EXPLANATORY NOTES TO DRAFT INCOME TAX LEGISLATION ON DEMUTUALIZATION OF INSURANCE COMPANIES

ITA
49.1

Section 49.1 of the *Income Tax Act* is introduced to clarify that property is not disposed of by a taxpayer as a consequence of the acquisition of a particular property by the taxpayer in satisfaction of an absolute or contingent obligation to provide the particular property. This rule is of significance in the context of the new income tax rules for demutualization because it clarifies that there will not be any tax consequences because of the satisfaction of an undertaking to issue shares. New section 49.1 is also intended to apply on a more general basis in connection with property acquired by a taxpayer as a result of the execution of any contract. The cost of property acquired in circumstances to which section 49.1 applies can be determined in accordance with general principles – there is no necessity for a specific rule in this regard.

This amendment applies to obligations satisfied after ANNOUNCEMENT DATE.

ITA
54
"proceeds of disposition"

The expression "proceeds of disposition" in section 54 of the Act, which is relevant for the purposes of determining a taxpayer's capital gain or loss from the disposition of property, is contained in section 54. Under paragraph (k), the portion of those proceeds (otherwise determined) that is deemed to be a dividend under subsection 84.1(1) or 212.1(1) is excluded from those proceeds.

Paragraph (k) is amended, effective from ANNOUNCEMENT DATE, so that deemed dividends under new subsection 212.2(2) are likewise excluded.

ITA
89(1)
"paid-up capital"

The definition "paid-up capital" is contained in subsection 89(1) of the Act. Paragraph (b) of the definition defines "paid-up capital" in respect of a class of shares of the capital stock of a corporation. Subparagraph (*b*)(iii) of the definition provides that after March 31, 1977 paid-up capital is to be calculated without reference to any provisions of the Act other than those listed in the subparagraph.

The amendment to this subparagraph adds references to new subsections 139.1(5) and (6). These provisions adjust the paid-up capital of shares issued in connection with the demutualization of an insurance corporation. For further details on demutualization, see the commentary on section 139.1.

This amendment applies after ANNOUNCEMENT DATE.

ITA
139.1

New section 139.1 of the Act contains rules that apply where a mutual insurance corporation converts into a corporation with share capital -- a process referred to as demutualization. In general terms, the rules treat policyholders as if they were shareholders participating in the reorganization of the share capital of a corporation. In particular, the rules enable policyholders to receive shares in place of their ownership interest, with no immediate tax consequences. Cash payments and other non-share benefits are treated as taxable corporate dividends paid by the insurer.

Section 139.1 is structured as follows:

- Subsection 139.1(1) defines expressions used in the section.
- Subsections 139.1(2) and (3) set out a number of application rules for the purposes of the section.
- Subsection 139.1(4) sets out various consequences of a demutualization, including the treatment of benefits received by policyholders pursuant to a demutualization.
- Subsections 139.1(5) and (6) contain rules relating to the paid-up capital of shares issued by an insurance corporation or a holding corporation in connection with the demutualization of the insurance corporation.
- Subsection 139.1(7) provides that certain policy dividends payable pursuant to a demutualization are not considered to be policy dividends.
- Subsection 139.1(8) deems a person who receives a demutualization benefit that is a “specified insurance benefit” to have paid a premium to the insurer.
- Subsection 139.1(9) assigns a cost to a demutualization benefit other than a “specified insurance benefit”.
- Subsection 139.1(10) excludes demutualization benefits from the application of the shareholder benefit rule in subsection 15(1).
- Subsection 139.1(11), in conjunction with subsection 139.1(12), ensures that the provision of a demutualization benefit does not produce an inappropriate result under the rules relating to RRSPs, RRIFs, DPSPs and pension plans.

- Subsection 139.1(13) contains rules that apply with respect to employee-funded group insurance policies.

- Subsection 139.1(14) provides, in general, that the acquisition of shares by a holding corporation of an insurance corporation on the demutualization of the insurance corporation will not be considered to result in an acquisition of control of the insurance corporation.

Section 139.1 applies to any arrangement by which the demutualization of an insurance corporation is implemented. Under one arrangement, the documents constituting the corporation would be amended to provide for share capital and shares would then be issued to policyholders (and possibly former policyholders). Another arrangement involves the issuance of shares to a holding corporation which, in turn, would issue its shares to policyholders. A third arrangement would be to issue the shares of the insurance corporation to a holding corporation that is a mutual corporation controlled by policyholders of the insurance corporation. A demutualization could also be effected by a mutual insurance corporation merging with a corporation that has share capital.

Section 139.1 applies to the demutualization of both resident and non-resident insurers, and it applies to both resident and non-resident policyholders.

Section 139.1 applies to transactions that occur after ANNOUNCEMENT DATE.

ITA
139.1(1)

New subsection 139.1(1) of the Act defines several expressions used in section 139.1.

“cash”

This definition is discussed in the commentary below on subsection 139.1(14).

“conversion benefit”

A “conversion benefit” is defined as a benefit that is received in connection with the demutualization of an insurance corporation because of an interest of any person in an insurance policy to which the insurance corporation has been a party. If a “conversion benefit” is a “taxable conversion benefit” (as described in the commentary below), the recipient of the benefit is generally treated under paragraph 139.1(4)(*f*) as having received a dividend from the insurance corporation. Subsections 139.1(2) and (3) set out a number of rules determining when a benefit is considered to be received.

“demutualization”

A “demutualization” is defined as the conversion of a mutual insurance corporation into a non-mutual insurance corporation -- that is, into an insurance corporation with share capital,

where shareholders have the voting rights and the right to the residual assets of the corporation on dissolution.

"holding corporation"

A "holding corporation" with respect to an insurance corporation is a corporation that has, in connection with the demutualization of the insurance corporation, issued shares to stakeholders and that owns shares of the insurance corporation acquired in connection with the demutualization that entitle it to 90% or more of shareholder votes. The shares of the insurance corporation may be acquired directly from the insurance corporation, or they may be acquired from the stakeholders.

"mutual holding corporation"

A "mutual holding corporation" in respect of an insurance corporation is a mutual corporation which satisfies two conditions: (i) the corporation was established to hold shares of the insurance corporation, and (ii) the only persons entitled to vote at an annual meeting of the mutual corporation are policyholders of the insurance corporation. The expression is used in the definitions "ownership rights", "stakeholder" and "taxable conversion benefit", paragraph 139.1(4)(*d*) and section 139.2.

"ownership rights"

"Ownership rights" in a mutual insurance corporation are rights in respect of that corporation that are analogous to shareholder rights and are held because of an interest of any person in an insurance policy to which that corporation is a party. Examples of ownership rights include voting rights and the right to share in the residual assets of the mutual insurance corporation on its dissolution. While ownership rights are normally held by policyholders, a demutualization may involve the transfer of ownership rights to a holding corporation as a preliminary step to the issuance of shares by the insurance corporation. Under paragraphs 139.1(4)(*a*) and (*d*), shares acquired in exchange for ownership rights or for the alteration or dilution of ownership rights are received on a rollover basis at a deemed cost of nil.

A mutual holding corporation, as defined in subsection 139.1(1), holds the shares of the capital stock of an insurance corporation. "Ownership rights" in respect of the mutual holding corporation are held because of the interest of any person in an insurance policy to which the insurance corporation is a party. "Ownership rights" in respect of a mutual holding corporation are referred in paragraph (*c*) of the definition "taxable conversion benefit" and paragraph 139.1(4)(*d*). These rights would normally include the right to vote at meetings of the mutual holding corporation and the right to share in the residual assets of the mutual holding corporation on its dissolution.

"person"

A "person" is defined to include a partnership.

"share"

A "share" of the capital stock of a corporation is defined to include a right granted by the corporation to acquire a share of its capital stock. It is intended to include a right of a contingent nature.

"specified insurance benefit"

This definition is discussed in the commentary below on subsection 139.1(7).

"stakeholder"

The expression "stakeholder" is defined with reference to a demutualization of an insurance corporation. A "stakeholder" is a person entitled to a conversion benefit in connection with the demutualization, other than a holding corporation or a mutual holding corporation. The expressions "holding corporation" and "mutual holding corporation" are defined elsewhere in subsection 139.1(1).

"taxable conversion benefit"

A "taxable conversion benefit" is any "conversion benefit" (described in the commentary above) received by a stakeholder in connection with the demutualization of an insurance corporation, other than certain excluded conversion benefits. Under paragraph 139.1(4)(*f*), the receipt by a stakeholder of a taxable conversion benefit is generally treated as a deemed dividend for the stakeholder. Benefits excluded for this purpose are:

- shares of an insurance corporation,
- shares of a holding corporation, and
- ownership rights in a mutual holding corporation, as described in the commentary above on the definition "ownership rights".

By virtue of the definition of "share" in subsection 139.1(1), rights to acquire shares are also excluded from being taxable conversion benefits.

The following, if provided in connection with the demutualization of an insurance corporation, are examples of taxable conversion benefits:

- a cash payment,
- a policy dividend (see paragraphs 139.1(3)(*c*) to (*f*) and subsection 139.1(7)),

- an enhancement of benefits under an insurance policy,
- a new insurance policy, and
- a reduction in future premiums under an insurance policy (see paragraph 139.1(3)(*b*)).

ITA
139.1(2) and (3)

Subsection 139.1(2) of the Act sets out a number of general rules of application for the purposes of section 139.1. Rules of application to deal with special cases are set out in subsection 139.1(3).

ITA
139.1(2)(*a*) to (*c*)

New paragraphs 139.1(2)(*a*) and (*b*) of the Act contain rules that apply where a corporation becomes obligated (absolutely or contingently) to make or arrange a payment in providing a benefit in respect of a demutualization. These rules are relevant where taxable conversion benefits are provided on the demutualization of an insurance corporation. They are necessary because there are two transactions which might otherwise be considered to give rise to the receipt of benefits: the undertaking of an obligation to provide benefits, and the payment pursuant to the obligation.

Paragraphs 139.1(2)(*a*) and (*b*) specify when the benefit received consists of the undertaking of the obligation to make the payment, and when it consists of the actual payment. They apply together with paragraphs 139.1(2)(*d*) and (*f*) to determine when a taxable conversion benefit is considered to be received and the value of the benefit. Where the undertaking of an obligation constitutes the benefit, the benefit is considered to be received at the time of demutualization, and its value is its fair market value at that time. Where the making of a payment constitutes the benefit, the benefit is considered to be received when the payment is made, and the value of the benefit is equal to the amount of the payment.

Paragraph 139.1(2)(*a*) applies unless paragraph 139.1(2)(*b*) or (*c*) applies. Where, in connection with a demutualization, a corporation becomes obligated to make or arrange a payment, the benefit is considered to consist of the undertaking of the obligation and not of the making of the payment. The obligation may be of an absolute or contingent nature. In the event that this obligation results in the deemed receipt under paragraph 139.1(4)(*f*) by a taxpayer of a dividend as of the time of the demutualization, the corporation is obliged to report the deemed receipt of the dividend to Revenue Canada. However, it is intended that potential reporting obligations pursuant to paragraph 139.1(2)(*a*) will be suspended in the period during which it is reasonable to consider that paragraph 139.1(2)(*b*) or (*c*) may ultimately override the application of paragraph 139.1(2)(*a*).

Paragraph 139.1(2)(*b*) applies, except as noted below, if within 13 months after a demutualization, a corporation makes a payment in connection with the demutualization. In this case, the benefit consists of the making of the payment and not the undertaking of the obligation to make or arrange the payment. The Minister of National Revenue has the discretion to allow paragraph 139.1(2)(*b*) to apply to payments made more than 13 months after a demutualization.

Paragraph 139.1(2)(*b*) does not apply with respect to payments (other than policy dividends) under an insurance policy. For example, if the amount payable under life insurance policies is increased in connection with a demutualization, paragraph 139.1(2)(*b*) will not apply to any payments made pursuant to the increase. Paragraph 139.1(2)(*a*) will therefore apply, and the benefit will consist of the policy improvements. These improvements will have to be valued for the purpose of determining the amount of the taxable conversion benefit.

The following example illustrates the application of paragraphs 139.1(2)(*a*) and (*b*). Assume that, in connection with its demutualization, an insurer undertakes to pay a special policy dividend. If the special dividend is paid to a particular policyholder within 13 months after the demutualization, the policyholder will be considered to have received a taxable conversion benefit when the dividend is paid. If the dividend is payable to another policyholder more than 13 months after the demutualization, that policyholder's taxable conversion benefit will consist of the right, which may be contingent, to receive the dividend (assuming that the Minister has not extended the 13-month period during which paragraph 139.1(2)(*b*) applies). In this case, whether or not the dividend is ultimately paid, the policyholder will be considered to have received a taxable conversion benefit.

Paragraph 139.1(2)(*c*) applies in the unusual event that a stakeholder to whom an undertaking has been provided in connection with a demutualization does not receive any payment pursuant to the undertaking and the undertaking expires, within the 13-month period following the demutualization (or within a longer period acceptable to the Minister). Where this is the case, no benefit is considered to have been received in respect of the undertaking. Paragraph 139.1(2)(c) does not, however, apply in connection with an undertaking of an obligation to make or arrange a payment pursuant to the terms of an insurance policy, unless the payment was to be a policy dividend.

ITA
139.1(2)(*d*)

New paragraph 139.1(2)(*d*) of the Act specifies the time at which a stakeholder is considered to receive a taxable conversion benefit in connection with the demutualization of an insurance corporation. This paragraph is relevant primarily for paragraph 139.1(4)(*f*), which sets out the tax treatment of taxable conversion benefits. If the benefit consists of a payment, it is considered to be received when the payment is made. If the benefit is an undertaking to make a payment, an agreement to reduce policy premiums or any other type of taxable conversion benefit, it is considered to be received at the time of demutualization. Paragraphs 139.1(2)(*a*) and (*b*) specify when a conversion benefit consists of a payment and when it consists of an undertaking to make a payment. In general terms, where a payment is to be made within 13 months after a demutualization, the payment is the benefit. Otherwise, the undertaking is the benefit.

ITA
139.1(2)(*e*)

Several provisions in section 139.1 of the Act refer to the time at which an insurance corporation demutualizes. New paragraph 139.1(2)(*e*) provides that this time is generally the time at which the insurance corporation first issues a share of its capital stock.

Paragraph 139.1(2)(*e*) also contemplates the possibility that an insurance corporation could issue non-voting shares of its capital stock before demutualization, in which case it could remain a mutual corporation until demutualization. The issue of these shares is ignored for the purpose of determining the time of demutualization.

ITA
139.1(2)(*f*)

Under paragraph 139.1(4)(*f*) of the Act, the tax treatment of a taxable conversion benefit is based on the value of the benefit. New paragraph 139.1(2)(*f*) provides that the value of a benefit is the fair market value of the benefit at the time it is received by the stakeholder. Paragraph 139.1(2)(*d*) specifies the time at which a stakeholder is considered to receive a taxable conversion benefit.

ITA
139.1(3)(*a*)

New paragraph 139.1(3)(*a*) of the Act applies where benefits are enhanced under an insurance policy in connection with the demutualization of an insurance corporation. The enhancement is considered to be a benefit that is received by the policyholder. This rule clarifies that the taxable conversion benefit resulting from a policy enhancement is a benefit of the policyholder even though, for example, any payment pursuant to the enhancement may be made to another person. Paragraph 139.1(3)(*a*) applies to all policy enhancements, whether implemented by policy amendment, by the addition of riders, or in any other way.

ITA
139.1(3)(*b*)

New paragraph 139.1(3)(*b*) of the Act contains rules that apply where premiums payable under an insurance policy are reduced in connection with the demutualization of an insurance corporation. It is intended to ensure that a reduction in premiums is considered to be a single benefit, rather than a series of benefits that are provided each time the policyholder pays a reduced amount of premium. The rules provide that the policyholder is, in these circumstances, deemed to receive a benefit equal to the present value (at the time of demutualization) of the additional premiums that would otherwise be payable. The present value would be determined

taking into account the probability that the policy will be in existence on each premium payment date.

ITA
139.1(3)(*c*) to (*f*)

New paragraph 139.1(3)(*c*) of the Act provides that a policy dividend is considered to be provided in connection with a demutualization only to the extent that

- the demutualization proposal sent to stakeholders refers to the dividend,
- the payment of the dividend is contingent on stakeholder approval for the demutualization, and
- the dividend was not paid pursuant to an undertaking given to ensure that the demutualization would not have an adverse impact on policy dividends.

The purpose of paragraph 139.1(3)(*c*) is to provide an administratively workable distinction between normal policy dividends, on the one hand, and extraordinary policy dividends payable in connection with a demutualization.

Paragraph 139.1(3)(*c*) also applies to undertakings to pay policy dividends. An undertaking is considered to be provided in connection with a demutualization only to the extent that the undertaking is to pay a dividend that meets the requirements described above.

The reason for paragraph 139.1(3)(*c*) applying to both policy dividends and undertakings to pay policy dividends is that, in some cases, the payment of a dividend constitutes the conversion benefit while in other cases it is the undertaking to pay the dividend that is the benefit. For further detail in this regard, see the commentary on paragraphs 139.1(2)(*a*) and (*b*).

Paragraph 139.1(3)(*d*) contains a rule that applies if only part of a policy dividend is a benefit provided in connection with a demutualization. It deems that part of the policy dividend to be a separate dividend from the other part of the policy dividend. This rule is relevant for subsection 139.1(7), which provides that a policy dividend is not treated as such (other than for the purposes of section 139.1) if the payment of the dividend is a taxable conversion benefit.

Paragraph 139.1(3)(*e*) of the Act clarifies that a reference to a policy dividend includes an amount that is in lieu of payment of, or in satisfaction of, a policy dividend.

Paragraph 139.1(3)(*f*) clarifies that the payment of a policy dividend includes the application of a policy dividend to pay premiums or to repay a policy loan. If a policy dividend is applied as described above (or is otherwise paid) within 13 months of the demutualization, paragraph 139.1(2)(*b*) and subsection 139.1(7) generally ensure that the policy dividend is not treated as such, other than for the purposes of section 139.1. As a consequence, paragraph 148(2)(*a*) would not apply in these circumstances.

ITA
139.1(3)(*g*)

New paragraph 139.1(3)(*g*) of the Act applies where an insurance corporation demutualizes by merging with one or more other corporations. The corporate entity formed by the merger is deemed, for the purposes of section 139.1, to be the same corporation as, and a continuation of, the mutual insurance corporation. This rule applies whether the insurance corporation is a resident or non-resident corporation.

ITA
139.1(4)

New subsection 139.1(4) of the Act sets out many of the tax consequences that apply where an insurance corporation has undertaken to demutualize.

ITA
139.1(4)(*a*)

New paragraph 139.1(4)(*a*) of the Act provides that the disposition, alteration or dilution of ownership rights in connection with the demutualization of an insurance corporation does not give rise to any gain or loss.

Paragraph 139.1(4)(*a*) would apply, for example, where stakeholders receive shares of the insurance corporation or of a holding corporation on the extinguishment of their ownership rights. It would also apply to the transfer of ownership rights by stakeholders to a holding corporation in return for shares of the holding corporation, and to the subsequent surrender of those rights by the holding corporation for shares of the insurance corporation.

ITA
139.1(4)(b)

New paragraph 139.1(4)(*b*) of the Act clarifies that an amount paid or payable to a stakeholder in connection with the disposition, alteration or dilution of the stakeholder's ownership interest is not an eligible capital expenditure. This amount is intended not to be deductible in computing the payer's income.

ITA
139.1(4)(*c*)

New paragraph 139.1(4)(*c*) of the Act provides that an election cannot be made under subsection 85(1) or (2) in respect of the disposition of ownership rights in connection with the demutualization of an insurance corporation. The rules in subsection 139.1(4) are expected to achieve substantially the same result as elections under those subsections, without the need for any elections to be filed.

ITA
139.1(4)(d)

New paragraph 139.1(4)(d) of the Act applies where, in connection with the demutualization of an insurance corporation, a person acquires shares of the corporation, or of a holding corporation, for consideration that includes the transfer, surrender, alteration or dilution of ownership rights in the insurance corporation. Paragraph 139.1(4)(d) provides that the shares have a cost of nil to the person. The paragraph is not limited to stakeholders. It would apply if a holding corporation acquires ownership rights from stakeholders and then surrenders the rights.

Paragraph 139.1(4)(*d*) also applies with respect to the cost of a right granted by the insurance corporation, or the holding corporation, to acquire a share of the corporation. This follows from the expanded definition of "share" in subsection 139.1(1).

If an insurance corporation issues shares to its stakeholders in return for the surrender of their ownership rights, and the stakeholders subsequently transfer the shares to a holding corporation in exchange for shares of the holding corporation, paragraph 139.1(4)(*d*) will not apply with respect to the acquisition of shares from the holding corporation. Only the first transaction involves an acquisition of shares for consideration that includes the surrender of ownership rights.

Paragraph 139.1(4)(*d*) also applies where, in connection with a demutualization, a stakeholder acquires ownership rights in a mutual holding corporation. These ownership rights are deemed to have a cost of nil. For further detail, see the commentary on the definition "ownership rights" in subsection 139.1(1).

ITA
139.1(4)(*e*)

Paragraph 139.1(4)(*e*) of the Act applies where a demutualization is effected by having an insurance corporation issue shares to a holding corporation and the holding corporation issue its own shares to stakeholders. The paragraph deems the cost of the shares of the insurance corporation acquired by the holding corporation to be nil.

ITA
139.1(4)(*f*)

New paragraph 139.1(4)(*f*) of the Act sets out the tax treatment of a taxable conversion benefit received at any time by a stakeholder in connection with the demutualization of an insurance corporation. It provides that the corporation that conferred the benefit (i.e., generally the insurance corporation or a corporation holding the shares of the insurance corporation) is considered to have paid, and the stakeholder is considered to have received, a dividend at that time on shares of that corporation in an amount equal to the value of the benefit. The rules in the

Act applicable to corporate dividends will therefore apply with respect to the benefit. In certain cases where the insurer is non-resident, paragraph 139.1(4)(*g*) deems the insurer to be a resident corporation and a taxable Canadian corporation with respect to the dividend.

New paragraph 139.1(4)(*f*) does not, however, apply in circumstances to which subsection 139.1(12) applies. See, in this regard, the commentary below on subsection 139.1(12).

Subsection 139.1(2) contains rules regarding the time at which a benefit is considered to be received and the determination of the value of the benefit. For a description of the rules, see the commentary on that subsection.

ITA
139.1(4)(g)

New paragraph 139.1(4)(*g*) of the Act applies where a non-resident insurer confers a taxable conversion benefit on a stakeholder. For the purposes of Part I, any resulting dividend is deemed to be paid by a corporation resident in Canada that is a taxable Canadian corporation. As a consequence, if the stakeholder is a resident individual, the dividend gross-up and tax credit mechanism will apply. If the stakeholder is a resident corporation, the inter-corporate dividend deduction will generally be available, and Part IV tax may apply. However, paragraph 139.1(4)(*g*) does not apply if a deduction under section 126 in respect of any foreign tax on the dividend is claimed.

ITA
139.1(5)

New subsection 139.1(5) of the Act sets out rules that apply to the determination of the paid-up capital of shares of an insurance corporation resident in Canada that has demutualized. The purpose of the subsection is to prevent stakeholders from being deemed by subsection 84(1) to receive dividends because of an increase in stated capital on the issuance of shares as a conversion benefit. Instead, a deemed dividend will arise at the time, if ever, when the shares are redeemed or acquired by the insurance corporation.

Paragraph 139.1(5)(*a*) deducts from the paid-up capital of a class of shares of the insurer the total amount that subsection 84(1) would, if paragraph 139.1(5)(*a*) were not applicable, deem to have been paid as dividends on shares of that class in connection with the demutualization. Subsection 84(1) deems a dividend to have been paid when the paid-up capital of a class of shares is increased, other than in specified ways. For example, if surplus or other amounts are converted to stated capital on the demutualization of the insurer, paragraph 139.1(5)(*a*) will deduct a corresponding amount from paid-up capital.

Paragraph 139.1(5)(*b*) provides for an addition to the paid-up capital of a class of shares where paragraph 139.1(5)(*a*) has reduced the paid-up capital of the class. The amount that is added at

any time is equal to the total dividends deemed by subsections 84(3), (4) and (4.1) to have been paid on shares of the class before that time minus the dividends that would have been deemed to have been paid if subsection 139.1(5) had not applied to the class of shares. In other words, paragraph 139.1(5)(*b*) reverses the reduction in paid-up capital to the extent that additional deemed dividends have arisen because of the reduction.

EXAMPLE

On its demutualization, Insurance Co. issues 100 shares each to its 1,000 policyholders and adds $1 million to its stated capital. Subsequently, Insurance Co. redeems 40,000 shares for $14 per share, reducing its stated capital by $10 per share. What is the paid-up capital of that class of shares after the redemption of the shares?

Without reference to subsection 139.1(5), the paid-up capital is $600,000 ($1 million – (40,000 x $10)). Paragraph 139.1(5)(*a*) requires $1 million to be subtracted in computing paid-up capital, which means that there is a total deemed dividend of $560,000 to shareholders. If the $1 million had not been subtracted, the deemed dividend would have been only $160,000. Consequently, the paid-up capital after the redemption is nil ($600,000 - 1,000,000 + (560,000 – 160,000)).

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ITA
139.1(6)

New subsection 139.1(6) of the Act sets out rules that apply to the determination of the paid-up capital of shares of a particular corporation resident in Canada that has been a holding corporation that acquired shares of an insurance corporation from the insurance corporation on its demutualization.

The rules in subsection 139.1(6) are the same as the rules in subsection 139.1(5), except for the specification of the amount to be deducted from paid-up capital. The amount deducted from the paid-up capital of a class of shares is equal to the total amount by which the paid-up capital of the class would, but for subsection 139.1(6), increase as a result of the holding corporation's acquisition of shares of the insurance corporation on its demutualization.

The reference in subsection 139.1(6) to the acquisition of shares on the demutualization of the insurer is intended to refer only to the initial acquisition of shares as part of the transaction whereby the insurer ceases to be a mutual insurance corporation. This acquisition would not involve the holding corporation paying any consideration to the insurer for the shares. Subsection 139.1(6) is not intended to apply where the holding corporation acquires shares for full consideration payable to the insurer, even though this might occur as part of the same series of transactions as the demutualization.

ITA
139.1(7)

New subsection 139.1(7) of the Act provides that if the payment of a policy dividend is a taxable conversion benefit, the policy dividend is deemed, for the purposes of provisions in the Act (other than section 139.1 itself), not to be a policy dividend. Consequently, the rules in section 148 that apply in respect of policy dividends will not be applicable. Subsection 139.1(7) also provides that the insurer may not include an amount in respect of the policy dividend in computing its deductible reserves. Such policy dividends are generally treated as corporate dividends pursuant to paragraph 139.1(4)(*f*).

In determining the treatment of policy dividends under section 139.1, several provisions must be considered. Paragraphs 139.1(2)(*a*) and (*b*) contain rules for determining whether a conversion benefit consists of an obligation (whether absolute or contingent) of the insurer to make a payment, or the payment itself. Subsection 139.1(7) applies with respect to a policy dividend only if the payment of the dividend is the benefit, i.e., only if paragraph 139.1(2)(b) is applicable. In general, these are dividends that are paid within 13 months after the demutualization. Paragraph 139.1(3)(*c*) specifies which policy dividends are considered to be paid in connection with a demutualization. Paragraph 139.1(3)(*d*) splits a policy dividend into two separate dividends where only part of the dividend is paid because of the demutualization. Paragraphs 139.1(3)(*e*) and (*f*) clarify the circumstances in which a policy dividend is considered to be paid.

ITA
139.1(8)

New subsection 139.1(8) of the Act provides that if, in connection with the demutualization of an insurance corporation, a stakeholder receives a taxable conversion benefit that is a specified insurance benefit, the stakeholder is deemed to have paid a premium to the insurer equal to the value of the benefit. The payment date for the premium is the time of demutualization, which is stated by paragraph 139.1(2)(*e*) to be the time the insurer first issues a share. Pursuant to paragraphs 139.1(2)(*d*) and (*f*), the value of the specified insurance benefit is its fair market value at the time of demutualization.

The combined effect of subsection 139.1(8) and paragraph 139.1(4)(*f*) is to treat the stakeholder and the insurer as if the insurer had paid a corporate dividend to the stakeholder at the time of demutualization, which the stakeholder immediately paid as a premium under an insurance policy.

Under subsection 139.1(1), a "specified insurance benefit" is a taxable conversion benefit provided by the demutualizing insurer that is

- the enhancement of benefits under an insurance policy,

- the issuance of an insurance policy,

- the undertaking by the insurer of an obligation to pay a policy dividend, or
- a reduction in the premiums payable under an insurance policy.

Paragraphs 139.1(2)(*a*) and (*b*) specify when an undertaking to pay a policy dividend constitutes the benefit for purposes of section 139.1 and when the actual payment of the dividend is the benefit. Generally, the undertaking will be the benefit if the dividend is payable more than 13 months after demutualization. A "specified insurance benefit" includes taxable conversion benefits that are undertakings to pay policy dividends. It does not include taxable conversion benefits that consist of the payment of policy dividends.

ITA
139.1(9)

New subsection 139.1(9) of the Act applies where a stakeholder receives a taxable conversion benefit that is not a "specified insurance benefit", as described above. Where this is the case, the stakeholder is deemed to have acquired the benefit at a cost equal to the value of the benefit. Pursuant to paragraph 139.1(2)(*f*), the value of the benefit is its fair market value at the time the stakeholder is considered to receive the benefit. This time is determined under paragraph 139.1(2)(*d*).

ITA
139.1(10)

New subsection 139.1(10) of the Act provides that subsection 15(1) does not apply to a conversion benefit. Subsection 15(1) includes in income certain benefits conferred by a corporation on a shareholder or on a person in contemplation of the person becoming a shareholder. The purpose of subsection 139.1(10) is to ensure that the issuance of shares or rights to acquire shares in connection with a demutualization is not treated as a shareholder benefit to which subsection 15(1) applies.

ITA
139.1(11) and (12)

Subsection 139.1(11) applies for the purposes of the rules in the Act relating to RRSPs, RRIFs, DPSPs and superannuation or pension funds or plans. For these purposes, a conversion benefit is deemed not to have been received out of, under or because of any insurance policy.

However, subsection 139.1(11) does not apply in the event that a demutualization benefit is received because of an interest in a life insurance policy, otherwise than by the trust that governs any such fund or plan and holds the interest in the policy. In this case, subsection 139.1(12) provides that the demutualization benefit is received because of the fund or plan and would, as a consequence, be fully included in computing the recipient's income.

Subsection 139.1(11) ensures that:

- where a life insurance policy is registered as an RRSP or a RRIF, a conversion benefit is not taxable as a benefit out of or under the RRSP or RRIF, nor is it considered a benefit or advantage that is conditional on the existence of the RRSP or RRIF;
- where a life insurance policy constitutes a superannuation or pension fund or plan, a conversion benefit is not taxable as a superannuation or pension benefit; and
- a conversion benefit will be disregarded for the purpose of the special rules in subsection 198(6) applicable to the acquisition of a life insurance policy by a trust governed by a DPSP or an RRSP.

ITA
139.1(13)

New subsection 139.1(13) of the Act is intended to allow an employer that receives a conversion benefit in respect of a group insurance policy to contribute an amount equal to the value of the conversion benefit to the policy without the contribution being considered an employer contribution. This subsection is applicable with respect to disability and life insurance coverage that is fully employee-funded, and prevents the benefits from becoming taxable by virtue of the contribution.

Specifically, subsection 139.1(13) applies where the following conditions are met:

- a stakeholder receives property as a conversion benefit because of the stakeholder's interest in a group insurance policy under which employees are insured;
- employees have borne the full cost of a particular insurance coverage under the policy;
- the stakeholder pays a premium in respect of the particular insurance coverage; and
- it is reasonable to conclude that the stakeholder intended to apply, for the benefit of the insured employees, all or part of the fair market value of the portion of the property that is in respect of the particular insurance coverage.

Where subsection 139.1(13) applies, the premium paid by the stakeholder is deemed to have been paid instead by the insured employees, for the purposes of paragraph 6(1)(*f*) and regulations made under subsection 6(4). Paragraph 6(1)(*f*) includes periodic disability payments in income if they are paid under a plan to which the employer has made a contribution. Regulations made under subsection 6(4) specify the amount of the taxable benefit arising from coverage under a group term life insurance policy. There is no taxable benefit if the life insurance is fully paid for by employees.

Subsection 139.1(13) also provides that the stakeholder is not entitled to deduct a premium to which the subsection applies.

Subsection 139.1(13) also applies to a premium paid under a group insurance policy that provides replacement coverage for the particular insurance coverage that gave rise to the conversion benefit. This rule is intended to accommodate the situation where a new group insurance policy has been entered into, most likely with a different insurer, before the conversion benefit is paid.

Where more than one coverage is provided under a group insurance policy -- for example, long term disability and medical and dental benefits -- subsection 139.1(13) requires a determination of the extent to which a conversion benefit is attributable to a particular employee-funded coverage. Information for this purpose should be obtained from the insurer.

ITA
139.1(14)

Subsection 256(7) of the Act sets out rules for determining whether there has been an acquisition of control for the purposes of certain provisions of the Act. In the case of a demutualization of an insurance corporation where policyholders are issued shares for their ownership rights in the corporation, there would be no acquisition of control expected for the purposes of these provisions because of paragraph 256(7)(a) and subsection 256(8.1).

New subsection 139.1(14) provides that, where demutualization of an insurance corporation is effected through the creation of a holding corporation, the acquisition of shares by the holding corporation will similarly not result in an acquisition of control for the purposes of these provisions. More specifically, there will be no acquisition of control because of an acquisition of shares of the insurance corporation by a particular corporation, in connection with the demutualization of the insurance corporation, where immediately after the time that the particular corporation becomes a holding corporation

- the particular corporation is not controlled by any person or group of persons, and

- the total of the “cash” of the particular corporation and the fair market value of the shares of the capital stock of the insurance corporation is not less than 95% of the fair market value of all the assets of the particular corporation.

Subsection 139.1(14) is modelled on a similar rule in paragraph 256(7)(e), but is adapted to apply to the anticipated circumstances where a holding corporation is used in connection with a demutualization.

For the purpose of subsection 139.1(14), the “cash” of a corporation is defined in subsection 139.1(1) as ordinary money (including foreign currency), specified deposits of such money and specified government-backed securities.

ITA
139.2

New section 139.2 of the Act sets out the tax treatment of distributions made by a mutual holding corporation, as defined by subsection 139.1(1).

Section 139.2 applies where a mutual holding corporation for an insurance corporation distributes property to policyholders of the insurance corporation. The section provides that the corporation is considered to have paid, and each policyholder is considered to have received, a dividend on shares of the capital stock of the mutual holding corporation. The amount of the dividend received by a policyholder is equal to the fair market value of the property distributed to the policyholder. The most common application of section 139.2 will be with respect to the distribution by a mutual holding corporation of dividends received on shares of the insurance corporation.

Section 139.2 applies to transactions that occur after ANNOUNCEMENT DATE.

ITA
140(1)

Subsection 140(1) of the Act, in conjunction with subparagraph 138(1)(*a*)(v), allows an insurance corporation a deduction in respect of the crediting to a policyholder of a dividend or refund of premiums or premiums deposits.

Subsection 140(1) is clarified, effective after ANNOUNCEMENT DATE, to ensure that it only applies in respect of policy dividends.

ITA
141

Section 141 of the Act provides that a life insurance corporation resident in Canada is deemed to be a public corporation. This provision is renumbered as subsection 141(2) and new provisions are added that apply where an insurance corporation has demutualized. These amendments apply after ANNOUNCEMENT DATE.

ITA
141(1)

New subsection 141(1) of the Act defines “demutualization” and “holding corporation” for the purposes of section 141. Those expressions have the meanings given to them by new subsection 139.1(1).

ITA
141(3) and (4)

New subsection 141(3) of the Act applies to a corporation resident in Canada that is a holding corporation in respect of an insurance corporation that has demutualized. It deems the holding corporation to be a public corporation at a particular time if the corporation has a class of shares that meets the conditions relating to the number of shareholders and the dispersal of ownership referred to in paragraphs 4800(1)(*b*) and (*c*) of the *Income Tax Regulations.* In this context, the reference to "that class" in those paragraphs intended to refer to any particular class of the capital stock of the corporation (whether or not that class is qualified for distribution to the public). "Holding corporation" is defined in subsection 139.1(1).

Normally, a corporation that does not have any shares listed on a Canadian stock exchange cannot become a public corporation unless a class of its shares is qualified for distribution to the public. Subsection 141(3) eliminates this condition for a holding corporation and it also eliminates the need to make an election to be a public corporation.

Subsection 141(3) applies only during the period specified in new subsection 141(4). The specified period for a corporation starts when it became a holding corporation, and ends when it becomes a public corporation because of any other provision of the Act.

ITA
141(5)

New subsection 141(5) of the Act contains a rule that is generally intended, for a temporary period pending the anticipated listing of shares of a resident insurance corporation or its holding corporation on a prescribed stock exchange, to exclude shares issued by those corporations from taxable Canadian property. Consequently, a non-resident shareholder's gain from disposing of such shares will not be taxable in Canada, even though the shares are not listed on a prescribed stock exchange at the time of the disposition.

Subsection 141(5) applies for the purpose of subparagraph 115(1)(*b*)(iv), which provides that a share of a corporation resident in Canada (other than a mutual fund corporation) is taxable Canadian property unless the share is listed on a prescribed stock exchange. Subsection 141(5) deems certain shares to be listed on a prescribed stock exchange.

More specifically, subsection 141(5) applies to a class of shares of an insurance corporation that has demutualized if the corporation has a class of shares that meets the conditions relating to the number of shareholders and the dispersal of ownership referred to in paragraphs 4800(1)(*b*) and (*c*) of the Regulations. In this context, the reference to "that class" in those paragraphs intended to refer to any particular class of the capital stock of the corporation (whether or not that class is qualified for distribution to the public). The subsection also applies to the shares of a holding corporation in respect of the insurance corporation if the holding corporation is deemed by new subsection 141(3) to be a public corporation.

Subsection 141(5) applies for a maximum of 6 months after a demutualization occurs. It does not apply to the shares of a corporation at a time when any shares of the corporation are listed on a stock exchange.

ITA
212.2

New section 212.2 of the Act is designed to discourage series of transactions designed so that Canadian corporate surplus distributed to non-residents escapes tax under Part XIII. The following example sets out one example of this type of series of transactions, that might be relevant in the context of a demutualization.

> **EXAMPLE**
>
> Holdco owns 90% of the shares of Insurco. Insurco issues shares to a non-resident policyholder on a demutualization. Rather than Insurco redeeming the share, Holdco buys the shares several days and later uses dividends received from Insurco to fund the purchase price.
>
> If Insurco had redeemed the share, there would have been a deemed dividend equal to the amount of the proceeds of redemption. By having Holdco buy the shares, the deemed dividend rules are avoided. Dividends received from Insurco in this example would be received on a tax-free basis because of the intercorporate dividend deduction.

Specifically, section 212.2 applies where each of the following conditions is satisfied:

- a taxpayer at a particular time disposes of a share of the capital stock of a corporation resident in Canada (or any property more than 10% of the fair market value of which can be attributed to shares of the capital stock of corporations resident in Canada) to a person (referred to below as the “specified person”) or partnership (referred to below as the “specified partnership) where:

  (i) the specified person is resident in Canada,

  (ii) any person resident in Canada has, directly or indirectly, an interest in the specified partnership; or

  (iii) the acquisition by the specified person or specified partnership is in the course of carrying on a business through a permanent establishment in Canada;

- subsection 212.1(1) does not apply to the disposition;

- the taxpayer is non-resident at the particular time;

- it is reasonable to conclude that the disposition is part of an expected series of transactions or events that includes the issue after ANNOUNCEMENT DATE of a particular share of the capital stock of a particular corporation resident in Canada and

  (i) the redemption, acquisition or cancellation of the particular share, or a share substituted for the particular share, by the particular corporation or the, or a share substituted for the particular share, by the particular corporation or the issuer of the substituted share, as the case may be,

  (ii) an increase in the level of dividends declared or paid on the particular share or a share substituted for the particular share, or

  (iii) the acquisition of the particular share or a share substituted for the particular share by

    (A) a person not dealing at arm's length with the particular corporation or with the issuer of the substituted share, as the case may be, or

    (B) a partnership any direct or indirect interest in which is held by a person not dealing at arm's length with the particular corporation or with the issuer of the substituted share, as the case may be; and

- at the particular time, the specified person or any person who has, directly or indirectly, an interest in the specified partnership knew, or ought reasonably to have known, of the expected series of transactions or events described above.

Where subsection 212.2(1) applies to the disposition of property by a taxpayer to a specified person or specified partnership, a taxable dividend is deemed by subsection 212.2(2) to have been paid by the specified person or specified partnership to the taxpayer. For this purpose, the specified person or partnership is deemed to be a corporation resident in Canada. The amount of the dividend is determined with reference to the paid-up capital of shares to which the property relates. In a simple example where subsection 212.2(1) applies in respect of a disposition of a share, the deemed dividend is equal to the amount by which the proceeds of disposition for the share exceed the paid-up capital in respect of the share.

The amount of any deemed dividend in respect of a share or other property resulting from section 212.2 is excluded under amended paragraph (k) of the definition "proceeds of disposition" in section 54 from the non-resident taxpayer's proceeds of disposition for the property. This provision is intended to ensure that no double taxation in Canada occurs in connection with the disposition by a non-resident of taxable Canadian property.

Section 212.2 applies after ANNOUNCEMENT DATE.

ITA
237(2) and (3)

Subsection 237(2) of the Act provides that any person making an information return has to make a reasonable effort to obtain the Social Insurance Number or business number of the person or partnership to which the return relates. In addition, the person making the return cannot release this information, except as set out in the subsection.

Subsection 237(2) of the English version of the Act is amended to allow the release of this information, when authorized by the Act. New subsection 237(3) permits a person to release this information to another related person, where the related person is required to make an information return that requires this information. This amendment is of significance in the context of demutualization, as it permits an insurance corporation to release this information to its holding corporation in connection with the holding corporation's responsibility to report dividends and other amounts payable to persons who were policyholders in respect of the insurance corporation.

This amendment applies on Royal Assent.