Explanatory Notes Relating to the Income Tax Act and Regulations

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Preface

These explanatory notes describe proposed amendments to the *Income Tax Act* and the *Income Tax Regulations*. These explanatory notes describe these proposed amendments, clause by clause, for the assistance of Members of Parliament, taxpayers and their professional advisors.

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These notes are intended for information purposes only and should not be construed as an official interpretation of the provisions they describe.

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Legislative proposals relating to the Income Tax Act and Regulations

Please note that these draft legislative proposals have been prepared taking into account draft legislative proposals previously released by the Department of Finance (for example, the release made on July 16, 2010).

Income Tax Act

Clause 1

Amounts to be included as income from office or employment

ITA
6(1)(*e.1*)

Section 6 of the Act provides for the inclusion in an employee's income of most employment-related benefits other than those that are specifically excluded.

New paragraph 6(1)(*e.1*) includes the amount of an employer's contributions to a group sickness or accident insurance plan in an employee's income for the year in which the contributions are made, except to the extent that the contributions are in respect of a plan that provides wage-loss replacement benefits paid on a periodic basis (in those cases, paragraph 6(1)(*f*) will apply in respect of benefits received by the employee). For example, this new paragraph would apply to critical illness insurance or dismemberment insurance that provides benefits paid in lump-sum payments.

This amendment applies in respect of employer contributions made after March 28, 2012 to the extent that the contributions relate to coverage after 2012, except that such contributions made after March 28, 2012 and before 2013 are included in the employee's income for 2013.

Clause 2

Deductions – "excess EPSP amount"

ITA
8(1)(*o.2*)

Section 8 of the Act provides for the deduction of various amounts in computing income from an office or employment.

New paragraph 8(1)(*o.2*) is introduced consequential on the introduction of new section 207.8, which generally imposes a special tax on excessive allocations to specified employees (as defined in subsection 248(1)) under employee profit sharing plans (EPSPs).

Paragraph 8(1)(*o.2*) allows a taxpayer to deduct an amount that is an "excess EPSP amount" (as defined in subsection 207.8(1)) in computing income for a taxation year. In general terms, under subsection 207.8(1), a taxpayer's excess EPSP amount in respect of an employer for a taxation year is the portion of the employer's total contributions to an EPSP that is allocated to the taxpayer for the year and that exceeds 20% of the taxpayer's total other employment income received in the year from the employer. Excess EPSP amounts are subject to a special tax under subsection 207.8(2), which may be waived or cancelled by the Minister in certain circumstances. The deduction under paragraph 8(1)(*o.2*) is not available to the extent that the taxpayer's tax for the year under subsection 207.8(2) in respect of the excess EPSP amount is waived or cancelled.

For further information, please see the commentary on new section 207.8.

This amendment applies to the 2012 and subsequent taxation years.

Clause 3

Income inclusions

ITA
12(1)(*l.1*)

Budget 2012 announced the extension of the thin capitalization rules in subsection 18(4) of the Act to debts of a partnership of which a corporation resident in Canada is a member. As part of the implementation of this budget measure, new paragraph 12(1)(*l.1*) is introduced to include an amount in computing the income of a corporation in certain circumstances.

The amount included in a partner's income is determined by reference to interest paid or payable by a partnership of which the corporation is a member on the portion of the debts of the partnership that is allocated to the corporation under subsection 18(7) and that exceeds the corporation's permitted debt-to-equity ratio under the thin capitalization rules.

Since partnership income is calculated at the partnership level and allocated to its partners on a net basis (i.e., after any deduction of interest expense), a partnership's interest expense cannot be denied at the partner level. This income inclusion effectively adds back the relevant portion of the interest that is deductible at the partnership level to the partner's income. The net effect is therefore similar to the interest restriction rule in subsection 18(4). For further information, please see the commentary on subsections 18(4) and 18(7).

The amount included in computing a taxpayer's income is the total of all amounts determined on a partnership-by-partnership basis by the formula A x B / C – D.

Variable A is the deductible interest on the taxpayer's share of the outstanding debts of the particular partnership owing to specified non-residents. The taxpayer's share of the debts is determined by reference to its "debt amount" (as defined in paragraph 18(7)(*a*)). Consistent with the look-through approach to partnerships in subsection 18(7), the taxation year of the corporation is the relevant period for determining what interest is included. Interest that is paid by the partnership in the corporation's taxation year or that is payable by the partnership in respect of the corporation's taxation year is therefore included regardless of the fiscal period of the partnership.

B / C is the fraction, if any, of the taxpayer's debts (including its share of partnership debts) that exceed the allowable debt-to-equity ratio specified in the thin capitalization rules.

Variable D effectively reduces the paragraph 12(1)(*l.1*) income inclusion by the amount of any foreign accrual property income of a controlled foreign affiliate of the taxpayer that is in respect of interest described in A and that is included in the taxpayer's income for the year or a subsequent year or included in computing the income of the partnership. This variable is the corollary in the partnership context of subsection 18(8), which applies in respect of interest paid or payable to a corporation by a controlled foreign affiliate of the corporation. For further information, please see the commentary on subsection 18(8).

This paragraph applies to taxation years that begin after March 28, 2012.

Clause 4

Shareholder debt

ITA
15(2)

Subsection 15(2) of the Act requires that certain shareholder indebtedness be included in the income of the debtor. Where the debtor is a non-resident, subsection 15(2) works in conjunction with subsection 214(3) to cause a deemed dividend that is subject to non-resident withholding tax under Part XIII of the Act.

Subsection 15(2) is amended to create a new exception in respect of a “pertinent loan or indebtedness”. “Pertinent loan or indebtedness” is defined for this purpose in new subsection 15(2.11), which is discussed below.

This amendment applies to loans received and indebtedness incurred after March 28, 2012.

Pertinent loan or indebtedness

ITA
15(2.11)

New subsection 15(2.11) of the Act defines the term “pertinent loan or indebtedness” for the purposes of the new exception to the application of subsection 15(2). The result of being a “pertinent loan or indebtedness” is that such debt, instead of potentially being treated as a deemed dividend under the combined operation of subsections 15(2) and 214(3), will be subject to the new interest imputation rule set-out in new section 17.1, discussed below. This regime applies to all loans and indebtedness (to which subsection 15(2) would otherwise apply) that become owing after March 28, 2012 to a corporation resident in Canada (the “CRIC”) by either a non-resident corporation that controls the CRIC (the “controller”) or a non-resident corporation that is not dealing at arm’s length with the controller, if the CRIC and the controller file a joint election.

The election need only be made once in respect of each non-resident debtor, but it must be filed before the CRIC’s filing-due date for the taxation year that includes the time after March 28, 2012 that the first such loan or indebtedness arises. The result is that all debt obligations between the CRIC and the relevant non-resident debtor, that subsection 15(2) would otherwise apply to and that become owing after March 28, 2012, will be subject to the new interest imputation regime and will not be subject to subsection 15(2).

New subsection 15(2.11) applies to loans received and indebtedness incurred after March 28, 2012.

Clause 5

Deemed interest income – sections 15 and 212.3

ITA
17.1

New section 17.1 of the Act provides the interest deeming rules for the new elective “pertinent loan or indebtedness” regimes in the context of subsection 15(2) and section 212.3. More specifically, section 17.1 applies to “pertinent loans and indebtedness” as defined either in new subsection 15(2.11) (discussed above) or new subsection 212.3(9) (discussed below). Section 17.1 generally requires that the interest inclusion to a corporation resident in Canada (the “CRIC”) in respect of such loans and indebtedness be at least equal to the amount determined by computing that interest at the rate prescribed under paragraph 4301(*a*) of the *Income Tax Regulations* or, where the CRIC (or certain non-arm’s length persons or partnerships) has incurred one or more debt obligations in order to fund the loan or indebtedness, the amount of interest payable on that debt obligation (or those debt obligations) if it is greater than the amount determined using the prescribed rate.

The references to “indirectly funded” and to interest payable by persons or partnerships other than the CRIC are intended to deal with situations where, for example, a corporation resident in Canada that does not deal at arm’s length with the CRIC borrows money, makes an equity contribution to the CRIC and the CRIC then makes the loan to the relevant non-resident debtor. In such a case, the imputed interest under section 17.1 is intended to be based on the interest payable by the other corporation if that actual borrowing cost exceeds the interest determined using the prescribed rate.

Because of the potential overlap between existing section 17 and new section 17.1, section 17 is made inapplicable to these “pertinent loans and indebtedness”. It is also notable that the prescribed rate for section 17.1 is not the same as the rate for section 17: the rate for section 17.1 is 4 percentage points higher, pursuant to the use of paragraph 4301(*a*) of the *Income Tax Regulations* for this purpose.

New section 17.1 applies to taxation years that end after March 28, 2012.

Clause 6

Limitation re deduction of interest by certain corporations

ITA
18(4)

The thin capitalization rules in subsection 18(4) of the Act prevent corporations resident in Canada from deducting interest on debts owing to certain specified non-residents to the extent that the debts exceed the corporation's permitted debt-to-equity ratio.

Budget 2012 announced the following amendments to the thin capitalization rules.

- The permissible debt-to-equity ratio in subparagraph 18(4)(*a*)(ii) is reduced from 2:1 to 1.5:1. The new ratio applies to taxation years that begin after 2012.
- The thin capitalization rules are extended to include debts of partnerships that have Canadian resident corporate partners, either directly or through multiple tiers of partnerships. For further information, please see the commentary on paragraph 12(1)(*l.1*) and subsection 18(7).
- The portion of subsection 18(4) before paragraph 18(4)(*a*) is amended to allow for the introduction of an exception to the thin capitalization rules in subsection 18(8) that applies in respect of interest on loans from controlled foreign affiliates. This amendment applies to taxation years that end after March 28, 2012. For further information, please see the commentary on subsection 18(8).
- Interest that is denied under subsection 18(4) or included in a corporation's income under paragraph 12(1)(*l.1*) will be treated as a dividend and not as interest for the purposes of Part XIII withholding tax. For further information, please see the commentary on new subsection 214(16)).

Example

Canco 1 and Canco 2 are Canadian-resident corporations and are equal partners in a partnership that earns income from a business. Canco 1 is wholly owned by Forco, a non-resident corporation. The Canco 1 shares owned by Forco have paid-up capital of $4,000 but Canco 1 has no other capital for the purposes of the thin capitalization rules. Forco lends $3,000 to the partnership and lends $8,500 directly to Canco 1. Absent the application of the thin capitalization rules, interest on both loans is deductible. Interest on both loans is payable on the 15th of every month.

Canco 1 has a 50% interest in the partnership and will therefore be allocated 50% of the partnership loan ($1,500) for thin capitalization purposes. Canco 1 has capital of $4,000 and is considered to have outstanding debts to a specified non-resident (Forco) of $10,000 ($8,500 debt owed by Canco 1 to Forco (direct debt) plus $1,500 in debt allocated from the partnership (indirect debt)).

With a permitted debt-to-equity ratio of 1.5-to-1, Canco 1 has $4,000 of total excess debt (direct and indirect debts) – that is, ($10,000 – 1.5 x $4,000)/10,000, or 2/5, of $10,000. This 2/5 ratio is applied to interest on the debt owed directly to Forco by Canco 1 as well as the debt allocated from the partnership to determine how much interest is denied by subsection 18(4), or added back to income under paragraph 12(1)(l.1), respectively. Accordingly, 2/5 of the interest deduction in respect of the $8,500 direct loan from Forco will be denied and an amount equal to 2/5 of the deductible interest expense in respect of the $1,500 debt allocated from the partnership will be required to be included in computing the income of Canco 1 from the partnership's business.

2/5 of each amount paid as interest by Canco 1 throughout the year on the direct loan from Forco will be deemed to have been paid as dividends by Canco 1 to Forco. This includes any interest that is payable at the end of Canco 1's taxation year. Canco 1 may then designate which payments of interest are to be designated as dividends for thin capitalization purposes.

Similarly, the amount included under paragraph 12(1)(l.1) in computing the income of Canco 1 will be deemed to have been paid as a dividend by Canco 1 to Forco at the end of Canco 1's taxation year.

Contributed surplus

An amendment is also made to subsection 18(4) in the context of the foreign affiliate dumping rules. The contributed surplus provision in clause 18(4)(*a*)(ii)(B) is amended in order to exclude any portion of a corporation's contributed surplus that arises in connection with an investment to which new subsection 212.3(2) applies by virtue of subsection 212.3(1). That is, although the consequences under subsection 212.3(2) would not apply to the extent contributed surplus arises, subsection 212.3(2) applies where the conditions in paragraphs 212.3(1)(*a*) to (*c*) are met. For example, as a result of this amendment, a foreign parent that transfers shares of a non-resident subsidiary to its Canadian subsidiary for no consideration would, if the conditions in subsection 212.3(1) are met, be prevented from counting any contributed surplus arising from such a transfer in determining its thin capitalization "room". In effect, for the purposes of the foreign affiliate dumping rules, contributed surplus is put on the same footing as paid-up capital (which is reduced under paragraph 212.3(2)(*b*)), as a result of this amendment to the thin capitalization rules. Similar amendments are also made to subsection 84(1), as discussed below.

Refer to the commentary on section 212.3 for a detailed description of the foreign affiliate dumping rules.

This amendment comes into force on March 29, 2012.

Partnership debts

ITA
18(7)

New subsection 18(7) of the Act extends the application of the thin capitalization rules in subsection 18(4) to include a corporation's share of debts of partnerships in which it is a member, either directly or through multiple tiers of partnerships, in determining whether it has exceeded its permitted debt-to-equity threshold.

Subsection 18(7) deems that, for the purposes of paragraph 18(4)(*a*), subsections 18(5) to (6) and paragraph 12(1)(*l.1*),

- each member of a partnership owes that member's share of the debts of the partnership (called the "debt amount");
- the member owes this debt amount to the creditor; and
- the member has paid the interest that is deductible by the partnership with respect to the debt amount.

A partner's share of the debts of a partnership is determined at any time by reference to its "specified proportion" in respect of the partnership for the last fiscal period of the partnership ending before the partner's taxation year end. Where this is not determinable (e.g. because the first fiscal period of the partnership ends after the partner's year end), the partner's share of the debts of a partnership is determined by reference to the relative fair market value of its interest in the partnership.

Paragraphs 18(7)(*b*) and (*c*) ensure that the allocated debts qualify as "outstanding debts to specified non-residents" as defined in subsection 18(5). Paragraph 18(7)(*b*) ensures that the relationship between the lender and the corporate partner that is potentially subject to the subsection 18(4) interest deduction denial is tested to determine whether the relevant debts are payable to a specified non-resident. Paragraph 18(7)(*c*) ensures that the debt will meet the conditions in subparagraph (a)(ii) of the definition of "outstanding debts to specified non-resident" in subsection 18(5) to the extent an amount in respect of the interest is deductible to the partnership.

This subsection applies to taxation years that begin after Mach 28, 2012.

Exception – foreign accrual property income

ITA
18(8)

Since debts owing by a Canadian corporation to a controlled foreign affiliate of the corporation can qualify as outstanding debts to specified non-residents for the purposes of subsection 18(4) of the Act, interest on such a debt could be both included in the Canadian corporation's income (in respect of foreign accrual property income (FAPI)) under subsection 91(1) and non-deductible because of subsection 18(4).

New subsection 18(8) prevents this form of double taxation by permitting a corporation to deduct interest that would otherwise have been disallowed under the thin capitalization rules to the extent an amount in respect of the interest is included, either in the corporation's taxation year or a subsequent taxation year, in the corporation's income as FAPI.

Example

Canco is a taxable Canadian corporation and a wholly-owned subsidiary of a Canadian public corporation. Canco owns 75% of the only class of shares of Forco, which is a controlled foreign affiliate (as defined in subsection 95(1)) of Canco. Forco lends $1,000 to Canco with an annual interest rate of 5%. Canco has no capital for thin capitalization purposes. Forco has $10 of expenses that may be deducted in computing its FAPI and Canco's participating percentage in respect of Forco is 75% for the purposes of subsection 91(1).

The entire $50 of interest payable in respect of the year would, absent the application of subsection 18(8), therefore be denied by subsection 18(4). However, $30 of the $50 of interest paid by Canco to Forco (75% of its $40 of FAPI) would be included by subsection 91(1) in computing the income of Canco. The amount of interest denied by subsection 18(4) would therefore be reduced to $20 ($50 denied interest - $30 FAPI).

This subsection applies to taxation years that end after March 28, 2012.

Clause 7

Scientific research and experimental development

ITA
37

Budget 2012 announced a number of changes to the income tax treatment of expenditures incurred by a taxpayer on or in respect of scientific research and experimental development (SR&ED) carried on in Canada. These changes will impact the types of expenditures that are deductible under section 37 of the Act and are eligible for an investment tax credit (ITC) under section 127, (commonly known as SR&ED tax incentives). First, expenditures of a capital nature will no longer qualify for SR&ED tax incentives. Second, the rate at which overhead SR&ED expenditures are accounted for under the so-called proxy method will be gradually reduced from 65 % to 55%. Third, third-party arm's length payments for SR&ED expenditures will only be 80% eligible for ITCs. Fourth, the basic 20% ITC for SR&ED qualified expenditures will be reduced to 15%.

Section 37 provides, among other things, that a taxpayer carrying on business in Canada may deduct certain expenditures of a current nature incurred on SR&ED carried on in Canada. For an expenditure of a capital nature to be so eligible, the expenditure must be "all or substantially all" attributable to the prosecution of SR&ED in Canada. Under subsection 37(1), the expenditures are pooled to be deducted in the year incurred or carried forward indefinitely.

There are a number of ways in which SR&ED may be performed. Taxpayers can perform SR&ED directly, have someone else perform SR&ED on their behalf, or make payments for SR&ED to be carried on by third-parties.

ITA
37(1)

Subsection 37(1) of the Act is amended in two respects.

Subparagraph 37(1)(*a*)(i) describes expenditures of a current nature made by a taxpayer on SR&ED carried on in Canada directly by or on behalf of the taxpayer, and related to the taxpayer's business. Paragraph (*a*) is amended by adding new subparagraph (i.01), which describes SR&ED carried out on behalf of the taxpayer. As a consequence, subparagraph (*a*)(i) is also amended to remove the reference to SR&ED carried out on behalf of the taxpayer.

The amendments to subparagraph 37(1)(*a*) apply in respect of expenditures made after 2012.

Second, paragraph 37(1)(*b*) describes expenditures of a capital nature directly made by a taxpayer on SR&ED carried on in Canada and related to the taxpayer's business. Paragraph (*b*) is repealed. Such capital expenditures will be subject to the treatment otherwise applicable to them under the Act.

The amendment to subparagraph 37(1)(*b*) applies in respect of expenditures made after 2013 and expenditures that subsection 37(1.2) deems not to have been made before 2014. In general terms, subsection 37(1.2) provides that an expenditure of a capital nature has not been made (i.e., cannot be deducted under section 37) until the property is first available for use.

Interpretation

ITA
37(8)

Subsection 37(8) of the Act provides rules for determining which expenditures incurred in respect of SR&ED are eligible for inclusion in subsection 37(1) in the case of expenditures incurred in Canada and subsection 37(2) in the case of expenditures incurred outside Canada.

ITA
37(8)(*a*)

Subparagraph 37(8)(*a*)(ii) of the Act provides rules for interpreting the expression "expenditures on or in respect of scientific research and experimental development" incurred in Canada.

Subclauses 37(8)(*a*)(ii)(A)(III) and 37(8)(*a*)(ii)(B)(I), (III) and (VI) are repealed consequential on the repeal of paragraph 37(1)(*b*), which implements the Budget 2012 proposal to no longer allow the deduction of expenditures of a capital nature under section 37. In addition, subclause 37(8)(*a*)(ii)(B)(II) is amended to ensure that it applies only to an expenditure of a current nature.

These amendments apply in respect of expenditures made after 2013 and expenditures that subsection 37(1.2) deems not to have been made before 2014.

ITA
37(8)(*d*)

Paragraph 37(8)(*d*) of the Act provides, amongst other things, that a capital expenditure made for, or in respect of, a building (other than a prescribed special-purpose building) does not qualify as an expenditure on, or in respect of, SR&ED. Paragraph 37(8)(*d*) is amended consequential on the repeal of paragraph 37(1)(*b*).

Paragraph 37(8)(*d*) is amended to provide that an expenditure of a current nature does not include an expenditure made by a taxpayer for the acquisition of a property from a person or partnership that is a capital property of the taxpayer, or expenditures for the use of, or the right to use, property that would be capital property of the taxpayer if the property were owned by the taxpayer. As a consequence, expenditures incurred by a taxpayer in developing a capital property, e.g., salaries paid to employees to develop a SR&ED property, will generally be considered, for tax purposes, to be expenditures of a current nature.

This amendment applies in respect of expenditures made after 2013 and expenditures that subsection 37(1.2) deems not to have been made before 2014.

Look-through rule

ITA
37(14)

New subsection 37(14) of the Act provides for a look-through rule to ensure that expenditures incurred by a taxpayer in respect of SR&ED performed on behalf of the taxpayer or by third-party entities include only expenditures of a current nature. In particular, for the purposes of subparagraphs 37(1)(*a*)(i.01) to (iii), the amount of a particular expenditure made by a taxpayer is to be reduced by the amount of any related expenditure of the person or partnership (the SR&ED performer) to whom the particular expenditure is made that is not an expenditure of a current nature of the person or partnership.

This amendment applies in respect of expenditures made after 2013 and expenditures that subsection 37(1.2) deems not to have been made before 2014.

Reporting of certain payments

ITA
37(15)

New subsection 37(15) of the Act provides that where a taxpayer is required to reduce an expenditure because of the expenditure look-through rule in subsection 37(14), the SR&ED performer (the person or the partnership referred to in subsection 37(14)) is required to inform the taxpayer in writing of the amount of the reduction. This information is to be provided without delay if requested by the taxpayer and in any other case no later than 90 days after the end of the calendar year in which the expenditure was made.

This amendment applies in respect of expenditures made after 2013 and expenditures that subsection 37(1.2) deems not to have been made before 2014.

Clause 8

Amounts to be deducted

ITA
53(2)(*c*)

Paragraph 53(2)(*c*) of the Act provides for deductions to the adjusted cost base of a taxpayer's partnership interest. Subparagraph 53(2)(*c*)(xiii) is introduced consequential on the introduction of the provisions relating to transfer pricing secondary adjustments found in subsections 247(12) to (15). These subsections apply only to corporations and as a result, subparagraph 53(2)(*c*)(xiii) is only relevant for corporate partners. For further information on subsections 247(12) to (15), see the commentary on those subsections.

Subparagraph 53(2)(*c*)(xiii) provides for a reduction in the adjusted cost base of a taxpayer's interest in a partnership equal to the amount by which a deemed dividend under subsection 247(12) in respect of a transaction or series of transactions in which the partnership was a participant, is reduced under subsection 247(13) as the result of a repatriation of funds to the taxpayer. This adjusted cost base reduction results from what is, in effect, a distribution of funds from the partnership to the taxpayer that is made through the repatriation mechanism in subsection 247(13).

This subparagraph applies to transactions (including transactions that are part of a series of transactions) that occur after March 28, 2012.

Clause 9

Deemed dividend

ITA
84(1)(*c.1*) to (*c.3*)

Subsection 84(1) of the Act deems a dividend to have been paid by a corporation on the shares of a class of its capital stock where the paid-up capital of the class is increased by the corporation in circumstances other than those set out in that subsection. Paragraphs 84(1)(*c.1*) to (*c.3*) provide exceptions where the paid-up capital is increased by way of a conversion of contributed surplus in certain circumstances.

Similar to the amendment to clause 18(4)(*a*)(ii)(B) discussed above, paragraphs 84(1)(*c.1*) to (*c.3*) are amended in order to exclude any portion of contributed surplus that arises in connection with an investment to which the foreign affiliate dumping rules in new subsection 212.3(2) apply by virtue of subsection 212.3(1). Thus, a deemed dividend will now arise to the extent that contributed surplus created in a foreign affiliate dumping transaction is converted into paid-up capital. For further information, see the commentary on clause 18(4)(*a*)(ii)(B).

These amendments come into force on March 29, 2012.

Clause 10

Winding-up

ITA
88

Section 88 of the Act deals with the tax consequences arising from the winding-up of a corporation. One of the rules in the section provides that the cost of certain capital assets acquired by a taxable Canadian corporation (the parent) on the winding-up of its 90-percent-owned subsidiary that is also a taxable Canadian corporation can be increased to take into account, subject to certain limits, the amount paid by the parent to acquire the shares of the subsidiary. Properties that could produce income upon a disposition are not eligible for this cost base increase, such as eligible capital property, depreciable property, inventory and resource property (ineligible property). The same rule allowing for a cost base increase also applies on the vertical amalgamation of a parent and its wholly-owned-subsidiary.

Budget 2012 announced a number of changes to prevent structures that have been used in an attempt to, as part of a series of transactions, indirectly increase the cost base of ineligible properties on the winding-up of a subsidiary. Typically, a subsidiary would hold such properties indirectly through a partnership, and the parent corporation would seek to increase the cost base of the partnership interest, even if the fair market value of the interest is attributable to ineligible property. Budget 2012 also announced that related anti-avoidance amendments to the Act would be introduced as necessary to give effect to the budget proposal.

Winding-up

ITA
88(1)

Subsection 88(1) of the Act provides rules that apply if a subsidiary has been wound-up into its parent in circumstances where both the parent and its subsidiary are taxable Canadian corporations and the parent owns at least 90% of the issued shares of each class of the capital stock of the subsidiary.

ITA
88(1)(*d*)(ii.1)

Paragraph 88(1)(*d*) of the Act determines, for the purposes of paragraph 88(1)(*c*), the amount by which the parent may increase or “bump” the adjusted cost base (ACB) of non-depreciable capital property acquired by it on the winding-up of its subsidiary. Subparagraph 88(1)(*d*)(ii) provides that the bump amount (i.e., the increase in ACB) cannot exceed the amount, if any, by which the fair market value of the capital property at the time the parent last acquired control of the subsidiary exceeds the cost amount to the subsidiary of the property immediately before the winding up.

Paragraph 88(1)(*d*) is amended by adding new subparagraph 88(1)(*d*)(ii.1). Subparagraph 88(1)(*d*)(ii.1) reduces the fair market value of an interest in a partnership held by a subsidiary at the time the parent last acquired control of the subsidiary to the amount determined by the formula A – B where

A	is the fair market value of the partnership interest at the time the parent last acquired control of the subsidiary (determined without reference to subparagraph 88(1)(*d*)(ii.1)).

B	is the portion of the amount by which the fair market value of the interest at the time the parent last acquired control of the subsidiary exceeds its cost amount as may reasonably be regarded as being attributable to the total of all amounts each of which is

- in the case of a depreciable property held directly by the partnership or held indirectly by the partnership through one or more other partnerships, the amount by which the fair market value (determined without reference to liabilities) of the depreciable property exceeds its cost amount – that is, the amount that is the fair market value of the interest is reduced by the amount of unrealized recapture income and gains in respect of the partnership's depreciable property when the parent last acquired control of the subsidiary;
- in the case of a Canadian resource property or a foreign resource property held directly by the partnership or held indirectly by the partnership through one or more other partnerships, the fair market value (determined without reference to liabilities) of the property; and
- in the case of a property that is not capital property, a Canadian resource property or a foreign resource property (for example, eligible capital property and inventory of a business) held directly by the partnership or held indirectly by the partnership through one or more other partnerships, the amount by which the fair market value (determined without reference to liabilities) of the property exceeds its cost amount.

Subparagraph 88(1)(*d*)(ii.1) is meant to ensure that the bump available in respect of a subsidiary's interest in a partnership does not reflect unrealized gains and recapture income in respect of property that would not be eligible for a bump if it were held directly by the subsidiary (i.e., ineligible property). The subparagraph achieves this by reducing the fair market value of the partnership interest by the unrealized gains and recapture income in respect of ineligible property that is either held directly by the partnership or held indirectly through one or more other partnerships.

In particular, the subparagraph reduces the fair market value of the subsidiary's interest in a partnership by the portion of its gain in respect of the partnership interest (i.e., the subsidiary's "outside" gain) that "may reasonably be regarded as being attributable" to the total gains in respect of the partnership's ineligible property (i.e., the total "inside" gains). The determination of the portion of a corporate partner's outside gain in respect of a partnership interest that "may reasonably be regarded as being attributable" to the total inside gains in respect of the partnership's ineligible property will depend on the factors present in each particular situation, including whether the outside gain is lower or higher than the inside gain attributable to ineligible property and whether there are inside gains in respect of other partnership property.

Three examples of the application of subparagraph 88(1)(*d*)(ii.1) are provided below.

Example 1

Example 1 shows a situation in which the outside gain of a subsidiary's interest in a partnership equals the total inside gains in respect of all property held by the partnership.

Facts

- *The fair market value (FMV) of the subsidiary's 99.9% interest in Partnership ABC at the time control of the subsidiary is last acquired by the parent is $100,000 and the adjusted cost base (ACB) of the interest at that time is $70,000. Therefore, an unrealized gain of $30,000 exists in respect of the partnership interest.*
- *Partnership ABC holds two properties at the time control of the subsidiary is last acquired by the parent, one of which is land and the other is depreciable property (a building).*
  - *In the case of the land, its FMV is $10,000 and its ACB is $5,000.*
  - *In the case of the building, its FMV is $90,000 and its undepreciated capital cost (UCC) is $65,000.*
  - *Consequently:*
    - *The combined FMV of the two partnership properties is $100,000 and the combined tax cost is $70,000 ($5,000 + $65,000).*
    - *The FMV of the subsidiary's partnership interest ($100,000) equals the FMV of the land and building ($100,000).*
    - *The outside gain ($30,000) equals the total inside gains ($30,000 = $5,000 + $25,000).*
    - *The outside ACB of the partnership interest ($70,000) equals the total tax cost of the partnership's two properties ($70,000 = $5,000 + $65,000).*
  - *But for new subparagraph 88(1)(d)(ii.1), if the parent were to wind-up the subsidiary immediately after acquiring control, the bump room in respect of the subsidiary's partnership interest would be, in this example, $30,000 ($100,000 - $70,000).*
  - *No other factors are relevant.*

Application of subparagraph 88(1)(d)(ii.1)

- *The FMV of the subsidiary's interest in Partnership ABC is deemed to be $75,000 (instead of $100,000). This FMV is calculated as follows: it is the amount that is A – B where*
  - *A is $100,000 (the FMV of the partnership interest without reference to the subparagraph); and*
  - *B is $25,000 ($30,000 x $25,000/$30,000): $25,000 is the portion of the $30,000 outside gain in respect of the partnership interest ($100,000 less its cost amount of $70,000) that may reasonably be regarded as being attributable to*

    (A) in the case of the depreciable property, $25,000 (being its $90,000 FMV minus its $65,000 UCC); and

    (B) in the case of resource property, nil; and

    (C) in the case of non-capital property, nil.

In Example 1, the relationship between the outside gain of $30,000 in respect of the partnership interest and the inside gain in respect of ineligible property ($25,000) is relatively easy to appreciate because the outside gain and the total inside gains are equal. The portion of the $30,000 outside gain that is reasonably attributable to the gain on the ineligible property is the $25,000 gain for the ineligible property held by the partnership. The fair market value of the partnership interest is thus reduced from $100,000 to $75,000 by subtracting the $25,000 inside gains in respect of the partnership's ineligible property.

Example 2

Example 2 concerns a situation in which the outside gain in respect of the partnership interest is less than the total inside gains in respect of property held by the partnership.

Facts

- *The fair market value (FMV) of the subsidiary's 99.9% interest in Partnership ABC at the time control of the subsidiary is last acquired by the parent is $100,000 and the adjusted cost base (ACB) of the interest at that time is $70,000. Therefore, an unrealized gain of $30,000 exists in respect of the partnership interest.*
- *Partnership ABC holds two properties at the time control of the subsidiary is last acquired by the parent, one of which is land and the other is depreciable property (a building).*
  - *In the case of the land, its FMV is $10,000 and its ACB is $5,000.*
  - *In the case of the building, its FMV is $90,000 and its undepreciated capital cost (UCC) is $35,000.*
  - *Consequently:*
    - *The combined FMV of the two properties is $100,000 and the combined tax cost is $40,000 ($5,000 + $35,000).*
    - *The FMV of the subsidiary's partnership interest ($100,000) equals the FMV of the land and building ($100,000).*
    - *The outside gain ($30,000) is less than the total inside gains ($60,000 = $5,000 + $55,000).*
    - *The outside ACB of $70,000 in respect of the partnership interest exceeds the total tax cost of $40,000 in respect of the partnership's two properties ($5,000 + $35,000).*
- *But for new subparagraph 88(1)(d)(ii.1), if the parent were to wind-up the subsidiary immediately after acquiring control, the bump room in respect of the subsidiary's partnership interest would be, in this example, $30,000 ($100,000 - $70,000).*
- *No other factors are relevant.*

Application of subparagraph 88(1)(d)(ii.1)

- *The FMV of the subsidiary's interest in Partnership ABC is deemed to be $72,500 (instead of $100,000). This FMV is calculated as follows: it is the amount that is A – B where*
  - *A is $100,000 (the FMV of the partnership interest determined without reference to the subparagraph); and*
  - *B is $27,500 ($30,000 x $55,000/$60,000), which is the portion of the amount of $30,000 – the FMV of the partnership interest ($100,000) less the cost amount ($70,000) of the interest – that may reasonably be regarded as being attributable to*

    (A) in the case of the depreciable property, $55,000 (being its $90,000 FMV minus its $35,000 UCC); and

    (B) in the case of resource property, nil; and

    (C) in the case of non-capital property, nil.

In Example 2, the amount of variable B is $27,500 because the unrealized outside gain of $30,000 is attributable to <u>both</u> the unrealized gain and recapture in respect of the depreciable property ($55,000) and the unrealized gain in respect of the land ($5,000). Consequently, the portion of the outside gain that may reasonably be regarded as being attributable to the building is based on an apportionment of the outside gain *to the inside gains in respect of the two properties held by the partnership (i.e., $27,500 = $30,000 x $55,000/$60,000).*

Example 3

Example 3 is a situation in which the outside gain in respect of the partnership interest exceeds the total inside gains in respect of the partnership's properties.

Facts

- *The fair market value (FMV) of the subsidiary's 99.9% interest in Partnership ABC at the time control of the subsidiary is last acquired by the parent is $100,000 and the adjusted cost base (ACB) of the interest at that time is $70,000. Therefore, an unrealized gain of $30,000 exists in respect of the partnership interest.*
- *Partnership ABC holds two properties at the time control of the subsidiary is last acquired by the parent one of which is land and the other is depreciable property (a building).*
    - *In the case of the land, its FMV is $30,000 and its ACB is $20,000.*
    - *In the case of the building, its FMV is $70,000 and its undepreciated capital cost (UCC) is $60,000.*
    - *Consequently:*
        - *The combined FMV of the two properties is $100,000 and the combined tax cost is $80,000 ($20,000 + $60,000).*
        - *The FMV of the subsidiary's partnership interest ($100,000) equals the FMV of the land and building ($100,000).*
        - *The outside gain ($30,000) exceeds the inside gain ($20,000 = $10,000 + $10,000).*
        - *The outside ACB of $70,000 in respect of the partnership interest is less than the total tax cost of $80,000 of the partnership's two properties.*
- *But for new subparagraph 88(1)(d)(ii.1), if the parent were to wind-up the subsidiary immediately after acquiring control, the bump room in respect of the subsidiary's partnership interest would be, in this example, $30,000 ($100,000 - $70,000).*
- *No other factors are relevant.*

Application of subparagraph 88(1)(d)(ii.1)

- *The FMV of the subsidiary's interest in Partnership ABC is deemed to be $90,000 (instead of $100,000). This FMV is calculated as follows: it is the amount that is A – B where*
    - *A is $100,000, the FMV of the partnership interest (determined without reference to the subparagraph); and*
    - *B is $ 10,000, which is the portion of the amount of $30,000 – the FMV of the partnership interest ($100,000) less the cost amount ($70,000) of the interest – that may reasonably be regarded as being attributable to*

        (A) in the case of the depreciable property, $10,000 (being its $70,000 FMV minus its $60,000 UCC); and

        (B) in the case of resource property, nil; and

        (C) in the case of non-capital property, nil.

In Example 3, the amount of variable B is $10,000 because it is reasonable to conclude that only $10,000 of the $30,000 outside gain is attributable to the depreciable property held by the partnership. In calculating the amount of variable B, the reference in the description to "may reasonably regarded as being attributable" to gains in respect of ineligible property generally means that the reduction in the fair market value of the partnership interest under subparagraph 88(1)(d)(ii.1) is not expected, in normal circumstances, to exceed the total of all gains attributable to ineligible property held, directly or indirectly, by the partnership.

Examples 1 to 3 show that the calculation of the deemed fair market value of a subsidiary corporation's interest in a partnership under subparagraph 88(1)(*d*)(ii.1) depends on a number of factors, including the unrealized outside gain in respect of the partnership interest held by the subsidiary and the unrealized gain and recapture existing in respect of ineligible property and other property held, directly or indirectly, by the partnership.

To ensure that subparagraph 88(1)(*d*)(ii.1) is effective, new paragraph 88(1)(*e*) and new subsection 97(3) are also introduced. In general, paragraph 88(1)(*e*) applies to certain transfers of ineligible property to a partnership in which an interest is held by a subsidiary (either directly or indirectly) before the parent's acquisition of control of the subsidiary, while subsection 97(3) applies to certain transfers of property to a partnership after the parent acquires control of the subsidiary. For further information, please see the commentary on those two provisions.

It is recognized that a subsidiary may wish to transfer ineligible property to a taxable Canadian corporation before there is an acquisition of control of the subsidiary in order to preserve the bump room that would otherwise be, but for subparagraph 88(1)(*d*)(ii.1), available in respect of the partnership interest. Consequently, subparagraph 88(1)(*d*)(ii.1) does not reduce the fair market value of a partnership interest by the unrealized gains and recapture income existing in respect of shares of a taxable Canadian corporation held by the partnership, even if properties held by the corporation are ineligible properties.

In general, subparagraph 88(1)(*d*)(ii.1) applies after March 28, 2012. An exception is provided where a taxable Canadian corporation (referred to as the "parent corporation") has acquired control of another taxable Canadian corporation (referred to as the "subsidiary corporation") – for an amalgamation of the parent and the subsidiary corporation that occurs before 2013 or a winding-up of the subsidiary corporation into the parent corporation that begins before 2013, if

- the parent corporation acquired control of the subsidiary corporation before March 29, 2012, or was obligated as evidenced in writing before March 29, 2012 to acquire control of the subsidiary (except that the parent corporation shall not be considered to be obligated if, as a result of amendments to the Act, it may be excused from the obligation to acquire control), and
- the parent corporation had the intention as evidenced in writing before March 29, 2012 to amalgamate with, or wind up, the subsidiary corporation.

ITA
88(1)(*e*)

New paragraph 88(1)(*e*) of the Act provides an anti-avoidance rule that, if applicable, reduces the fair market value of a subsidiary's partnership interest for the purpose of applying the description of A in the formula in subparagraph 88(1)(*d*)(ii.1). In particular, the fair market value of an interest in a particular partnership held by the subsidiary at the time the parent last acquired control of the subsidiary is deemed not to include the amount that is the total of each amount that is the fair market value of a property that would otherwise be included in the fair market value of the interest, if

- as part of a series of transactions or events in which control of the subsidiary (that holds an interest in a particular partnership) is last acquired by the parent and on or before the acquisition of control,

  - the subsidiary disposes of the property to the particular partnership or any other partnership and subsection 97(2) applies to the disposition, or
  - the subsidiary acquires an interest in a partnership from a person or partnership with whom it does not deal at arm's length (otherwise than because of a right referred to in paragraph 251(5)(*b*)) and section 85 applies to the acquisition; and
- at the time of the acquisition of control of the subsidiary, the particular partnership holds, directly or indirectly through one or more other partnerships, ineligible property described in clauses (A) to (C) of the description of B in subparagraph 88(1)(*d*)(ii.1).

Paragraph 88(1)(*e*) is meant to address transfers of property under subsection 97(2) to a partnership, or of an interest in a partnership under section 85, before the parent acquires control of the subsidiary corporation (during the series of transactions in which control is acquired) in circumstances where the transfers are made to change the factors that may be relevant when applying the formula in subparagraph 88(1)(*d*)(ii.1).

Generally, new paragraph 88(1)(*e*) applies on and after Announcement Date. However, paragraph 88(1)(*e*) does not apply to a disposition that occurs before 2013 pursuant to an obligation under a written agreement entered into before Announcement Date by parties that deal with each other at arm's length and no party to the agreement may be excused from the obligation as a result of amendments to the Act.

Clause 11

Paid-up capital

ITA
89(1)

Subsection 89(1) of the Act defines the term "paid-up capital" for the purposes of various provisions of the Act. Paragraph (*b*) of that definition defines "paid-up capital" in respect of a class of shares of the capital stock of a corporation and subparagraph (*b*)(iii) makes it explicit that various provisions of the Act are to be taken into account in determining paid-up capital of a class.

Subparagraph (*b*)(iii) of the definition "paid-up capital" in subsection 89(1) is amended, consequential on the introduction of the foreign affiliate dumping rules, to add references to new paragraph 128.1(1)(*c.3*) and new section 212.3.

This amendment comes into force on March 29, 2012.

Clause 12

Shares held by a partnership

ITA
93.1(1)

Subsection 93.1(1) of the Act applies for the purpose of determining whether a non-resident corporation is a foreign affiliate of a corporation resident in Canada, for certain enumerated provisions of the Act and the *Income Tax Regulations*, where the Canadian corporation owns the non-resident corporation's shares through a partnership. In this regard, subsection 93.1(1) deems the Canadian corporation to own its proportionate number of the non-resident corporation's shares based on its relative fair market value interest in the partnership.

Subsection 93.1(1) is amended, consequential on the introduction of the foreign affiliate dumping rules, to add references to new paragraph 128.1(1)(*c.3*), new section 212.3 and new subsection 219.1(2) to its list of enumerated provisions.

This amendment comes into force on March 29, 2012.

Clause 13

Acquisition of property by partnership

ITA
97

Section 97 of the Act sets out rules that apply when a partnership acquires property from a taxpayer.

Rules where election by partners

ITA
97(2)

Subsection 97(2) of the Act sets out rules which allow a taxpayer to transfer certain types of property on a tax-deferred basis to a Canadian partnership. Subsection 97(2) is amended to make it subject to new subsection 97(3), which is described below.

This amendment applies in respect of dispositions made after March 28, 2012.

Where subsection 97(2) not applicable

ITA
97(3)

New subsection 97(3) of the Act provides that the tax-deferred transfer rule in subsection 97(2) does not apply to certain dispositions of property made by a taxpayer to a Canadian partnership in which a subsidiary (referred to in subsection 88(1)) holds an interest where the disposition occurs after control of the subsidiary is acquired by its parent (referred to in subsection 88(1)). This anti-avoidance rule is meant to ensure that property that is not eligible for a cost base increase or "bump" under paragraph 88(1)(*c*) (ineligible property) is not transferred on a tax-deferred basis under subsection 97(2) to a partnership of the subsidiary after control of the subsidiary is acquired by the parent in circumstances that would seek to frustrate the purpose of new subparagraph 88(1)(*d*)(ii.1), which operates to reduce the fair market value of a subsidiary's partnership interest in certain circumstances. For further information, see the commentary for new subparagraph 88(1)(*d*)(ii.1).

New subsection 97(3) applies to preclude the application of subsection 97(2) to a disposition of property to a particular partnership if

- as part of a transaction or event or series of transactions or events that includes the disposition
  - control of a taxable Canadian corporation (the subsidiary) is acquired by another taxable Canadian corporation (the parent),
  - the subsidiary is wound-up under subsection 88(1) or amalgamated with one or more corporations under subsection 87(11), and
  - the parent makes a designation under paragraph 88(1)(*d*) in respect of an interest in the partnership;
- the disposition occurs after the acquisition of control of the subsidiary;
- the particular partnership acquires property that is ineligible for the bump (for example, depreciable property, inventory and resource property) or is an interest in a partnership that holds such property; and
- the subsidiary is the taxpayer or has, before the disposition of the property, directly or indirectly in any manner whatever, an interest in the taxpayer.

For example, new subsection 97(3) may apply in the following situations:

1. A taxable Canadian corporation (the Subsidiary) has an interest in Partnership ABC at the time another taxable Canadian corporation (the Parent) acquires control of the Subsidiary. The Subsidiary seeks to transfer ineligible property under subsection 97(2) to Partnership ABC after the acquisition of control of the Subsidiary by the Parent.
2. A taxable Canadian corporation (the Subsidiary) has an interest in Partnership ABC. Partnership ABC, in turn, has an interest in Corporation Y at the time another taxable Canadian corporation (the Parent) acquires control of the Subsidiary. Corporation Y, either prior to the time Parent acquired control of Subsidiary or after that time, has an interest in Partnership XYZ (the taxpayer). Partnership XYZ seeks to transfer ineligible property under subsection 97(2) to Partnership ABC after the acquisition of control of the Subsidiary by the Parent.

New subsection 97(3) applies in respect of dispositions made after March 28, 2012.

Clause 14

Disposition of an interest in a partnership

ITA
100(1)

Subsection 100(1) of the Act provides that a taxpayer's taxable capital gain for a taxation year from the disposition of an interest in a partnership to any person exempt from tax under section 149 is one-half of the portion of the taxpayer's capital gain from the disposition that can reasonably be attributed to increases in value of capital property other than depreciable property of the partnership plus the whole of the remaining portion of the gain.

Subsection 100(1) is amended to extend its application.

First, the preamble of subsection 100(1) is amended so that the subsection applies when, as part of a transaction or event or series of transactions or events, there is a disposition of a partnership interest and an acquisition by a person or partnership described in any of new paragraphs 100(1.1)(*a*) to (*d*). In general, subsection 100(1) will apply when a person that is exempt from tax under section 149 or a non-resident person acquires a partnership interest. The commentary on subsection 100(1.1) provides further information including commentary on the operation of look-through rules that apply to a disposition of a partnership interest where the interest is acquired by another partnership or a trust.

Second, paragraph 100(1)(*a*) – which applies to one-half of the portion of the taxpayer's capital gain from the disposition that can reasonably be attributed to increases in value of non-depreciable capital property of the partnership – is amended to ensure that paragraph 100(1)(*b*) applies to depreciable property and to property that is not capital property (e.g., eligible capital property, inventory and resource property) if held indirectly by a partnership through one or more other partnerships.

Generally, amended subsection 100(1) applies to dispositions of an interest in a partnership made by a taxpayer after March 28, 2012. Transitional relief is provided for certain dispositions completed before Announcement Date, or before 2013 pursuant to an arm's length agreement entered into before March 29, 2012.

Acquisition by certain persons or partnerships

ITA
100(1.1)

New subsection 100(1.1) of the Act provides that subsection 100(1) applies in respect of a disposition of a partnership interest by a taxpayer if the interest is acquired by certain persons or partnerships.

Paragraphs 100(1.1)(*a*) and (*b*) refer to direct acquisitions of the taxpayer's interest in a partnership by a person exempt from tax under section 149 or a non-resident person, respectively. A non-resident person includes a non-resident trust.

Paragraphs 100(1.1)(*c*) and (*d*) provide look-through rules where the partnership interest is acquired by another partnership or by a trust resident in Canada (other than a mutual fund trust), referred to as the “purchasing partnership” and “purchasing trust” respectively. In general, these rules look through a purchasing partnership or purchasing trust to ensure that subsection 100(1) applies appropriately to the taxpayer’s disposition of an interest in a partnership.

In the case of paragraph 100(1.1)(*c*), the look-through rule applies to the extent that the partnership interest acquired by the purchasing partnership can reasonably be considered to be held indirectly through one or more partnerships by a person that is

- exempt from tax under section 149,
- a non-resident person, or
- a trust resident in Canada (other than a mutual fund) if
    - an interest as a beneficiary under the trust is held directly or indirectly through one or more partnerships by a person exempt from tax under section 149 or a trust (other than a mutual fund trust), and
    - the total fair market value of the interests as beneficiaries in the trust held by a person exempt from tax under section 149 or by another trust (other than a mututal fund trust) exceeds 10 % of the total fair market value of all interests as beneficiaries under the trust.

In the case of paragraph 100(1.1)(*d*), the look-through rule applies to the extent that the purchasing trust can reasonably be considered to have a beneficiary that is, in general terms, a person exempt from tax under section 149. This rule will apply where:

- a partnership is a beneficiary under the purchasing trust;
- one or more persons that are exempt from tax or are trusts (other than mutual fund trusts) are, directly or indirectly, members of the partnership; and
- the total fair market value of the interests held, directly or indirectly, by all such persons in the partnership exceeds 10% of the fair market value of all the interests in the partnership.

Similarly, the rule will also apply where:

- another trust (other than a mutual fund trust) is a beneficiary under the purchasing trust;
- one or more beneficiaries under the other trust are exempt from tax, are partnerships or are trusts (other than mutual fund trusts); and
- the total fair market value of the interests held as beneficiaries under the other trust by all such persons and partnerships exceeds 10% of the fair market value of all the interests as beneficiaries under the other trust.

Example 1

Facts

- *Taxpayer A disposes of an interest in Partnership ABC to Partnership XYZ and realizes a capital gain of $100,000 from the disposition.*
- *100% of the assets of Partnership ABC consist of resource property.*
- *40% of the interests in Partnership XYZ are held by persons exempt from tax under section 149 or by non-resident persons.*

- *60% of the interests in Partnership XYZ are held by taxable persons.*

Calculation of Taxpayer A's taxable capital gain under subsection 100(1)

- *By reason of subsection 100(1.1), 40% of Taxpayer A's disposition (40% of the $100,000 capital gain) of its interest in Partnership ABC is subject to subsection 100(1). That is, 40% is the percentage representing the extent to which the interest in Partnership ABC disposed of by Taxpayer A was acquired by persons exempt from tax or by non-resident persons through Partnership XYZ.*
- *The taxable capital gain of Taxpayer A resulting from the disposition of the interest in Partnership ABC after applying subsection 100(1) is $70,000, calculated as follows:*
    - *$30,000 (50% of the $60,000 portion of capital gain that is not subject to subsection 100(1)); and*
    - *$40,000 (100% of the $40,000 portion of the gain under paragraph 100(1)(b)).*

Example 2

Facts

- *Taxpayer A disposes of an interest in Partnership ABC to Partnership XYZ and realizes from the disposition a capital gain of $100,000.*
- *100% of the assets of Partnership ABC consist of depreciable property.*
- *40% of the interests in Partnership XYZ are held by persons exempt from tax under section 149 or by non-resident persons.*
- *30% of the interests in Partnership XYZ are held by Partnership MNO, and 50% of the members of Partnership MNO are persons exempt from tax under subsection 149 or non-resident persons.*
- *30% of the interests in Partnership XYZ are held by Trust M (which is a resident of Canada and is not a mutual fund trust), and 50% of the beneficiaries of Trust M are persons exempt from tax under section 149.*

Calculation of Taxpayer A's taxable capital gain under subsection 100(1)

- *By reason of subsection 100(1.1), 85% of Taxpayer A's disposition of its interest in Partnership ABC is subject to subsection 100(1). That is, 85% is the total of*
    - *40% - the percentage representing the extent to which the interest in Partnership ABC disposed of by Taxpayer A is held by persons who are exempt from tax or are non-resident through Partnership XYZ.*
    - *15% - the percentage representing the extent to which the interest in Partnership ABC disposed of by Taxpayer A is held by persons who are exempt from tax under section 149 or non-resident persons through Partnership XYZ and Partnership MNO (Partnership MNO has a 30% interest in Partnership XYZ and a 50% interest in Partnership MNO is held by persons exempt from tax or by non-resident persons). The term "to the extent that" directs that one or more partnerships be looked-through to the portion held by such persons.*
    - *30% - the percentage representing the extent to which the interest in Partnership ABC disposed by Taxpayer A is held through Partnership XYZ by Trust M, and more than 10% of the fair market value of the interests under Trust M are held by persons that are exempt from tax under section 149.*

- *The taxable capital gain of Taxpayer A resulting from the disposition of the interest in Partnership ABC after applying subsection 100(1) is $92,500 calculated as follows:*
    - *$7,500 (50% of the $15,000 portion of capital gain that is not subject to subsection 100(1)); and*
    - *$85,000 ($100% of the $85,000 portion of the gain under paragraph 100(1)(b)).*

Examples 1 and 2 do not consider the case where a trust resident in Canada (other than a mutual fund trust) acquires the partnership interest disposed of by Taxpayer A. In such a case, the term “to the extent that” of paragraph 100(1.1)(*d*) looks through the acquiring trust to its beneficiaries.

It should be noted that subsection 100(1.2) provides a 10% *de minimus* exception from the application of paragraphs 100(1.1)(*c*) and (*d*).

New subsection 100(1.1) comes into force on Announcement Date. Transitional relief is provided for certain transactions completed before 2013 pursuant to an arm’s length agreement entered into before Announcement Date.

De minimus

ITA
100(1.2)

New subsection 100(1.2) of the Act provides a 10% *de minimus* exception from the application of the look-through rule in paragraphs 100(1.1)(*c*) and (*d*). The exception applies to a taxpayer’s disposition of a partnership interest to a partnership or trust (other than a discretionary trust) if the extent to which subsection 100(1) would, but for new subsection 100(1.2), apply to the taxpayer’s disposition does not exceed 10% of the taxpayer’s interest.

New subsection 100(1.2) comes into force on Announcement Date. Transitional relief is provided for certain transactions completed before 2013 pursuant to an arm’s length agreement entered into before Announcement Date.

Exception – non-resident person

ITA
100(1.3)

New subsection 100(1.3) of the Act provides an exception from the application of subsection 100(1) in respect of the disposition of a partnership interest to a non-resident person. The exception applies to the disposition if

- property of the partnership is used, immediately before and immediately after the acquisition of the interest by the non-resident person, in carrying on business through one or more permanent establishments in Canada; and
- the total fair market value of the partnership’s property equals at least 90% of the total fair market value of all property of the partnership (determined without reference to liabilities).

The definition “permanent establishment” in section 8201 of the *Income Tax Regulations* is amended consequential on this amendment.

New subsection 100(1.3) comes into force on March 29, 2012.

Anti-avoidance – dilution

ITA
100(1.4)

New subsection 100(1.4) of the Act, together with subsection 100(1.5), provide an anti-avoidance rule that applies where partnership interests are created or changed in a way that is economically equivalent to a direct disposition of a partnership interest without a disposition of an interest having been made. Subsection 100(1.4) provides that if two conditions are met, subsection 100(1.5) will apply. The first condition is that it is reasonable to conclude that one of the purposes of a dilution, reduction or alteration of a partnership interest is to avoid the application of subsection 100(1) in respect of the partnership interest. The second condition is that there be, as part of a transaction or event or series of transactions or events that includes the dilution, reduction or alteration,

- an acquisition of an interest in the partnership by a person or partnership described in any of paragraphs 100(1.1)(*a*) to (*d*); or
- an increase in, or alteration of, an interest in the partnership held by a person or partnership described in any of paragraphs 100(1.1)(*a*) to (*d*).

New subsection 100(1.4) comes into force on Announcement Date. Transitional relief is provided for certain transactions completed before 2013 pursuant to an arm's length agreement entered into before Announcement Date.

Deemed gain – dilution

ITA
100(1.5)

If the conditions in subsection 100(1.4) of the Act are met, subsection 100(1.5) provides that, for the purposes of subsection 100(1),

- the taxpayer is deemed to have disposed of an interest in the relevant partnership at the time of the dilution, reduction or alteration. Dilution includes the diminishment of, or the lessening of the value of, the partnership interest;
- the taxpayer is deemed to have a capital gain from the disposition equal to the amount by which the fair market value of the particular interest immediately before the dilution, reduction or alteration exceeds its fair market value immediately thereafter; and
- a person or partnership referred to in paragraph 100(1.4)(*b*) – in general terms, a person exempt from tax under section 149 or a non-resident person – is deemed to have acquired an interest in the partnership as part of the transaction or event or series of transactions or events that includes the deemed disposition. This deeming rule is meant to ensure that the requirements in subsection 100(1) – that there be both a disposition and acquisition of a partnership interest – are met.

Subsection 100(1.5) comes into force on Announcement Date. Transitional relief is provided for certain transactions completed before 2013 pursuant to an arm's length agreement entered into before Announcement Date.

Clause 15

Overseas employment tax credit

ITA
122.3

Section 122.3 of the Act currently provides an "overseas employment tax credit" (OETC) to individuals resident in Canada who are employed for at least six consecutive months in a foreign country by a specified employer in connection with a resource, construction, installation, agricultural or engineering project. Section

122.3 is amended to phase out the OETC. During the phase out period, the factor (currently 80%) applied to an employee's qualifying foreign employment income in determining the employee's OETC will be reduced to 60% for the 2013 taxation year, 40% for the 2014 taxation year and 20% for the 2015 taxation year. At the same time, the maximum qualifying foreign employment income eligible for the OETC (currently $80,000) will be correspondingly reduced. The OETC will be eliminated for the 2016 and subsequent taxation years.

The phase out rules will not apply with respect to qualifying employment income earned by an employee in connection with a project or activity to which the employee's employer had committed in writing before March 29, 2012. For example, if an employer has tendered an irrevocable bid in writing for a project before March 29, 2012, the employer will be considered to have committed in writing to the project irrespective of whether the bid has been accepted before March 29, 2012. In this case, the factor applied to an employee's qualifying foreign employment income in determining the employee's OETC will remain 80% for the 2013, 2014 and 2015 taxation years. The OETC will be eliminated for the 2016 and subsequent taxation years and will not be available to the employee after 2015.

Deduction from tax payable where employment out of Canada

ITA
122.3(1)(*c*) and (*d*)

The OETC is determined by multiplying an employee's Part I tax otherwise payable for a taxation year by a fraction: the numerator of that fraction, determined under paragraphs 122.3(1)(*c*) and (*d*) of the Act, consists of the lesser of $80,000 and 80% of the individual's overseas employment income for the year; and the denominator of that fraction, determined under paragraph 122.3(1)(*e*), is the individual's income for the year reduced by certain deductions listed in subparagraph 122.3(1)(*e*)(iii). The $80,000 figure set out in paragraph 122.3(1)(*c*) is reduced, on a prorated basis, if the number of days in the "qualifying period" or on which the individual was resident in Canada that are in the year is less than 365.

Paragraph 122.3(1)(*c*) is amended to replace "$80,000" with "the specified amount for the year", which is defined in new subsection 122.3(1.01). Paragraph 122.3(1)(*d*) is amended to replace "80%" with "the specified percentage for the year", which is defined in new subsection 122.3(1.02). These amendments provide transitional rules for the phase out of the OETC. The formulas in new subsections 122.3(1.01) and (1.02) determine the extent to which an employee's income is eligible for the OETC.

Specified amount

ITA
122.3(1.01)

New subsection 122.3(1.01) of the Act defines the term "specified amount" for the purposes of paragraph 122.3(1)(*c*). The specified amount for the 2013 to 2015 taxation years is determined by the formula [$80,000 x A/(A+B)] + [C x B/(A+B)].

Amount A is the individual's income described in paragraph 122.3(1)(*d*) for the taxation year that is earned in connection with a contract that was committed to in writing before March 29, 2012 by a specified employer of the individual.

Amount B is the individual's income described in paragraph 122.3(1)(*d*) for the taxation year, other than income included in the description of A.

Amount C is $60,000 for the 2013 taxation year, $40,000 for the 2014 taxation year and $20,000 for the 2015 taxation year.

The specified amount is nil for the 2016 and subsequent taxation years, effectively eliminating the OETC after 2015.

This amendment applies to the 2013 and subsequent taxation years.

Specified percentage

ITA
122.3(1.02)

New subsection 122.3(1.01) defines the term “specified percentage” for the purposes of paragraph 122.3(1)(*d*). The specified percentage for the 2013 to 2015 taxation years is determined by the formula [80% x A/(A+B)] + [C x B/(A+B)] .

Amount A is the individual’s income described in paragraph 122.3(1)(*d*) for the taxation year that is earned in connection with a contract that was committed to in writing before March 29, 2012 by a specified employer of the individual.

Amount B is the individual’s income described in paragraph 122.3(1)(*d*) for the taxation year, other than income included in the description of A.

Amount C is 60% for the 2013 taxation year, 40% for the 2014 taxation year and 20% for the 2015 taxation year.

The specified percentage is 0% for the 2016 and subsequent taxation years, effectively eliminating the OETC after 2015.

This amendment applies to the 2013 and subsequent taxation years.

Clause 16

Deductions from Part I tax

ITA
127

Section 127 of the Act allows a taxpayer to take certain deductions in computing tax payable for logging taxes, political contributions and investment tax credits.

Investment tax credit

ITA
127(5)

Subsection 127(5) of the Act provides for the deduction of investment tax credits (ITCs) from a taxpayer’s Part I tax otherwise payable for a taxation year. The term “investment tax credit” is defined in subsection 127(9).

Budget 2012 announced a number of changes to the eligibility of expenditures for ITCs. First, the 10% ITC on the cost of property primarily used in oil, gas and mining activities in Atlantic Canada is phased out. Second, the 10% ITC for pre-production mining expenditures is phased out. Third, certain types of electricity generation equipment and clean energy generation equipment used in eligible activities in Atlantic Canada will qualify for the 10% Atlantic ITC. Fourth, the scientific research and experimental development (SR&ED) expenditures eligible for ITCs will be changed as follows:

- Expenditures of a capital nature no longer qualify for ITCs.
- The rate at which overhead SR&ED expenditures are accounted for under the proxy method for ITC purposes is reduced from 65% to 55%.
- Only 80% of expenditures in respect of third-party arm’s length payments for SR&ED are eligible for ITC.
- The basic 20% ITC rate for SR&ED qualified expenditures is reduced to 15%.

Definitions

ITA
127(9)

Subsection 127(9) of the Act provides various definitions relevant for the purpose of calculating the investment tax credits of taxpayers.

“contract payment”

The definition “contract payment” in subsection 127(9) avoids the duplication of investment tax credits (ITCs) where a person performing scientific research and experimental development (SR&ED) receives payments or compensation from another person in respect of that SR&ED. The definition “contract payment” is relevant only for SR&ED expenditures of arm’s length parties.

There are a number of ways in which SR&ED can be performed. Taxpayers can perform SR&ED in-house, have someone else perform the SR&ED on their behalf (contract-SR&ED), or make payments for SR&ED to be carried on by certain third-party entities (third-party SR&ED).

A taxpayer is entitled to claim ITCs in respect of a “qualified expenditure” as defined in subsection 127(9). In the case of contract-SR&ED and third-party SR&ED, qualified expenditures of a performer are reduced by the amount of a payor’s contract payment to the performer. This ensures that both the payor and the performer cannot claim ITCs on the same qualified expenditure. The definition “contract payment” is amended in two respects.

First, subparagraph (*a*)(i) of the definition “contract payment” is amended, consequential on the introduction of new subparagraph 37(1)(*a*)(i.01), to replace the reference to subparagraph 37(1)(*a*)(i) with a reference to subparagraph 37(1)(*a*)(i.01).

Second, paragraph (*b*) of the definition “contract payment” is amended, consequential on the repeal of paragraph 37(1)(*b*), to ensure that only expenditures of a current nature are relevant for the purposes of the definition.

The amendment to subparagraph (*a*)(i) of the definition applies in respect of expenditures made after 2012 and the amendment to paragraph (*b*) applies in respect of expenditures made after 2013.

“first term shared-use-equipment”

The definition “first term shared-use-equipment” in subsection 127(9) describes certain depreciable property of a taxpayer that is eligible for an investment tax credit (ITC). An expenditure of a capital nature made by a taxpayer in respect of scientific research and experimental development (SR&ED) carried on in Canada is not eligible for an ITC unless the property is used all or substantially all in the prosecution of SR&ED. However, where a property is not all or substantially used by a taxpayer for SR&ED, but is primarily used by the taxpayer in SR&ED (referred to as shared-use-equipment), part of the cost of such property can be included in the taxpayer’s “qualified expenditure” as defined in subsection 127(9), and therefore is partially eligible for an ITC.

The definition “first term shared-used-equipment” is amended as of March 29, 2012, consequential on the repeal of paragraph 37(1)(*b*), to ensure that it will only apply in respect of property acquired before 2014.

Because of the interaction of the definition “first term shared-use-equipment” with the definition “second term shared-use-equipment” in subsection 127(9), ITCs may still be claimed in taxation years ending after 2013 in respect of first term shared-use-equipment acquired before 2014. However, ITCs will not be available in respect of either first term shared-use-equipment or second term shared-use-equipment for taxation years ending after February 1, 2017. As a result, the definitions “first term shared-used-equipment” and “second term shared-use-equipment” are repealed as of February 1, 2017.

“investment tax credit”

The definition “investment tax credit” in subsection 127(9) provides for the calculation of a taxpayer’s investment tax credits (ITCs) at the end of a taxation year and also ensures that a tax credit is not generated in circumstances where the business income to which a cost or expenditure relates is not subject to income tax. Paragraphs (*a*), (*a.1*) and (*a.3*) of the definition are amended to implement several Budget 2012 proposals.

Paragraph (*a*) of the definition “investment tax credit” provides for the inclusion of the total of all amounts each of which is the specified percentage of the capital cost to a taxpayer of certified property or qualified property acquired by the taxpayer in the year. This paragraph is amended to remove the reference to “certified property” which is no longer relevant (since such property generally cannot be acquired after 1995), and to add a reference to the new definition “qualified resource property.”

Paragraph (*a.1*) of the definition “investment tax credit” provides for the inclusion of 20% of the amount by which a taxpayer’s SR&ED qualified expenditure pool for a year exceeds the taxpayer’s super-allowance benefit amount for the year. Budget 2012 announced that the 20% rate would be reduced to 15%. Paragraph (*a.1*) is amended by replacing the reference to 20% with 15%.

Paragraph (*a.3*) of the definition “investment tax credit” provides for the inclusion of a specified percentage (10% for expenditures incurred after 2004) of a pre-production mining expenditure incurred by a taxable Canadian corporation in a taxation year. The paragraph is amended consequential on the introduction of new subparagraphs (*a*)(i) and (ii) in the definition “pre-production mining expenditure” in subsection 127(9).

The amendments to paragraphs (*a*) and (*a.3*) of the definition “investment tax credit” apply to taxation years ending after March 28, 2012.

The amendment to paragraph (*a.1*) of the definition “investment tax credit” to reduce the SR&ED ITC rate from 20% to 15% applies to taxation years that end after 2013, except that, for taxation years that include January 1, 2014, the 5 percentage point reduction in the rate is pro-rated based on the number of days in the taxation year that are after 2013.

“phase”

The new definition “phase” in subsection 127(9) is added consequential on the introduction of the new definition “qualified resource property” in subsection 127(9).

Budget 2012 announced the phase out of the 10% investment tax credits available for certain assets used in the Atlantic provinces, the Gaspé Peninsula and their associated offshore regions (commonly referred to as the “Atlantic ITC”). The Budget proposal phases out the 10% Atlantic ITC for the cost of property primarily used in oil, gas and mining activities. Subject to grandfathering, the 10% Atlantic ITC will be reduced to 5% for such assets acquired in 2014 and 2015 and to 0% for assets acquired after 2015. Assets acquired before 2017 as part of a grandfathered phase of a project will be eligible for the 10% Atlantic ITC.

The new definition “phase” is relevant for determining if a phase of a taxpayer’s project is a grandfathered phase eligible for transitional relief. In this context, a phase is defined as a discrete expansion in the extraction, processing or production capacity of a project of a taxpayer beyond a capacity level that was attained before March 29, 2012 and which expansion in capacity was the taxpayer’s demonstrated intention immediately before March 29, 2012.

The new definition comes into force on March 29, 2012.

“pre-production mining expenditure”

The definition “pre-production mining expenditure” in subsection 127(9) describes the type of exploration expenses that are eligible for the 10% investment tax credit (ITC) (specified percentage) rate and are included in paragraph (*a.3*) of the definition “investment tax credit” (ITC).

Generally, a pre-production mining expenditure is a grass roots exploration or pre-production development expenditure incurred in Canada in respect of qualifying minerals. These expenditures are certain expenses described in paragraphs (*f*) and (*g*) of the definition "Canadian exploration expense" in subsection 66.1(6).

Paragraph (*a*) of the definition "pre-production mining expenditures" is amended consequential on the phase out of the 10% ITC for such expenditures. New subparagraph (*a*)(i) of the definition refers to certain expenses described in paragraph (*f*) of the definition "Canadian exploration expense" in subsection 66.1(6) and new subparagraph (*a*)(ii) refers to certain expenses described in paragraph (*g*) of the definition "Canadian exploration expense" in subsection 66.1(6). The ITC rate (described more fully in the commentary to the definition "specified percentage") that applies after 2013 for pre-production mining expenditures described in subparagraph (*a*)(i) is different from the rate that applies to pre-production mining expenditures described in subparagraph (*a*)(ii).

In addition paragraph (*a*) of the definition "pre-production mining expenditure" is amended to clarify that subparagraphs (*a*)(i) and (ii) of the definition only apply to expenditures that are "Canadian exploration expenses" as defined in subsection 66.1(6).

The amendment applies with respect to expenditures incurred after March 28, 2012.

"qualified expenditure"

The definition "qualified expenditure" in subsection 127(9) sets out the type of expenditures incurred by a taxpayer on scientific research and experimental development (SR&ED) that are eligible for investment tax credits (ITCs).

Paragraph (*a*) of the definition "qualified expenditure" includes expenditures described in paragraph 37(1)(*a*), subparagraph 37(1)(*b*)(i), and for first term shared-use-equipment and second term shared-use-equipment as those terms are defined in subsection 127(9).

Budget 2012 announced that expenditures of a capital nature will no longer qualify for SR&ED tax incentives and that only 80% of expenditures in respect of third-party arm's length payments for SR&ED are eligible for ITC. Paragraph (*a*) of the definition "qualified expenditure" is amended in three respects to implement these proposals.

First, the ordering of the subparagraphs in paragraph (*a*) of the definition "qualified expenditure" is changed in order to accommodate the different effective dates of various amendments. In particular,

- subparagraph (*a*)(i) of the definition "qualified expenditure", which previously referred to an expenditure for first term shared-use-equipment and second term shared-use-equipment, is amended to refer to an expenditure described in subparagraph 37(1)(*a*)(i),
- subparagraph (*a*)(ii) of the definition "qualified expenditure", which previously referred to an expenditure described in paragraph 37(1)(*a*), is amended to refer to 80% of an expenditure that is described in any of subparagraphs 37(1)(*a*)(i.01) to (iii),
- subparagraph (*a*)(iii) of the definition "qualified expenditure", which previously referred to an expenditure described in subparagraph 37(1)(*b*)(i), is amended to refer to an expenditure for first term shared-use-equipment and second term shared-use-equipment, and
- new subparagraph (*a*)(iv) of the definition "qualified expenditure" refers to an expenditure described in subparagraph 37(1)(*b*)(i).

These amendments to paragraph (*a*) of the definition "qualified expenditure" apply in respect of expenditures made after 2012.

Second, consistent with the repeal of paragraph 37(1)(*b*), subparagraph (*a*)(iv) of the definition is repealed in respect of expenditures made after 2013.

Third, consistent with the repeal of the definitions “first term shared-use-equipment” and “second term shared-use-equipment,” amended subparagraph (*a*)(iii) is repealed as of February 1, 2017.

In addition, paragraph (*b*) of the definition “qualified expenditure”, which refers to a prescribed proxy amount, is amended to remove the reference to paragraph (*e*) of the definition “qualified expenditure”. Paragraph (*e*) had been previously repealed.

The amendment to paragraph (*b*) of the definition “qualified expenditure” applies in respect of expenditures made after 2012.

“qualified property”

The definition “qualified property” in subsection 127(9) provides for the types of property the cost of which is eligible for an investment tax credit (ITC). The types of property are, in general, prescribed buildings and machinery and equipment used primarily for eligible activities generally in Atlantic Canada. Prescribed buildings are described in subsection 4600(1) of the *Income Tax Regulations* and subsection 4600(2) of the *Income Tax Regulations* describes prescribed machinery and equipment.

The definition “qualified property” is amended in five respects. First, the preamble of the definition is amended, consequential on the introduction of the new definition “qualified resource property” in subsection 127(9), to exclude qualified resource property. In addition, the preamble is amended to remove obsolete references to approved project property and certified property.

Second, new paragraph (*b.1*) is added to the definition “qualified property” to include a new type of property, prescribed energy generation and conservation property. Budget 2012 proposed to treat certain electricity generation equipment and clean energy generation equipment used primarily in an eligible activity (that is, farming, fishing, logging, manufacturing and processing, storing grain and harvesting peat) as qualified property. Prescribed energy generation and conservation property, which is described in new subsection 4600(3) of the *Income Tax Regulations,* is depreciable property generally included in any of subparagraph (*a.1*)(i) of Class 17 and Classes 43.1, 43.2 and 48 of Schedule II to the Regulations.

Third, paragraph (*c*) of the definition “qualified property” is amended to exclude property used in oil, gas and mining activities. For more information on the exclusion, please see the commentary to the new definition “qualified resource property” in subsection 127(9).

Fourth, paragraph (*c.1*) of the definition “qualified property” is amended to exclude prescribed energy generation and conservation property. This amendment ensures that the prescribed energy generation and conservation property will not qualify as “qualified property” eligible for the Atlantic ITCs, if it is used for activities described in paragraph (*c.1*) of the definition “qualified property.”

Fifth, paragraph (*d*) of the definition “qualified property” is amended in two respects. The reference to subparagraphs (*c*)(i) to (xiii) is replaced with a reference to paragraph (*c*) as a consequence of the introduction of the definition “qualified resource property” in subsection 127(9). As well, a reference is added to new paragraph (*b.1*) consequential on the introduction of that paragraph.

These amendments apply in respect of property acquired after March 28, 2012.

“qualified resource property”

The new definition “qualified resource property” is added to subsection 127(9) as a result of the phase out of the 10% investment tax credit for assets used in the oil, gas and mining activities in the Atlantic provinces, the Gaspé Peninsula and their associated offshore regions (commonly referred to as the “Atlantic ITC”). Subject to grandfathering, the 10% Atlantic ITC will be reduced to 5% for such assets acquired in 2014 and 2015 and to 0% for assets acquired after 2015. Assets acquired before 2017 as part of a grandfathered phase of a project will be eligible for the 10% Atlantic ITC.

Essentially, a qualified resource property is a property that would have been a qualified property if it had been acquired before March 29, 2012 for use in oil, gas and mining activities. In particular, a qualified resource property of a taxpayer is a prescribed building or prescribed machinery and equipment acquired by the taxpayer after March 28, 2012 for use by the taxpayer in Canada primarily in oil, gas and mining activities in the Atlantic provinces, the Gaspé Peninsula and their associated offshore regions. Prescribed buildings are described in subsection 4600(1) of the *Income Tax Regulations* and subsection 4600(2) of the *Income Tax Regulations* describes prescribed machinery and equipment. Qualified resource property cannot have been used, or acquired for use or lease, for any purpose whatever before it was acquired by the taxpayer.

Qualified resource property acquired after March 28, 2012 cannot be a qualified property. Therefore, no other ITC rate other than the ITC rate relevant for a qualified resource property can apply in computing the ITC available in respect of such property. No transitional relief other than that described above is available in respect of qualified resource property acquired after March 28, 2012 (i.e., no other transitional relief can be claimed for such property under other relieving provisions that might have previously applied in respect of such property).

The new definition comes into force on March 29, 2012.

“second term shared-use-equipment”

Consistent with the repeal of the definition “first term shared used equipment”, the definition “second term shared-use-equipment” in subsection 127(9) is repealed as of February 1, 2017.

“specified percentage”

The definition “specified percentage” in subsection 127(9) sets out the relevant rates at which investment tax credits (ITCs) are earned in different circumstances. The definition is amended in two respects to implement Budget 2012 proposals to phase out the Atlantic ITC and the ITC for pre-production mining expenditures.

New paragraph (*a.1*) of the definition “specified percentage” sets out the Atlantic ITC rate for qualified resource property.

- Subparagraph (*a.1*)(i) provides a 10% rate for qualified resource property acquired after March 28, 2012 and before 2014.
- Subparagraph (*a.1*)(ii) provides a 10% rate for qualified resource property acquired after 2013 and before 2017 if the property is acquired by the taxpayer under a written agreement of purchase and sale entered into by the taxpayer before March 29, 2012, or is acquired as part of a grandfathered phase of a taxpayer’s project. A grandfathered phase is a phase of a project the construction of which was started by, or on behalf of, the taxpayer before March 29, 2012 or the engineering and design work for the construction of which, as evidenced in writing, was started by, or on behalf of, the taxpayer before that date.
- Subparagraph (*a.1*)(iii) provides a 5% rate for qualified resource property acquired in 2014 and 2015, and 0% rate for such property acquired after 2015 and which rates apply in respect of property not otherwise grandfathered.

Paragraph (*j*) of the definition “specified percentage” provides a 10% rate for a pre-production mining expenditure incurred after 2004. Paragraph (*j*) is amended and new paragraph (*k*) is introduced consequential on the introduction of subparagraphs (*a*)(i) and (ii) of the definition “pre-production mining expenditure”.

Paragraph (*j*) of the definition “specified percentage” is amended to provide that an expenditure described in subparagraph (*a*)(i) of the definition “pre-production mining expenditure” will earn a credit at the rate of

- 10%, if the expenditure is incurred before 2013,
- 5%, if the expenditure is incurred in 2013, and
- 0%, if the expenditure is incurred after 2013.

New paragraph (*k*) provides the rates at which an expenditure described in subparagraph (*a*)(ii) of the definition "pre-production mining expenditure" will earn ITCs.

Subparagraph (*k*)(i) provides an ITC rate of 10% for expenditures described in subparagraph (*a*)(ii) incurred before 2014.

Subparagraph (*k*)(ii) provides transitional relief by providing a 10% ITC rate for an expenditure incurred after 2013 and before 2016, if the expenditure is incurred under a written agreement entered into by the taxpayer before March 29, 2012, or as part of the development of a grandfathered mine. A grandfathered mine is a new mine the construction of which was started by, or on behalf of, the taxpayer before March 29, 2012 or the engineering and design work for which, as evidenced in writing, was started by, or on behalf of, the taxpayer before that date.

Subparagraph (*k*)(iii) provides a 7% ITC rate for expenditures incurred in 2014, a 4% ITC rate for expenditures incurred in 2015 and a 0% rate for expenditures incurred after 2015.

For the purposes of new subparagraphs (*a.1*)(ii) and (*k*)(ii) of the definition "specified percentage", neither construction nor engineering and design work include activities such as obtaining permits or regulatory approvals, conducting environmental assessments, community consultations or impact benefit studies, and similar activities.

New paragraph (*a.1*) applies in respect of property acquired after March 28, 2012.

The amendments to paragraph (*j*) and new paragraph (*k*) apply in respect of expenditures incurred after March 28, 2012.

Additions to investment tax credit

ITA
127(10.1)

Subsection 127(10.1) of the Act provides a 15% investment tax credit (ITC) in addition to the basic 20% ITC for certain scientific research and experimental development (SR&ED) expenditures incurred by a Canadian-controlled private corporation (CCPC). As a result, such expenditures qualify for a total ITC of 35%.

Subsection 127(10.1) is amended as a consequence of the amendment to paragraph (*a.1*) of the definition "investment tax credit" in subsection 127(9), which reduces the basic 20% ITC to 15%. The reference to 15% in subsection 127(10.1) is replaced by a reference to 20% in order to maintain the overall 35% ITC rate.

The amendment applies to taxation years that end after 2013. Consistent with the amendment to paragraph (*a.1*) of the definition "investment tax credit" in subsection 127(9), for taxation years that include January 1, 2014, the 5% increase under subsection 127(10.1) is pro-rated based on the number of days in the taxation year that are after 2013.

Interpretation

ITA
127(11)

Subsection 127(11) of the Act provides rules for determining whether a property is a "qualified property" as defined in subsection 127(9). Subsection 127(11) is amended in two respects consequential on the introduction of the new definition "qualified resource property" in subsection 127(9).

First, the preamble is amended to add a reference to the new definition "qualified resource property." Second, paragraph 127(11)(*b*) is amended to add a reference to paragraph (*a*) of the new definition "qualified resource property."

These amendments come into force on March 29, 2012.

Time of expenditure and acquisition

ITA
127(11.2)

Subsection 127(11.2) of the Act provides that, for the purposes of claiming an investment tax credit (ITC) under subsection 127(5) or allocating an ITC under subsection 127(7) or (8), property is not considered to have been acquired, and expenditures are not considered to have been made, by a taxpayer until the property is considered to have become "available for use" by the taxpayer. Subsection 127(11.2) is amended in three respects.

The first amendment removes the reference to "certified property", which is no longer relevant, in paragraph 127(11.2)(*a*) and adds a reference to the new definition "qualified resource property". The second amendment removes the reference to "first term shared-use-equipment" in paragraph 127(11.2)(*a*). The third amendment removes a reference to subparagraph 37(1)(*b*)(i) in paragraph 127(11.2)(*b*).

The first amendment comes into force on March 29, 2012. Consistent with the repeal of the definition "first term shared-use-equipment", the second amendment applies as of February 1, 2017. Consistent with the repeal of paragraph 37(1)(*b*), the third amendment applies in respect of expenditures made after 2013.

Adjustments to qualified expenditures

ITA
127(11.5)

Subsection 127(11.5) of the Act reduces, in certain circumstances, qualified expenditures incurred by a taxpayer. Subsection 127(11.5) is amended in two respects.

Paragraph 127(11.5)(*a*) requires that for the purposes of the definition "qualified expenditure" in subsection 127(9), the amount of a qualified expenditure in respect of a capital property is generally to be determined without reference to subsections 13(7.1) and (7.4). Paragraph (*a*), which is amended consequential to the repeal of paragraph 37(1)(*b*), removes the references to subsections 13(7.1) and (7.4).

Paragraph 127(11.5)(*b*) requires that where an expenditure is for first term shared-use-equipment or second term shared-use-equipment only ¼ of the capital cost of the equipment is taken into account and the capital cost of such property is determined without capitalized interest being added to the capital cost under section 21. Subsection 127(11.5) is amended to repeal paragraph (*b*) consequential on the repeal of the definitions "first term shared-use-equipment' and "second term shared-use-equipment".

Consistent with the repeal of paragraph 37(1)(*b*), the amendment to paragraph 127(11.5)(*a*) applies in respect of expenditures made after 2013. Consistent with the repeal of the definitions "first term shared-use-equipment" and "second term shared-use-equipment," the amendment to paragraph 127(11.5)(*b*) applies as of February 1, 2017.

Non-arm's length costs

ITA
127(11.6)

Subsection 127(11.6) of the Act provides rules for determining expenditures for the purposes of subsection 127(11.5) in respect of purchases of goods and services acquired from non-arm's length parties. Consequential on the repeal of paragraph 37(1)(*b*), the mid-amble of subsection 127(11.6) and subparagraph 127(11.6)(*d*)(i) are amended by removing the reference to "capital" in the phrase "capital cost to the taxpayer of the property."

Consistent with the repeal of the definitions "first term shared-use-equipment" and "second term shared-use-equipment", these amendments come into force on February 1, 2017.

Interpretation for non-arm's length costs

ITA
127(11.8)

Paragraph 127(11.8)(*c*) of the Act provides that the leasing of a property is considered to be the rendering of service for certain purposes. Consistent with the repeal of subparagraph 37(1)(*b*) and the amendments to paragraph 37(8)(*d*), paragraph 127(11.8)(*c*) is repealed.

This amendment applies in respect of expenditures made after 2013.

Certain non-arm's length transfers

ITA
127(33)

Subsections 127(33) to (35) of the Act apply where a non-arm's length transfer of property to another taxpayer would otherwise trigger the scientific research and experimental development (SR&ED) investment tax credit (ITC) recapture provisions. Subsection 127(33) provides that the SR&ED ITC recapture provisions do not apply to a taxpayer who disposes of SR&ED property to a non-arm's length purchaser if the purchaser continues to use the property all or substantially all for SR&ED.

Subsection 127(33) is amended to ensure that notwithstanding the repeal of paragraph 37(1)(*b*) and subclauses 37(8)(*a*)(ii)(A)(III) and (B)(III), the non-application of the recapture rules will remain in effect for non-arm's length transfers of SR&ED property.

This amendment comes into force on March 29, 2012.

Clause 17

Refundable investment tax credit

ITA
127.1

Section 127.1 of the Act provides for the refundability of investment tax credits (ITCs) under certain circumstances. A qualifying corporation may be eligible for either a 40% or 100% refund for its ITCs depending on the nature of the expenditures.

Definitions

ITA
127.1(2)

Subsection 127.1(2) of the Act sets out definitions relevant for the purposes of section 127.1.

The definition "refundable investment tax credit" defines the portion of investment tax credits (ITCs) that are refundable in a taxation year of a taxpayer that are earned by the taxpayer in respect of a qualified expenditure as defined in subsection 127(9).

Consequential on the repeal of paragraph 37(1)(*b*) and the amendments to paragraph 37(8)(*d*), subparagraph (*f*)(i) of the definition "refundable investment tax credit" is amended to remove the phrase "(other than expenditures of a capital nature)".

Consistent with the repeal of the definitions "first term shared-use-equipment" and "second term shared-use-equipment", this amendment comes into force on February 1, 2017.

Addition to refundable investment tax credit

ITA
127.1(2.01)

Subsection 127(2.01) of the Act provides for the refundability of certain investment tax credits (ITCs) earned by a Canadian-controlled private corporation (CCPC) that is neither a qualifying corporation nor an excluded corporation as defined in subsection 127.1(2).

For a CCPC (other than a qualifying corporation or an excluded corporation) the rate of refund of the 35% ITC is 100% for SR&ED expenditures of a current nature and 40% for SR&ED expenditures of a capital nature.

Consequential on the repeal of paragraph 37(1)(*b*) and the amendments to paragraph 37(8)(*d*), subsection 127.1(2.01) is amended by replacing its paragraphs (*a*) and (*b*) with its existing paragraphs (*c*) and (*d*) (and by repealing paragraphs (*c*) and (*d*)).

Consistent with the repeal of the definitions "first term shared-use-equipment" and "second term shared-use-equipment", these amendments come into force on February 1, 2017.

Clause 18

Foreign affiliate dumping – immigrating corporation

ITA
128.1(1)(*c.3*)

New paragraph 128.1(1)(*c.3*) of the Act is added in order to deter certain corporate immigrations that could otherwise be used as substitutes for transactions that are addressed by the foreign affiliate dumping rules in new section 212.3.

Paragraph 128.1(1)(*c.3*) can cause a deemed dividend and/or a paid-up capital reduction to occur in circumstances where a non-resident corporation immigrates to Canada, the immigrating company is controlled by another non-resident and the immigrating company owns shares of a non-resident company (which could include the foreign parent) that becomes a foreign affiliate of the immigrating company either immediately after the immigration or as part of a series of transactions or events that includes the immigration. In these circumstances, the immigration could otherwise lead to a result similar to that which the foreign affiliate dumping rules in new section 212.3 are aimed at preventing.

For the purposes of paragraph 128.1(1)(*c.3*), the look-through rules in subsections 93.1(1) and 212.3(18) apply where one or more partnerships are in the ownership structure. As well, the "multiple control" rule in subsection 212.3(11) applies so that, generally, only one non-resident corporation is considered to control the immigrating company.

New paragraph 128.1(1)(*c.3*) applies in respect of corporations that become resident in Canada after March 28, 2012.

Example 1

Assumptions

- *NR Co 1 owns all the shares of NR Co 2.*
- *NR Co 2 owns all the shares of NR Co 3.*
- *NR Co 2 becomes resident in Canada on May 1, 2012.*

- *Immediately before the immigration, all companies are non-residents of Canada, have a fair market value (FMV) of $100, have a single class of shares and have no debt obligations outstanding.*
- *NR Co 2 has paid-up capital (PUC) of $100 as result of the immigration.*

Analysis

- *NR Co 2 will have achieved a foreign affiliate "dump" as NR Co 3 will become a foreign affiliate of NR Co 2 upon the immigration.*
- *Subparagraph 128.1(1)(c.3)(i) will apply to reduce NR Co 2's PUC by $100, based on the FMV of the NR Co 3 shares at the time of immigration.*

Example 2

Assumptions

- *Same as in Example 1, except that NR Co 2 has debt of $50 outstanding at the time of immigration and the FMV of the shares of NR Co 3 is $150.*

Analysis

- *In addition to the PUC grind set out in Example 1, NR Co 1 would be subject to a deemed dividend of $50 under subparagraph 128.1(1)(c.3)(ii) – based on the excess of the FMV ($150) of the NR Co 3 shares over the amount of the PUC reduction ($100) under subparagraph 128.1(1)(c.3)(i).*

Paid-up capital adjustment

ITA
128.1(3)

Subsection 128.1(3) of the Act ensures that the adjustment to paid-up capital under subsection 128.1(2) does not provide an inappropriate result where, because of a share redemption, acquisition, or cancellation or a reduction of paid-up capital, subsection 84(3), (4) or (4.1) subsequently treats the corporation as having paid a dividend on the shares to which the paid-up capital reduction relates. Similar rules exist in various other provisions of the Act that adjust paid-up capital – see for example paragraph 85(2.1)(*b*) and subsection 212.1(2).

Subsection 128.1(3) is split into two paragraphs. New paragraph 128.1(3)(*a*) contains the existing rule, as modified to modernize its language, and new paragraph 128.1(3)(*b*) introduces a similar rule in respect of paid-up capital reductions under the new foreign affiliate dumping rule in paragraph 128.1(1)(*c.3*).

This amendment comes into force on March 29, 2012.

Clause 19

Registered education savings plan

ITA
146.1

Section 146.1 of the Act sets out various rules applicable to registered education savings plans (RESPs). Budget 2012 announced a number of measures relating to registered disability savings plans (RDSPs), including one to facilitate a tax-deferred transfer or "rollover" of RESP investment income to an RDSP in certain circumstances. The amendments to section 146.1 give effect to this measure.

Definitions

ITA
146.1(1)

Subsection 146.1(1) of the Act defines a number of terms that apply to registered education savings plans. The definition “registered education savings plan” is amended to introduce the acronym “RESP” for drafting convenience and to improve readability. A similar amendment is made in subsection 248(1).

This amendment comes into force on Royal Assent.

Election

ITA
146.1 (1.1) and (1.2)

New subsections 146.1(1.1) and (1.2) of the Act set out the mechanism to permit a rollover of RESP investment income (referred to in the RESP rules as “accumulated income payments”) to an RDSP.

In general terms, a subscriber of an RESP that allows accumulated income payments and a holder of an RDSP may jointly elect in prescribed form to transfer an accumulated income payment under the RESP to the RDSP if, at the time of the election, the RESP beneficiary is also the beneficiary under the RDSP and

- the beneficiary is, or will be, unable to pursue post-secondary education because he or she has a severe and prolonged mental impairment; or
- the RESP has been in existence for more than 35 years, or for at least 10 years and each beneficiary under the RESP has attained 21 years of age and is not eligible to receive educational assistance payments.

Under subsection 146.1(1.2), the promoter of the RESP must file the election with the Minister without delay.

In order to facilitate the transfer of accumulated income payments under RESPs to RDSPs without requiring amendments to the specific terms of existing specimen plans and RESPs established using them, or requiring new specimen plans to be prepared to reflect new terms, subsection 146.1(1.2) also suspends the plan condition in paragraph 146.1(2)(*d.1*) and any terms of the RESP required by that paragraph.

Subsections 146.1(1.1) and (1.2) come into force on January 1, 2014.

Plan conditions

ITA
146.1(2)

Subsection 146.1(2) of the Act sets out the requirements that must be satisfied in order to register an education savings plan. Paragraph 146.1(2)(*i.1*) requires that a plan that allows accumulated income payments must provide that it will be terminated before March of the year after the year in which the first such payment is made.

Consequential on the introduction of subsection 146.1(1.2), which suspends the plan condition under paragraph 146.1(2)(*d.1*) in respect of RESPs under which an accumulated income payment is transferred on a tax-free basis to an RDSP, paragraph 146.1(2)(*i.1*) is amended to remove the reference to paragraph 146.1(2)(*d.1*). This amendment ensures that plans that allow a rollover to an RDSP have the same termination requirement as plans that allow accumulated income payments. In other words, if RESP investment income is rolled over to an RDSP, the RESP must be terminated before March of the year following the year in which the rollover occurred.

This amendment comes into force on January 1, 2014.

Income inclusion

ITA
146.1(7.1)

Paragraph 146.1(7.1)(*a*) of the Act provides that accumulated income payments received under an RESP by a taxpayer in a taxation year must be included in computing the taxpayer's income for the year. Paragraph 146.1(7.1)(*a*) is amended to exclude accumulated income payments made under subsection 146.1(1.2). This carve out ensures that a transfer of an accumulated income payment to an RDSP occurs on a tax-deferred basis.

This amendment comes into force on January 1, 2014.

Clause 20

Registered disability savings plan

ITA
146.4

Budget 2012 announced a number of measures relating to registered disability savings plans (RDSPs). Amendments to section 146.4 of the Act give effect to the measures relating to:

- maximum and minimum withdrawal rules;
- the rollover of registered education savings plan (RESP) investment income;
- the termination of an RDSP following the cessation of eligibility for the disability tax credit (DTC); and
- administrative changes and filing requirements.

Definitions

ITA
146.4(1)

Subsection 146.4(1) of the Act defines a number of terms that apply for the purposes of the rules relating to registered disability savings plans (RDSPs).

"contribution"

The definition "contribution" is relevant for the purposes of several provisions in section 146.4 and Part XI of the Act. Paragraph (*d*) of the definition "contribution" is amended in two respects.

First, it is amended to exclude an accumulated income payment (AIP) made under a registered education savings plan (RESP) to an RDSP under subsection 146.1(1.2), except for certain purposes, similar to the current treatment under paragraph (*d*) of a "specified RDSP payment" (as defined in subsection 60.02(1)).

Second, paragraph (*d*) is amended to expand the purposes for which a specified RDSP payment and an AIP are to be treated as a contribution. Under this amendment, a specified RDSP payment and an AIP made to the RDSP will be a contribution for the purposes of paragraphs 146.4(4)(*f*) to (*h*) and (*n*), as well as paragraph (*b*) of the definition "advantage" in subsection 205(1). This means that specified RDSP payments and AIPs will be subject to the overall RDSP lifetime contribution limit of $200,000, and can only be made in respect of "DTC-eligible individuals" (as defined in subsection 146.4(1)) who are under 60 years old and resident in Canada at the time of the payment (see paragraphs 146.4(4)(*f*) and (*g*)). Specified RDSP payments and AIPs will, under paragraph 146.4(4)(*h*), have to be made either by, or with the consent of, the RDSP holder. Under paragraph 146.4(4)(*n*), specified RDSP payments and AIPs will be treated as private contributions and not as amounts received under the *Canada Disability Savings Act*. Further, specified RDSP payments and AIPs made to an RDSP will not be considered an "advantage" for the purposes of subsection 205(1). As is the case for a specified RDSP payment, an AIP paid to an RDSP will not attract Canada Disability Savings Grants.

These amendments come into force on January 1, 2014.

“registered disability savings plan”

The definition “registered disability savings plan” is amended to introduce the acronym “RDSP” for drafting convenience and to improve readability. A similar amendment is made in subsection 248(1).

This amendment comes into force on Royal Assent.

“specified maximum amount”

Subsection 146.4(1) is amended to introduce a new definition “specified maximum amount” in relation to a disability savings plan. This definition is relevant for the purposes of subparagraph 146.4(4)(*n*)(i), which imposes the maximum annual limit on the amount of disability assistance payments that can be made from an RDSP when the plan is a primarily government-assisted plan (i.e., where the total of all grants and bonds paid under the *Canada Disability Savings Act* in respect of the beneficiary of the plan exceeds the total of all private contributions made in respect of the beneficiary, as described in the opening portion of paragraph 146.4(4)(*n*)).

The new definition “specified maximum amount”, in conjunction with the amendment to paragraph 146.4(4)(*n*), gives effect to the Budget 2012 measure to increase the maximum annual limit for withdrawals from a primarily government-assisted plan to the greater of the amount determined by the lifetime disability assistance payment (LDAP) formula in paragraph 146.4(4)(*l*) and 10% of the fair market value of the RDSP assets at the beginning of the calendar year.

In general terms, consistent with the foregoing, the specified maximum amount in respect of a disability savings plan for a calendar year is the greater of

- the amount determined by the LDAP formula in paragraph 146.4(4)(*l*) in respect of the plan for the calendar year;

and

- 10% of the fair market value of the RDSP assets at the beginning of the calendar year or, if the RDSP is holding a “locked-in” annuity, the sum of 10% of the fair market value of the RDSP assets (other than the annuity contract) and the total amount of periodic payments received by the RDSP trust (or, if the RDSP trust disposed of the right to such payments, an estimate of the payments that the RDSP trust would have received) in the calendar under the annuity.

This amendment comes into force on January 1, 2014.

Specified disability savings plans

ITA
146.4(1.2)

Under the RDSP rules, a specified disability savings plan (SDSP) is, in general terms, an RDSP of a beneficiary who has a shortened life expectancy (as certified by a medical doctor) where the holder of the RDSP has elected to have the RDSP treated as such a plan. An SDSP is not subject to the requirement to repay assistance holdback amounts on early withdrawals. Subsection 146.4(1.2) of the Act describes the circumstances in which a plan will cease to be an SDSP. Subsection 146.4(1.2) is amended in several respects.

Paragraph 146.4(1.2)(*b*) is amended consequential on the introduction of new rules to increase the maximum annual limit for withdrawals from a primarily government-assisted plan (i.e., a plan in which the total of all grants and bonds paid under the *Canada Disability Savings Act* in respect of the beneficiary of the plan exceeds the total of all private contributions made in respect of the beneficiary, as described in the opening portion of paragraph 146.4(4)(*n*)) to the greater of the amount determined by the LDAP formula in paragraph 146.4(4)(*l*) and 10% of the fair market value of the RDSP assets at the beginning of the calendar year. This increase in limits is not extended to plans that are SDSPs. The amendment to paragraph 146.4(1.2)(*b*) therefore preserves the existing maximum annual withdrawal limits applicable to SDSPs.

Subparagraph 146.4(1.2)(*c*)(ii) is amended consequential on the introduction of new rules that allow, in certain circumstances, for the transfer of investment income from a RESP to an RDSP on a tax-deferred (or "rollover") basis. These transfers are treated as contributions to a plan for certain purposes. Consistent with the general rule that contributions cannot be made to a plan while it is an SDSP, the amendment to subparagraph 146.4(1.2)(*c*)(ii) provides that a plan will cease to be an SDSP immediately before the transfer of RESP investment income to the SDSP.

Paragraph 146.4(1.2)(*d*) is amended consequential on the introduction of new rules applicable to a plan when the beneficiary no longer has severe and prolonged impairments (i.e., the beneficiary becomes ineligible for the disability tax credit - "DTC-ineligible"). In rare circumstances, a beneficiary under an SDSP may recover to the point of becoming DTC-ineligible, in which case the beneficiary should be subject to the same rules that apply to other RDSP beneficiaries who have become DTC-ineligible. New subparagraph 146.4(1.2)(*d*)(iii) effectively prohibits a beneficiary under an SDSP who becomes DTC-ineligible from obtaining unintended results.

Paragraph 146.4(1.2)(*f*) is amended consequential on the introduction of new paragraph 146.4(4)(*n.1*), which extends to all RDSPs the minimum annual withdrawal requirement that currently applies to primarily government-assisted plans. This amendment effectively requires that the total amount of disability assistance payments made from an SDSP in a calendar year be at least equal to the amount determined by the LDAP formula set out in paragraph 146.4(4)(*l*).

These amendments come into force on January 1, 2014.

Registered status

ITA
146.4(3)

Subsection 146.4(3) of the Act deems a disability savings plan never to have been a registered disability savings plan if the conditions set out in that subsection are not met.

Subsection 146.4(3) is amended to replace the 60-day and 120-day deadlines imposed under that subsection with requirements that issuers take action "without delay". This change is intended to provide greater flexibility in dealing with situations such as incorrectly completed forms or other circumstances where the fixed time frames may not have provided adequate time for compliance.

Under existing paragraph 146.4(3)(*a*), an issuer is required, within 60 days of the establishment of a plan, to notify the specified Minister of the establishment of the plan. Paragraph 146.4(3)(*a*) is amended to instead require an issuer to notify without delay the specified Minister of the establishment of a plan. The issuer is still required to provide the notification in prescribed form containing prescribed information.

If the beneficiary of a plan is, at the time the plan is established, the beneficiary under another plan, paragraph 146.4(3)(*b*) requires that other plan to be terminated within 120 days of the new plan being entered into (or such later day as the specified Minister considers reasonable in the circumstances. Paragraph 146.4(3)(*b*) is amended to require that the other plan instead be terminated without delay.

These amendments come into force on Royal Assent.

Plan conditions

ITA
146.4(4)

Subsection 146.4(4) of the Act sets out registration conditions applicable to RDSPs. Subsection 146.4(4) is amended in several respects.

Maximum and minimum limits

ITA
146.4(4)(*n*) and (*n.1*)

Paragraph 146.4(4)(*n*) of the Act imposes limits on the amount of disability assistance payments that can be made in a calendar year from an RDSP when the plan is a primarily government-assisted plan (i.e., where the total of all grants and bonds paid under the *Canada Disability Savings Act* in respect of the beneficiary of the plan exceeds the total of all private contributions made in respect of the beneficiary, as described in the opening portion of paragraph 146.4(4)(*n*)). Primarily government-assisted plans are subject to the maximum annual withdrawal limit set out in subparagraph 146.4(4)(*n*)(i) and, in respect of an RDSP beneficiary who has attained 59 years of age, the minimum annual withdrawal requirement set out in subparagraph 146.4(4)(*n*)(ii).

Paragraph 146.4(4)(*n*) is amended in two respects. First, subparagraph 146.4(4)(*n*)(i) is amended to establish the maximum annual withdrawal limit at the "specified maximum amount", as defined in subsection 146.4(1). Second, the existing plan condition in subparagraph 146.4(4)(*n*)(ii) related to the requirement for minimum annual withdrawals after age 59 is moved to new paragraph 146.4(4) (*n.1*) (and, as a result, subparagraph 146.4(4)(*n*)(iii) is renumbered as subparagraph 146.4(4)(*n*)(ii)).

The amendment to subparagraph 146.4(4)(*n*)(i), in conjunction with the new definition "specified maximum amount" in subsection 146.4(1), gives effect to the Budget 2012 measure to increase the maximum annual limit for withdrawals from a primarily government-assisted plan to the greater of the amount determined by the LDAP formula in paragraph 146.4(4)(*l*) and 10% of the fair market value of the RDSP assets at the beginning of the calendar year. For further information, see the commentary on the definition "specified maximum amount" in subsection 146.4(1).

Moving the plan condition in existing subparagraph 146.4(4)(*n*)(ii) to new paragraph 146.4(4)(*n.1*) and making the condition applicable to all plans gives effect to the Budget 2012 measure to extend to all RDSPs the minimum annual withdrawal requirement that currently applies to primarily government-assisted plans. This amendment therefore means that, for years after an RDSP beneficiary attains 59 years of age, the RDSP must provide for minimum annual withdrawals equal to the amount determined by the LDAP formula in paragraph 146.4(4)(*l*).

These amendments come into force on January 1, 2014.

Transfers

ITA
146.4(4)(*o*)

Paragraph 146.4(4)(*o*) of the Act requires that the terms of an RDSP must provide that the issuer shall, at the direction of the holders of the plan, transfer all the property held by the plan trust (or an amount equal to its value) to another RDSP of the beneficiary, together with all information in the issuer's possession that may reasonably be considered necessary for the new plan to comply with the requirements of the Act and with any conditions and obligations imposed under the *Canada Disability Savings Act*.

To reduce the administrative burden for issuers, Budget 2012 conferred on Human Resources and Skills Development Canada (rather than the issuer of the RDSP) the responsibility for providing this information to the issuer of the new RDSP when an RDSP transfer occurs.

Paragraph 146.4(4)(*o*) is amended to require the issuer of the RDSP to provide to the issuer of the new RDSP only that information which the specified Minister (i.e., the Minister of Human Resources and Skills Development) has not provided to the issuer of the new RDSP when an RDSP transfer occurs. A similar amendment is made to paragraph 146.4(8)(*c*).

This amendment comes into force on Royal Assent.

Plan termination on cessation of eligibility for the disability tax credit (DTC)

ITA
146.4(4)(*p*) & 146.4(4.1) to (4.2)

Paragraph 146.4(4)(*p*) of the Act requires the wind-up of an RDSP by the end of the calendar year following the earlier of the calendar year in which the beneficiary dies and the first calendar year throughout which the beneficiary has no severe and prolonged impairments with the effects described in paragraph 118.3(1)(*a.1*) (i.e., the beneficiary becomes DTC-ineligible).

To reduce the administrative burden on beneficiaries who might, due to the nature of their condition, become temporarily DTC-ineligible and to ensure greater continuity in their long-term savings, Budget 2012 introduced a measure to enable the holder of an RDSP to elect to keep the RDSP open for up to five years in circumstances where the beneficiary has become DTC-ineligible.

To give effect to this measure, new subsections 146.4(4.1) and (4.2) are introduced and subparagraph 146.4(4)(*p*)(ii) is amended.

New subsection 146.4(4.1) sets out the conditions that a holder of an RDSP must meet in order to make an election to keep the RDSP open in respect of a beneficiary who is DTC-ineligible for a particular taxation year. Specifically,

- the beneficiary must have been DTC-eligible for the year immediately preceding the particular taxation year;
- a medical doctor must certify in writing that the nature of the beneficiary’s condition is such that, in the doctor’s professional opinion, the beneficiary is likely to become DTC-eligible again;
- the holder must make the election in a manner and format acceptable to the specified Minister (i.e., the Minister of Human Resources and Skills Development) before the end of the year immediately following the particular taxation year and provide the election and medical certification in respect of the beneficiary to the issuer of the plan; and
- the issuer must notify the specified Minister of the election in a manner and format acceptable to the specified Minister.

New subsection 146.4(4.2) provides that an election made under subsection 146.4(4.1) ceases to be valid at the time that is the earlier of the beginning of the first taxation year for which the beneficiary is again DTC-eligible and the end of the fourth taxation year following the particular taxation year referred to in subsection 146.4(4.1). This means that

- if the beneficiary re-qualifies for the DTC within five years, the plan would revert to being a regular RDSP and the usual rules would apply commencing with the taxation year for which the beneficiary is DTC-eligible. The election would cease to be valid at the beginning of that year; and
- if the beneficiary does not re-qualify for the DTC within five years, the election would cease to be valid at the end of the fifth taxation year for which the beneficiary is DTC-ineligible and the plan would need to be wound up by the end of the year following that year.

Subparagraph 146.4(4)(*p*)(ii) is amended consequential on these new rules:

- If an election to keep the RDSP open is made under subsection 146.4(4.1), clause 146.4(4)(*p*)(ii)(A) requires that the plan terms provide for the wind-up of the plan by the end of the calendar year following the first year that includes the time that the election ceases, because of paragraph 146.4(4.2)(*b*), to be valid. In other words, because the beneficiary did not re-qualify for the DTC within five years, the plan would have to be wound up by the end of the calendar year following the fifth taxation year for which the beneficiary was DTC-ineligible.

- In any other case, clause 146.4(4)(*p*)(ii)(B) requires that the plan terms provide for the wind-up of the plan by the end of the calendar year following the first calendar year throughout which the beneficiary is DTC-ineligible.

New subsections 146.4(4.1) and (4.2) and the amendment to subparagraph 146.4(4)(*p*)(ii) come into force on January 1, 2014. However, new subsection 146.4(4.3) provides a special transitional rule for a plan the beneficiary of which is DTC-ineligible for the 2011 or 2012 taxation year and which has not been terminated. For further information, see the commentary below on subsection 146.4(4.3).

Transitional rule

ITA
146.4(4.3)

New subsection 146.4(4.3) of the Act contains a special transitional rule for a plan the beneficiary of which is DTC-ineligible for the 2011 or 2012 taxation year and which has not been terminated.

Under new subsection 146.4(4.3), if 2011 or 2012 is the first calendar year throughout which the beneficiary of a plan is DTC-ineligible and the plan has not been terminated, unless an election is made under subsection 146.4(4.1) the plan must be terminated by the end of 2014. In order to make this transitional rule available to plans without requiring amendments to the specific terms of existing specimen plans and plans established using them, or requiring new specimen plans to be prepared to reflect new terms, subsection 146.4(4.3) also suspends the plan condition in paragraph 146.4(4)(*p*)(ii) as it read on March 28, 2012 and any terms of the plan required by that paragraph.

For further information on subsection 146.4(4.1), see the commentary on paragraph 146.4(4)(*p*).

Subsection 146.4(4.3) comes into force on March 29, 2012.

Transfers

ITA
146.4(8)

Subsection 146.4(8) provides rules governing transfers from one RDSP of a beneficiary to another. Paragraph 146.4(8)(*c*) requires that the issuer of the RDSP provide the issuer of the other RDSP with all information in its possession that may reasonably be considered necessary for the other RDSP to comply with the requirements of the Act and with any conditions and obligations imposed under the *Canada Disability Savings Act*.

To reduce the administrative burden for issuers, Budget 2012 conferred on Human Resources and Skills Development Canada, rather than the issuer of the RDSP, the responsibility for providing this information to the issuer of the other RDSP when an RDSP transfer occurs.

Paragraph 146.4(8)(*c*) is amended to require the issuer of the RDSP to provide to the issuer of the new RDSP only that information which the specified Minister (i.e., the Minister of Human Resources and Skills Development) has not provided to the issuer of the new RDSP when an RDSP transfer occurs. A similar amendment is made to paragraph 146.4(4)(*o*).

This amendment comes into force on Royal Assent.

Clause 21

Definitions – “net tax owing”

ITA
156.1(1)

Subsection 156.1(1) of the Act sets out definitions that are relevant in determining whether an individual is required to make tax instalment payments. The description of A in the definition “net tax owing” is amended consequential on the introduction of new Part XI.4, under which a special tax is imposed on excessive allocations to specified employees (as defined in subsection 248(1)) under employees profit sharing plans (EPSPs). Specifically, the amendment ensures that taxes payable under Part XI.4 in respect of excess EPSP amounts are included in the calculation of an individual's instalment base for a year. For further information, see the commentary on section 207.8.

This amendment applies to the 2012 and subsequent taxation years.

Clause 22

Retirement compensation arrangements

ITA
207.5

In general terms, retirement compensation arrangements (RCAs) are funded, employer-sponsored pension or other retirement savings arrangements that are not registered pension plans or registered retirement savings plans. They are subject to special tax rules. "Retirement compensation arrangement" is defined in subsection 248(1) of the Act. Budget 2012 announced new rules to address tax planning arrangements that had developed using RCAs. The new rules generally extend the "prohibited investment" and "advantage" concepts from Part XI.01 of the Act – which currently apply to registered retirement savings plans, registered retirement income funds and tax-free savings accounts – to RCAs. The definitions "prohibited investment" and "advantage", along with a number of supporting definitions and rules, and taxes that apply in relation to prohibited investments and advantages, are introduced in Part XI.3 (the part of the Act that deals with RCAs). Budget 2012 also announced a measure to restrict the ability of an RCA to obtain a refund of RCA refundable tax in circumstances where the property of the RCA has declined in value; this restriction is also introduced as an amendment to Part XI.3.

Definitions

ITA
207.5(1)

Subsection 207.5(1) of the Act provides definitions that are relevant for the purposes of Part XI.3. Several definitions are being amended or introduced to implement the Budget 2012 measures.

"advantage"

The new definition "advantage" in subsection 207.5(1) describes amounts derived from several types of transactions or events in respect of which unintended tax benefits could be obtained. The amount of an advantage is subject a tax equal to its fair market value under new section 207.62. Under new section 207.64, the Minister of National Revenue may waive all or a portion of the tax in appropriate circumstances. For more information, please see the commentary on those provisions.

In order to maintain consistency with the definition "advantage" in subsection 207.01(1), paragraphs (*a*) to (*e*) of the definition "advantage" in subsection 207.5(1) closely follow paragraphs (*a*) to (*e*) of the definition "advantage" in subsection 207.01(1), with modifications that reflect the specific attributes of RCAs. For example, no exception for payments into an RCA by its "issuer or carrier" is included in paragraph (*a*) because RCAs do not have issuers or carriers.

In the RCA context, the key aspects of the definition "advantage" are the inclusion of income and gains on prohibited investments held in connection with an RCA, and the inclusion of the amount of any RCA strip. "Prohibited investment" and "RCA strip" are new defined terms in subsection 207.5(1). For more information, please see the commentary on those definitions.

The definition "advantage" applies after March 28, 2012, except that it does not apply in relation to transactions or events involving property acquired before March 29, 2012 if either of two conditions is met. First, the amount of what would otherwise be an advantage involving subject property of an RCA held before March 29, 2012 will not be treated as an "advantage" or subject to the advantage tax under new section 207.62 to the extent that the amount is included in the income of a beneficiary of the RCA, or an employer in respect of the RCA, for the taxation year in which the amount arose or the following year.

Second, where the property that would or could otherwise give rise to an advantage is a promissory note or similar debt obligation, its retention by an RCA will not cause the advantage rules to apply if commercially reasonable payments of principal and interest are made at least annually after 2012 in respect of the note or obligation and no RCA strip occurs in relation to the RCA. An amendment to the terms of a note or obligation to provide for such payments is deemed not to be a disposition or acquisition of the note or obligation for the purposes of applying this transitional rule.

“prohibited investment”

The new definition “prohibited investment” in subsection 207.5(1) is essentially the same as the definition of that term in subsection 207.01(1) in Part XI.01. However, instead of referring to a “controlling individual” (the term used in subsection 207.01(1)), the new definition refers to a “specified beneficiary” of an RCA. An RCA can have more than one specified beneficiary. For more information, please see the commentary on the new definition “specified beneficiary”.

This amendment applies after March 28, 2012. For more information regarding the coming into force of the prohibited investment and advantage rules in respect of RCAs, please see the commentary on the new definition “advantage” and the taxes imposed under new sections 207.61 and 207.62.

“RCA strip”

The new definition “RCA strip”, which is based closely on the existing definition “RRSP strip” in subsection 207.01(1), generally describes amounts extracted from an RCA without being included in income under Part I. Like the definition “RRSP strip”, the new definition “RCA strip” includes a purpose test and the new definition applies where there has been a reduction in value of the subject property of the RCA as part of a transaction or event (or a series of transactions or events) one of the main purposes of which was to enable a specified beneficiary (or a person who does not deal at arm’s length with the beneficiary) to use or obtain the benefit of the subject property of the RCA and there has been no related income inclusion. The definition will apply, for example, in circumstances where an RCA has directly or indirectly made a loan to, or acquired a debt of, a specified beneficiary or a person who does not deal at arm’s length with the beneficiary, and steps are undertaken to ensure that the loan cannot be repaid. The definition is not limited to loan-back transactions, however, and could apply in other circumstances where the basic operation of the RCA regime would otherwise be circumvented.

An RCA strip is included in the definition “advantage” under subsection 207.5(1). As a consequence, an RCA strip will subject to tax under new section 207.62 and the amount of the tax will equal the amount of the RCA strip. This tax may be waived or cancelled under new section 207.64.

The definition “RCA strip” applies after March 28, 2012. For example, it could apply in relation to a debt acquired by an RCA before March 29, 2012 if the value of the debt is impaired after March 28, 2012 as part of a series of transactions that meets the test set out in the definition.

“significant interest”

The new definition “significant interest” in subsection 207.5(1) adopts the meaning provided by subsection 207.01(4) for the same term.

This amendment applies after March 28, 2012.

“specified beneficiary”

The new definition “specified beneficiary” in subsection 207.5(1) refers to an individual who has an interest or right in relation to an RCA and who has, or had, a significant interest in an employer in respect of the RCA.

This amendment applies after March 28, 2012.

Refund

ITA
207.5(3)

Under the RCA rules in Part XI.3 of the Act, the concept “refundable tax” for an RCA in essence operates as a pool that maintains a running balance of 50% of the amount by which contributions to the RCA plus income and capital gains (net of losses and capital losses) of the RCA exceeds distributions from the RCA. At the end of each taxation year of an RCA trust, the refundable tax of the RCA for the current year is compared with its refundable tax at the end of the preceding year. If the RCA’s refundable tax for the year exceeds its refundable tax for the preceding year, that excess is payable as a tax under subsection 207.7(1). Alternatively, if the RCA’s refundable tax for the preceding year exceeds its refundable tax for the current year, subsection 207.7(2) provides that the excess is refundable to the RCA by the Minister of National Revenue.

Consequently, it is advantageous for RCAs to have a low “refundable tax” balance at the end of the current year. Normally the refundable tax balance of an RCA can be reduced, and tax refunds triggered, by making distributions to the beneficiaries of the RCA. However, in situations where the property held by an RCA has declined in value, there might not be enough property in the RCA to support the distributions necessary to trigger a refund of tax under subsection 207.7(2). To address such situations, subsection 207.5(2) allows an RCA in certain circumstances to make an election to set its refundable tax at the end of the current year to be an amount lower than the amount that would otherwise be determined.

In addition to the introduction of “prohibited investment” and “advantage” rules for RCAs, Budget 2012 announced a measure to restrict the availability of the election in subsection 207.5(2). New subsection 207.5(3) implements this restriction. It generally provides that the election under subsection 207.5(2) will not be available if any part of a decline in value of the property of the RCA is reasonably attributable to a prohibited investment or to an advantage in respect of the RCA. This restriction will not apply if the Minister of National Revenue is satisfied that it is just and equitable to allow the subsection 207.5(2) election to be made, having regard to all the circumstances. Where the Minister is satisfied that the subsection 207.5(2) election should be permitted, the Minister may adjust the amount deemed by subsection (2) to be the refundable tax of the arrangement to take into account all or part of the decline in value of the subject property.

This amendment applies in relation to tax paid on RCA contributions made after March 28, 2012 and on income earned, and capital gains realized, in respect of such contributions.

Clause 23

Tax on prohibited investments

ITA
207.61(1) to (4)

New section 207.61 of the Act introduces a tax in respect of prohibited investments for RCAs. New section 207.61 is similar to section 207.04, except that it applies only in relation to prohibited investments – the non-qualified investment rules do not apply to RCAs.

New subsection 207.61(1) provides that the custodian of an RCA trust is liable to pay the prohibited investment tax if the RCA acquires a prohibited investment or if an existing investment becomes a prohibited investment after March 29, 2012. An investment would become a prohibited investment, for example, in circumstances where an RCA holds debt of a corporation, a specified beneficiary of the RCA holds 800 out of 10,000 outstanding Class A shares, and, after March 29, 2012, a 25% shareholder in the same class of shares in the corporation redeems their 2,500 shares, turning what had been an 8% interest in the corporation held by the specified beneficiary into a 10.67% interest. In contrast, a significant interest in a corporation, such as a debt of a corporation controlled by a specified beneficiary of an RCA, already held by the RCA before March 29, 2012 is not subject to this tax.

New subsection 207.61(2) provides that the amount of tax payable in section 207.61 is 50% of the fair market value of the prohibited investment at the time it was acquired or became a prohibited investment. New subsection 207.61(3) generally provides for a refund of the prohibited investment tax on the disposition of the prohibited investment, unless new paragraph 207.61(3)(*b*) applies. Paragraph 207.61(3)(*b*) applies to deny a refund if

- the custodian knew, or ought to have known, at the time the investment was acquired, that the investment was (or would become) a prohibited investment, or
- the property is not disposed of by the RCA before the end of the year after the year in which the tax arose (or such later date that the Minister of National Revenue considers reasonable).

In other words, a refund is generally available in relation to the prohibited investment tax if the property was acquired by mistake and disposed of promptly.

New subsection 207.61(4) provides a deemed-disposition-and-reacquisition rule for property that becomes, or ceases to be, a prohibited investment for an RCA. This rule assists in the calculation of advantage tax (under subsection 207.62(1)) in relation to income and capital gains on prohibited investments.

These amendments apply after March 28, 2012. In this regard, a rule ensures that amendments to the terms of a promissory note or a similar debt obligation that is subject property of an RCA acquired before March 29, 2012 will not be considered to result in a disposition or acquisition of the note or obligation. Without this rule, amendments to a note or obligation made for the purpose of establishing commercially reasonable payments of principal and interest in order to avoid the application of the definition “advantage” might be considered to constitute an acquisition of a prohibited investment.

Tax in respect of advantages

ITA
207.62(1) and (2)

New section 207.62 of the Act imposes a tax on advantages in respect of an RCA. It is based closely on section 207.05 in Part XI.01 of the Act. New subsection 207.62(1) establishes that the custodian of an RCA trust has primary liability for the advantage tax. New subsection 207.62(2) provides that the tax is equal to the amount of the advantage.

This amendment applies after March 28, 2012.

Joint liability

ITA
207.63

New section 207.63 of the Act creates joint, several and (for civil law purposes) solidary liability for a specified beneficiary of an RCA in respect of the taxes imposed under sections 207.61 or 207.62, to the extent that the beneficiary participated in, assented to, or acquiesced in the transaction or event or series of transactions or events that resulted in the liability. This means that a specified beneficiary, such as, for example, an adult child of an owner-manager who was employed part-time in the parent’s business, who had no knowledge at all of the tax planning that gave rise to the section 207.61 or 207.62 tax would not normally have any joint, several or solidary liability for the taxes. However, a specified beneficiary who has knowledge of the basic intent, or expected result, of a particular plan or arrangement may have acquiesced in the transaction or event or series of transactions or events.

This amendment applies after March 28, 2012.

Waiver of tax payable

ITA
207.64

New section 207.64 of the Act authorizes the Minister of National Revenue to waive or cancel a tax (or a portion of a tax) payable because of any of sections 207.61 to 207.63 if the Minister considers it just and equitable to do so having regard to all the circumstances. New paragraphs 207.64(*a*) and (*b*) in effect provide examples of circumstances where it may be just and equitable to waive or cancel these taxes.

This amendment applies after March 28, 2012.

Deemed distribution

ITA
207.65

New section 207.65 of the Act provides a rule for the calculation of "refundable tax" of an RCA in circumstances where the custodian of an RCA has a liability to pay a tax under section 207.61 or 207.62. The payment of these taxes out of property of the RCA is deemed to be a distribution from the RCA. This ensures that the 50% refundable tax payable under subsection 207.7(1) is not also payable on amounts paid as tax under section 207.61 or 207.62 (to the extent that the taxes under those sections are not waived, cancelled or refunded).

This amendment applies after March 28, 2012.

Clause 24

Tax on excess EPSP amounts

ITA
207.8

To ensure that employees profit sharing plans (EPSPs) are used for their intended purposes, Budget 2012 proposed a targeted measure to discourage excessive employer contributions. This measure is in the form of a special tax payable by a specified employee (as defined in subsection 248(1) of the Act) on an "excess EPSP amount".

New subsection 207.8(1) defines "excess EPSP amount" for the purposes of new Part XI.4 of the Act. Under new subsection 207.8(1), a specified employee's excess EPSP amount for a taxation year in respect of an employer is the amount determined by the formula

$$(A - 20\% \times B)$$

where A is, in general terms, the portion of employer EPSP contributions that is allocated to the specified employee for the year and B is, in general terms, the specified employee's total income for the year from employment with the employer (determined without reference to paragraph 6(1)(*d*) and sections 7 and 8). In other words, EPSP allocations to a specified employee that exceed 20% of the specified employee's regular salary will generally be considered excess EPSP amounts.

New subsection 207.8(2) imposes a special tax on a specified employee who has an excess EPSP amount for a taxation year. The tax payable on the excess EPSP amount is 29% plus one of three rates set out in the description of variable B:

- If the specified employee is resident in the Province of Quebec at the end of the taxation year, B is 0%.
- If the specified employee is resident in a province other than the Province of Quebec at the end of the taxation year, B is the highest percentage rate of tax, including surtaxes but not taxes that are capped at a maximum amount, imposed by the province for the year on the income of an individual who is a resident of the province.

- In any other case, B is 14%. For example, this rate would apply in the case of non-resident specified employees.

New subsection 207.8(3) allows the Minister of National Revenue to waive or cancel all or part of a tax imposed under subsection 207.8(2) if it is just and equitable to do so. This provision is also relevant for the purposes of new paragraph 8(1)(*o.2*) as the deduction available under that paragraph to the specified employee in relation to excess EPSP amounts is reduced to the extent that the specified employee's tax liability is waived or cancelled under this provision.

New subsection 207.8(4) sets out the tax return filing and payment of tax obligations in respect of taxes payable under Part XI.4. Specifically, it provides that a person liable for Part XI.4 tax for a taxation year must file a return on or before the person's tax return filing-due date for the year, estimate in the return the amount of tax payable under this Part by the person and pay to the Receiver General the amount of tax payable under this Part by the person for the year.

New subsection 207.84(5) provides that Part XI.4 is subject to certain general rules relating to assessments and administration under the Act.

Section 207.8 applies to the 2012 and subsequent taxation years. However, it does not apply in respect of payments made by an employer to an EPSP before March 29, 2012, or before 2013 pursuant to an obligation arising under a written agreement or arrangement entered into before March 29, 2012.

Clause 25

Foreign affiliate dumping

ITA
212.3

Overview

Included in this package of draft amendments are various amendments to the Act to address so-called "foreign affiliate dumping". The main provision in this regard is new section 212.3. Supporting amendments are also made to existing provisions of the Act in order to address variations of the main types of foreign affiliate dumping transactions.

In general terms, these new rules result in deemed dividends subject to non-resident withholding tax or reductions of paid-up capital. Subject to certain exceptions, these rules are designed to deter Canadian subsidiaries of foreign-based multinational groups from making investments in non-resident corporations that are, or become as a result of the investment or a series of transactions that includes the investment, foreign affiliates of the Canadian subsidiary in situations where these investments can result in the inappropriate erosion of the Canadian tax base. The erosion can arise because of the exempt treatment of most dividends from these foreign affiliates in combination with the interest deductions on debt incurred to make such investments (Part I tax base) or the ability to extract corporate surplus from Canada free of dividend withholding tax (affecting directly the Part XIII tax base and, indirectly through the dimunition of income-earning capacity in Canada, the Part I tax base). In the case of Canadian subsidiaries of foreign-based multinational groups, the result of planning that exploits Canada's system of foreign affiliate taxation is inappropriate, particularly when undertaken without providing any significant economic benefits to Canada.

Targeted investments include purchases of, and subscriptions for, shares of a foreign affiliate, capital contributions and loans to a foreign affiliate and acquisitions of shares of a Canadian company the assets of which are primarily foreign affiliate shares. Supporting rules are provided in the context of certain corporate migrations as well as capital contributions to the Canadian subsidiary by its foreign parent.

There are certain exceptions to these new foreign affiliate dumping rules, which can be grouped in three categories: pertinent loans or indebtedness, corporate reorganizations and strategic business expansions.

- The pertinent loans or indebtedness exception allows loans to a foreign affiliate to be excluded from the foreign affiliate dumping rules on an elective basis. Such an election then subjects these loans to an interest imputation regime vis-à-vis the Canadian subsidiary (in new section 17.1). Although not directly related to the foreign affiliate dumping measure, a similar election is being provided in the context of loans made directly by a Canadian subsidiary to its foreign parent and certain other related non-residents (for further information, see the commentary on subsection 15(2)).
- The corporate reorganization exceptions are generally aimed at excluding certain acquisitions of foreign affiliate shares, in the context of a corporate reorganization, from the application of the rules where they do not represent a new investment in the foreign affiliate.
- The exception for strategic business expansions allows Canadian subsidiaries to invest in foreign affiliates in certain circumstances where the Canadian subsidiary is making a strategic acquisition of (or an investment in) a business that is more closely connected to its business than to any other member of the multinational group and officers of the Canadian subsidiary are the predominant decision makers in a commercial and economic sense.

Other rules ensure that certain foreign-controlled Canadian subsidiaries that structure their foreign affiliate investments in a manner that does not allow them to obtain Canadian tax benefits are able to avoid the consequences of the foreign affiliate dumping rules – through the deemed dividend set-off rule in subsection 212.3(5) and the paid-up capital reinstatement rule in subsection 212.3(7), as discussed below.

These rules apply prospectively – that is, they generally apply to transactions and events that occur after March 28, 2012. However, the Government believes that existing anti-avoidance rules in the Act, including the general anti-avoidance rule in section 245, would apply to certain past cases of foreign affiliate dumping. As is the case with respect to all other provisions of the Act, it is intended that such existing anti-avoidance rules apply to any new foreign affiliate dumping transactions that might not technically come within the ambit of this new legislation but that – on a full appreciation of the circumstances of the transactions – seek to frustrate the purpose of these foreign affiliate dumping rules, as described in this commentary and other Government documents.

Foreign affiliate dumping — conditions for application

ITA
212.3(1)

New subsection 212.3(1) of the Act provides the conditions for the application of subsection 212.3(2), the main operative rule for the foreign affiliate dumping rules in new section 212.3. By virtue of subsection 212.3(1), subsection 212.3(2) will apply to an "investment" (as defined in subsection 212.3(8)) in a non-resident corporation (referred to in section 212.3 and in this commentary as the "subject corporation") by a corporation resident in Canada (referred to in section 212.3 and this commentary as the "CRIC") where three conditions are met.

The first condition, in paragraph 212.3(1)(*a*), is that the subject corporation must be a foreign affiliate of the CRIC immediately after the investment is made (or must become a foreign affiliate of the CRIC as part of a series of transactions or events that includes the making of the investment). By virtue of the "series of transactions" reference, subsection 212.3(2) can also apply where a portfolio (non-foreign affiliate) interest in a non-resident corporation is acquired by a CRIC in contemplation of a future event as a result of which the non-resident becomes a foreign affiliate of the CRIC.

The second condition, in paragraph 212.3(1)(*b*), is that the CRIC must be controlled by a non-resident corporation (referred to in section 212.3 and in this commentary as the "parent") at the time the investment is made (or become so controlled as part of a series of transactions or events that includes the making of the investment). This condition generally distinguishes between Canadian-based multinationals, to which the rules do not apply, and foreign-based multinationals with Canadian subsidiaries, to which the rules are intended to apply.

The third condition, in paragraph 212.3(1)(*c*), is that neither subsection 212.3(12) nor 212.3(13) applies in respect of the investment. In general terms, subsection 212.3(12) provides an exception from the application of subsection 212.3(2) in circumstances where the investment is made by the CRIC in the context of a strategic business expansion. Subsection 212.3(13) provides exceptions from the application of subsection 212.3(2) where the CRIC's investment in the subject corporation is made in the context of certain reorganization transactions that do not involve a new investment by the CRIC in the subject corporation. For further details, see the commentary on those subsections, below.

Foreign affiliate dumping — consequences

ITA
212.3(2)

New subsection 212.3(2) of the Act is the main operative rule in section 212.3 and it applies when the three conditions in subsection 212.3(1) are satisfied.

Subsection 212.3(2) can apply to deem dividends to be paid to the parent by the CRIC or can cause the paid-up capital (PUC) of the shares of the CRIC to be reduced. Although not contained in section 212.3, the application of subsection 212.3(2) can also cause certain contributed surplus to be ignored in the application of the thin capitalization rules in subsection 18(4) or in the determination of deemed dividends under subsection 84(1). For further information on the inter-relationship between section 212.3 and those two subsections, see the commentary on those subsections.

Paragraph 212.3(2)(*a*) deems a dividend to be paid by the CRIC to the parent in an amount equal to the fair market value of any properties transferred, obligations assumed or incurred, or benefits otherwise conferred, by the CRIC that can reasonably be considered to relate to the investment in the subject corporation. The result of a deemed dividend under paragraph 212.3(2)(*a*) is that the parent is subject to Part XIII dividend withholding tax under subsection 212(2).

The reference in paragraph 212.3(2)(*a*) to "benefit otherwise conferred" is intended to capture any other means by which the CRIC transfers value to the subject corporation (for example, a forgiveness of debt) and is meant to be interpreted and applied in a fashion similar to that of the shareholder benefit conferral rule in subsection 15(1). (The contribution of capital rule in paragraph 212.3(8)(*b*) has corresponding language.) However, under the new "secondary adjustment" rules in section 247 of the Act, subsection 212.3(2) will not apply to a benefit conferral to the extent that new subsection 247(12) applies in respect of the benefit conferral, as provided under new subsection 247(15).

Paragraph 212.3(2)(*b*) causes the PUC of the CRIC to be reduced where the creation of the PUC is related to an investment in a subject corporation. Thus, where a subject corporation is transferred by the parent to the CRIC in exchange for shares of the CRIC, any PUC increase resulting from that transfer would be negated.

Where, for example, a parent first contributes cash to the CRIC in exchange for shares of the CRIC with PUC equal to the amount of the cash and the CRIC subsequently uses that cash to make an investment in a subject corporation, it is intended that only the deemed dividend rule apply – the PUC creation would not be considered to relate to the investment (as it is one step removed). Furthermore, in many such cases, the CRIC and the parent will be allowed to elect to have the deemed dividend reduced by the amount of PUC so created, as discussed below under subsections 212.3(4) and (5).

The "reasonably considered to relate" language is mainly intended to deal with situations in which the "indirect acquisition" rule in paragraph 212.3(8)(*f*) is applicable, i.e., where the CRIC acquires foreign affiliate shares indirectly by acquiring shares of a Canadian corporation, in certain circumstances. In these situations, it would often be the case that the acquired Canadian corporation would also own assets other than foreign affiliate shares and thus, it is necessary to reasonably allocate the consideration paid by the CRIC to the foreign affiliate assets. In the absence of specific factors that indicate otherwise, it would be expected that the most reasonable way to allocate the consideration would be on a pro-rata basis based on the fair market value of the underlying assets acquired.

Modification of terms – paragraph (8)(*e*)

ITA
212.3(3)

New subsection 212.3(3) of the Act specifies the amount deemed to be paid as a dividend under paragraph 212.3(2)(*a*) where an investment in a subject corporation is deemed under paragraph 212.3(8)(*e*) to be made by a CRIC by virtue of the extension of the maturity date of a debt obligation owing by the subject corporation to the CRIC or the extension of the redemption date of shares of the subject corporation owned by the CRIC.

Subsection 212.3(3) deems the CRIC to have transferred to the subject corporation property with a fair market value equal to the amount owing, in the case of a debt obligation, and equal to the fair market value of the share, in the case of redeemable shares. For further information, see the commentary below on paragraph 212.3(8)(*e*).

Election to reduce paid-up capital

ITA
212.3(4) and (5)

New subsections 212.3(4) and (5) of the Act provide elective rules that allow for dividends that are otherwise deemed to arise under paragraph 212.3(2)(*a*) to be offset against the PUC of the shares of the CRIC in certain circumstances. These new rules recognize that, absent the creation of PUC, the tax benefits sought under the types of transactions that the foreign affiliate dumping rules are intended to curtail do not generally arise in cases where equity capital is raised by a CRIC and invested offshore through foreign affiliates. For example, if a CRIC is listed on a Canadian stock exchange and raises equity in order to finance mining activities offshore (carried on indirectly through foreign affiliates), these new rules provide a mechanism, subject to certain conditions, to avoid the tax consequences arising under the foreign affiliate dumping rules.

Subsection 212.3(4) provides the conditions for subsection 212.3(5) (the operative rule) to apply. The main conditions relate to the classes of shares of the CRIC and the manner in which those shares are held. Where the CRIC has only one class of shares and those shares are all owned by the parent, any dividend otherwise deemed to arise under paragraph 212.3(2)(*a*) will be eligible for set-off against the CRIC's PUC existing immediately before the time of the investment in the subject corporation.

Where there are two or more classes of shares of the CRIC, there is a requirement to trace the creation of PUC to the property transferred by the CRIC that otherwise would give rise to a deemed dividend under paragraph 212.3(2)(*a*). To the extent that tracing requirement is met, the CRIC will be able to reduce its deemed dividend by the amount of PUC so traced.

Where all the shares of the CRIC are not directly held by the parent, the CRIC will be entitled to effect this set off only if all the other shareholders of the CRIC are dealing at arm's length with the CRIC. In particular, this means that a set off will not be allowed where the CRIC is owned indirectly by the parent through a Canadian intermediary company.

The election to use this set-off provision must be filed jointly by the CRIC and the parent before the CRIC's filing-due date for its taxation year that includes the time the investment is made.

Paid-up capital adjustment

ITA
212.3(6)

New subsection 212.3(6) of the Act ensures that the reductions to paid-up capital made by paragraphs 212.3(2)(*b*) and (5)(*b*) do not produce an inappropriate result where, because of a share redemption, acquisition, or cancellation or a reduction of paid-up capital, subsection 84(3), (4) or (4.1) subsequently treats the corporation as having paid a dividend on the shares to which the paid-up capital reduction relate. Similar rules exist in various other provisions of the Act that adjust paid-up capital – see for example paragraph 85(2.1)(*b*), subsection 212.1(2), and, as discussed above, subsection 128.1(3).

One difference with the rule in subsection 212.3(6) is that it also takes into account any increase in paid-up capital under the so-called "paid-up capital reinstatement" rule in subsection 212.3(7), which is discussed below.

Paid-up capital reinstatement

ITA
212.3(7)

New subsection 212.3(7) of the Act allows for a reinstatement of PUC immediately before a return of capital in certain circumstances where the PUC was initially reduced by the operation of paragraph 212.3(5)(*b*). As discussed above, the combined operation of subsections 212.3(4) and (5) allows for an elective set-off of a deemed dividend, that would otherwise occur under paragraph 212.3(2)(*a*), against the PUC of a CRIC.

The main purpose of subsection 212.3(7) is to allow a CRIC to extract an investment in a subject corporation, without tax consequences, to the extent of the initial amount of PUC that arose on or in connection with the investment. For example, a parent may want to use a CRIC as a conduit through which to acquire or make a strategic investment in a particular country because the parent is precluded from doing so directly as a consequence of foreign laws. Thus, the parent sets up the CRIC, capitalizes it with cash in exchange for shares, and the CRIC then uses the cash to acquire a foreign affiliate. In these circumstances, the CRIC and the parent will be able to elect under subsection 212.3(4) to set off the deemed dividend against PUC and, at a later time, distribute the shares of the foreign affiliate or the cash proceeds from its sale (within 30 days of the sale) to the parent free of withholding tax, at least to the extent of the initial value of the investment as reflected in the initial amount of PUC created upon the share subscription.

Therefore, through the combined operation of subsections 212.3(4), (5) and (7), a parent may use Canada as a conduit and not suffer adverse tax consequences under the foreign affiliate dumping rules. On the other hand, these rules are also intended to ensure that a CRIC will not be able to gain any tax advantage from the acquisition of a foreign affiliate.

Investment in subject corporation

ITA
212.3(8)

New subsection 212.3(8) of the Act defines an investment in a subject corporation made by a CRIC for the purposes of section 212.3. By virtue of paragraph 212.3(8)(*a*), an investment for these purposes includes an acquisition of shares of the subject corporation by the CRIC. This includes acquisitions by the CRIC of newly issued shares of the subject corporation. It also includes acquisitions by the CRIC of issued and outstanding shares of the subject corporation from the CRIC's non-resident parent corporation, another corporate group member or an arm's length person or partnership.

By virtue of paragraph 212.3(8)(*b*), an investment for purposes of section 212.3 includes a contribution of capital to the subject corporation by the CRIC. Thus, a transfer of property by the CRIC to the subject corporation is an investment for such purposes even if the CRIC does not take back any shares or debt of the subject corporation. In addition, for these purposes, paragraph 212.3(8)(*b*) deems a contribution of capital to include any transaction or event under which a benefit is conferred on the subject corporation by the CRIC. This benefit conferral rule is similar to the rule in subsection 15(1) that applies in the shareholder benefit context.

By virtue of paragraph 212.3(8)(*c*), an investment for purposes of section 212.3 includes a transaction as part of which an amount becomes owing by the subject corporation to the CRIC, unless the amount owing satisfies either of two exceptions. The first exception, in subparagraph 212.3(8)(*c*)(i), is for an amount owing that becomes owing to the CRIC in the ordinary course of the CRIC's business and is repaid, other than as part of a series of loans and repayments, within 180 days of the day it becomes owing. The "ordinary course of business" exception could apply, for example, where the CRIC supplies property to the subject corporation on credit in the ordinary course of the CRIC's business operations (and the resulting debt is repaid in the manner required by that exception). The second exception, in subparagraph 212.3(8)(*c*)(ii), is for an amount owing that the CRIC and the parent have jointly elected under paragraph 212.3(9)(*c*) to have treated as a "pertinent loan or indebtedness", as discussed below. Subject to the foregoing two exceptions, paragraph 212.3(8)(*c*) is generally intended to include, as investments for purposes of section 212.3: loans made by the CRIC to the subject corporation; transactions resulting in trade debts or other unpaid purchase price owing by the subject corporation to the CRIC; and any other transaction as part of which an amount becomes owing by the subject corporation to the CRIC.

By virtue of paragraph 212.3(8)(*d*), an investment for purposes of section 212.3 includes an acquisition of a debt obligation of the subject corporation by the CRIC from another person, subject to two exceptions. The first exception, in subparagraph 212.3(8)(*d*)(i), is for an acquisition in the "ordinary course of the business" of the CRIC from a person with which the CRIC deals, at the time of the acquisition, at arm's length. The second exception, in subparagraph 212.3(8)(*d*)(ii), is for an amount owing that the CRIC and the parent have jointly elected under paragraph 212.3(9)(*c*) to have treated as a "pertinent loan or indebtedness", as discussed below. Paragraph 212.3(8)(*d*) is intended to include acquisitions of outstanding debts of a subject corporation from any person (or, by virtue of the look-through rules in subsection 212.3(18), any partnership), whether dealing at arm's length or non-arm's length with the CRIC.

Paragraph 212.3(8)(*e*) provides that an investment for purposes of section 212.3 includes an extension of either the maturity date of a debt obligation owing by the subject corporation to the CRIC or the date on which shares of the subject corporation held by the CRIC are to be redeemed, acquired or cancelled by the subject corporation. For example, where the subject corporation issued a debt obligation or preferred shares to the CRIC before March 29, 2012 (i.e., the effective date of the foreign affiliate dumping rules) that would have been an investment under paragraph 212.3(8)(*c*) or 212.3(8)(*a*), respectively, had they instead been issued after March 28, 2012, an extension of the maturity date of the debt or the redemption date of the preferred shares would constitute an investment. Where, instead, the debt obligation or the shares are issued by the subject corporation to the CRIC after March 28, 2012, and subsection 212.3(2) applies to such investment, a subsequent extension of the maturity or redemption date, as the case may be, would result in a second investment to which subsection 212.3(2) could apply.

For the purposes of determining the quantum of a dividend the CRIC is deemed to pay to its non-resident parent under paragraph 212.3(2)(*a*) in respect of an investment described in paragraph 212.3(8)(*e*), subsection 212.3(3) deems the CRIC to have transferred property to the subject corporation (that relates to the investment) with a fair market value equal to the amount owing on the debt obligation, or the fair market value of the shares, immediately after the investment. These rules are intended to give results similar to those that would occur had the debt been repaid and re-loaned, or had the shares been redeemed and re-issued, as the case may be, instead of being extended.

Paragraph 212.3(8)(*f*) provides that an investment for the purposes of section 212.3 includes certain indirect acquisitions of foreign affiliate shares by a CRIC, through the direct acquisition of shares of another Canadian-resident "target" corporation. (For these purposes, it is important to take into account the partnership "look-through" rules in subsection 212.3(18).) Specifically, where a CRIC acquires directly shares of another Canadian-resident target corporation – which itself owns, directly or indirectly, shares of one or more foreign affiliates – the indirect acquisition of each such foreign affiliate by the CRIC will be considered a separate investment in a subject corporation if the total fair market value of all the foreign affiliate shares owned, directly or indirectly, by the Canadian target corporation comprises more than 50% of the total fair market value of all the properties owned by the Canadian target.

The parenthetical language in paragraph 212.3(8)(*f*) requires that the computation of the total fair market value of all the properties owned by the Canadian target corporation be made without taking into account any debts of any Canadian corporation in which the Canadian target has a direct or indirect interest. As a result, where the Canadian target owns shares of another Canadian corporation, the fair market value of those shares is to be determined for these purposes without taking into account any debts of that other corporation. The debts of the Canadian target are also not taken into account because the 50% test is applied based on the "properties" of the Canadian target.

The other computation required to be made in applying the 50% test in paragraph 212.3(8)(*f*) is of the total fair market value of all the shares the Canadian target corporation owns, directly or indirectly (i.e., through shareholdings of other corporations), of its foreign affiliates. This computation includes only the value of the Canadian target's proportionate equity interest in its foreign affiliates, rather than the total value of each foreign affiliate. In addition, since the parenthetical language in paragraph 212.3(8)(*f*) excludes only debts of Canadian corporations, any debts of foreign affiliates will be reflected in their share values for these purposes. Finally, where a foreign affiliate itself owns shares of another foreign affiliate of the Canadian target, such that the value of the upper-tier foreign affiliate's shares reflects that of the lower-tier affiliate, the rule against "double counting", in paragraph 212.3(10)(*b*), precludes taking the value of the lower-tier foreign affiliate into account more than once.

If the condition in paragraph 212.3(8)(*f*) is satisfied, then for the purposes of subsection 212.3(2), the CRIC will be considered to have made a separate investment in a subject corporation for each foreign affiliate of the Canadian target corporation (all of which were indirectly acquired by the CRIC). As noted above in the commentary on subsection 212.3(2), the CRIC must reasonably allocate the consideration paid for the Canadian target corporation to the foreign affiliate shares in order to determine the appropriate consequences under subsection 212.3(2).

Even if the condition in paragraph 212.3(8)(*f*) is not met at the time of the CRIC's investment in the Canadian target, paragraph 212.3(10)(*a*) will deem it to have been met at that time if property of the Canadian target corporation is subsequently disposed of as part of the same series of transactions as the investment. For further information, see the commentary on paragraph 212.3(10)(*a*) below.

By virtue of paragraph 212.3(8)(*g*), an investment for purposes of section 212.3 includes an acquisition by a CRIC of an option or interest in respect of either shares or debt (other than the kinds of debt excepted from the definition of investment under any of subparagraphs 212.3(8)(*c*)(i), (*c*)(ii), (*d*)(i) and (*d*)(ii)) of a subject corporation. The reference to an "interest" in this paragraph is not intended to include, in and of itself, an acquisition by a CRIC of shares of another Canadian corporation that itself holds shares or debt of a subject corporation.

Example (212.3(8)(f))

Assumptions

- *NR Co, a non-resident corporation, owns all the shares of Canco 1, a corporation resident in Canada. Canco 1 has excess cash that it uses to acquire all the shares of Canco 2, a Canadian-resident corporation that deals at arm's length with Canco 1 at all times prior to the acquisition, for $28 million.*
- *Canco 2's assets consist of business assets, with an aggregate fair market value of $10 million, and all of the shares of Canco 3, another corporation resident in Canada whose shares have an aggregate fair market value of $18 million.*
- *Canco 3's assets consist of:*
    - *Canadian business assets, with an aggregate fair market value of $5 million;*

- *all of the shares of FA 1, a foreign affiliate of Canco 3; and*
- *50% of the shares of FA 2, another foreign affiliate of Canco 3.*

- *Canco 3 has debt obligations payable in an aggregate amount of $2 million.*
- *The fair market value of all the shares of FA 1 is $8 million. FA 1's assets consist of business assets with an aggregate fair market value of $7 million, and all of the shares of FA 3, which have a fair market value of $1 million. FA 3 itself has business assets with a fair market value of $1 million and no liabilities.*
- *The fair market value of all the shares of FA 2 is $14 million. FA 2 has business assets with an aggregate fair market value of $18 million, and debts in an aggregate amount of $4 million. The other 50% of FA 2's shares is held by an arm's length person.*
- *Neither FA 1 nor FA 2 satisfies the conditions for the exception in subsection 212.3(12).*

Analysis

Part A

- *In this example, Canco 1 has, by acquiring the shares of Canco 2, indirectly acquired the shares of FA 1, FA 2 and FA 3. In order to determine whether subsection 212.3(2) applies to these acquisitions, it is necessary to test whether the acquisition by Canco 1 of the shares of Canco 2 satisfies the condition in paragraph 212.3(8)(f).*
- *Paragraph 212.3(8)(f) requires a comparison between, on the one hand, the total fair market value of all the foreign affiliate shares owned, directly or indirectly, by Canco 2 and, on the other hand, the total fair market value (determined without reference to debt obligations of any Canadian corporation in which Canco 2 has a direct or indirect interest) of all the properties owned by Canco 2. It is necessary to first determine the aggregate fair market value of all the shares Canco 2 owns, directly or indirectly, in its foreign affiliates. In this case, Canco 2 owns, indirectly through Canco 3, 50% of the shares of FA 2, with a fair market value of $7 million (i.e., 50% of the $14 million total fair market value of all the shares of FA 2). Canco 2 also owns indirectly all of the shares of FA 1, with a fair market value of $8 million. Although Canco 2 also owns indirectly all of the shares of FA 3, because the value of such shares is reflected in the value of the shares of FA 1, and is thus already taken into account once, the rule against "double counting", in paragraph 212.3(10)(b) (discussed below), ensures that the value of the shares of FA 3 is not taken into account separately. Thus, the total fair market value of all the foreign affiliate shares that are owned, directly or indirectly, by Canco 2 is $15 million.*
- *It is then necessary to determine the aggregate fair market value of all the properties owned (i.e., directly) by Canco 2. In this case, Canco 2 owns business assets worth $10 million. In addition, Canco 2 owns all the shares of Canco 3, which have a fair market value of $18 million. However, for the purposes of the test in paragraph 212.3(8)(f), the value of the Canco 3 shares is to be determined without taking into account Canco 3's debts of $2 million, by virtue of the parenthetical language in that paragraph. Accordingly, the value of the Canco 3 shares for these purposes is $20 million. Therefore, the total fair market value of all of Canco 2's properties for these purposes is $30 million.*
- *Based on the foregoing, the condition in paragraph 212.3(8)(f) will not be met in the case of Canco 1's acquisition of the shares of Canco 2 because the total fair market value of all of the foreign affiliate shares owned, directly or indirectly, by Canco 2 ($15 million) does not exceed 50% of the total fair market value of all of the properties owned by Canco 2 ($30 million). As a result, Canco 1's indirect acquisitions of the foreign affiliates of Canco 2 will not constitute "an investment in a*

subject corporation made by a CRIC" under subsection 212.3(8) and subsection 212.3(2) will not apply.

Part B

- *If, on the other hand, it were assumed that the foreign affiliates in this case were worth $1 more, the 50% threshold in paragraph 212.3(8)(f) would be exceeded and Canco 1's indirect acquisitions of each of FA 1, FA 2 and FA 3 would constitute separate investments in a subject corporation by a CRIC to which subsection 212.3(2) would apply.*
- *In that case, for the purposes of subsection 212.3(2), and assuming that the debt obligations of Canco 3 are not specifically attributable to any particular assets of Canco 3, the portion of the $28 million purchase price paid by Canco 1 for the acquisition of Canco 2 that could reasonably be considered to relate to Canco 1's investment in FA 1 would be $6.3 million ($7.0 million less $0.7 million, the pro-rata portion of Canco 3's debt attributable to FA 1); to Canco 1's investment in FA 2 would be $6.3 million ($7.0 million less $0.7 million, the pro-rata portion of Canco 3's debt attributable to FA 2); to Canco 1's investment in FA 3 would be $0.9 million ($1.0 million less $0.1 million, the pro-rata portion of Canco 3's debt attributable to FA 3); and to Canco 3's Canadian business assets would be $4.5 million ($5.0 million less $0.5 million, their pro-rata portion of Canco 3's debt).*
- *Thus, $13.5 million of the $28 million total purchase price paid would be attributable to the foreign affiliates, and the other $14.5 million would be attributable to the business assets of Canco 2 ($10 million) and Canco 3 ($4.5 million). (Note that the result would generally be no different if the purchase price allocation to the foreign affiliate shares were instead made on the basis that FA 3's value was included in the value of the FA 1 shares, rather than ascribing separate values to FA 1 and FA 3.) Thus, under paragraph 212.3(2)(a), Canco 1 would be deemed to pay a dividend to NR Co in the amount of $13.5 million.*

Pertinent loan or indebtedness

ITA
212.3(9)

New subsection 212.3(9) of the Act defines the term "pertinent loan or indebtedness", for the purposes of subparagraphs 212.3(8)(*c*)(ii) and (*d*)(ii), as an amount owing by a subject corporation to a CRIC where certain conditions are met. The conditions are that the amount owing must become owing after March 28, 2012, it must not be described in either subparagraph 212.3(8)(*c*)(i) or (*d*)(i) – as these provide their own exceptions from subsection 212.3(2) – and the CRIC and the parent must jointly elect in respect of all amounts that become owing by the subject corporation to the CRIC after March 28, 2012. The joint election need only be made once – it will apply to all amounts that meet the conditions set out above – but the election must be filed before the CRIC's filing-due date for the taxation year that includes the time after March 28, 2012 that the first amount becomes owing by the subject corporation to the CRIC.

The result of being a "pertinent loan or indebtedness" is that such debts, instead of being subject to subsection 212.3(2), will be subject to the new interest imputation rule set out in section 17.1, discussed above.

Rules for paragraph (8)(*f*)

ITA
212.3(10)

New subsection 212.3(10) of the Act provides two rules for applying the "indirect acquisition" rule in paragraph 212.3(8)(*f*). First, paragraph 212.3(10)(*a*) is an anti-avoidance rule that effectively extends the time for applying the 50% test in paragraph 212.3(8)(*f*) to the entire series of transactions that includes the acquisition of the

Canadian target shares by the CRIC. Even if the condition in paragraph 212.3(8)(*f*) is not satisfied because the 50% threshold is not exceeded at the time of the acquisition, paragraph 212.3(10)(*a*) deems the condition to have been satisfied at that time if properties of the Canadian target corporation are subsequently disposed of as part of the series of transactions that includes the acquisition and such dispositions cause the 50% threshold to be exceeded at any time in the series. This rule is meant to address situations where, for example, the CRIC is, at the time of the purchase, intending to retain the foreign affiliate investments while divesting itself of the Canadian business assets of the Canadian target. The rule is also meant to address situations where the Canadian target, in anticipation of its acquisition by the CRIC, "stuffs" itself with non-foreign affiliate assets that clearly have no long-term use in the company and will be disposed of shortly after the acquisition.

Paragraph 212.3(10)(*b*) contains a rule against "double counting" in applying the 50% test in paragraph 212.3(8)(*f*). In computing the total fair market value of all the foreign affiliate shares owned directly or indirectly by the Canadian target, if a foreign affiliate itself owns shares of another foreign affiliate of the Canadian target such that the value of the upper-tier foreign affiliate's shares reflects that of the lower-tier affiliate, paragraph 212.3(10)(*b*) precludes the value of the lower-tier foreign affiliate's shares from being taken into account separately. In effect, this rule is meant to achieve a form of consolidation for the purposes of the indirect acquisition rule.

Multiple control

ITA
212.3(11)

New subsection 212.3(11) of the Act provides that for the purposes of both section 212.3 and the corporate immigration rule in paragraph 128(1)(*c.3*), a CRIC that is controlled by more than one non-resident corporation is deemed not to be controlled by any such corporation that controls another non-resident corporation that controls the CRIC – unless the application of the deeming rule in subsection 212.3(11) would result in the CRIC not being controlled by any non-resident corporation.

Subsection 212.3(11) is a relieving provision. It is intended to prevent multiple dividends from being deemed under subsection 212.3(2) or paragraph 128(1)(*c.3*). Multiple dividends could otherwise arise under subsection 212.3(2) due to the fact that paragraph 212.3(2)(*a*) deems the CRIC to have paid a dividend to the "parent", which is defined in paragraph 212.3(1)(*b*) to mean any non-resident corporation that controls the CRIC at the time of the investment. Consequently, in the absence of subsection 212.3(11), where more than one non-resident corporation controls the CRIC (for example where a non-resident public company owns another non-resident corporation that, in turn, owns the CRIC), paragraph 212.3(2)(a) could deem a separate dividend to have been paid to each such non-resident. Similarly, in the absence of subsection 212.3(11), multiple dividends could be deemed under paragraph 128(1)(*c.3*) in similar circumstances since that paragraph deems an immigrating corporate taxpayer to have paid a dividend to a "particular non-resident corporation", which term refers to any non-resident corporation that controls the CRIC.

Subsection 212.3(11) applies unless its application would result in the CRIC not being controlled by at least one non-resident corporation. This exclusion addresses situations where corporate groups organize themselves so that all non-resident "controllers" control each other.

Exception – more closely connected business activities

ITA
212.3(12)

New subsection 212.3(12) of the Act provides an exception from the operative foreign affiliate dumping rule in subsection 212.3(2). This exception generally recognizes that certain foreign affiliate investments made by foreign-controlled CRICs may have been made by the CRIC even if the CRIC had not been foreign-controlled. The exception is intended to allow a Canadian subsidiary of a foreign multinational corporation to invest in foreign affiliates in certain circumstances where the Canadian subsidiary is making a strategic acquisition of a business that is more closely connected to its business than to that of any non-resident member of the multinational group.

The CRIC is required to demonstrate that the conditions in subsection 212.3(12), as described below, are met. Thus, the onus is on the CRIC to establish these facts. Also, the exception will not be available where the shares acquired are what are commonly referred to as "preferred shares". The "preferred shares" carve-out is discussed in the commentary on subsection 212.3(14), below.

The exception applies where five conditions are met. The first condition, in paragraph 212.3(12)(*a*), generally requires that the business activities of the subject corporation, and any corporation in which the subject corporation has an equity percentage, be, collectively, more closely connected to the business activities carried on by the CRIC (or a Canadian-resident corporation that does not deal at arm's length with the CRIC) in Canada than to those of any other non-resident corporation that does not deal at arm's length with the CRIC. For these purposes, "business activities" is intended to refer to active business operations rather than simply investing in shares in other companies and the management and governance activities that may relate thereto.

The concept of "connectedness" is not defined, but for the purposes of these rules it is intended that the business activities of two corporations be considered "connected" in either of two circumstances. First, business activities can be considered connected where they are similar in nature or "parallel". For example, two businesses could be closely connected where they both involve the manufacture and distribution of similar types of products, or the provision of similar services. Second, business activities can be considered connected where they are integrated, in the sense of one corporation's business being "upstream" or "downstream" to the business of the other corporation, or in the sense of one business using technology of the other in its operations. Thus, for example, two corporations could be considered to have connected business activities if the primary activity of one corporation consists of selling the output of, or providing inputs to, the manufacturing process of the other corporation. In each case, the question is whether the businesses are connected in a manner indicative of the investment in the subject corporation being a logical expansion of the CRIC's business.

In order for the condition in paragraph 212.3(12)(*a*) to be satisfied, it is not sufficient that the CRIC's and the subject corporation's businesses be connected or even closely connected – the businesses must be more closely connected to one another than the subject corporation's business is to the business of any other non-resident corporate group member (other than the subject corporation or any corporation in which it has an equity percentage). Thus, this condition would not be met where, for example, the subject corporation's business is less or equally closely connected to that of the CRIC than to that of another non-resident group member. This requirement reflects the intention that the exception from subsection 212.3(2) apply only where the relationship between the CRIC's and the subject corporation's businesses clearly justify the investment in the subject corporation being made by the CRIC rather than by another member of the multinational group.

Paragraph 212.3(12)(*a*) further requires that the parties have an expectation, at the time of the investment, that the closer business connection described above will continue for the foreseeable future. This requirement acts as a check to ensure that the connection to Canada is not temporary or contrived.

The second condition, in paragraph 212.3(12)(*b*), is that officers of the CRIC must have had and exercised the principal decision-making authority in respect of the making of the investment and a majority of those officers must be resident, and work principally, in Canada at the time the investment is made. This condition will be satisfied only where the Canadian officers both have the decision-making authority and actually exercise such authority. Where this is the case, the CRIC would be, in this respect, acting in a manner similar to a Canadian (non-foreign controlled) multinational corporation undertaking a strategic foreign expansion of its business.

The reference in paragraph 212.3(12)(*b*) to "principal" decision-making authority is intended to ensure that this condition will be met only where substantive responsibility for the decision to make the investment, and with respect to the terms of the investment, rests with and is exercised by relevant officers of the CRIC. Where the CRIC's officers have and exercise only formal authority to approve the investment, but the real decision-making authority with respect to the making of the investment resides with officers of a non-resident corporation, then this condition will not be met. Similarly, where the formal decision-making authority with respect to an investment in a foreign affiliate by a CRIC is exercised by officers or directors of the non-resident parent of the CRIC, the condition could still be met if the substantive business decisions with respect to the investment are made by the relevant officers of the CRIC, based on their execution of the business plan of the CRIC and having undertaken or managed all of the commercial and investment due diligence relating to the acquisition or investment in the subject corporation.

In recognition of the fact that the same individuals may be officers of both a non-resident group member (e.g., the foreign parent) and a Canadian subsidiary, paragraph 212.3(12)(*b*) requires that a majority of the officers of the CRIC having and exercising the principal decision-making authority in respect of the investment be resident, and working principally, in Canada. Although this condition is intended to accommodate certain "dual officer" and regional "investment" and "management" committee structures, the condition requires that the principal business decision-making authority be exercised by officers of the CRIC, consistent with the requirement that the investment involve an expansion of the business of the CRIC through a foreign affiliate whose business activities are more closely connected with those of the CRIC than with those of any other member of the multinational group. The officers will be considered to work principally in Canada if they spend the majority of their working time in Canada, and also carry out a majority of their important functions, and make most of their important decisions, with respect to the CRIC in Canada.

The third and fourth conditions, in subparagraphs 212.3(12)(*c*)(i) and (ii), are that, at the time the investment is made, there must be a reasonable expectation that, at all times following the time of the investment, officers of the CRIC will have and exercise the principal decision-making authority in respect of the investment and that a majority of those officers will be residents of, and work principally in, Canada. This requirement will be met only where the relevant CRIC officers are expected to have and exercise the principal authority in respect of the key decisions concerning the ongoing investment in the subject corporation. The particular matters over which they would be expected to hold and exercise such authority would generally depend on the relative size and nature of the CRIC's investment in the subject corporation. For example, where the CRIC owns a controlling interest in the subject corporation, the range of matters in respect of the subject corporation over which the CRIC's officers can be expected to exercise principal decision-making authority will be greater than where the CRIC does not own a controlling interest in the subject corporation. The commentary on paragraph 212.3(12)(*b*) above, regarding the nature of the decision making authority expected of the officers of the CRIC, is also relevant for subparagraph 212.3(12)(*c*)(i).

The fifth condition, in subparagraph 212.3(12)(*c*)(iii), is that it must reasonably be expected, at the time of the investment, that the performance evaluation and compensation of officers of the CRIC (who are resident, and work principally, in Canada) will be based on the operating results of the subject corporation to a greater extent than will be the performance evaluation and compensation of any officer of another non-resident group member. The extent to which an officer's performance evaluation or compensation is based on operating results would generally be expected to be determined based on a proportion of the officer's overall performance or compensation. Thus, where, for example, officers of the CRIC and officers of the non-resident parent corporation both receive comparable bonus amounts that are linked (e.g., by a compensation formula) to the performance of the subject corporation, the compensation of the CRIC's officers may nevertheless be considered to be connected to the subject corporation's results to a greater extent than that of the parent's officers if such bonuses constitute a greater proportion of the overall compensation of the former than of the latter.

As discussed above, it is expected that an officer's performance evaluation and compensation will reflect, to some extent, the operating results of the subject corporation. The extent to which the operating results of the subject corporation affect the performance evaluation and compensation of an officer would depend on the relative size and complexity of the subject corporation's operations and the level of responsibility the officer has over those operations. Where the CRIC acquires control of the subject corporation in circumstances where the investment in the subject corporation constitutes a strategic expansion of the CRIC's business, it is expected that the relevant officers of the CRIC would have a high level of responsibility over the subject corporation's operations and that a greater proportion of their compensation would be based on the operations of the subject corporation than any other officer's compensation in the multinational group. The same expectation exists where the CRIC does not have or acquire control of the subject corporation but the subject corporation is controlled by the multinational group of which the CRIC is a member.

For a discussion of the requirement that the relevant officers be "resident, and work principally, in Canada", see the commentary on paragraph 212.3(12)(*b*) above.

Example 1 – foreign-controlled Canadian manufacturer

If commercial aircraft are manufactured by the CRIC and several non-resident companies in a foreign-based multinational group that includes the CRIC, the closer business connection condition in paragraph 212.3(12)(a) would not likely be met if the CRIC were to purchase a non-resident corporation that is a competing commercial aircraft manufacturer. In that case, the business activities of the acquired company would likely be no more closely connected to those of the CRIC than to those of one or more of the non-resident group members that manufacture commercial aircraft.

If, however, the CRIC were the only company in the multinational group that manufactures military aircraft, then the closer business connection condition in paragraph 212.3(12)(a) may well be satisfied were the CRIC to purchase a non-resident corporation that was a competing military aircraft manufacturer.

Example 2 – foreign-based private equity fund

If a foreign-based private equity ("PE") fund acquired a Canadian operating company (the "CRIC"), the PE fund is managed by its foreign-based general partner ("GP"), the CRIC is controlled by the GP, the CRIC is a portfolio company of the PE fund (i.e., the CRIC is the parent of a group of companies all of which carry on a particular type of business and is the entity that would be sold or taken public), and the CRIC either owns foreign affiliates that require funding or expands internationally through the acquisition of foreign affiliates, the exception may be available with respect to investments in foreign affiliates made by the CRIC. In these circumstances, it may be reasonable to expect that the business of any foreign affiliate in which the CRIC makes an investment would be more closely connected to the CRIC than to any business carried on by the GP or any other portfolio company in the group. In addition, provided the CRIC had stand-alone executive management whose performance and compensation was determined exclusively by reference to the performance of the multinational group of which the CRIC was the parent, then it would also be reasonable to expect that the decision making elements of the exception would be satisfied. In particular, the nature of the oversight exercised by the GP would not normally be considered to displace the decision making authority of the officers of the CRIC for purposes of this exception. This reflects the normal role of a GP as an owner (and manager of portfolio companies), separate and distinct from the governance and management of the CRIC.

If, however, the PE fund also owned, for example, a non-resident corporation in a business similar to the CRIC and if the CRIC was operationally a part of a group that included such non-resident corporation (whether or not the CRIC was a subsidiary of the non-resident corporation), in applying this exception, regard must be given to whether the business activities of any foreign affiliates of the CRIC, in which the CRIC makes an investment, are more closely connected to the CRIC than to the non-resident corporation and to whether any officers of such non-resident corporation exercised decision making control over the CRIC. If the business activities of the foreign affiliates in which the CRIC made investments were as or more closely connected with the non-resident corporation, or officers of the non-resident corporation in effect controlled the decision making of the CRIC, this exception would not apply.

Exception – corporate reorganizations

ITA
212.3(13)

New subsection 212.3(13) of the Act provides a number of exceptions from the foreign affiliate dumping rules for various forms of corporate reorganizations and distributions that result in the acquisition of shares of a subject corporation by a CRIC. The underlying premise for these exceptions is that if no incremental value is being transferred from a CRIC to a subject corporation, subsection 212.3(2) should not apply. However, a subset of these exceptions (found in paragraph 212.3(13)(*c*)) will not apply to transactions involving what are commonly referred to as “preferred shares”, notwithstanding that no incremental value may be transferred. The “preferred shares” carve out is discussed in the commentary on subsection 212.3(14), below.

Paragraph 212.3(13)(*a*) deals with acquisitions of foreign affiliate shares by one Canadian-resident corporation from another. Where the two companies are related at the time of the acquisition, subsection 212.3(2) will not apply unless the companies deal at arm’s length at any time before the acquisition and within the series of transactions that includes the acquisition. This paragraph is intended to cover, among other things, situations where foreign affiliate shares are transferred by a Canadian corporation on a winding up into its Canadian-resident parent (subject to the arm’s length/series test). Whether the two companies are related and deal at arm’s length is to be determined without regard to rights referred to in paragraph 251(5)(*b*).

Paragraph 212.3(13)(*b*) is virtually identical to paragraph 212.3(13)(*a*) but applies to acquisitions of foreign affiliate shares by a CRIC that is formed on the amalgamation of two or more Canadian-resident corporations.

Paragraph 212.3(13)(*c*) lists a number of exceptions relating to share-for-share transactions at the foreign affiliate level and certain distributions made by a foreign affiliate. In this regard, the exceptions will only apply to foreign affiliate shares that are received – subsection 212.3(2) is intended to apply to the extent that debt or other forms of non-share consideration are also received as a result of the share-for-share or distribution transaction. As noted above, these exceptions do not apply to “preferred share” acquisitions, as set out in subsection 212.3(14). Also, regard must be had to subsection 212.3(15) for distributions described in subparagraphs 212.3(13)(*c*)(v) to (vii). For further information, see the commentary below on subsection 212.3(15).

Preferred shares

ITA
212.3(14)

New subsection 212.3(14) of the Act provides that the exceptions in subsection 212.3(12) and paragraph 212.3(13)(*c*) are not available in respect of a CRIC’s acquisition of shares of a subject corporation if the CRIC does not have a fully participating equity interest in the subject corporation. In other words, the exceptions are not available where the CRIC acquires what are commonly referred to as “preferred shares”.

For the purposes of subsection 212.3(14), the determination of whether the shares acquired by the CRIC fully participate in the profits of the subject corporation and any appreciation in the value of the subject corporation is to be made having regard to all the terms and conditions of the shares themselves and any agreement in respect of the shares. However, even if the shares of the subject corporation acquired by the CRIC are less than fully participating, subsection 212.3(14) further provides that this fact will not preclude the availability of the exceptions in subsection 212.3(12) and paragraph 212.3(13)(*c*) if the subject corporation is a “subsidiary wholly-owned corporation” of the CRIC, as defined in subsection 248(1). For the subject corporation to be a “subsidiary wholly-owned corporation”, the CRIC must own all of its shares (except directors’ qualifying shares). Thus, if the CRIC owns all of the shares of the subject corporation, the CRIC would be considered to have a fully participating interest in any preferred shares of the subject corporation that the CRIC acquires.

For these purposes, it is intended that the existence of preferred shares, in and by itself, would not preclude a CRIC that acquires common shares from being considered to have acquired fully participating shares.

Assumption of debt on liquidation or distribution

ITA
212.3(15)

New subsection 212.3(15) of the Act overrides the rules in subparagraphs 212.3(13)(*c*)(v) to (vii) – which otherwise except certain foreign affiliate distributions from the rule in subsection 212.3(2) – by making subsection 212.3(2) apply to an acquisition by a CRIC of foreign affiliate shares on such a distribution to the extent of any debt assumed by the CRIC in respect of the distribution. Subparagraphs 212.3(13)(*c*)(v) to (vii), taken together, provide that subsection 212.3(2) does not apply to an acquisition of shares of a subject corporation by a CRIC where those shares are acquired on any of the following three types of transactions:

- a liquidation and dissolution of a foreign affiliate to which subsection 88(3) applies;
- a redemption of the shares of another foreign affiliate of the CRIC; or
- a dividend in respect of the shares of another foreign affiliate of the CRIC.

However, where a top-tier foreign affiliate is liquidated into a CRIC, and the shares of a lower-tier foreign affiliate are distributed to the CRIC in a transaction to which subsection 88(3) applies, the CRIC might in certain cases assume debt of the top-tier affiliate. Similarly, where the top-tier foreign affiliate distributes shares of a lower-tier affiliate to the CRIC, either on a redemption of shares or as a dividend in kind, the CRIC might assume debt of the top-tier affiliate in respect of the distributed shares. In all three of the foregoing situations, where debt is assumed by the CRIC, paragraph 212.3(15) will cause subsection 212.3(2) to apply to the acquisition by the CRIC of the shares of the lower-tier foreign affiliate to the extent of the value of the debt assumed.

Mergers

ITA
212.3(16)

For the purposes of section 212.3 of the Act, subsection 212.3(16) provides "continuity" rules – similar to the rules in subsections 87(1.2) and 88(1.5), among other provisions – that apply to amalgamations under subsection 87(11) and windings-up under subsection 88(1). It also contains complementary deeming rules that effectively exclude from the application of the rule in subsection 212.3(2) acquisitions by a CRIC of foreign affiliate shares resulting from a merger to which subsection 87(11) or 88(1) applies.

Indirect investment

ITA
212.3(17)

New subsection 212.3(17) of the Act is an anti-avoidance rule targeted at situations where a CRIC uses a "good" foreign affiliate as a conduit to make an investment in a "bad" foreign affiliate. A "good" foreign affiliate would be a subject corporation an investment in which, by the CRIC, would satisfy the exception in subsection 212.3(12); an investment by the CRIC in a "bad" foreign affiliate would not satisfy that exception. More specifically, subsection 212.3(17) provides that subsection 212.3(2) applies to an investment by a CRIC in a subject corporation where the subject corporation may reasonably be considered to have used, directly or indirectly as part of a transaction or event or series of transactions or events that includes the investment, a property it received from the CRIC (or any property substituted for such property) to make an investment in a non-resident corporation to which subsection 212.3(2) would have applied had the investment been made directly by the CRIC. Thus, subsection 212.3(17) can apply to, effectively, override subsection 212.3(12).

Partnerships

ITA
212.3(18)

New subsection 212.3(18) of the Act contains “look-through” rules for partnerships for the purposes of the foreign affiliate dumping rules in section 212.3 and the foreign affiliate dumping immigration and emigration rules in paragraphs 128.1(1)(*c.3*) and subsection 219.1(2), respectively.

For those purposes, paragraph 212.3(18)(*a*) deems each member of a partnership to have entered into any transaction entered into by the partnership itself, in proportion to the fair market value of the member’s direct and indirect (i.e., held through other partnerships) interests in the partnership. Therefore, where a CRIC is a member of a partnership that enters into any of the transactions described in paragraphs 212.3(8)(*a*) to (*g*), the CRIC is deemed to enter into the partnership’s transaction, which would generally result in the CRIC being considered to have made an investment in a subject corporation. The reference in paragraph 212.3(18)(*a*) to an “event participated in” is intended to capture any event described in paragraphs 212.3(8)(*a*) to (*g*) that cannot be considered to be a transaction, which may include certain benefit conferrals described in paragraph 212.3(8)(*b*) or term extensions described in paragraph 212.3(18)(*e*).

Paragraph 212.3(18)(*b*) is similar to paragraph 212.3(18)(*a*) except that it deals with the ownership of property rather than entering into transactions.

Paragraph 212.3(18)(*c*) provides rules that ensure appropriate results under the foreign affiliate dumping rules where relevant events occur at the partner level, as opposed to the partnership level. In this regard, subparagraph 212.3(18)(*c*)(i) provides that, where there is an increase in the portion of a partnership property that paragraph 212.3(18)(*b*) deems a member to own, the member is deemed to acquire the additional portion of the property. This rule ensures that where there is an increase in a CRIC’s proportionate interest in a partnership that owns, directly or indirectly, foreign affiliate shares, this will result in an investment by the CRIC in a subject corporation under subsection 212.3(8).

In the same circumstances, subparagraph 212.3(18)(*c*)(ii) will deem the CRIC to “transfer property that relates to the acquisition” that has a fair market value equal to the fair market value of the additional portion of the partnership property. This is intended to ensure that the investment by the CRIC in the foreign affiliate results in appropriate consequences under paragraph 212.3(2)(*a*), which deems the CRIC to pay a dividend equal to the portion of the fair market value of “property transferred” by the CRIC that can “reasonably be considered to relate to” the investment.

Paragraph 212.3(18)(*d*) is analogous to paragraphs 212.3(18)(*a*) and (*b*), except that it applies to amounts owing by a partnership.

Paragraph 212.3(18)(*e*) provides relief from the foreign affiliate dumping rules where a CRIC that is a member of a partnership transacts with the partnership. In general terms, where a transaction is between a member of a partnership and the partnership, the paragraph overrides the deeming rule in paragraph 212.3(18)(*a*) by providing that it does not apply to the extent it would otherwise have deemed the member to have entered into the transaction. For example, where a CRIC sells its shares of a foreign affiliate to a partnership of which it owns a 50% interest, paragraph 212.3(18)(*e*) will prevent paragraph 212.3(18)(*a*) from treating the CRIC as having acquired, through the partnership, 50% of those foreign affiliate shares.

Paragraph 212.3(18)(*f*) is a rule for tiered partnerships, that is, partnerships that are members of other partnerships. Specifically, the paragraph deems a person or partnership that is (or is deemed under that paragraph to be) a member of a particular partnership, that itself is a member of another partnership, to be a member of the other partnership. In other words, this rule ensures that a member of an upper-tier partnership is also considered to be a member of a lower-tier partnership of which the upper-tier partnership is a member.

Coming-into-force for section 212.3

New section 212.3 applies in respect of transactions and events that occur after March 28, 2012, with two exceptions. First, certain transactions in progress at the time these rules were first announced (March 29, 2012) are exempt, i.e., grandfathered, unless a party to the transaction may be excused from completing the transaction as a result of changes to the Act. Second, taxpayers may elect to have a version of the rule based on the March 29, 2012 Notice of Ways and Means Motion apply for transactions that occur before Announcement Date.

Clause 26

Deemed dividends & deemed interest payments

ITA
214(16) and (17)

New subsections 214(16) and (17) of the Act implement the measure announced in Budget 2012 to treat interest that is not deductible because of the thin capitalization rules as a deemed dividend for the purposes of Part XIII of the Act.

Paragraph 214(16)(*a*) deems thin capitalization interest (i.e., an amount disallowed as a deduction under subsection 18(4) or an amount included in income under paragraph 12(1)(*l.1*)) of a corporation to be a dividend paid by the corporation and not to be interest for the purposes of Part XIII. For example, if an amount in respect of interest paid by a partnership is included in a corporation’s income under paragraph 12(1)(*l.1*) and is then deemed to have been paid by the corporation as a dividend for Part XIII purposes, the partnership paying the interest will be deemed not to have paid the amount as interest. As a consequence, the non-resident lender will be entitled to apply for a refund of any excess withholding tax remitted by, or on behalf of, the non-resident lender.

In addition, paragraph 214(16)(*b*) allows the corporation to designate in its return of income for a taxation year which payments of interest in the year are to be recharacterized as dividends. Absent a designation, the appropriate portion of each interest payment is deemed to be a dividend.

Subsection 214(17) provides certain rules for the purposes of subsection 214(16). Paragraph 214(17)(*a*) provides that interest (other than compound interest) that is payable at the end of a corporation’s taxation year to have been paid at the end of that year and not at any other time (i.e., not to have been paid or credited when it is actually paid or credited). This applies to interest that is payable by a corporation at the end of its taxation year and to interest that is payable at the end of a corporation’s taxation year by a partnership of which the corporation is a member.

These amendments apply to taxation years that end after March 28, 2012. However, for taxations years that include March 29, 2012, the deemed dividend for the year is prorated based upon the number of days in the year that are after March 28, 2012.

Paragraph 214(17)(*b*) ensures that these deemed dividend rules cannot be avoided by transferring a debt obligation in the circumstances described in either subsection 214(6) or (7). Paragraph 214(17)(*b*) provides that interest that is non-deductible due to the application of the thin capitalization rules and payable by a corporation at the time of a transfer to which either subsection 214(6) or (7) applies will be deemed, for the purposes of subsection 214(16), to have been paid by the corporation to the non-resident immediately before the transfer.

This amendment applies on and after Announcement Date.

Clause 27

Corporate emigration

ITA
219.1

Section 219.1 of the Act imposes a tax (commonly known as the "departure tax") on a corporation that ceases to be resident in Canada. The tax is computed as 25% of the difference between the fair market value of all the property owned by the corporation at the time of emigration and the total of certain other amounts, one of which is the paid-up capital of all the shares of the corporation at the time of emigration. Pursuant to section 219.3, the 25% rate can be reduced by a tax treaty.

Section 219.1 is split into two new subsections. Subsection 219.1(1) contains the existing rule, as modified to modernize its language and structure. Subsection 219.1(2) contains a new rule that deems, in certain circumstances, the paid-up capital of the company to be nil, for the purposes of the departure tax calculation. New subsection 219.1(2) is being added in order to deter certain corporate emigration strategies that could be used as substitutes for transactions that are addressed by the foreign affiliate dumping rules in new section 212.3.

Subsection 219.1(2) applies where any shares of the emigrating corporation are owned by a Canadian-resident corporation that is controlled by a non-resident corporation and the emigrating corporation is a foreign affiliate of the shareholder immediately after the emigration. In these circumstances, the emigration would lead to a result similar to that which the foreign affiliate dumping rules in new section 212.3 are aimed at preventing. As such, where these conditions are met, any PUC that the emigrating corporation otherwise would have is deemed to be nil, with the result that a higher departure tax will be payable by the emigrating corporation.

For the purposes of subsection 219.1(2), the look-through rules in subsections 93.1(1) and 212.3(18) apply where one or more partnerships are in the ownership structure.

These amendments apply to corporate emigrations that occur after March 28, 2012.

Example

Assumptions

- *NR Parent, a non-resident corporation, owns all the shares of Canco 1, a Canadian-resident corporation.*
- *Canco 1 owns all the shares of Canco 2.*
- *Canco 2 is incorporated and resident in Canada at first, but it emigrates to Bermuda on May 1st, 2012.*
- *At the time of its emigration:*
    - *Canco 2 has no assets other than cash of $100 and has no liabilities; and*
    - *Canco 2 has paid-up capital (PUC) of $100.*
- *Shortly after the emigration, Canco 2 uses its $100 of cash to purchase all the shares of a corporation resident in Germany from NR Parent.*

Analysis

- *Canco 1 will have achieved a foreign affiliate "dump" as Canco 2 will become a foreign affiliate of Canco 1 upon the emigration. Section 212.3 will not apply to the purchase of the German subsidiary because Canco 2 is a not a CRIC at the time of the purchase. (Also, section 212.3 will* *not apply to the initial investment by Canco 1 in Canco 2 because Canco 2 is not a non-resident at that time.)*

- *Subsection 219.1(2) will apply in these circumstances to eliminate Canco 2's PUC at the time of emigration such that departure tax of $25 will be payable.*

Clause 28

No penalty – certain deemed payments

ITA
227(8.5)

New subsection 227(8.5) of the Act is introduced to provide two exemptions from the penalty for failing to withhold tax in subsection 227(8). Paragraph 227(8.5)(*a*) provides that no penalty will apply in respect of a dividend deemed to have been paid under subsection 214(16) unless the taxpayer would be liable for a penalty for failing to withhold on the payment of interest that is deemed to be a dividend. Similarly, paragraph 227(8.5)(*b*) provides that no penalty applies in respect of dividends deemed to have been paid due to a transfer pricing secondary adjustment under subsection 247(12).

Subsection 214(16) deems a dividend to have been paid by a corporation for the purposes of Part XIII to the extent that interest paid or payable by the corporation is not deductible because of subsection 18(4) or that an amount in respect of interest paid or payable by a partnership is included in computing the corporation's income under new paragraph 12(1)(*l.1*).

In the context of a transfer pricing secondary adjustment, subsection 247(12) deems a dividend to have been paid by a corporation for the purposes of Part XIII. For further information, see the commentary on subsections 214(16) and 247(12).

This subsection applies to taxation years that end after March 28, 2012.

Clause 29

Deemed dividends to non-residents

ITA
247(12)

New subsection 247(12) of the Act is introduced to clarify the treatment of "secondary adjustments" as dividends for purposes of Part XIII. Where the terms or conditions of a transaction or series of transactions do not reflect arm's length terms and conditions, subsection 247(2) may adjust, for tax purposes, any amounts related to the transactions or series to reflect arm's length and conditions. This is commonly referred to as a "primary adjustment".

In general terms, subsection 247(12) provides that a corporation that is resident in Canada for the purposes of Part XIII and that is subject to a primary adjustment will be deemed to have paid a dividend to each non-arm's length non-resident participant in the transaction or series of transactions equal to the benefit conferred on the non-resident. This is commonly referred to as a "secondary adjustment".

For example, if a Canadian corporation buys goods from its non-resident parent corporation for $100 but parties dealing at arm's length would have charged $80, the primary adjustment would reduce by $20 the cost of the goods to the Canadian taxpayer. A secondary adjustment of $20 reflects the benefit that was conferred on the non-resident parent (i.e., the amount by which the non-resident parent was overpaid for the goods).

Subsection 247(12) implements the secondary adjustment by deeming a dividend to have been paid by a particular corporation and received by a particular non-resident person immediately before the end of the particular corporation's taxation year. Subsection 247(12) first treats the particular corporation (or a partnership of which the particular corporation is a member) as having undertaken no transactions or series of transactions other than those in which the particular non-resident person (or a partnership of which the particular non-resident person is a member) was a participant. In order for the subsection to apply, the particular non-resident person (or a partnership of which the particular non-resident person is a member) must deal at non-arm's length with the particular corporation.

If, having regard to the foregoing, the particular corporation would have a transfer pricing capital adjustment or a transfer pricing income adjustment for the taxation year, then paragraph 247(12)(*a*) deems a dividend to have been paid by the particular corporation and received by the particular non-resident at the end of the year.

The amount of the deemed dividend is determined under paragraph 247(12)(*b*) and it is the amount that is the portion of the total of the particular corporation's transfer pricing capital and income adjustments that exceed the transfer pricing capital and income setoff adjustments that could reasonably be considered to relate to the particular non-resident person (if the definition "transfer pricing capital adjustment" in subsection 247(1) were read without reference to the references therein to "1/2 of" and "3/4 of" and the only transactions or series of transactions undertaken by the particular corporation were those in which the particular non-resident was a participant). The "reasonably be considered" requirement accommodates series of transactions involving more than one non-resident person.

No deemed dividend will arise if the non-resident is a controlled foreign affiliate (as defined for the purposes of section 17) of the Canadian corporation since the benefit conferred on the non-resident is more akin to a capital contribution than a dividend.

This subsection applies to transactions (including transactions that are part of a series of transactions) that occur after March 28, 2012.

Repatriation

ITA
247(13)

New subsection 247(13) of the Act applies in circumstances where subsection 247(12) deems a dividend to have been paid by a Canadian corporation and received by a non-resident and the non-resident repatriates an amount to the Canadian corporation. If the repatriation is made with the concurrence of the Minister of National Revenue, paragraph 247(13)(*a*) provides that the amount of the deemed dividend is reduced (in the subsection referred to as the "reduction") by the amount the Minister of National Revenue considers appropriate, having regard to all the circumstances.

This discretion provides the Minister of National Revenue with the ability to determine the amount of the reduction based on all the circumstances surrounding the secondary adjustment and the associated repatriation. This includes, but is not limited to, taking into consideration the currency in which the adjusted transaction and the repatriation occurs. For example, the Minister of National Revenue has the discretion to reduce a secondary adjustment in full where the repatriation is made in a foreign currency in respect of an adjusted transaction that occurred in the foreign currency even though that currency may have depreciated or appreciated in value relative to the Canadian dollar from the time of the transaction to the time of the repatriation.

As provided by paragraph 247(13)(*b*), interest under subsection 227(8.3) will, subject to subsection 247(14), be payable on amounts that were not withheld or deducted. This interest is computed from the day the Part XIII tax is required to be deducted or withheld (determined without reference to any reduction in the Part XIII tax resulting from repatriation under subsection 247(13)) until the day of the repatriation. For this purpose, the repatriation is treated as a remittance to the Receiver General in an amount equal to the reduction. Paragraph 247(13)(*b*) also provides that subsection 227(8.1) (which imposes joint and several liability on the particular non-resident person) will apply in respect of the interest that is payable as a result of the application of subsection 227(13).

This subsection applies to transactions (including transactions that are part of a series of transactions) that occur after March 28, 2012.

Repatriation – interest

ITA
247(14)

New subsection 247(14) of the Act provides that where the amount of a deemed dividend is reduced under paragraph 247(13)(*a*), the amount of interest payable on the tax that should have been withheld and remitted in respect of the deemed dividend may be reduced by the Minister of National Revenue, having regard to all the circumstances, including whether the country in which the relevant non-resident person is resident provides reciprocal treatment. For example, the amount of interest could be reduced if there is a reciprocal treatment by a country in which the non-resident person that received the deemed dividend is resident.

This subsection applies to transactions (including transactions that are part of a series of transactions) that occur after March 28, 2012.

Non-application of ss. 15, 56(2), 212.3(2) and 246

ITA
247(15)

Subsection 247(15) of the Act is introduced to ensure that benefits conferred on a non-resident in circumstances that result in a deemed dividend under subsection 247(12), or that would have resulted in a deemed dividend in the absence of the reduction under subsection 247(13), are subject to subsection 247(12) and not to any of section 15, subsections 56(2) and 212.3(2) and section 246. In circumstances where subsection 247(12) does not apply to deem a dividend (e.g., the taxpayer is a trust or natural person), these other provisions will remain applicable as appropriate.

This subsection applies to transactions (including transactions that are part of a series of transactions) that occur after March 28, 2012.

Clause 30

Definitions

ITA
248(1)

“registered education savings plan”

The definition “registered education savings plan” is amended to introduce the acronym “RESP” for drafting convenience and to improve readability. A similar amendment is made in subsection 146.1(1).

This amendment comes into force on Royal Assent.

“registered disability savings plan”

The definition “registered disability savings plan” is amended to introduce the acronym “RDSP” for drafting convenience and to improve readability. A similar amendment is made in subsection 146.4(1).

This amendment comes into force on Royal Assent.

Income Tax Regulations

Clause 31

Capital cost allowance – interpretation

ITR
1104

Section 1104 of the *Income Tax Regulations* (the Regulations) sets out various definitions that apply for the purposes of determining the capital cost allowance (CCA) for a taxation year in respect of a depreciable property of a taxpayer.

Section 1104 is amended in three respects consequential to amendments made to Classes 43.1 and 43.2 in Schedule II to the Regulations as announced in Budget 2012. First, the definitions “plant residue” and “eligible waste fuel” are amended. Second, new subsection 1104(17) is added. Third, the preamble to subsection 1104(13) is amended to add a reference to new subsection 1104(17).

Classes 43.1 and 43.2 – energy conservation property

ITR
1104(13)

Subsection 1104(13) of the Regulations sets out various definitions that apply for the purposes of Class 43.1 (30% CCA rate) and Class 43.2 (50% CCA rate) in Schedule II to the Regulations.

Subsection 1104(13) is amended consequential on the expansion, as announced in Budget 2012, of Classes 43.1 and 43.2 to include certain properties.

The definition “eligible waste fuel” is amended to add a reference to plant residue. As well, the definition “plant residue,” is amended to specifically contemplate its use as an eligible waste fuel. The preamble to subsection 1104(13) is also amended to add a reference to new subsection 1104(17).

These amendments come into force on March 29, 2012.

ITR
1104(17)

New subsection 1104(17) of the Regulations is introduced to require environmental compliance in respect of certain properties before those properties can be included in Class 43.1 or 43.2 in Schedule II. Class 43.1 provides for an accelerated capital cost allowance (CCA) rate of 30% and Class 43.2 provides for a temporary accelerated CCA rate of 50% for certain Class 43.1 properties acquired before 2020.

Subsection 1104(17) prevents the inclusion of the capital cost of certain property in Class 43.1 or Class 43.2 in Schedule II if the property is not in compliance with environmental laws, by-laws and regulations at the time when the property becomes available for use. The new subsection applies to property that would otherwise be included in subparagraph (*c*)(i) of Class 43.1 or is described in any of subparagraphs (*d*)(viii), (ix), (xi) and (xiii) of Class 43.1 and paragraph (*a*) of Class 43.2. Property is not in compliance if at the time the property becomes available for use by the taxpayer, the taxpayer has not satisfied the requirements of all environmental laws, by-laws and regulations of Canada, a province or a municipality in Canada, or of a municipal or public body performing a function of government in Canada, applicable in respect of the property.

If a property is excluded from Class 43.1 or Class 43.2 because of new subsection 1104(17), the property may be included in the CCA class that would otherwise apply to that property.

This amendment comes into force on March 29, 2012.

Clauses 32 to 34

Scientific research and experimental development

ITR
Part XXIX

Part XXIX of the Regulations provides rules with respect to scientific research and experimental development.

Scientific research and experimental development

ITR
2900

Section 37 of the Act allows the deduction of certain expenditures incurred by a taxpayer on scientific research and experimental development (SR&ED). Section 127 of the Act provides for, among other things, investment tax credits (ITCs) for certain SR&ED expenditures described in section 37 of the Act. Section 2900 of the Regulations provides the meanings of terms and expressions used in sections 37 and 127 of the Act.

ITR
2900(4)

Subsections 2900(4) to (10) of the Regulations determine the prescribed proxy amount for the purposes of paragraph (*b*) of the definition “qualified expenditure” in subsection 127(9) of the Act. The prescribed proxy amount provides a simplified method for calculating overhead expenditures for the purpose of determining SR&ED ITCs. The prescribed proxy amount is a substitute for an item-by-item accounting and apportioning of certain expenditures that could otherwise be considered to be directly attributable to SR&ED carried on in Canada. The prescribed proxy amount is relevant only for the purposes of calculating SR&ED ITCs. It does not form part of the SR&ED expenditure pool under subsection 37(1) of the Act and neither do any of the expenditures for which the prescribed proxy amount is a substitute.

Under subsection 2900(4) of the Regulations, the prescribed proxy amount is currently 65% of the total of the eligible portion of salaries of employees directly engaged in SR&ED in Canada. Budget 2012 announced the reduction of the applicable percentage to 60% for 2013 and to 55% after 2013.

Subsection 2900(4) is amended to replace the reference to the percentage rate in the calculation of the prescribed proxy amount with 55%. This amendment applies to taxation years that end after 2012 except that for taxation years that include days in 2012 or 2013 the applicable percentage will be prorated using 65% and 60%, respectively, based on the number of days in the taxation year that are in each of those calendar years.

Prescribed expenditures

ITR
2902

Section 2902 of the Regulations sets out the expenditures that are prescribed expenditures for the purposes of the definition “qualified expenditure” in subsection 127(9) of the Act. Prescribed expenditures do not qualify for investment tax credits (ITCs).

Section 2902 of the Regulations is amended in two respects consequential on changes to the scientific research and experimental development (SR&ED) and ITC provisions in the Act announced in Budget 2012.

ITR
2902(*b*)

Paragraph 2902(*b*) of the Regulations provides that certain expenditures of a capital nature are prescribed expenditures for the purposes of the definition “qualified expenditure” in subsection 127(9).

Subparagraph 2902(*b*)(ii) of the Regulations is amended to add a reference to the new definition “qualified resource property” in subsection 127(9) of the Act. This amendment ensures that the cost of the acquisition of qualified resource property is not a qualified expenditure for SR&ED ITC purposes.

Paragraph 2902(*b*) of the Regulations is also further amended consequential on the repeal of paragraph 37(1)(*b*) of the Act, amendments to paragraph 37(8)(*d*) of the Act and the repeal of definitions “first term shared-use-equipment” and “second term shared-use-equipment in subsection 127(9) of the Act.

The amendment to subparagraph 2902(*b*)(ii) applies in respect of expenditures incurred after March 28, 2012, while the other amendments to paragraph 2902(*b*) apply in respect of expenditures incurred after 2013.

ITR
2902(*e*)

Paragraph 2902(*e*) of the Regulations is amended to remove a reference to “of a current or a capital nature”. This change is consequential on the repeal of paragraph 37(1)(*b*) of the Act and amendments to the definition “qualified expenditure” in subsection 127(9) of the Act.

This amendment applies in respect of expenditures incurred after 2013.

Special-purpose buildings

ITR
2903

Expenditures in respect of the capital cost of a building are generally not deductible under section 37 of the Act except in the case of a prescribed special-purpose building. Section 2903 of the Regulations describes a prescribed special-purpose building for the purposes of paragraph 37(8)(*d*) of the Act.

Section 2903 of the Regulations is repealed consequential on the repeal of paragraph 37(1)(*b*) of the Act and amendments to paragraph 37(8)(*d*) of the Act.

This amendment applies after 2013.

Clause 35

Prescribed rate of interest

ITR
4301

Section 4301 of the Regulations prescribes rates of interest for various provisions of the Act. Paragraph 4301(*a*) is amended to add a reference to new section 17.1 of the Act. As such, the imputation rate for interest under section 17.1 will be based on the Government of Canada treasury bills rate plus 4 percentage points.

This amendment comes into force on March 29, 2012.

Clause 36

Investment tax credit – qualified property

ITR
4600

Part XLVI of the Regulations provides rules that apply for the purposes of various definitions in subsection 127(9) of the Act. The definitions in subsection 127(9) of the Act are relevant for the purposes of the investment tax credit (ITC) regime.

A 10% ITC is available for certain assets used in the Atlantic provinces, the Gaspé Peninsula and their associated offshore regions (commonly referred to as the Atlantic ITC). Atlantic ITCs can be claimed in respect of the cost of qualified property as defined in subsection 127(9) of the Act. As well, Atlantic ITCs can be claimed in respect of qualified resource property as defined in subsection 127(9) of the Act – this new definition applies in respect of expenditures incurred and property acquired after March 28, 2012.

Section 4600 of the Regulations is amended in two respects. First, subsections 4600(1) and (2) of the Regulations are amended to ensure that the buildings and machinery and equipment described in those subsections are prescribed buildings and prescribed machinery and equipment for the purposes of the definition “qualified resource property” in subsection 127(9) of the Act. Second, new subsection 4600(3) of the Regulations is added to describe prescribed energy generation and conservation property for the purposes of the definition “qualified property” in subsection 127(9) of the Act.

ITR
4600(1)

Subsection 4600(1) of the Regulations sets out what constitutes a prescribed building for the purposes of the definition “qualified property” in subsection 127(9) of the Act. An Atlantic ITC may be earned in respect of the cost of a qualified property. An Atlantic ITC may be deduced, under subsection 127(5) of the Act, against tax otherwise payable by a taxpayer.

The preamble to subsection 4600(1) is amended to add a reference to the new definition “qualified resource property”, consequential on the introduction of that definition in subsection 127(9) of the Act. This amendment ensures that the cost of a building described in the subsection is a prescribed building for the purposes of the definition “qualified resource property” in subsection 127(9) of the Act and is therefore eligible for an Atlantic ITC.

This amendment comes into force on March 29, 2012.

ITR
4600(2)

Subsection 4600(2) of the Regulations prescribes machinery and equipment for the purposes of the definition “qualified property” in subsection 127(9) of the Act. An Atlantic ITC may be earned in respect of the cost of a qualified property. A deduction may be claimed, under subsection 127(5) of the Act, in respect of an ITC against tax otherwise payable by a taxpayer.

The preamble to subsection 4600(2) is amended to add a reference to the new definition “qualified resource property”, consequential on the introduction of that definition in subsection 127(9) of the Act. This amendment ensures that the cost of machinery and equipment described in the subsection is prescribed machinery and equipment for the purposes of the definition “qualified resource property” in subsection 127(9) of the Act and is therefore eligible for an Atlantic ITC.

This amendment comes into force on March 29, 2012.

ITR
4600(3)

New subsection 4600(3) of the Regulations prescribes certain energy generation and conservation property for the purposes of the definition “qualified property” in subsection 127(9) of the Act. Prescribed energy generation and conservation property is depreciable property included in any of subparagraph (a.1)(i) of Class 17 and Classes 43.1, 43.2 and 48 of Schedule II to the Regulations. This amendment ensures that the cost of energy generation and conservation property described in the subsection is prescribed energy generation and conservation property for the purposes of the definition “qualified property” in subsection 127(9) of the Act and is therefore eligible for an Atlantic ITC.

Subsection 4600(3) comes into force on March 29, 2012.

Clause 37

Permanent establishment

ITR
8201

Section 8201 of the Regulations defines the meaning of "permanent establishment" for various purposes of the Act. This section is amended to add a reference to subsection 100(1.3) of the Act, which concerns the exception from the special capital gain rule in subsection 100(1) of the Act. In general terms, subsection 100(1) may apply to a disposition of an interest in a partnership to a person exempt from tax under section 149 of the Act or a non-resident person where the partnership holds properties the disposition of which can result in the realization of income, such as depreciable property and inventory of a business.

This amendment applies to the 2012 and subsequent taxation years.

Clause 38

Schedule II – capital cost allowance

ITR
Class 43.1 and 43.2

Class 43.1 in Schedule II to the Regulations currently provides an accelerated capital cost allowance (CCA) rate of 30% per year (on a declining balance basis) for certain clean energy generation and energy conservation equipment. Class 43.2 provides an accelerated CCA rate of 50% per year (on a declining balance basis) for property included in that Class. In general, Class 43.2 includes property described in Class 43.1 that is acquired on or after February 23, 2005 and before 2020. Unlike Class 43.1, however, Class 43.2 applies to co-generation equipment described in paragraphs (*a*) to (*c*) of Class 43.1 only if the heat efficiency of fuels used in the eligible co-generation system does not exceed a 4,750 BTU requirement (instead of a 6,000 BTU requirement).

Class 43.1 (and indirectly Class 43.2) is amended in two respects to implement the Budget 2012 proposals that expand Class 43.2 with respect to waste-fuelled thermal energy equipment and equipment of a district energy system that uses thermal energy provided primarily by eligible waste-fuelled thermal energy equipment. These amendments complement the Budget 2012 proposal to include equipment that uses the residue of plants – generally produced by the agricultural sector – to generate electricity and heat.

ITR
Class 43.1(*d*)(ix)

Subparagraph (*d*)(ix) of Class 43.1 applies to equipment that generates heat primarily from the consumption of an eligible waste fuel only if two conditions are met. The first condition is that the heat generated by the equipment must be used in an industrial process or a greenhouse. Budget 2012 announced the removal of this condition. The second condition is that no fuel other than a fossil fuel or an eligible waste fuel be used to generate the heat.

Subparagraph (*d*)(ix) of Class 43.1 is amended in three respects. First, the term "if the heat energy is used directly in an industrial process, or in a greenhouse," is deleted. This amendment implements the Budget 2012 proposal to remove the first above-mentioned condition.

Second, the term "sole" is added to ensure that equipment described in the subparagraph (*d*)(ix) is used only for the purpose of generating heat and the term "primarily" is moved to clarify that it relates to the consumption of eligible waste fuel.

Consequential on the second amendment, subparagraph (*d*)(ix) is amended to replace the reference to "electrical generating equipment" in the exclusion list with a reference to "equipment used for the purpose of producing heat energy to operate electrical generating equipment."

These amendments come into force on March 29, 2012.

ITR
Class 43.1 (*d*)(xv)

Budget 2012 proposed to expand Class 43.2 to include equipment that is part of a district energy system and that distributes thermal energy primarily generated by waste-fuelled thermal energy equipment.

Property described in paragraph (*d*) of Class 43.1 is included in Class 43.2. District energy equipment that is part of a district energy system is currently included in subparagraph (*d*)(xv) of Class 43.1 only if the system distributes thermal energy primarily generated by one or more of an eligible cogeneration system, a ground source heat pump, active solar heating equipment and heat recovery equipment.

Clause (*d*)(xv)(B) of Class 43.1 is amended to add a reference to property described in subparagraph (*d*)(ix) of Class 43.1. This amendment adds waste-fuelled thermal energy equipment to the list of eligible sources of energy generation for the purposes of subparagraph (*d*)(xv).

This amendment comes into force on March 29, 2012.