income that has been earned, or reduces some other asset, or reduces any "expected income" under paragraph 55(5)(a).

Potential Tension Between Safe Income and Paragraph 88(1)(d) Bump

A realization of a gain by the target prior to the end of a period will increase the target's net income and potentially create additional safe income for the vendor. While not unique to financial institutions, the new definition of safe income determination time, coupled with recent transactions, has heightened the potential for conflict between purchasers and vendors. The potential for tension existed in the LIG transaction. Sometime between the start of the Royal Bank bid and the closing of the GWL-

[39] See, for example, Revenue Canada document no. 9611245, May 6, 1996 and document no. 9630155, September 27, 1996.

[40] John R. Robertson, "Capital Gains Strips: A Revenue Canada Perspective on the Provisions of Section 55," in *Report of Proceedings of the Thirty-Third Tax Conference*, 1981 Conference Report (Toronto: Canadian Tax Foundation, 1982), 81-109.

Lifeco bid, LIG announced the realization of a significant gain on the sale of its annuity subsidiary, Security First, to Metropolitan Life in the United States. A purchaser who could acquire LIG prior to closing the Security First transaction would potentially be able to eliminate the corporate level of tax on the Security First transaction at the LIG level, using the limited inside basis step-up available under Canadian tax laws following certain acquisitions.[41] From a vendor's perspective, if the Security First deal closed before the LIG sale, then the realized gain would be available to the vendors as additional safe income.

In the end, delays in receiving regulatory approval in Canada for the acquisition of LIG by GWL-Lifeco allowed the necessary time for the closing of the Security First sale to occur naturally, thereby increasing the safe income available for the vendors but denying the purchaser the opportunity to step up the basis of Security First prior to sale. In any event, for the purchaser to access a step-up on the Security First shares, the bid structure would have required reworking to cope with existing preferred shares in LIG (one of the requirements for the step-up is that all of the shares of the target should be owned at the time the transaction is implemented, to qualify for the bump, or as a minimum 90 percent of each class of shares of the target should be owned by the purchaser, with any minority being held at arm's length). Since the preferred shares were not redeemable, an alternative bid structure would have been required, which would complicate an already complex bid structure and risk possibly failing the "competing bid" requirements contained in the initial Royal Bank bid.

Accessing Safe Income

Safe income can best be extracted by payment of an actual dividend, although there are a variety of means to create a dividend that would facilitate access to the safe income.[42] The regulatory constraints described earlier place additional limits where a financial institution is either a purchaser or a vendor.

The ability of a vendor to extract a target's safe income is a crucial part of any takeover these days. Accordingly, purchasers have generally been willing to accommodate significant shareholders in structuring transactions that will provide a dividend alternative, either in the original design of a structure or in a follow-up alternative. The most common feature to achieve this in most transactions in the past five years has been the Holdco alternative (see figure 1).[43]

In general, the Holdco alternative enables corporate vendors to defer recognition of the gain on the sale of the target's shares by triggering a

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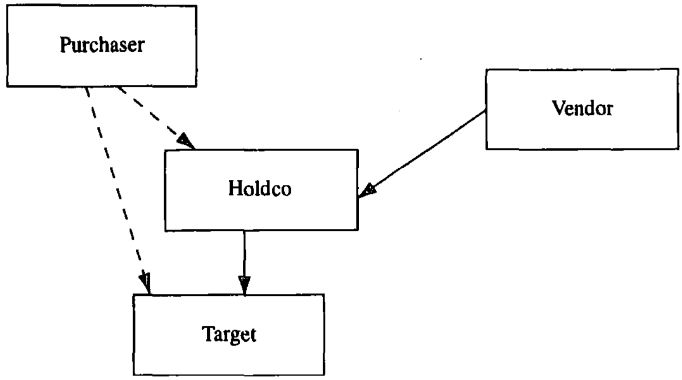
[41] See, for example, paragraphs 88(1)(c) and (d) of the Act.

[42] See, for example, Denega, supra footnote 36, at 16:4, and Richter, ibid., at 1365.

[43] See, for example, Denega, supra footnote 36, at 16:10.

Figure 1



dividend to the extent of the corporate vendor's share of safe income which could otherwise have been received free of part I tax.

The corporate vendor typically transfers its shares in the target to a newly formed holding company, and the purchaser agrees to buy the Holdco shares from the vendor on the same terms as would have been the case had the share of the target been acquired directly. The purchase of the Holdco is usually subject to a purchase agreement that contains a number of covenants to protect the purchaser from tax and other liabilities in the Holdco. The purchaser usually then winds up the Holdco to hold the target's shares directly.

Where a purchaser is a financial institution for the purposes of the mark-to-market rules contained in sections 142.2 through 142.6, the holding company alternative will generally not be feasible for the reasons discussed below. For example, as noted in the RBC offering circular for London Insurance Group:

> It is unlikely that a Shareholder will be able to take advantage of the Holdco Alternative if less than 10% of the LIG Shares are held by such Shareholder and related persons. In the case of such a Shareholder, the Holdco alternative could entail significant adverse tax consequences. Owing to the status of the Bank as a "financial institution" for purposes of the Tax Act, the Holdco of such a Shareholder could become a "financial institution" upon its acquisition by the Bank. As a result, the Holdco could be deemed to have disposed of its LIG Shares for their fair market value prior to the acquisition of Holdco by the Bank. Accordingly, it is unlikely that such a Shareholder will be able to provide the required representation and warranty that its Holdco will have no tax liabilities.[44]

Recall that a financial institution must annually recognize gains on certain securities it holds at the end of a year[45] and treat any gains or

[44] See the offering circular, at 18.

[45] Subsection 142.5(2).

losses as being on income account. Such securities include all shares other than shares of a corporation in which the financial institution has a significant interest at any time in the year. A financial institution has a significant interest in a corporation at any time in a taxation year if:

1) the financial institution is related to the corporation (other than by virtue of paragraph 251(5)(b)), or

2) the taxpayer holds shares that give the taxpayer 10 percent or more of the votes that could be cast under all circumstances at an annual meeting of shareholders, and shares having a fair market value of all of the issued shares of the corporation.

A property will not be considered a mark-to-market property if the financial institution has a significant interest at any time in the year. Thus, the Act has a bright-line test for determining whether any particular property is a mark-to-market property for the entire year. Each property either is or is not a mark-to-market property in a particular year.

In addition, for the purposes of determining whether at any time in a taxation year a financial institution has a significant interest in a corporation, the financial institution is deemed to hold each share that is held by a person or partnership to whom the financial institution is related (again, other than related by virtue of a right referred to in paragraph 251(5)(b)).

Special rules apply where a taxpayer becomes (or ceases to be) a financial institution. The Holdco alternative will not be feasible for a non-financial institution vendor unless the vendor holds a significant interest in the target at any time in its year. This is because when the shares of the holding company are acquired there will be a deemed year-end of the Holdco immediately before the acquisition of control.[46] In addition, the Holdco now being controlled by a financial institution will also be a financial institution. As a consequence of becoming a financial institution, the Holdco will be deemed to dispose of, immediately before the end of its taxation year that ends immediately before the time it becomes a financial institution, each property that is a mark-to-market property for the year. Accordingly, any gain inherent in the share of the target will be crystallized upon acquisition of the Holdco by the financial institution purchaser.

A financial institution vendor will be unable to take advantage of the holding company alternative for mark-to-market property for a number of reasons. First, to set up the Holdco alternative, the target shares must first be transferred on a rollover basis to a Holdco. Property can generally only be transferred on a rollover basis under subsection 85(1), and only eligible property[47] may be transferred. Eligible property includes, inter alia, certain capital property and certain inventory. Clearly, mark-to-market property will not be capital property because of the definition of capital property,[48] which requires gains or losses from the disposition of the

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[46] By virtue of paragraph 249(4)(a).

[47] Subsection 85(1.1).

[48] Section 54.

property to give rise to capital gains or capital losses. Dispositions of mark-to-market property are included on income account; however, mark-to-market property is clearly not inventory.[49] Property eligible for rollover under subsection 85(1) also includes a security[50] used or held in the course of carrying on a business of insurance or lending money, other than where the taxpayer is a financial institution and the property is a mark-to-market property[51] for the year. Even if a financial institution vendor had the foresight to hold the mark-to-market property in a sole-purpose corporation, the holding company alternative would not be possible for the simple reason that on the acquisition of control a year-end will occur, giving rise to a mark-to-market event and realizing any remaining gain in the target's shares in the holding company.

A financial institution vendor, applying the bright-line test for significant interests in shares, could in theory resolve this dilemma by causing particular shares to not be mark-to-market property for the year if at some point in the year the corporation held a significant interest in the shares directly or indirectly. This could be achieved by acquiring directly or indirectly, at any time in the year, a sufficient number of shares of the target that would give rise to a significant interest for the year.

An alternative means to achieve this might be to have two taxpayers pool their interests with one another to create a significant interest in shares of the target in one company. This could be achieved for financial institutions or financial institutions along with non-financial institutions, or by non-financial institutions alone. What comes to mind immediately when one considers pooling to achieve some bright-line test in the Act is the general anti-avoidance rule (GAAR) and specifically the comments in *Information Circular* 88-2.

The GAAR circular[52] contains numerous examples analyzing the application of the GAAR, including an example where two taxpayers pool their interests in Holdco, a jointly held holding company, to cause it to be connected (more than 10 percent of the votes and value) with another corporation expected to pay a dividend. The facts outlined in the GAAR circular state that the primary purpose of the transaction is to avoid the part IV tax. The circular concludes that "the transfer of the shares would be a misuse of a provision of the Act or an abuse of the Act as a whole and subsection 245(2) would be applied."[53]

However, in at least two subsequent published opinions provided by Revenue Canada, GAAR was not applied to pooling transactions. In the first example, an individual owned shares of an operating company directly and indirectly through a wholly owned private corporation. The

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49 Subsection 142.6(3).

50 Includes a share by any definition.

51 Which by virtue of subsection 85(1.4) imports the meanings assigned by subsection 142.2(1).

52 *Information Circular* 88-2, October 21, 1988.

53 Ibid., paragraph 14.

corporation owned less than 10 percent of the shares, but in aggregate the individual and his corporation owned more than 10 percent of the shares. The individual sought to consolidate the holdings prior to the receipt of a dividend by the operating company.[54]

Initially, in reliance on paragraph 14 of the GAAR circular, the transaction was determined to be a misuse or abuse of the Act. On reflection, Revenue Canada subsequently reversed its position and advised that the transaction could be distinguished from the example in paragraph 14 of the GAAR circular and that such a transaction would not generally constitute a misuse of a provision of the Act or an abuse of the Act read as a whole. Revenue Canada did not elaborate on how the situation could be distinguished.

In a subsequent example of pooling,[55] three individuals wished to each acquire 5 percent of the shares of an operating company. The taxpayers planned to do so through a single holding company to avoid the application of part IV tax on dividends received from the operating company in the future. Revenue Canada opined in this situation that the pooling did not result in a misuse of the provisions or an abuse of the Act read as a whole, nor would its position change if the shares had already been owned prior to the establishment of the holding company. One can conclude from the above that the example in paragraph 14 of the GAAR circular has perhaps been sufficiently modified by more recent pronouncements that it may no longer have general application.

To illustrate the provisions of the Act dealing with how pooling may allow the setup of the Holdco alternative, consider the following:

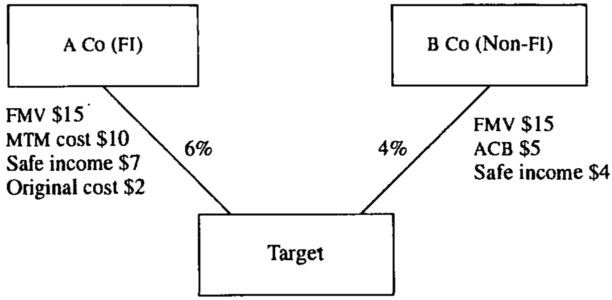
A Co is a financial institution that holds 6 percent of the shares of a target with a gain of $5 since its last mark-to-market; its original cost of the target shares was $2; and it is being offered $15 per share. A Co's safe income per share is $7. B Co is not a financial institution. It holds 4 percent of the shares in target as capital property; its original cost is $5; and its share of safe income is $4 per share. (See figure 2.)

A Co incorporates Newco and transfers its shares of the target to Newco in exchange for class A shares of Newco. At this point, the shares of the target would still be mark-to-market property to A Co and accordingly would not be eligible for rollover treatment under subsection 85(1). B Co transfers its shares of the target to Newco in exchange for class B shares of Newco. At this point in time, Newco would continue to be controlled by and related to A Co. Accordingly, since A Co is deemed to hold each share that is held by a related person (Newco), and by virtue of the bright-line significant interest test, the target shares to both Newco and A Co are not mark-to-market property for the year. Since the property is not

[54] Revenue Canada letter reported as document no. December 1990-213 in *TaxPartner* (Scarborough, Ont.: Carswell) [database online].

[55] Revenue Canada Round Table, *APFF Congrès 90* (Montreal: Association de planification fiscale et financière, 1991), question 27.

Figure 2



mark-to-market property for the year, it is now eligible property for the purposes of the subsection 85(1) rollover as capital property under paragraph 85(1.1)(a), as inventory under paragraph 85(1.1)(b), or as a non-mark-to-market security held in the course of an insurance or moneylending business by a financial institution under paragraph 85(1.1)(g).

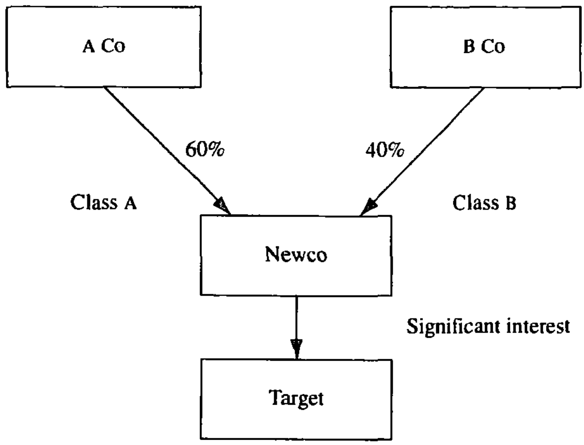
Once Newco has been set up, the safe income can be capitalized to each of A Co and B Co, and Newco can be tendered to the bid under the Holdco alternative since it is a financial institution. On the deemed year-end on change of control there is no automatic realization of the gain, since the target shares are not, for that year, mark-to-market property.

Another alternative to allow holders of mark-to-market interests to access any available safe income would be to design a transaction structure that would accommodate the tax profiles of a wider group of shareholders and develop a transaction that would have the effect of generating either an actual or a deemed dividend. Keep in mind that if a property is a mark-to-market property, then any dividend received will not run afoul of the dividend-stripping rules contained in subsection 55(2), since that provision only applies to property that is a capital property. If a holding in shares constitutes a significant interest and so meets the bright-line test for exclusion from the mark-to-market rules, a determination must then be made as to whether the shares constitute capital property or inventory. Again, subsection 55(2) will only be relevant in the context of capital property.

Obviously, a cash dividend would reduce the value of the shares. Accordingly, when the profit or loss is measured for the purposes of computing the annual mark-to-market adjustment, the profit would be reduced accordingly. Where the dividend is such that it reduces the value of the shares below their value at the time of the last mark-to-market, the taxpayer will realize a loss for the year on the disposition. Ordinarily, this loss would be denied if the taxpayer and related persons owned more than 5 percent of any class of shares or if the taxpayer owned the shares for less than 365 days before the loss was sustained.[56] The general stop-loss

[56] See, for example, subsections 112(3) and (4).

Figure 3



rules do not apply to a share that is a mark-to-market property for the year of a taxpayer that was a financial institution in the year. Rather, special rules exist which in effect allow a loss on a mark-to-market property to the extent of dividends so long as the loss was not created by dividends in excess of gains realized above the original cost in prior years. For example, again assume that a financial institution that holds 6 percent of the shares of a target has a $5 gain since its last mark-to-market. Its original cost of the target shares was $2 and it is being offered $15 per share. Assume that it received dividends in prior years of $3 and the remaining safe income per share is $7. If a dividend of $7 per share could be received by the financial institution with a sale of the shares at $8 instead of $15, a $2 loss would be realized for the year.

The loss is not denied by subsection 112(3) or (4), since the taxpayer is a financial institution in the year and the property is a mark-to-market property.[57] The loss denial rules for financial institutions are contained in subsections 112(5) through (6). These rules apply by adjusting the proceeds of disposition by an amount that would, if a deniable loss exists, be sufficient to eliminate the loss. The adjustment is determined by the following formula:

$A + B - (C - D)$

where A is the proceeds otherwise determined (in this case, $8);

B is the lesser of the loss based on original cost and the amount of any tax-free dividends (in this case, the lesser of nil and $10, therefore nil); and

C and D are prior year's adjustments under these provisions.

[57] Subsection 112(5.5).

In the example described above, there would be no adjustment to the proceeds of disposition. Accordingly, the $2 loss arising since the last mark-to-market would be allowed. If a more extreme transaction was contemplated—for example, a dividend of $14 per share with a purchase of the share for $1—then a denied loss would exist. In that case, a loss of $9 would result for the year before application of the stop-loss rule. The proceeds would then be adjusted upward by a further $1, reducing the computed loss to $8, which represents the mark-to-market gains crystallized in prior years. So as a rule a tax-free dividend can be received to the extent of any previously realized mark-to-market gains. The fact that there is no recharacterization rule such as subsection 55(2) to recharacterize such dividends as income demonstrates the quid pro quo to the prepayment of tax by financial institutions on undistributed earnings.

An alternative to an actual dividend would be a deemed dividend arising, for example, on a redemption of the target's stock. This would occur as follows. Using the same example, A Co could tender the shares back to the target for redemption (funded under a plan of arrangement by the purchaser). The proceeds in this case would be $15; assuming the paid-up capital (PUC) of the target's shares was nominal, a deemed dividend of $15 would arise. When computing the financial institution's profit on the disposition of the shares, it is less clear whether the proceeds of $15 can be reduced by the amount of the dividend deemed to arise on the redemption of the stock. Assuming that it can, the stop-loss rule for financial institutions would apply to deny the resulting $10 loss by increasing the proceeds by $2, thus restricting the loss except to the extent that it relates to a gain previously recognized under the mark-to-market rules. This is illustrated in the accompanying table.

Proceeds on redemption	$15
PUC	0
Deemed dividend	$15
Proceeds	$15
Eliminate duplication—subsection 248(28)	(15)
Proceeds for measuring profit	0
Mark-to-market cost	(10)
Loss under mark-to-market rules	$10
Stop-loss rule applied:	
A: Proceeds otherwise determined	$0
+ B: Least of loss based on original cost ($2) and tax-free dividend ($15)	2
Increase in proceeds	$2
Proceeds otherwise determined	0
Revised proceeds for measuring profit	$2
Mark-to-market cost	(10)
Revised loss under mark-to-market rules	$8

There are at least four arguments in favour of an interpretation that adjusts the proceeds for mark-to-market purposes by the deemed dividend. First, subsection 248(28) might apply to eliminate the double inclusion of the proceeds on redemption to the extent that it has already been included in computing the deemed dividend. Second, the definition in subdivision c of proceeds of disposition should be used as well for the purposes of the mark-to-market rules in determining proceeds. This definition reduces the proceeds of disposition by the amount of any deemed dividends under subsection 84(3).[58] Third, as illustrated in the examples, reducing the proceeds to the extent of any deemed dividend provides a result that is the same as would be the case with an actual dividend, and therefore, in a policy sense, should be afforded some serious consideration. Finally, the mark-to-market rules contain little guidance on the determination of profit for the purposes of dispositions of mark-to-market property. Financial institutions account for yields on long-term investments under a variety of models; for example, banks carry portfolio investments at cost, recognizing dividends as received and profits only on disposition. Insurers, on the other hand, use more of a moving-average basis, recognizing some gains each year on a smoothing basis. The cost method is a basis of accounting for long-term investments whereby the investment is initially recorded at cost; earnings from such investments are recognized only to the extent received or receivable. When the investment is in the form of shares, dividends received in excess of the investor's pro rata share of post-acquisition income are recorded as a reduction of the amount of the investment.[59]

If the redemption transaction is recorded in a manner consistent with its substance, the redemption proceeds should be split between a realization of post-acquisition earnings, which would be tantamount to a dividend, and any remainder above the cost recognized as a gain on the disposition. The profit or loss on the disposition for the purposes of the mark-to-market rules would be this latter amount. The taxable income would then need to be adjusted to reflect the intercorporate dividend and the application of the stop-loss rules for financial institutions.

It would appear that Revenue Canada plans to resist an adjustment to the proceeds for subsection 84(3) dividends by applying subsection 248(28) or some other device.[60] In an access letter dated June 6, 1997, Revenue discusses the application of subsection 248(28) in these circumstances and concludes:

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[58] Some support for this can be developed from *Street v. MNR*, 91 DTC 369 (TCC), and *Pollock v. The Queen*, 90 DTC 6142 (FCTD).

[59] Canadian Institute of Chartered Accountants, *CICA Handbook* (Toronto: CICA) [database online], section 3050.02.

[60] Revenue Canada seems to have reversed its views on the interaction between subsection 84(3) and gains on non-capital property. This issue existed long before the mark-to-market rules were introduced. See, for example, Revenue Canada document no. 9337225, March 30, 1996, and document no. 9408775, April 25, 1994, and an even earlier position from the "Revenue Canada Round Table" in *Report of Proceedings of the Thirty-Sixth Tax Conference*, 1984 Conference Report (Toronto: Canadian Tax Foundation, 1985), 783-847, question 46, at 818-19.

> It is our view that there is a tenable argument that the provisions of subsection 142.5(1) are more specific than those in subsection 84(3) and therefore subsection 142.5(1) should take precedence on a redemption of shares held by a financial institution. To the extent that an amount is included in computing income under subsection 142.5(1), such amount should not be taken into account a second time for the purposes of subsection 84(3).[61]

In short, Revenue Canada prefers an answer which, in the example we have considered, would result in a profit of $5 and would appear to ignore the dividend issue completely. In our view, this is clearly not the correct technical answer given the existence of the stop-loss provisions, which provide a detailed computational result had an actual dividend been received. Since subsection 84(3) would appear to be designed to mimic the effect of an actual dividend, Revenue Canada's position provides a result that is different. Therefore, the recent access letter should be reconsidered.

As regards accessing the safe income, or what are clearly undistributed profits, it would seem a rather anomalous situation that certain shareholders would be precluded from accessing a target's safe income (or in the case of a financial institution its "dividend entitlement").[62] This is particularly harsh in the case of financial institutions, since they are required to, in effect, prepay tax on undistributed earnings by virtue of the stark application of the mark-to-market rules. Fortunately, the rules contain a number of bright-line tests that can be applied to soften what would appear to be unintended effects of the mark-to-market rules.

Proration of Safe Income Where Gains Are Partially Realized

Revenue Canada has long held the view that when a taxpayer realizes a portion of a gain on a share, a portion of the safe income is also realized. This position seems to have developed out of the small business capital gains exemption and the transaction used to crystallize gains (portions of which reflect undistributed earnings). When dealing with financial institutions, the mark-to-market rules create complexity, in that these rules constantly recognize gains that are partially represented by safe income. The issue becomes whether the intervening events, such as the mark-to-market[63] gain recognition, erode safe income, and what happens when

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[61] Revenue Canada document no. 9631867, June 6, 1997.

[62] Being the amount of a dividend that can be received while creating a loss in the current year that will not give rise to adjustment under subsection 112(5.2).

[63] We choose mark-to-market gains for a number of reasons. First, it is consistent with the theme of this paper, but principally because the scheme of the Act for mark-to-market property applies a test for each year, so, depending on a financial institution's positions in a particular stock at each point in the year, such property could become non-mark-to-market for a particular year and, accordingly, inventory or capital property, depending on the type of financial institution and intentions towards the investment.

post-event gains exceed the amount of the safe income otherwise undistributed.

At the 1996 Ontario Tax Conference round table, Revenue observed:

> The Department has set out its views on the interaction of safe income and the capital gains exemption in a Technical Interpretation dated April 10, 1995, issued by the Reorganizations and Foreign Division of Revenue Canada. The Department indicated that where a taxpayer crystallizes a capital gains exemption by transferring shares of an operating company ("Opco") to a holding corporation ("Holdco"), there is a proportionate reduction in the safe income attributable to the Opco shares. In addition, the Department has indicated that a similar result will occur where the shareholder elects to realize a gain in order to use the capital gains exemption. . . . Subsection 55(2) requires that a determination be made of the portion of a capital gain on a share that is attributable to safe income and the portion that is attributable to something else.
>
> The Department's long-standing position is that each share of a corporation represents only its proportionate share of the value of the company and therefore is entitled only to its proportionate share of the safe income of the corporation during the relevant holding period of that share.
>
> Accordingly, to the extent that a corporation has safe income, in our view, it is reasonable to consider that any gain realized on a share of that corporation will have both a safe-income and non-safe-income component, determined on the pro rata basis described in the technical interpretation above.[64]

Obviously, safe income is not relevant to a property that is a mark-to-market property, but it serves as a useful reference point to illustrate the effect of intervening gain recognition on safe income. The options that exist include the following:

1) all undistributed safe income is available to be crystallized to the extent of any unrecognized gains;

2) safe income is eroded to zero each year and only rejuvenates in the current year; and

3) safe income during the entire holding period is prorated on a ratio that is consistent with the proportion of the gain that has been recognized to date under the mark-to-market views.

The effect of the three alternatives is illustrated in the accompanying table, which assumes an original cost of $5, a mark-to-market cost of $10, an ultimate sale price of $18 at a time when the taxpayer has a significant interest and safe income of $2 earned prior to the intervening recognition events, and $2 earned after that period.

[64] Revenue Canada document no. 9621950b, October 8, 1996.

	Start	*Intervening event*	*Sale*
Cost	5	5	10
FMV		10	18
Gain recognized (MTM)		5	
Gain on sale			8
Safe income	0	2	4
Gain attributable to SI		2	?

The safe income available will be $4 under the first interpretation, $2 under the second interpretation, and $2.50 (8/13 × $4) under the third interpretation. In our view, the first alternative is the technically correct result, since all of the earnings remain in the target and the mark-to-market recognition only represents a partial prepayment of the tax on the gains from all sources, including the undistributed profits. When the final profit is known—that is, on the ultimate disposition of the share—so long as the remaining gain is at least equal to the undistributed profits the full amount of safe income should be available.

Deemed Acquisition of Control on Certain Mergers

Since the Bank Act and the regulatory framework constrain one of the large Canadian chartered banks from "owning" another, the only way in which two banks could merge would be by virtue of a horizontal amalgamation. Such a merger would have to qualify under section 87 to avoid the other rules of general application under the Act.

Regulation

From a regulatory perspective, the Bank Act enables banks to amalgamate on application to the minister of finance, with the minister, upon approving the amalgamation, issuing letters patent amalgamating and continuing the applicants as one bank.[65] The new "Amalco" bank would still be subject to the current ownership restriction. Banks proposing to amalgamate (other than the vertical short form and horizontal short form for parent and subsidiary or sister subsidiaries) must enter into an amalgamation agreement and must provide for cancellation of those shares upon amalgamation without any capital repayment or conversion into Amalco bank shares.[66] In short, then, without the informal "big shall not buy big" policy, it seems possible for two banks to amalgamate currently without any changes in the law. In fact, one may speculate (as a matter of academic interest, since it is subject to ministerial discretion) that if an amalgamation does not create an acquisition (that is, a merger of equals), then the "big shall not buy big" policy should not apply.

[65] See the Bank Act, section 223, subject to shareholder, director, and ministerial approval.

[66] Ibid., section 224(3).

Acquisition of Control

While there would not be a de jure acquisition of control, draft provisions of the Act provide that control would be acquired of one of the predecessors where a group of persons control Amalco that did not control the predecessor prior to the amalgamation. Given the current 10 percent limit on shareholdings, it would be difficult to see how subparagraph 256(7)(b)(ii) would apply unless one were to argue that one bank's shareholders, no matter how widely dispersed, constituted a group of persons for the purposes of the Act. Control by a group of persons is sometimes thought to entail some form of "acting in concert," forcing Revenue Canada to argue that the specific group of persons were acting as a group. But the draft provisions in subsection 256(7) does not suggest such a requirement. In particular, subparagraph 256(7)(b)(iii) would deem an acquisition of control of one of the banks, subject to the exceptions in clauses B and C. Both of those clauses would not exempt a merger that was not a merger of equals, so that a widely dispersed group of persons which controlled one bank before the merger, and then held a majority of the shares of the merged bank post-acquisition of control, may lead to an acquisition of control of the smaller predecessor.

An acquisition of control would give rise to a whole series of tax consequences that would require effective corporate and tax planning to mitigate. Observe that an acquisition of control, if any, would occur throughout the entire bank company structure. If a bank has accrued losses in certain subsidiaries, then it may be possible to utilize such losses prior to the acquisition of control to step up the inside basis of the bank's holdings. Alternatively, subject to regulatory requirements, the banks may collectively wish to merge a number of subsidiaries first to maximize basis, so that, upon the final merger of the bank itself, the "problem" subsidiaries would already have been dealt with.

Some Issues That Arise When Mutuals Merge

Upon a merger of mutuals, the members/policyholders of one mutual become members and policyholders of the merged mutual. The Act provides that, for certain purposes, the amalgamated corporation is deemed to be the same corporation as, and a continuation of, each of the predecessor corporations where one or more of the predecessor corporations was an insurance corporation.[67] Thus, it is only necessary that one of the companies be an insurance company.[68]

Previously, a qualifying amalgamation transferred most (specified) tax accounts, tax losses, and (specified) reserves of predecessors. For the purposes of the loss provisions, the amalgamated corporation is a continuation

[67] For the purposes of section 148 (disposition of a policy) and section 138.1 (taxation of segregated funds).

[68] See the above discussion on year-ends.

of the parent where there is an amalgamation of the parent and wholly owned subsidiaries. In a horizontal amalgamation, the adjusted cost base of the shares of the amalgamated corporation would be equal to the aggregate of the adjusted cost bases of the predecessor's shares. However, new subsection 256(8.1), which treats corporations without share capital as having share capital for the purposes of subsections 256(7) and (8), has changed all of that. Since a mutual insurer would be treated as having share capital, then subparagraph 256(7)(b)(ii) would apply to create an acquisition of control of the smaller of the two amalgamating mutuals. Thus, the "normal" impacts of an acquisition of control would apply, including the extinguishment of capital losses.

For policyholders, an amalgamation of two mutuals raises some interesting issues. The *Sirois* decision seems to have recognized two types of property held by a policyholder: the policy and the membership in the mutual. Thus, upon the amalgamation of two mutuals, one may well ask whether there has been a disposition of the membership and a reacquisition of the same, and whether the cost base is the same in both.

Selecting a Taxation Year for a Financial Institution

Corporations are generally free to choose whatever taxation year suits their purposes. Takeovers and mergers create the opportunity to re-evaluate a taxation year. Ordinarily, certain financial institutions have fiscal periods set by statute. Corporations may be able to select a taxation year different from that required for regulatory purposes following an event that gives rise to a taxation year—for example, a taxation year arising on an amalgamation.[69] For example, both the Bank Act and the ICA mandate a financial period of either October 31 or December 31. Paragraph 249(1)(a) defines the taxation year of a corporation to be its fiscal period. Subsection 249.1(1) further defines a fiscal period to be the period of the corporation in respect of which its accounts are made up for the purposes of assessment under the Act, and that no fiscal period may end more than 53 weeks after the period began. If a corporation desires to change the time when its fiscal period ends, subsection 249.1(7) stipulates that it may not do so without ministerial approval.

For a bank or insurer formed by an amalgamation (Amalco), subsection 249.1(7) will not apply where it is not seeking to change the time when its fiscal period ends, but is selecting a time when its first fiscal period ends. Amalco is a new corporation entering its first taxation year and has not yet established a fiscal period. That is, it cannot change a fiscal period without first having established such a time. The fact that Amalco (before the merger) and its predecessors had taxation years has no bearing on the merged Amalco's taxation year-end. Arguably, Amalco may select any taxation year-end as long as it does so within the 53-week confines. Revenue Canada agrees that a request for the minister's approval

[69] Paragraph 87(2)(a).

for a change in fiscal period is not required where the fiscal period is revised by operation of law.[70]

The year-end rules for a corporation formed upon an amalgamation are comparable to other tax provisions that deal with deemed year-ends. Paragraph 249(4)(d) states that where at any time control of a corporation is acquired, for the purpose of determining the corporation's fiscal period after that time, the corporation is deemed not to have established a fiscal period before that time. Similarly, if at any time a non-resident insurer transfers its insurance business to a qualified related corporation, provided certain conditions are met, for the purposes of determining the fiscal periods of the transferor and transferee after that time, they are deemed not to have established fiscal periods before that time.[71]

Both paragraphs 249(4)(d) and 138(11.5)(d) deem the corporation not to have established a fiscal period because both contemplate what happens to the year-end of an existing company after a certain event. They presumably had already chosen a fiscal period end for their previous taxation years before the acquisition of control or the business transfer. By deeming a fiscal period to have not yet been established, both paragraphs 249(4)(d) and 138(11.5)(d) allow the corporation to have a fresh start in terms of establishing a year-end.[72]

The words in paragraphs 249(4)(d) and 138(11.5)(d) can be compared to paragraph 87(2)(a), which simply deems the corporation to be a new corporation the first taxation year of which commences at the time of the amalgamation. It is not necessary to deem that a fiscal period has not been established, since this is not an existing corporation that needs a fresh start in choosing its fiscal period. The amalgamated company is a new corporation that has never had a fiscal period prior to the current year, and naturally has not yet established a fiscal period.

Regulatory Requirements

Pursuant to both the Bank Act and the ICA, Amalco may elect to have its "financial year" end on either October 31 or December 31, and financial statements coinciding with that "financial year" must be submitted to OSFI. This seems to dictate that Amalco create financial statements in accordance with GAAP for the period ended either October 31 or December 31 for OSFI. The Act, however, has no statutory requirement that Amalco's fiscal period for tax purposes coincide with such a "financial year" established for regulatory and financial accounting reporting purposes.[73]

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[70] Paragraph 5 of *Interpretation Bulletin* IT-179R, May 28, 1993.

[71] Paragraph 138(11.5)(d).

[72] Subsection 249.1(7) is inapplicable, since the corporation is not changing its fiscal period because such a fiscal period has not yet been established.

[73] Subsection 249.1(1) defines a fiscal period as the period for which a company's accounts are made up for the purposes of assessment under the Act, not for purposes of regulatory or financial reporting. Revenue Canada's administrative position confirms this by stating that the fiscal period for tax purposes need not coincide with the accounting year.

Consequently, Amalco, it seems, may choose a day ending before either October 31 or December 31. This may require that Amalco produce business accounts on the day it so chooses. The period used to make up the accounts for assessment under the Act in filing tax returns will become Amalco's fiscal period for the purposes of the Act.[74]

Goodwill

The issue of the creation of goodwill on a merger or on any acquisition is generally an unsought and often intractable issue with which acquirors wrestle. This is especially true for large financial institutions, which bear a heavy capital tax burden. Any combination of large financial institutions that creates accounting goodwill will balloon the balance sheet, resulting in additional capital tax. That is, while the federal capital taxes and Ontario's recently announced harmonization measures with the federal capital tax base do not directly tax goodwill, the ballooning effect on the equity portion of the balance sheet creates additional capital tax. There is also the amortization against earnings, which may affect the market's perception of the firm and so affect its market capitalization.

It may be useful to begin with a quick review of the accounting treatment. The two methods for accounting for an amalgamation recognized as acceptable under generally accepted accounting principles (GAAP) are the purchase method of accounting and the pooling-of-interests method of accounting.

The first method creates a notional purchase price by assuming that the shareholders of one of the predecessor companies control the successor company and assigning a fair value to the assets and liabilities of the notionally acquired company. This calculation of the fair value of one of the entities in an amalgamation is done without an actual realization of the fair value of the company. In other words, the shareholders of the so-called acquired firm would not have had an economic disposition of their interest such that they could show the true economic value of their interest in the acquired company. Economically, what happens is that they received a new class of shares but without realizing any inherent accrued gain on those shares, until an actual sale occurs. Thus, the accounting values assigned to assets are entirely notional.

[74] Section 87 of the Act is applicable for Ontario income tax purposes by virtue of section 29 of the Ontario Corporations Tax Act, RSO 1990, c. C.40, as amended (herein referred to as "the OCTA"). Section 249.1 of the Act applies to the OCTA pursuant to section 1(1) of the OCTA. Accordingly, the federal fiscal period rules apply in Ontario. Section 549 of the Quebec Taxation Act, RSQ, c. I-3, as amended (herein referred to as "the QTA") states that the first taxation year of the new corporation is deemed to begin at the time of a qualifying amalgamation. Section 1 of the QTA defines taxation year in the case of a corporation to be its fiscal period, which is defined in a manner similar to the federal definition.

By contrast, the second method (pooling) yields an entirely different result. The carrying values of assets and liabilities in the predecessor entities are carried forward and combined as carrying values in the successor entity. The pooling-of-interests method would not have yielded a notional "excess purchase price." This method of accounting is similar to the corporate law concept in some jurisdictions[75] of treating an amalgamation as the coming together of two entities without extinguishing either.

Under GAAP, the pooling-of-interests method is used only when the acquiror is not identifiable. A shareholder of either of the predecessor companies continues in the merged entity and is in the same relative position as before except that he owns a smaller interest in a larger entity. The person's basic rights as a shareholder are unaffected under the following conditions:

1) The combination must be effected by an exchange of voting shares.

2) A presumption exists that the extent of voting shares in the combined company held by any one of the predecessor shareholder groups should not exceed 50 percent, subject to an exception that enables one of the combining group to hold some smaller portion above 50 percent provided that certain conditions are met. For example, the composition of the board reflects both entities equally and the management team has representation from both entities.

In practice, the above exception is limited to cases in which one shareholder group holds no more than 55 percent of the voting shares and the other shareholder group holds no less than 45 percent of the voting shares.[76]

Achieving pooling is clearly more desirable should large financial institutions decide to merge, given the capital liability on an ongoing basis and the impact on earnings of a newly recombinant firm, especially where it is in the best interest of the firms to merge or wind up various subsidiaries on an acquisition.

An interesting aspect of the capital tax burden on financial institutions is the impact of the future regulatory framework as recommended (if at all) by the task force. That is, the capital tax burden may increase or decrease if the task force adopts a functional approach to financial regulation such that the deposit taking and certain financial intermediation activities are isolated in a narrow bank so that other activities may fall outside the scope of a regulated financial institution. Finance may find itself having to redefine a financial institution for capital tax purposes.

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[75] For example, Ontario.

[76] There is some controversy over whether pre-combination transactions designed to fit companies within the 45/55 ratio will upset the pooling of interests. Many accountants believe that such transactions should not affect whether pooling is appropriate, while others, including some regulators, believe otherwise.

Canadian Tax Aspects of Demutualizations

The life insurance market in Canada is dominated by Canadian-based mutual insurance companies. In 1995, the top 10 life insurers accounted for 75 percent of the industry's total assets, of which about 60 percent were in the hands of Canadian-based mutual insurance companies.[77] The lack of tier-1 Canadian stock companies is a function of both history and regulation. However, the recent takeover of London Life by Great West Lifeco consolidating the existing stock companies could signal the start of consolidation in the top tier of the industry itself.

Company	*Type*	*Estimated asset size*[a]	*Return on assets*	*Business outside Canada*[b]
Manulife	Mutual	$ 47.2B	1.15%	55.2%
Sun Life	Mutual	$ 45.6B	1.10%	65.3%
Mutual Life	Mutual	$ 27.8B	0.76%	15.6%
Canada Life	Mutual	$ 22.4B	1.07%	47.9%
Great West Life (Pre-London insurance purchase)	Stock	$ 28.0B	1.14%	68.9%
Total	—	$171.0B	1.03% avg.	

[a] Based on 1996 figures. [b] As measured by premium revenue.

Under a demutualization, the converting insurer is generally required to make a fair and equitable distribution of its equity base to eligible policyholders. In practice, this distribution is based on an actuarial determination of the pro rata portion each eligible policyholder has contributed or will contribute to aggregate policyholders' surplus. On this basis, eligible policyholders receive common stock of the new company in exchange for their ownership interest in the mutual company. In some cases, cash or additional policy benefits may be offered. The tax implications of these transactions under current tax law are discussed below.

Mutual companies seem to be caught on the horns of a dilemma: mutualization protects them from takeovers; however, should regulatory barriers collapse, they risk losing market share to integrated competitors in an unconsolidated industry. Outside Canada, many mutuals are demutualizing in anticipation of consolidation (see the accompanying table).[78] It remains to be seen whether the Canadian mutuals will follow.[79]

[77] Derived from 1995 statistics presented in the journal *Canadian Insurance*.

[78] UK building societies were among the first to demutualize by converting to banks (for example, Abbey National and, more recently, Halifax). These societies and former societies are very strong in the mortgage-lending market. Abbey National bought out CIBC's retail mortgage portfolio in the United Kingdom.

[79] For a detailed review of recent demutualizations outside Canada, see "Demystifying Demutualization" (October 1997), *Scotia Capital Markets*.

Country	*Company*	*Listed share price*
Australia	National Mutual	A$1.55 billion
Australia	Colonial Mutual	A$2.57 billion
Australia	AMP	A$10 billion (estimated)
United Kingdom	Norwich Union	£3 billion
United Kingdom	Scottish Amicable	Purchased
United States	Union Mutual	US$25.50 billion
United States	Equitable Life	US$9.00 billion

Current Structures for Demutualization

Current regulations recognize three forms for demutualizing (though the means and needs of restructuring may use some innovative forms): a direct demutualization, a layered demutualization, and an indirect demutualization. A direct demutualization (figure 4) involves the mutual company converting to a share capital corporation and issuing stock and possibly cash compensation to its current members in lieu of their membership rights.[80]

A layered demutualization (figures 5 and 6) uses a holding company for the common shares of the demutualized insurer.[81] The former members receive holding company shares and, possibly, other compensation for giving up their membership rights. This form may allow for an easier subsequent reorganization of the demutualized insurer, as the holding company would act as a buffer between operations and the shareholder, providing management with additional flexibility. This particular form may be used by non-resident insurers for flexibility in the Canadian business after a domestication of the Canadian business ar.d demutualization of the parent.

An indirect demutualization (figure 7) is not a true demutualization, since the members still retain control over the company.[82] Here, the mutual insurer converts to a stock company. The stock company issues common shares to a new mutual holding company. The previous members of the converted mutual insurer become members of the new mutual holding company. The stock company subsidiary gains access to capital markets so long as the mutual holding company controls the stock company. Restrictions on a mutual holding company include, inter alia, not engaging in any other activity other than holding shares in the stock company and investing any excess funds in short-term securities. Dividends received must be paid out within a year. Control is exercised by the members as a

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[80] This form is unlikely to work for a non-resident insurer's branch in Canada for a number of practical as well as regulatory considerations.

[81] Supra footnote 15, section 6(s).

[82] Ibid., section 6(r).

Figure 4

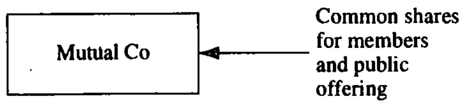


Figure 5

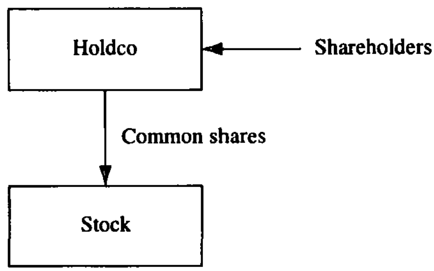


Figure 6

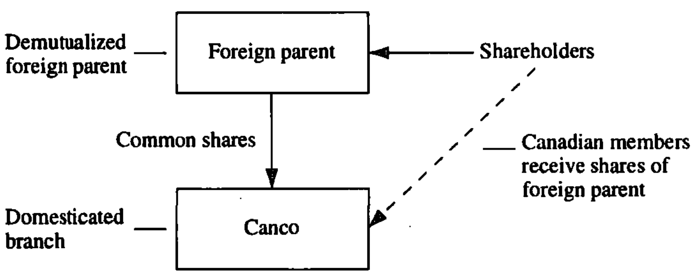
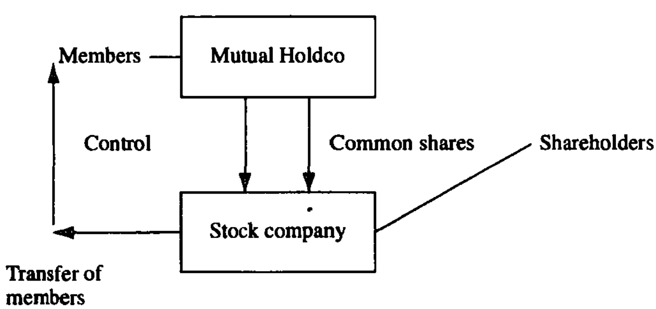


Figure 7



condition of this demutualization so that the holding company legally controls the stock company and sets the dividend policy for participating policies in the holding company. There is room for creative solutions using any of these structures to achieve full access to capital markets on a tax-efficient basis.

Unique Tax Issues That Arise on a Demutualization

The demutualization structure chosen will likely be designed to minimize any current tax cost to policyholders who surrender their membership rights in the mutual in exchange for shares; facilitate subsequent share issuances to achieve a principal objective of raising capital; minimize any immediate tax cost to the company; and remain flexible to allow subsequent restructurings. If access to capital was the only issue, a company could, subject to meeting the regulatory requirements, issue preferred shares.[83]

The corporate tax issues that arise on a demutualization are not substantially different from those which would arise on any major reorganization (and so are not positively unique) once the form of the demutualization is known.[84] That is, the mechanics of a demutualization will raise issues of acquisition of control,[85] including whether any group controls the demutualized company (generally not outside of a sponsored demutualization), the ability to create a cost base uplift on underlying assets, the paid-up capital of the shares issued by the company,[86] and the treatment of restructuring expenses.[87]

More complex issues arise in two areas: restructuring a life insurer for tax efficiency on a worldwide basis and so maximizing shareholder value prior to a demutualization, and policyholder taxation issues. We do not propose to deal with the restructuring issue, as it involves a host of questions beyond the scope of this paper, including international tax rules in various jurisdictions as part of worldwide tax minimization.[88]

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[83] Since 1987, dividends on preferred shares will generally give rise to a form of advance corporation tax, which has made them less attractive as a source of funds to non-taxable entities. With recent tax changes applicable to life insurers and a trend away from foreign branching, a higher incidence of mainstream taxes may make preferred shares more attractive.

[84] See M.J. O'Connor, "Demutualization: Recent Transactions, Tax Problems and Solutions," Fourteenth International Conference on Insurance Taxation, 1997, Centre for Tax Education and Research, at 2-35.

[85] See, for example, subsection 256(8.1), discussed further below. A change of control will trigger a number of tax issues, including, inter alia, a deemed year-end, expiry of capital losses, the streaming of non-capital losses (that is, rules not unique to an insurer), and "mark-to-market" issues. A widely held company will not face this issue after the conversion.

[86] See section 70 et seq. in part V of the ICA.

[87] Share issue costs are deductible straight-time over five years while three-quarters of an eligible capital expenditure is deductible at 7 percent per annum on a declining-balance basis.

[88] See Allan R. Lanthier and James J. Tobin, "Worldwide Tax Minimization," 1996 Conference Report, vol. 2, supra footnote 36, 36:1-37.

Canadian Tax Implications for Policyholders on Demutualization

The tax implications for policyholders will depend on a number of factors, including the manner in which the transaction is implemented, whether the converted company is a resident of Canada for income tax purposes, the residency status of the policyholders affected, the articles of the company and specifically the membership rights granted thereunder, the form (and quantum) of the compensation paid to members for surrendering their membership rights in the converted company, the tax status of the member-policyholder, the tax laws applicable in a foreign jurisdiction, and any double taxation relief available in a relevant tax treaty.

What Constitutes a Share

Some uncertainty in the Canadian tax treatment of policyholders involved in a demutualization stems from the fact that a mutual company does not have any issued capital stock. For Canadian tax purposes, the term "share" is defined to mean, inter alia, a share of the capital stock of a corporation.[89] Revenue Canada has taken a broader view for certain purposes of the Act, and has stated that, when dealing with participating interests in foreign corporations,

> in those instances in which the ownership of a foreign business entity is not divided into units entitled "shares," and in which the foreign business entity is considered to be a corporation, the Department views the foreign business entity as if it had a capital stock of 100 issued shares.[90]

It is unclear whether Revenue Canada would apply similar relief in the context of a demutualization of a foreign insurer to facilitate the Canadian tax objectives of a particular transaction. It would appear a simple enough matter for Finance to extend, for greater certainty or otherwise, the definition of "share" to include proprietary interests in mutual insurers if Revenue Canada's administrative largesse is otherwise unavailable. This simple change may preclude the need or desirability for more complex tax legislation for one sector only on a one-time transaction only.

The policyholder tax implications will depend on the transactions being proposed, and these will likely involve some variation of the transactions to accommodate the situation. In addition, the implications will depend on whether the policyholder's membership in the mutual is construed as a share of the capital of the insurer. Two results are possible:

1) If the proprietary interest constitutes a share of the corporation, it may be possible to defer recognition of any gain provided that the membership is

[89] The term includes, for greater certainty, a share of the capital of certain co-operative corporations and a share of the capital of a credit union, both entities that typically issue no capital stock.

[90] *Interpretation Bulletin* IT-392, September 26, 1977.

a capital property to the member and the consideration for the exchange is another share of that corporation.

2) If the interest is not a share, then the implications will depend on whether the consideration includes shares of a Canadian corporation. It will be possible to defer recognition of any gain under this interpretation only so long as the consideration for the exchange includes shares of a taxable Canadian corporation and any non-share consideration does not exceed the member's adjusted cost base in the membership rights.[91] However, a joint election between the policyholder and the converting company must be filed to obtain this treatment.[92] Where this election is not made, the taxpayer will be deemed to have received a dividend which will constitute the adjusted cost base of the shares for future capital gains tax purposes.

Under this result, if the converting company is a not a Canadian corporation, then the value of the shares issued will constitute proceeds of disposition for the member's interests and will result in a capital gain (assuming that the adjusted cost base of the membership interest is nil).

In a layered demutualization, this transaction can be achieved on a tax-deferred basis using the "property for share exchange" provisions discussed above. Non-residents may also defer Canadian tax using one of these exchange provisions, but generally will not be taxable in Canada on any gain. It is unclear whether the tax deferral provisions would apply on an indirect demutualization.

Opportunities for Deferring Gains

While holders of certain property may generally transfer that property to a Canadian corporation in exchange for shares on a rollover basis, there are only a limited number of "outbound" rollover provisions (that is, transfer of property by a resident of Canada to a foreign corporation on a tax-deferred basis). Accordingly, demutualizations involving foreign insurers with Canadian-resident members may potentially require tax to be paid in Canada by such members at capital gains rates. Where a demutualization event is in the form of a policy dividend, policy dividends reduce the adjusted cost basis of the policy. Where the adjusted cost basis of a policy becomes negative, there is an immediate income inclusion.

Relevant Case Law

Policyholder tax implications were addressed to some extent in *Sirois v. MNR*.[93] The issue was whether the amount a policyholder received upon

[91] Where the membership and any proprietary interest attached thereto were granted as a consequence of being a policyholder, the adjusted cost base will be nil.

[92] While it is not unusual in a public company transaction to offer the requisite tax elections, it is generally avoided because of the administrative and logistical requirements of doing so.

[93] 90 DTC 1840 (TCC).

disposing of his membership in a mutual insurance corporation when it became a publicly traded company was taxable as a disposition of an interest in an insurance policy. The situation involved a mutual insurance company transforming itself into a publicly traded stock company under US law. The taxpayer received a cash amount for disposing of his membership, including his proprietary interest in the company's surplus.

The minister had initially assessed the amount received as a dividend, but acknowledged the assessment to be incorrect and argued the case on the basis that the payment constituted a disposition of an interest in a life insurance policy, and was taxable as ordinary income.

The court disagreed and held that the amount was taxable as a disposition of a capital property. The court noted that the life insurance policies remained intact under the conversion to a stock company. The court noted that in the particular situation

> [w]hat the Appellant received was proceeds from the disposition of those property rights held merely in connection with, or incidental to, his interest under the subject policies.[94]

The motivation for Revenue Canada's attack may seem unclear, given that the tax rate differential in today's terms would only be on the order of 10 percent. However, an additional benefit that existed at the time of the demutualization of Mr. Sirois's insurer (Union Mutual) was a $100,000 exemption from capital gains taxation, which meant that the entire amount would have been tax-free to those Canadian policyholders.[95]

Revenue recently considered proprietary (or membership) rights obtained by policyholders at the time they acquired an insurance policy capital property. Following the *Sirois* decision and based on the facts presented, Revenue Canada concluded that such property constituted capital property.[96]

Means of Effecting a Demutualization

Some structures are available as a means of demutualizing without the need for specific Canadian tax rules while mitigating or deferring any immediate tax cost to Canadian policyholders. Strategies may include using a stock dividend as a demutualization vehicle, qualifying a demutualization as a foreign merger, using an exchangeable dividend access structure, or using either a policy dividend or a taxable dividend.

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94 Ibid., at 1842.

95 Ironically, in the United States, UNUM itself attempted to claim certain transaction benefits as policy dividends to obtain a deduction for US tax purposes. In *UNUM Corp. v. US*, 96-2 USTC 50, 346, the US District Court held that the transaction benefit in *Sirois* was not a policy dividend for US tax purposes. The lower court's decision was confirmed on appeal.

96 See Revenue Canada document no. 9641573.

Speed to Market: Using a Stock Dividend

On a demutualization, existing rollover relief is difficult in that relief applies where "shares of the capital stock" of a corporation have been transferred. In the case of a mutual, the member's interest is not necessarily assimilable to a share. A stock dividend (subject to regulatory requirements)[97] may achieve a tax rollover for Canadian (and possibly US) policyholders without a filing obligation and a deemed dividend for tax purposes if desirable, and may be easier to implement and explain to policyholders and the marketplace.

For Canadian tax purposes, a stock dividend means "any dividend . . . paid by a corporation to the extent that it is paid by the issuance of shares of any class of the capital stock of the corporation."[98] The tax treatment of a stock dividend is identical to the treatment for any other dividend; that is, the amount of the stock dividend is included in the recipient's income.[99] The amount included in income is the amount that is added to the stated capital of the shares when issued. To avoid immediate tax consequences, the amount that would be added to the stated capital would be nominal. Other issues that arise on receiving a dividend also apply, but depend on whether the recipient is an individual,[100] a corporation,[101] or a non-resident.[102] If it was desirable to trigger a dividend, such policyholders could be offered a stock dividend with a higher amount added to the stated capital of the shares. The cost base of the shares for the purposes of computing any future gain would also be equal to the amount that is added to the stated capital and included in the taxpayer's income. If only a nominal amount was added, then the cost base would be a nominal amount.

From an accounting perspective, the stock dividend may simply be an entry to the stated capital account of the common shares issued on the demutualization consistent with the thinking that the event merely evidences the policyholders' interests.

Foreign Mergers: Foreign Demutualizations

A taxpayer resident in Canada may defer recognition of a gain in shares of a foreign corporation disposed of in a qualifying foreign merger. A qualifying foreign merger is a merger of two or more foreign corporations to form one corporation resident in the same country, combined such that

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[97] See, for example, sections 70(1), 70(2), 83(3), and 464 of the ICA.

[98] Subsection 248(1) of the Act.

[99] Subsection 82(1), although note that paragraph 12(1)(j) does refer to shares of capital stock.

[100] For example, dividend gross-up and credit.

[101] For example, part IV tax, subsection 55(2), or part VI.1 tax.

[102] For example, non-resident withholding taxes.

all or substantially all of the property and liabilities of each predecessor become property or liabilities of the merged entity, and all or substantially all of the shares of each predecessor are exchanged for shares of the merged corporation. Since the rollover only applies to shares owned by a taxpayer in the capital stock of a predecessor, the foreign merger rules will have limited application, unless membership rights are regarded as a part of the capital stock of the predecessor under the relevant foreign laws, in which case the rollover of any accrued gain may still be possible.

Exchangeable Dividend Access Structure: Restructuring Prior to Demutualization

One common strategy in structuring cross-border acquisitions when structuring a merger of a Canadian corporation with a non-Canadian group is the use of exchangeable dividend access shares to obtain a deferral of gains in Canada.[103] This involves forming a Canadian holding company to which the policyholders would transfer their membership rights in exchange for shares. These shares would be exchangeable at a later date into shares of the foreign parent, and possibly will pay dividends equal to the dividends paid by the foreign parent. The benefits of such a structure include deferral of Canadian taxation as well as continuing to qualify the dividend yield to investors for preferential treatment when held by Canadian taxpayers.

Policy Dividend or Taxable Dividend

An alternative strategy may be to structure the transaction benefit as a policy dividend. Although the structure is complex from the policyholder's perspective in terms of the particular contract of insurance, it is possible that the amount of the transaction benefit would not necessarily be taxable immediately.[104] The company, on the other hand, would obtain a deduction in computing its income. In the normal course of events, participating policies receive policy dividends based on the distributable profits of the mutual insurer. In a demutualization, future policy dividends will come not from the distributable profits of the various participating funds but will generally be structured such that future policy dividends are unaffected. Accordingly, any transaction benefit may in effect be over and above a policyholder's dividend expectation, and therefore would potentially be regarded solely as compensation for the loss of the membership right.

Alternatively, structuring the transaction to create a taxable dividend for Canadian tax purposes will generally only be attractive for Canadian mutual companies, since dividends paid to individuals from taxable

[103] This is often done to achieve pooling-of-interests accounting in the United States. Note that the FASB has indicated that it intends to revisit the availability of pooling in these circumstances with a view to eliminating it.

[104] It may be taxable if the adjusted cost base of the policy goes negative.

Canadian corporations are eligible for a dividend tax credit and will therefore be taxable at a top rate of approximately 35 percent, which is presently lower than the equivalent rate on capital gains. Note that while a dividend may be attractive to a Canadian resident in certain situations, a capital gain may be more attractive to a non-resident.

Domestication of a Canadian Branch of a Foreign Insurer

For a non-resident insurer (Parentco) carrying on a business in Canada, the first step in an overall reorganization is often domesticating the Canadian branch (Canco post-domestication) on a tax-efficient basis.[105] Domesticating a branch insurance business may be done on a tax-deferred basis, provided that certain requirements are met: (1) the non-resident insurer ceases to carry on all or substantially all of an insurance business carried on in Canada; (2) the non-resident insurer has transferred all or substantially all of the property owned and used in the insurance business to a qualified related corporation (QRC);[106] (3) the QRC assumes all or substantially all of the obligations of the transferor that arose in the course of the Canadian insurance business; and (4) a joint election is made by the non-resident insurer and the QRC.

The rollover provisions generally allow for a complete flowthrough of all the tax attributes of the branch to the corporation at the branch tax values, including losses brought forward by way of underclaimed reserves. A domestication may be with either a new subsidiary or an existing one, but ultimately must be owned by the same parent.

Transfer of the Business

Assuming that a choice was made to proceed under subsection 138(11.5) of the Act,[107] the transfer of the business requires that the election under that subsection meet the four preconditions in that subsection. Further, Parentco may deduct its closing reserves, determined immediately before the year-end that is deemed to occur at the time of transfer, and Canco is required to bring those reserves into income as opening reserves on a going-forward basis on the domestication election. Canco's agreement to

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[105] See, for example, the demutualization of Norwich Union.

[106] A QRC is essentially a direct or indirect wholly owned subsidiary of the non-resident insurer or one that is under common control with the non-resident insurer. The definition is complex and requires careful attention to any subsequent corporate reorganizations.

[107] An asset transfer is deemed to occur at fair market value unless a relieving provision applies, such as a transfer to a qualified related corporation and electing under subsection 138(11.5) to defer the tax that would otherwise be payable on a transfer at fair market value and to obtain other "flowthrough" treatment. Alternatively, one might consider an election under subsection 85(1), provided that Canco issues treasury shares to the Parentco as part of the consideration for the assets and that other criteria are met (including restrictions on the value of non-share consideration); then the assets should be transferred at their tax basis.

assume Parentco's reserves is valued equal to the tax value of the reserves deducted by Parentco immediately before the transfer, so that no income or loss results from any difference between the assumption premium and the tax value of any assumed reserves.

The election is available only where Parentco, carrying on the branch business, has ceased to carry on all or substantially all of the business in the year and has at that time or within 60 days thereafter transferred all or substantially all of the property used in that business to Canco. Thus, delayed transfers (due, for example, to regulatory difficulties) may not comply with the election provision.[108]

If the deemed year-end rule applies where a domestication occurs, both Parentco and Canco are deemed to have year-ends. Assuming that a rollover transaction applies, shares of the Canco held by Parentco after the domestication and after the withdrawal of the branch business will be taxable Canadian property for the purposes of the Act, and any capital gain realized on their disposition will be subject to capital gains tax unless a tax treaty exempts the gain. Generally speaking, if Parentco no longer carries on business in Canada and has no permanent establishment in Canada, and if the value of the Canco shares is not derived principally from Canadian real property, the treaty exempts the gain from Canadian tax. Clearance certificates may be needed at that time.

Branch Tax Deferral and PUC

Branch tax is not payable by Parentco, but if it elects it may deduct in computing its Canadian investment fund[109] (CIF) as at the end of the immediately following taxation year a specified amount, within limits. If it does so, it will be required to pay a 25 percent branch tax on an amount equal to the difference between the reduction in its CIF and the amount elected on a branch domestication.[110] The elected amount to deduct from the CIF and on which branch tax is payable is based on the excess of any surplus earned after 1968 over a "minimum attributed surplus."[111] A foreign

[108] For example, cash may be injected from the foreign branch to capitalize the Canco before the actual domestication (while the Canco is obtaining its licences and meeting the initial capital requirements under the Act). If that capital invested for initial common shares is not part of the domestication, and in particular if this occurs more than 60 days before the actual transfer of the business, the paid-up capital may not be counted for the branch tax deferral under subsection 219(5.2) and the transfer of assets will not be eligible for certain elections.

[109] Regulation 2405(3).

[110] Basically, the CIF are investments considered to be used in the branch and thus are treated as giving rise to Canadian tax. Specific assets are identified to make up the CIF. Investment income on other assets outside the CIF is generally subject to non-resident tax at a flat rate. As a registered insurer, the foreign insurance company is generally not subject to withholding, but must pay tax on filing a T2016 return. See regulations 800, 801, 802, and 803.

[111] "Attributed surplus" is defined in subsection 219(7) with reference to regulation 2405(3), "attributed surplus."

insurance company that ceases to carry on all or substantially all of an insurance business in Canada is liable to pay branch tax, which depends on whether surplus has been accumulated in the branch and on whether branch tax has been paid in previous years.

Ceasing To Carry On Business

Upon ceasing to carry on business, tax[112] is paid on the amount determined following the "regular" branch tax calculation[113] that can reasonably be attributed to the business, including any disposition of property used in carrying on that business,[114] less any amount elected on the transfer of assets to a QRC.[115] The liability for branch tax arises where the foreign insurer has ceased to carry on "all or substantially all" of a particular insurance business in Canada.

Where Parentco has ceased to carry on all or substantially all of an insurance business in Canada and has transferred that business to Canco (as a QRC), and both corporations have filed an appropriate election, they may elect to reduce the amount that would otherwise be subject to branch tax. This reduction may not exceed the total of the PUC on the newly issued shares of Canco and any contributed surplus arising in Canco on the share issuance. Thus, if Canco is capitalized with appropriate share capital and contributed surplus, a deferral of the branch tax is available. The adjusted cost base of the shares issued on the election will be the amount by which the total cost base of the property transferred exceeds the fair market value of obligations assumed and any other non-share consideration received.

Where (at any time in a taxation year) the QRC ceases to qualify as such or its "tax-deferred account" exceeds the total of the PUC and contributed surplus, the QRC is deemed to have paid a dividend to the foreign insurer. The dividend will be subject to withholding tax as reduced under an applicable tax treaty. The tax-deferred account is defined as the amount elected to be deferred on the to transfer to a QRC. Thus, the PUC and contributed surplus should be equal to *at least* the deferred branch tax.

Future repatriations of capital will be affected by the tax-deferred account no matter what structure is used to repatriate capital. A dividend is deemed to be paid to the "insurer," which means the insurer at the time of the domestication; ergo, the appropriate withholding rate (depending on the corporate structure) may not be to the current parent but that which is applicable to Parentco. Cash dividends out of Canco do not reduce the tax-deferred account.

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[112] See subsection 219(5.1).

[113] Subsection 219(4).

[114] This would be designated insurance property—that is, property designated by the insurer as being in respect of the CIF.

[115] See subsection 219(5.2).

Paid-Up Capital and Contributed Surplus[116]

Special rules govern the calculations of Canco's PUC and any contributed surplus arising on the election.[117] Generally, where an election is not made under subsection 85(1),[118] the PUC is ground down to the extent that the PUC exceeds the "cost" of the transferred property to Canco less the fair market value of any non-share consideration received. Thus, PUC is created to the extent that the non-share consideration (property or an assumption of liabilities) received by Parentco is less than the elected amount. Any attempt to increase the PUC over that amount will not be recognized.

The contributed surplus otherwise arising on the transfer will be reduced to the extent that the fair market value of non-share consideration taken back on the transfer, plus the total increase in PUC,[119] plus the increase in contributed surplus otherwise determined exceeds the "cost" of the transferred assets under the relevant election and any PUC reduction.

Forgone Tax Benefits

For foreign insurers, domesticating a branch may result in increased taxes on investment income, since the "Canada only" tax rules will no longer be available. Accordingly, all assets used in the business will be subject to tax. As a result, other means of managing the company's Canadian tax exposure should be examined. Other tax considerations will be applicable, particularly in respect of a domestication where assets of the insurer include real property and depreciable property. These include provincial corporate income taxes, the federal goods and services tax, provincial land transfer taxes, provincial sales taxes, Quebec services tax, and the harmonized sales tax (federal and provincial) in certain provinces.

Back Office Alliances

Back office operations have moved to an area of strategic priority. The new operating model that is emerging is "one-touch" processing, which means that a transaction is entered into a system only once, by either the customer or an employee, and subsequently posted to all core systems. Electronic funds transfer has been ranked among the three most important home-banking services. Back office operations are moving from the traditional people-intensive operations to electronic state-of-the-art operations which require large investments in technology. As value networks evolve, operational areas of the business are becoming highly specialized. Many areas such as securities processing, credit card acquisition, and processing

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[116] Subsection 138(11.9).

[117] Subsection 138(11.7).

[118] A subsection 85(1) election generally does not provide as much coverage as the specific election under subsection 138(11.5) and does not permit the branch tax deferral election under subsection 219(5.2).

[119] Determined without taking into account the special rules in subsection 138(11.7) or 85(2.1).

are consolidating—and may be dominated by non-financial institutions (that is, specialists in that technology). Direct banking may allow a company to outsource most or all of its operations.[120]

Types of Alliances

Over the last two years, various financial institutions have merged certain of their backroom operations in a bid to achieve cost savings. The Toronto-Dominion Bank, the Bank of Montreal, and the Royal Bank have entered into an alliance with respect to cost savings. Similarly, the Canadian Imperial Bank of Commerce set up the Intria Corporation in an alliance with FiServe to undertake its back office operations. Clearly, some banks have realized that they have certain specialized capabilities which can be "spun off" in a limited fashion and marketed, while other financial institutions have begun to realize that outsourcing their backroom operations may be cheaper and more efficient. That is, they do not have to continually invest in technological upgrades and may benefit from the upgrades that others undertake. It remains to be seen whether these specialized corporations will be able to cross-market their services to other non-bank institutions in the financial services area.

Other strategic alliances involve the introduction of new technologies such as debit cards and cash cards, including the rival systems of Proton, Mondex, and Visa Cash.[121] The introduction of such technologies to Canada usually involves various alliances, including publicly announced alliances such as Exact Canada.

Tax-Efficient Structures

These types of alliances usually involve both financial institutions and non-financial institutions with different cultures, tax profiles, and profit expectations. Consequently, one sees many different profit-split structures with concomitant share structures to reflect this.

One such arrangement involves setting up a cooperative structure with either a share corporation or a non-share corporation. Under these structures, the participants are able to agree on their goals and objectives and on profit splits based on capital contributions, business brought to the venture, and other types of tangible and intangible contributions. As with most structures, the tax objective is to minimize taxes in the venture so as to improve the return out of the venture. For example, using a cooperative structure and paying patronage dividends may be one method of structuring the alliance while keeping the terms of the alliance flexible enough to achieve the tax objectives of the customers.[122]

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[120] Supra footnote 9, at 5.

[121] See "Electronic Money: Chipper for Now," *The Economist*, April 26, 1997, 72-77.

[122] See section 135 of the Act.

A patronage dividend is similar to a volume rebate paid to a customer who purchases a certain volume of product. Similar to a volume rebate, the terms of the dividend are agreed upon at the beginning of the year and assessed at the end of the year. Patronage dividends could, in theory, reduce a corporation's profits to nil. A contract is the usual means by which the patronage dividend is held out to the customers which should be in place prior to the start of the taxation year in which the dividend is paid. While a "normal" dividend is paid out of the after-tax profits of a company, a patronage dividend is paid from pre-tax profits and therefore reduces the net income subject to tax in the hands of the payer/venture. For a payment to qualify as a patronage dividend and be deductible in computing income, it must be made pursuant to allocations in proportion to patronage. As well, all customers must be credited equally for similar goods or services, and the amount must be paid to the customer within the taxation year for which the allocation is made or within 12 months after the end of that year.

This vehicle is fairly flexible, as a patronage dividend can be paid from any type of income, in cash or kind, by way of setoff or by payment or transfer of property to another person upon instruction.

GST Implications

Another key issue to note is the effect of the GST on financial institutions. Paying an additional 7 percent on transactions between venturers usually stops the deal and demonstrates one of the policy inefficiencies in the application of the GST to financial institutions. Further, the limited methods under the GST of transferring assets to a venture on a tax-free basis (unlike the Act) is another barrier to such ventures. The election to treat corporations controlled by financial institutions as financial institutions and so group the corporations together is one means of bypassing the strictures of the GST on intracompany transactions.[123] Provided that all contracts from arm's-length financial institutions are run through another financial institution, it may be possible to avoid charging GST on a transaction.

Another but more difficult means of bypassing the GST so as to allow the financial institutions to efficiently organize their operations is to use the rather limited CPA exemption in the GST regulations. Under the GST, the financial services regulations provide that:

> 3. Any service in relation to the clearing and settlement of cheques and other payment items under the national payments system of the Canadian Payments Association that is supplied by the Association or any of its members is prescribed for the purposes of paragraph (m) of the definition "financial service" in subsection 123(1) of the Act.[124]

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[123] Section 150 of part IX of the Excise Tax Act.

[124] Financial Services (GST) Regulations, PC 1990-2735, SOR/91-26 (1991), vol. 125, no. 2 *Canada Gazette Part II* 104-7, as amended, under part IX of the Excise Tax Act, as amended.

However, to use this exemption, the particular corporation must be a member of the CPA and the items must fall within the scope of "cheques and other payment items." Further, the regulation also provides that the transfer, collection, and processing of information and any administrative service, including those in relation to the payment or receipt of dividends, interest, principal, claims, benefits, or other amounts, are not financial services, subject to a supply of the service by a person at risk (and certain other related persons). Thus, there must be some as yet undefined element of risk. The GST here is an impediment to the financial services sector organizing its businesses in different units. While the impediment is not insurmountable, it does stand as an economic barrier to reorganizing the various business units in financial institutions. The impact of the changing CPA role and its membership remains to be seen.

Tax Issues in Foreign Branch Banking

The new ability of foreign banks to set up branches in Canada subject to regulatory requirements raises a number of structuring questions for those with operations in Canada and those seeking to establish operations in Canada. For those financial institutions without a Canadian presence, the issue is whether to set up a subsidiary or a branch. For those with existing subsidiaries (as required under the previous regulatory regime), the question is whether to continue as a subsidiary, convert the subsidiary's operations to a branch, or simply let the branch and the subsidiary run parallel.

The taxation of a branch has been dealt with elsewhere exhaustively, so we propose only to identify some issues of interest, including some unresolved issues on the federal proposal to allow foreign banks to operate branches in Canada.

Branch tax is presently imposed on Canadian banks carrying on business through branches in the United States. However, under subsection 219(2) of the Act, banks are exempt from branch tax in Canada. Special rules apply in computing branch tax for insurance companies.[125] Special rules would have to be drafted to apply this tax to banks (if exemption is not maintained), as the general rules in regulation 808 for the investment allowance do not seem to work properly. Some treaties (for example, with the United States) have a de minimis exemption of $500,000 of cumulative profit before branch tax applies.

Operational Issues

Currently, many subsidiaries of foreign banks are charged a royalty, franchise fee, or similar charge for the use of the name and access to the global marketing system of the foreign bank. Federal withholding (subject to treaty relief) and Ontario tax may apply to such non-arm's-length

[125] While banks are generally not defined under the Act, see section 35(1) of the Interpretation Act, RSC 1985, c. I-21, as amended.

payments. With a branch, unless there is an actual "cost" to allocate, it may be difficult to deduct from or reduce branch revenues for such charges.

Banks often face choices as to where to "book" a particular loan or other profitable business. Problems can be experienced with tax authorities as to whether a loan that has some connection to a particular jurisdiction should be booked there. For subsidiaries, this problem can often be resolved by paying a finder's fee, commission, or similar amount to the branch that originates or sources business for the network. With a branch this is more difficult to resolve, and banks may generally find it preferable to book all Canadian business in their Canadian branch to avoid possible conflict with Revenue Canada. However, Canada, strictly speaking, has no "force of attraction principle" under domestic tax law, and treaties support the "separate enterprise" approach. Accordingly, there may be circumstances where business with Canadian customers is booked at a foreign branch where foreign personnel have a substantial involvement in the business and where a Canadian withholding tax exemption is available.

Thin Capitalization

Interest expense is disallowed to a Canadian corporation on the highest amount in the year by which debts to specified non-residents exceed three times equity under subsection 18(4) of the Act. These rules presently apply to schedule II banks, although, as withholding tax also applies to any related-party debt, deposits or debenture liabilities that trigger this disallowance have rarely been encountered in practice.

Foreign corporations are not subject to this limitation on related-party financing cost, so a Canadian branch of a foreign corporation could obtain a full deduction for interest expense on financing from other foreign corporations. There is, however, a general reasonability test, sanctioned by treaties, which Revenue Canada may assert in extreme cases to limit interest deductions.[126] Furthermore, when the financing cost is allocated from head office on liabilities that are not booked in the Canadian branch, Revenue Canada can be expected to review the reasonability of such allocations.

The Bank Act will likely determine that 5 percent liabilities is a reasonable level of capital to maintain. (By comparison, 4 percent of assets is presently used for the International Financial Centre income determinations.) It follows that Revenue Canada should allow interest expense on all liabilities of the branch (or an allocation of financing cost on the head office account) to the extent that branch liabilities exceed the capital equivalence deposit. It seems inappropriate that the "three times equity" restriction should apply to schedule II bank subsidiaries in these circumstances.

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[126] See section 67 of the Act.

Reserves

Paragraphs 20(1)(l) and (p) of the Act provide for a reserve for doubtful loans and lending assets and a writeoff for the uncollectible portion of such assets, respectively. This mechanism provides for credit-related losses as incurred. If a loan suffers a gain or loss from interest rate risk, the loss cannot be recognized on a mark-to-market basis or through the inventory rules. If the asset is sold, the loss is amortized over the remaining term of the loan to match the loss against the related deposit financing cost.

These losses are not subject to the superficial loss rule in subsection 18(13) by virtue of subsection 142.6(7). It is not clear what the tax cost for Canadian purposes will be for a loan transferred to the Canadian branch from other than a Canadian vendor (for example, a schedule II subsidiary) at a time when there may be some value impairment. For some purposes, the Act redetermines "cost" to be fair market value at the time an asset becomes relevant for Canadian tax purposes. There is no general rule that would apply to loans or lending assets transferred to a Canadian branch by a foreign corporation.

Specific loss reserves are limited to the "reserve reported in the financial statements" of the taxpayer. We can assume that this will be interpreted as referring to OSFI statements for a foreign bank rather than statements prepared in a different currency under different GAAP for shareholder reporting in a foreign jurisdiction. Discounting is now being applied under Canadian GAAP in computing loan loss reserves. It is understood that Finance is presently drafting legislation to deal with this issue. No specific rules for losses exist where loans are transferred to a foreign branch from a Canadian branch.

Withholding Tax

If income is attributable to a Canadian branch, regulation 805 establishes that Canadian tax should apply to the net profit of the branch, and no Canadian withholding tax applies to gross income. To provide certainty to the payer, a certificate can be obtained under regulation 805(2) that no withholding is required. To obtain such certificates for every loan would be a needless burden. If foreign withholding tax is suffered on interest or fees paid to a Canadian branch, no credit is available under section 126 of the Act. Credit may be allowed under the terms of certain treaties—for example, the non-discrimination clause in article XXV(6) of the Canada-US treaty.

Only residents of Canada are generally required to withhold Canadian tax on payments to non-residents. Certain non-resident persons are deemed to be resident in Canada for this purpose under subsection 212(13.2) of the Act. As presently drafted, a foreign bank with a branch in Canada would not be deemed to be resident under subsection 212(13.2) and would not be required to withhold tax on any payments made to foreign persons.

Some countries (such as the United States) impose a withholding tax on payments made by a foreign corporation outside their jurisdiction to the extent that the payment is allocated to the local branch and deducted in computing its trading profit. Canada presently has no such taxation requirements. It seems illogical that foreign banks should have a competitive advantage over domestic banks, and some changes to these rules will likely occur. It is hoped that harmony will be achieved by increasing exemptions for domestic banks rather than increasing restrictions for foreign banks.

Capital Taxes

The federal large corporations tax (LCT) is calculated under subsection 181.3(1) of the Act as the sum of the carrying value of tangible property used in the business in Canada (other than loan realization property) and the proportion of the corporation's capital that Canadian assets are to total assets. This requires determinations of capital on a global basis, which can be time-consuming and difficult and which permits substantial swings from year to year as a result of foreign currency translation.

The recent Ontario changes aimed at harmonizing its capital tax treatment of financial institutions with the federal LCT do not, apparently, change the rules in section 63(1) of the Corporations Tax Act. Under that rule, all foreign corporations determine taxable capital as the greater of income capitalized at 8 percent and the amount by which total Canadian assets exceed current accounts payable—a clearly inappropriate result for a bank.

Mark-to-Market Rules

The mark-to-market rules in section 142.2 of the Act apply to financial institutions, which, as defined, include "a bank." Property held at the time a corporation becomes a bank is deemed to be acquired at FMV. However, there is no specific rule with respect to property held by a bank which is transferred to a Canadian branch from another branch of the foreign bank. It is assumed that income attributable to a branch will only include gain (loss) accruing after the Canadian branch acquires the asset. An amendment to section 142.6 would help clarify this issue.

Foreign corporations are not private corporations under the Act, and so are not subject to part IV tax. Banks are exempt in any event under section 186.2. There appear to be no special issues with respect to a bank establishing operations under the international financial centre rules in section 33.1 and benefiting from the tax exemption for international income earned therein. However, the bank must be a member of the Canadian Payments Association to be "prescribed" as eligible under regulation 7900.[127]

Shareholder Benefits

Subsection 15(2) of the Act provides that where a Canadian corporation makes a loan to a foreign shareholder (or a person connected with the

[127] See the previous discussion on membership revisions to the Canadian Payments Association.

shareholder), the amount of the loan is deemed to be a dividend unless it is repaid by the end of the following year where the repayment is not part of a series of loans and repayments. There is an exception for loans made in the ordinary course of the creditor's business on reasonable repayment terms. It is not clear that a deposit by a schedule II bank subsidiary with a branch of its parent in Canada will meet this "ordinary course" exception.

Conclusion

Canada's financial service sector has long been protected from global forces in the domestic market. Interestingly enough, the federal government enabled different means of protection for different parts of the sector. The life insurance industry, for example, was allowed to mutualize; the companies were turned inward without the scrutiny of the capital markets and shareholders. A specific tax and regulatory framework was put in place to allow them to mutualize.[128] No one person owned a mutual company or could own a mutual company without a change in the corporate form. By comparison, the banks were kept public with a widely diversified shareholder base and were subject to the intense scrutiny of the capital markets. No one person was allowed to own a schedule I bank, and informal restrictions rather than any explicit rule prevented mergers.

This rigid protection afforded to the Canadian institutions fostered their development as cornerstones of the Canadian economy. This may have inhibited the full growth potential of the regulated financial services sector. Such regulation had the effect of preventing the entry of new competitors into the same market, with the result that non-financial institutions and foreign financial institutions entered into niches (with mixed success) either not open to Canadian financial institutions or were slow to enter such niches (given regulatory protection of their core businesses). Regulation, coupled with changes in technology, seems to have in effect forced non-financial and foreign financial institutions to innovate their way around the regulatory regime.

The federal government faces a dilemma. On the one hand, a long-protected market is slowly being opened to foreign competition at a time when domestic enterprises are constrained from consolidating the domestic markets. At the same time, releasing the restrictions on domestic consolidation may, in the short term, reduce competition unless foreign enterprises are present to balance the potentially dampening effects on competition from domestic consolidation. At the domestic level, the big banks face both tighter restrictions and more protection than the insurers. Under the Bank Act, the 10 percent ownership restriction cannot be overridden by ministerial discretion, whereas the 10 percent ownership restrictions of a stock insurer can be. Should the mutual insurers demutualize at some point in the future, under

[128] See section 139 of the Act, which deals with the mutualization of provincial enterprises, and sections 91(1) and (22) of the Canadian and British Insurance Companies Act, RSC 1985, c. I-12, as amended.

current rules they could, subject to ministerial discretion, be acquired by a schedule I bank, whereas once demutualized they would not be in a position to do the reverse. Accordingly, without changes in the regulatory regime to create a level playing field, domestic consolidation could be a one-way street, as was the case when the investment dealers joined forces with the banks in the late 1980s.

Appendix 1: Constraints on Consolidation in Canada's Financial Services Sector

Entity	*Action*	*Constraints*
Schedule I banks	Takeovers, mergers, and other forms of consolidation	• 10 percent ownership restriction: no investor may own more than 10 percent of any class of shares of a schedule I bank.
		• "Big shall not buy big" restriction: informal policy applied by the minister of finance to requests for regulatory approvals of mergers and other discretionary transactions.
		• Commercial links restriction: policy that the regulated financial sector should not be directly linked with commercial enterprises, particularly as to downstream investments.
		• Unable to sell insurance through branches or carry on some types of businesses (such as automobile leasing).
Insurers	Demutualization and subsequent mergers or takeovers	• Mutuality—lack of access to capital markets; restrictions/lack of clarity on size; "widely held" requirement after a demutualization.
		• No acquisition currency and no ability of market to evaluate companies.
		• No regulatory framework for demutualization or post-demutualization.
		• "Widely held" requirement following demutualization may prevent takeovers.
		• 10 percent ownership restriction, subject to ministerial discretion.
		• Restricted ability to issue stock options post-demutualization.

Appendix 2: Overview of Certain Taxation Impacts

Takeover Bid Structured To Yield Proceeds of Disposition

					Corporations				
			Individuals		Public		Private		Other
Shareholding	Pension funds	Mutual funds	Resident	Non-resident	Financial institution[a]	Non-financial institution	CCPC[b]	Non-CCPC	Non-resident
More than 10% of Target common shares	Tax-exempt	Flowthrough	Capital gain	**Tax-exempt**	Income or capital gain; Holdco route possible but problematic	Tax-free dividend to extent of safe income; capital gain on balance, via Holdco route	Tax-free dividend to extent of safe income; capital gain on balance, via Holdco route	Tax-free dividend to extent of safe income; capital gain on balance, via Holdco route	**Tax-exempt**
Top tax rate	—	—	39%	—	44.6% or 33.5%	33.5% on gain portion	33.5% on gain portion	33.5% on gain portion	—
Less than 10% of Target common shares[c]	Tax-exempt	Flowthrough	Capital gain	**Tax-exempt**	Income[d]	Capital gain, no access to safe income	Capital gain, no access to safe income	Capital gain, no access to safe income	**Tax-exempt**
Top tax rate	—	—	39%	—	44.6% on gain since last marked	33.5%	33.5%	33.5%	—

Takeover Bid Structured To Provide a Dividend[e]

			Individuals		Corporations				
					Public		Private		Other
Shareholding	Pension funds	Mutual funds	Resident	Non-resident	Financial institution[a]	Non-financial institution	CCPC[b]	Non-CCPC	Non-resident
More than 10% of Target common shares	Tax-exempt	Flowthrough	**Dividend tax credit**	Canadian withholding tax	**Tax-free dividend**	**Tax-free dividend to extent of safe income**	Tax-free dividend to extent of safe income	**Tax-free dividend to extent of safe income**	Canadian withholding tax
Top tax rate	—	—	**35%**	15 to 25%	—	**33.5% on dividends in excess of safe income**	33.5% on dividends in excess of safe income	**33.5% on dividends in excess of safe income**	15 to 25%
Less than 10% of Target common shares[c]	Tax-exempt	Flowthrough	**Dividend tax credit**	Canadian withholding tax	**Tax-free dividend, gain previously taxed**	**Tax-free dividend to extent of safe income**	Refundable part IV tax on entire dividend	**Tax-free dividend to extent of safe income**	Canadian withholding tax
Top tax rate	—	—	35%	15 to 25%	—	**33.5% on dividends in excess of safe income**	33%	**33.5% on dividends in excess of safe income**	15 to 25%

Note: Bold-face type shows most likely preferred alternative for each particular group, reflecting most likely (but not necessarily all possible) implications.

[a] Safe income not relevant to income gains. [b] Some refundable taxes result. [c] At exactly 10% property will not be a mark-to-market property to an FI, but will be subject to part IV tax to a CCPC on a redemption. [d] No tax deferral available on share-for-share exchange. [e] Could result in a loss if ACB exceeds paid-up capital. Such loss will potentially be denied in certain cases.

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